

# Queensland Government Submission to the Review of GST Distribution

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QUEENSLAND  
GOVERNMENT



## EXECUTIVE SUMMARY

The Queensland Government delivered a clear message in its October 2011 and April 2012 submissions to the GST Distribution Review: while horizontal fiscal equalisation (HFE) was supported, the system by which the GST is distributed amongst the states and territories ('states') has run off-track.

- The purpose of the GST distribution system is unclear and unfocused.
- The mining assessment is seriously flawed and delivers perverse outcomes.
- The assessment process is so complex and dependent on unreliable or incomparable data and judgement that it engenders a lack of confidence in its results.

Attempts by the Commonwealth to use the HFE system to compel tax reform and to shore up its own resource rent tax revenues will inevitably compound the problems.

Queensland has joined with NSW, Victoria and Western Australia to propose a new model of HFE – the population based distribution of GST amongst states, with the Commonwealth taking responsibility for funding the additional financial assistance required for states with lower fiscal capacities so no state or territory is worse off. This model is fair, simple, transparent and predictable. It would encourage good policy and engender greater confidence in the system.

As this model is likely to be a longer term aspiration, Queensland proposes a package of reforms that will help address the flaws in the current GST distribution system.

- i. Change the operational definition of HFE from one that uses the GST distribution system to equalise states' fiscal capacities to deliver the same level of services, to one that enables states to deliver a comparable level. The Commonwealth also has a responsibility to do more of the "heavy lifting" when it comes to improving the level of services in the lower capacity states. This change in the definition will allow considerations of efficiency, simplicity and stability to be given greater weight.
- ii. Apply a general discount to reduce the redistributive churn of the GST system that currently takes place. The discount, incorporating the current 'minimum effort' of states with respect to expenses, would reflect acceptable standards and efficient delivery of services while still being based on what states actually do. The Commonwealth would then share the load of supporting services in recipient states by providing additional financial assistance to ensure that all states have the fiscal capacity to deliver the average level of services.
- iii. Apply a broad indicator to the revenue assessment based on household disposable income. This approach would better reflect the true economic incidence of state revenues, be simpler and more stable, and support better public policy.
- iv. Simplify the expense assessments by paring back or improving those assessments that lack a robust evidence base, to engender greater confidence in the outcomes.

But most of all, the mining assessment needs to be reformed to address its perverse outcomes. First, a single rate structure should replace the current two rate structure to enhance policy neutrality. Second, a discount to the mining assessment is required to reflect resource ownership by states and the tangible and intangible costs to government of the mining industry, and to restore the appropriate incentives to governments to develop the industry in their states.

Queensland also calls on the Review Panel to recommend that more be done to protect the GST base to ensure it remains a strong source of state revenue.

Queensland believes this is a constructive program of reforms that will deliver real benefits not only to the individual states and territories but to the nation as a whole.

## **1. INTRODUCTION**

1. Queensland's previous submissions to the GST Distribution Review have highlighted the importance of considering the distribution of GST in the broader context of federal financial relations, and of clearly establishing the desired outcome of the process.
2. The submissions set the following priorities for the Review as being:
  - clarifying and focusing the aim of the GST distribution process – the aim of the GST distribution process needs to be clear and focused on providing the necessary budget support so that all states have the capacity to provide services at a comparable standard. In doing so, Queensland has questioned the need for full equalisation, arguing that the focus of the GST distribution should simply be to provide appropriate financial support to those states that genuinely require it;
  - addressing the problems with the current assessment of mining revenue – the current assessment creates inappropriate outcomes and serious incentive problems for the two major resource states that undermine the principle of policy neutrality; and
  - simplifying the assessment process – the current process is highly complex, leading to the frequent use of unreliable or incomparable data and judgement, resulting in outcomes that may not be any better than those produced by a simpler method.
3. In responding to the issues raised by the GST Distribution Review's interim reports, this submission will continue to argue that these are the main priorities for reforming the GST distribution system.

## 2. AUSTRALIA'S CHALLENGES AND HFE

4. Australia is currently undergoing a period of structural economic adjustment as it seeks to exploit its vast mineral wealth at a time when the world is hungry for natural resources. Structural adjustment is not new – for at least the past three decades, Australia has been undergoing a continual process of industrial change as we have opened up our economy – and our society – to the world. What we have learned over that period is that the best approach to dealing with the pressures and exploiting the opportunities presented by globalisation is for Australia to play to its strengths – a well educated workforce, strong democratic institutions and vast natural wealth, including agricultural land, mineral deposits and natural beauty.
5. Along with fiscal, monetary and industrial relations policies, the tax and transfer system, and financial and competition regulation, Australia's horizontal fiscal equalisation (HFE) system is part of the framework policies for economic governance of the nation. This economic governance framework should balance efficiency and equity concerns to ensure strong economic growth, as well as a fair and reasonable distribution of the wealth generated.
6. In earlier submissions, Queensland has argued that the HFE system has failed to get this balance right – there is an overemphasis on equity, and concerns of efficiency, simplicity and transparency have not been given their due weight.
7. This submission argues that there are practical opportunities to reform the HFE system to improve the balance – to make the system simpler, more efficient and more effective while still addressing the equity concerns that are central to the system.

### 2.1 EFFICIENCY AND HFE

*The Panel's view:*

*While the Panel is not convinced that efficiency concerns provide grounds for radical changes to the HFE process, it is interested in views on whether any of the approaches outlined above would address concerns about the relationship between HFE and efficiency.*

**Queensland's response:**

**HFE is likely to hinder structural adjustment across the broader economy. Queensland believes there are three main ways that the efficiency concerns over HFE can be addressed.**

- **Repair the flawed mining assessment.**
- **Reduce the scale of the redistribution of GST.**
- **Use a broad indicator for assessing revenue capacity.**

8. Queensland believes there is merit in the argument that HFE is likely to hinder structural adjustment across the broader economy, especially with regard to the current mining boom. Box 2.1 (below) presents the academic support for this view.

9. By penalising the economically successful states through reduced GST, resources are withdrawn from those states where these resources can be most productively deployed; for example, to invest in infrastructure to sustain and build on high economic growth and to attract and retain labour.
10. Queensland and Western Australia have argued in previous submissions that equalising transfers act as a drag on structural adjustment in the economy more broadly, especially in the context of the current mining boom.
11. HFE is seen to restrain the fiscally motivated migration of resources and this is detrimental to the process of structural adjustment required to maximise the benefits of the resources boom.
12. In the context of the need for structural economic adjustment, Australia is failing to 'play to its strengths'. In so doing, Australia is ignoring the lessons of the past.
13. Queensland believes there are three main ways that the efficiency concerns over HFE may be addressed.
  - Repair the flawed mining assessment. This is dealt with in section 5.
  - Reduce the scale of the redistribution of GST. This is dealt with in section 4.1
  - Use a broad indicator for assessing revenue capacity. This is dealt with in section 4.2.

### **BOX 2.1 HFE - AN IMPEDIMENT TO STRUCTURAL ADJUSTMENT**

The Australian economy is currently undergoing an unprecedented period of structural adjustment. This process is driven by a high and growing global demand for commodities. While the effects of this are felt to varying degrees throughout the national economy, the isolated and uneven dispersion of mining activity dictates that some areas will be more affected than others. Governments must respond to this in turn.

Queensland and Western Australia have experienced a refocusing of economic activity into rural and remote areas. It is the role of all levels of government to facilitate, rather than hinder, this process of structural adjustment.

Despite the increase in demand for labour and capital in these states, there are a number of factors reducing incentives for Australians to move. By transferring funding away from resource states, HFE undermines the ability of these governments to facilitate and support economic activity in mining areas. The system effectively punishes economic success and shifts resources to regions where long term productivity is lower. This is a worrying development given the central role mining will continue to play in Australia's economic success.

Further to this, HFE inhibits the ability of resource state governments to provide public services or, alternatively, reduce taxes. This ultimately distorts market driven incentives for migration and impedes the movement of labour and capital to where they would be most productive.

In their final report to the Review of Commonwealth-State Funding, Garnaut and FitzGerald (2002) considered the dampening of incentives as one of the most critical considerations in assessing the efficiency implications of HFE. Further, costs associated with distorted incentives in state policy could generate considerable efficiency losses, in the order of one to two per cent of GDP. A key recommendation of the report was that states be allowed more freedom to manage their areas of competence and that efforts be made to remove disincentives and political biases against good economic performance.

Other modelling by the Monash University Centre of Policy Studies (CoPS) found that replacing HFE with an equal per capita grant distribution, or a "state of origin" grant distribution, would increase national welfare (Dixon, Pictor and Rimmer, 2002).

In a study previously commissioned by the Commonwealth Grants Commission, Dixon, Madden and Peter (1993) found that fiscal equalisation led to considerable annual production losses. Petchey and Levchenkova (2007) found that interstate transfers under a system of HFE result in inefficient spatial allocation of mobile resources. A range of other studies have documented the various dimensions of efficiency losses that result from equalisation (Groenewold, Hagger and Madden, 2002; Pincus, 2011; Petchey and Levchenkova, 2004).

Reform of the equalisation system to address and minimise the inherent incentive problems would go some way towards realising these potential economic gains.

### 3. THE BASIC HFE MODEL

#### 3.1 'COMPARABLE' AS A STANDARD FOR HFE

*The Panel's view:*

*The Panel intends to investigate whether providing comparable capacities for States would be an approach more suitable to current challenges than providing materially the same capacities.*

*The Panel therefore invites submissions on how this concept might be accurately described and effectively implemented.*

**Queensland response:**

**While supporting HFE, Queensland believes the current form redistributes too much from donor states, and is relieving the Commonwealth from doing more of the 'heavy lifting' when it comes to improving the level of services in the states with lower fiscal capacities. The current approach results in a level of redistribution of GST that can be harmful to considerations of efficiency, simplicity, transparency and stability, which should also be given their due weight.**

14. Queensland has concerns about the distribution of GST that the Commonwealth Grants Commission (CGC) currently implements – equalising fiscal capacities to the last dollar so all states can provide the same level of services is a position that governments have not formally endorsed.
15. Queensland agrees that some states and territories will need financial assistance in order to provide an appropriate level of services to their communities.
16. However, the GST distribution system is being expected to do too much, and is relieving the Commonwealth from doing more of the 'heavy lifting' when it comes to improving the level of services in the lower fiscal capacity states. Equalising GST should not be seen as a panacea for all the problems faced by states.
17. Queensland believes the current approach results in a level of redistribution of GST that can be harmful to considerations of efficiency, simplicity, transparency and stability, which should also be given their due weight.
18. The risk is that an overemphasis on equity outcomes in relation to the GST distribution will come at the cost of impeding the growth of national wealth to the detriment of all Australians. The operation of the HFE system should be consistent with the objective of increasing national wealth. A change in emphasis in the operation of HFE to provide more room for efficiency and other considerations has the potential to allow both the growth and sharing of national wealth so that all Australians are better off.
19. Efficiency, simplicity, transparency and stability considerations can be given greater weight in a number of ways, such as the use of broader indicators and higher materiality and robustness thresholds in revenue and expense assessments,

and use of discounts both generally and specifically to assessments associated with wealth generation.

20. In a separate joint submission provided to the Review, Queensland, NSW, Victoria and Western Australia discuss ways to reduce the redistributions among the states. It takes a step back and asks what the best way is to cut through the complexity and provide an efficient, fair and equitable system.
21. The joint submission argues that in the longer term the preferable model for HFE would be to distribute the GST on a population share basis, with the Commonwealth providing additional financial assistance to the states and territories with lower fiscal capacity so no state or territory is financially worse off.
22. In the more immediate term, Queensland proposes a package of reforms that will help address the existing flaws in the system. This package is considered in more detail in Sections 4 and 5 of this submission.
23. Queensland is pleased that the Panel is willing to consider recommending a change to the current form of HFE if that delivers a better balance of priorities.

### **3.2 PROTECTING THE GST BASE**

24. Because expenditure on GST-taxable items has fallen as a proportion of consumption and consumption has fallen as a proportion of gross domestic product (GDP), the ratio of GST to nominal GDP has been in decline. As a result, the GST pool is proving not to be the ‘growth tax’ it was originally envisaged it would be.
25. A situation where states are having to share a stagnant or slowly growing pool of GST funding will make the reform task more difficult and the potential for equitable outcomes less certain. A failure to properly protect the GST base will exacerbate the situation.
26. The June interim report of Queensland’s Commission of Audit documented a number of instances in which court decisions and less than timely responses by the Australian Government have eroded the pool of GST available to the states.
27. These cases include:

- **KAP Motors:** Hold-back payments in the motor vehicle industry were initially subject to GST. However, when the Australian Tax Office changed its view on the tax status of the payments, KAP Motors successfully exploited a deficiency in the law and recovered the GST it previously paid without having to return the corresponding amount to its customers who bore the cost of the GST. This represented a windfall gain to KAP Motors.

The Australian Government decision not to amend the law retrospectively to prevent windfall gain payments to taxpayers resulted in an estimated \$520 million of GST revenue being forgone.

- **PM Developments:** This case involved the payment of GST liabilities of entities in receivership or otherwise incapacitated, where the provision ensuring the recovery of GST applying to transactions the entity enters into during receivership was found to be ineffective.

Despite the states and territories unanimously agreeing in 2005 and 2008 to amend the law to rectify the deficiencies, no action was taken by the Australian Government prior to the case being litigated in 2008. Subsequently, the Australian Government announced prospective amendments to the GST law to restore the policy intent underpinning the provision. Given the application of the four year rule, entities were able to recover amounts of GST going back four years. The loss to the GST base has been estimated to be \$280 million.

- **Multiflex:** In this case, the ATO withheld GST refunds claimed by Multiflex on the grounds that it was investigating the veracity of those claims. However, deficiencies within the GST administration provisions in the *Taxation Administration Act 1953* (TAA) led the Federal Court to rule that the Commissioner had no power to withhold the refunds.

As of December 2011, the ATO began releasing \$298 million of refunds it had held to investigate the authenticity of the claims. Where refunds are paid that have been incorrectly claimed, the ATO advises it is difficult to recover the amounts involved.

While the Australian Government advised the states it would amend the provisions of the TAA following the Multiflex decision, it made the amendments conditional on the states agreeing to make carbon permits GST-free. This was contrary to the position in its own white paper which maintained carbon permits should be taxable. The trade in GST-free permits by consumers would represent a loss to the GST base.

- **Gloxinia:** The first sale or transfer of new residential premises by way of long term lease is taxable. In Gloxinia, long term leases were created when the property was strata titled by Council. At this point, the strata titles became subject to long term leases and were transferred to the developer. Once the strata titles were issued, the developer finalised sales of the long term leases with purchasers.

However, because the new residential premises (i.e. the strata titles) had previously been subject to a long term lease when they were transferred by the Council to the developer, the Federal Court held they were input taxed supplies. No GST was charged on the sale.

While the Australian Government announced it would amend the GST Act, generous transition arrangements enable developers who have some form of commitment to develop property to take advantage of the old law. No estimate has been provided of the revenue forgone due to the transition arrangements.

28. Another GST base issue relates to the imposition of GST on low value imports (under \$1,000). While Queensland agrees that administrative and compliance costs may provide a sensible reason not to collect GST in this instance, it is hoped that good public policy considerations drive the eventual decision.
29. As any reform arising from the Review will have a better chance of success if the GST pool is robust, Queensland hopes that the Panel recommends in its final report that the Commonwealth do more to protect the GST base.

### 3.3 STATE TAX REFORM, RESOURCE TAXES AND HFE

#### 3.3.1 Tax reform and HFE

*The Panel's view:*

*The Panel considers the optimal way to pursue State tax reform is on a multilateral basis — amongst the States and including the Commonwealth — to maximise the benefits of reforms. This multilateral, cooperative approach would allow any GST share effects to be identified and appropriately dealt with.*

*When the States and the Commonwealth have agreed on the desired specifications and pace of reform, it may be necessary to provide incentives to ensure that the agreement is acted upon by all parties.*

*To the extent that reform results in tangible fiscal benefits these should be shared.*

**Queensland response:**

**Queensland supports the Panel's view that the best approach to tax reform is multilateral, cooperative agreement. However, in Queensland's view, it is not desirable for the HFE system to be used to provide incentives for agreed reforms as policy neutrality is a cornerstone of the current process. If states are to be rewarded for implementing tax reform this should be outside of the HFE system, for example through the allocation of the Commonwealth's windfall revenue gain from state tax reform.**

30. Both of Queensland's previous submissions emphasise that the principle of policy neutrality is a cornerstone of the current process. The use of HFE to promote tax reform objectives would undermine this principle. Queensland notes that the Panel does not appear to be considering options that would reduce the policy neutrality of the process by imposing a particular view of tax reform on states. Queensland welcomes this decision on the basis that such options would be undesirable and unworkable.
31. However, Queensland has some concerns with the Panel's proposals to use the GST distribution to encourage states to pursue agreed reforms. In its second interim report, the Panel signalled that while it is not contemplating options that would use the GST distribution to force an external view of tax reform on states, it is considering options that would encourage states to follow through with reforms that have been agreed between the Commonwealth and states.
32. If states enter into an agreement to pursue a particular tax reform, this is in recognition of the benefits of reform, both fiscally and to the economy. Agreed timeframes for implementing reform (such as the timing of abolition of particular taxes) are based on expectations of states' capacities for implementation.
33. Changing circumstances can necessitate adjusting these timeframes so that tax reform is consistent with responsible fiscal management. This does not imply that states require incentives to follow through on agreements.
34. Differential timeframes for states may also be desirable in some situations – this may reflect different states' circumstances and a GST penalty for late implementation may not be appropriate.

35. It is important for reforms to retain the flexibility to adjust for changing or unforeseen circumstances. A formulaic GST mechanism to reduce this flexibility is not desirable.
36. Queensland has abolished eight taxes under the intergovernmental agreement associated with the introduction of the GST. Flexibility under these arrangements has allowed these taxes to be abolished when state budgets have had the capacity to accommodate them, allowing tax cuts to be consistent with responsible fiscal management.
37. Abolition of duty on core business assets has been deferred by Queensland because other state revenues have suffered under the impact of the global financial crisis. This decision was based on its policy merits, with Queensland not expected to benefit through any resultant change in the distribution of the GST.
38. Options that provide rewards to states outside the GST distribution process could be viable, but these would need to form part of an intergovernmental agreement to implement tax reform, and would be negotiated at that time. The incentives could be funded by the substantial revenue windfall to the Commonwealth that arises from state tax reform. The national competition reforms of the 1990s provides a good model for economic reform where agreement was struck between the Commonwealth and the states and territories, with financial rewards provided to the states funded from the revenue windfall received by the Commonwealth from state reforms.

### 3.3.2 Commonwealth resource rent taxes and HFE

*The Panel's view:*

*The Panel considers that the current situation is both undesirable and ultimately unsustainable and strongly endorses the advice of the Australia's Future Tax System review and the Policy Transition Group that the risks and rewards of Australia's resource tax arrangements be the subject of a negotiated agreement between the Commonwealth and the States.*

*The Panel considers that an agreement would secure, and build upon, the benefits of the resource tax reforms already undertaken.*

*The Panel considers that the Commonwealth unilaterally revisiting the design of the MRRT and PRRT is a fall back position available to the Commonwealth in the event that it is unable to secure an agreement with the States.*

**Queensland response:**

**Queensland strongly opposes the use of HFE to penalise states that increase their royalties. States own the mineral and petroleum resources within their jurisdictions and they have a right to charge for them to ensure their citizens receive an adequate return from the commercial exploitation of their finite resources.**

39. Queensland's second submission expressed the Government's strong opposition to the use of HFE to penalise states that increase their royalties. Minerals are owned by the states and they have a right to charge for them as they see fit.

40. The HFE process should not be used to generate specific policy outcomes that can be achieved through more appropriate means.
41. If the Commonwealth has a concern that the states' use of their sovereign right to increase royalty charges on the exploitation of their mineral resources will detract from their resource rent revenues, it is open to the Commonwealth to redesign their taxes or undertake negotiations with the states.
42. Any negotiations would need to recognise as a starting point that states own the mineral and petroleum resources within their jurisdictions and have the right to levy what they consider an appropriate charge for them.
43. The best way to reduce the incentive to increase existing royalty rates is to ensure that the mining states retain a fairer share of both royalty revenue and revenue from the MRRT and PRRT, and certainty that such shares are not equalised.

### 3.4 DONOR-RECIPIENT MODEL

*The Panel's view:*

*The Panel is receptive to a donor and recipient approach as it appears it could offer significant simplification gains, particularly to donor States, while still providing support to the recipient States. However, depending on how this approach was implemented, it could result in recipient States having a stronger fiscal capacity than some donor States. Ideally, the donor States would develop a proposal to be put to the recipient States for their consideration and approval, as a donor and recipient approach will only prove workable if there is genuine consensus amongst States.*

*The Panel seeks further details from States on the design of a donor and recipient approach, including how to determine the size of the GST pool allocated to the recipient States, how best to measure the fiscal capacity of recipient States and when a recipient State could become a donor State (and vice versa).*

**Queensland response:**

**In principle, Queensland supports the application of an agreed formula among all the states and territories to the distribution of the GST, but is sceptical that such an agreement could be achieved, made workable and be sustained without fiscal support from the Commonwealth.**

44. Queensland is sceptical that a formula could be found that satisfied all the states over a period of time.
45. Agreement would be required not only over the initial sharing of GST, but also the conditions under which the distribution formula would be changed, the mechanism by which it would be changed and the default position should agreement not be able to be achieved. Each of these would be problematic, and, overall, probably not less so than the current arrangements. It may simply be putting off the resolution of issues that this Review should be trying to resolve.
46. Issues that would need to be resolved include:
  - Structure of agreement

Any agreed solution to GST distribution would require unanimity. This may be easier to achieve if separate agreements are sought within two groupings of jurisdictions with similar interests.

- Initial distribution amongst states

The distribution of GST between the large and small states has been relatively stable, with the larger states receiving about 80% and the smaller jurisdictions around 20%. Thus an agreed distribution of GST between the groups may be achievable.

Agreement of any formula for the distribution within each group may be difficult to achieve and maintain. No state is likely to accept a share of GST significantly less than the share it receives under the current arrangements, even if that share is more stable. For example, any arrangement that makes one state significantly better off would need to be paid for by the other states in that group. If this were the case, a long transition period may make this situation more acceptable. However, this issue could be significantly ameliorated by the Commonwealth providing fiscal assistance to the overall process of HFE.

- Timing of future renegotiations of the distribution

It would be unlikely that a fixed unchanging distribution of GST between and within the groups would be satisfactory since circumstances would change. To deal with changing circumstances, there could be periodic reassessment (in which case large inequalities may develop if the period is long) or reassessment when there is a predefined change of circumstances (which would need to be agreed on).

- Renegotiations

Negotiations in future processes may be more difficult than the initial one, since presumably there would be no set of CGC assessed relativities that would act as a starting point for negotiation and perhaps less motivation to achieve an agreement. Agreements requiring consensus may be difficult to achieve, thereby requiring a default position for the distribution of GST. The default position could be either a formula (which would have to be agreed on prior to the negotiations) or a determination by a third-party (which presumably would have to develop a formula for the fair distribution of GST, the issue now facing the Review). The zero-sum nature of the GST distribution would make it more likely that the default position would be required – a situation that could only be ameliorated by Commonwealth financial assistance.

### 3.5 GOVERNANCE

*The Panel's view:*

*The Panel sees merit in separating responsibility for determining the objectives of the GST distribution and the definition of HFE from the responsibility for interpreting and implementing HFE. The Panel also sees merit in subjecting HFE outcomes to independent review from time to time.*

**Queensland response:**

**Queensland agrees that the responsibility for determining the objectives of the GST distribution and the definition of HFE should be separated from the responsibility of interpreting and implementing HFE. The former responsibilities should lie with the Standing Council of Federal Financial Relations with advice from Heads of Treasuries, while the latter responsibilities should lie with the Commonwealth Grants Commission (CGC).**

47. Queensland believes that the current form of HFE has gained dominance because the CGC has not previously been given proper direction by government. In the absence of this direction, the CGC has resorted to the form of HFE that most easily lends itself to mechanical formulation and implementation. It would be more desirable if policy and implementation were separated.
48. Queensland's joint submission with NSW, Victoria and Western Australia has further discussion on governance issues.

#### **4. IMPROVING THE HFE MODEL**

49. NSW, Victoria, Queensland and Western Australia have prepared a joint submission suggesting that the long term future for the HFE system lies with the GST being distributed among the states on a population share base, with the Commonwealth providing additional financial assistance to the states with lower fiscal capacity to ensure that no state is worse off and service standards across the nation remain high.
50. Such a population share-based model would be:
- fair – it would still represent a significant degree of equalisation of fiscal capacities;
  - easily understood, simple and transparent. It would be stable and less susceptible to change; and
  - more predictable and would allow States to plan budgets with greater certainty.
51. An equal per capita distribution would encourage good policy by focusing states on the merits of spending and revenue raising decisions rather than having to consider the possible impacts on GST shares from policy decisions. It would engender greater confidence in the HFE system.
52. The Commonwealth already raises over 80 per cent of tax revenue in Australia with the major revenue sources being the preserve of the federal government. It is therefore more appropriate for the federal government rather than a subset of states to meet the financial costs of further equalising payments (in addition to equal per capita) necessary to ensure all residents of the federation have access to comparable service levels.
53. These issues are discussed in more detail in a joint submission with NSW, Victoria and Western Australia that has also been presented to the Review.
54. While this population share model is a long term objective, there is still the opportunity to implement a significant range of reforms that would help correct many of the present system's flaws.
55. These reforms are discussed in the remainder of this section and in Section 5.

##### **4.1 IMPLEMENTING A COMPARABLE STANDARD**

56. The joint submission suggests that while a population share model with additional Commonwealth financial support is a long term objective, an interim model could be to change the standard of service by which GST is redistributed from one based on average levels of service to one based on a comparable standard of service, or specifically the current minimum service delivery level. The Commonwealth would then provide additional funding to ensure that no state was worse off.
57. This submission explores this latter approach in more detail.

##### **Implementing a “comparable” approach using the minimum service delivery level**

58. Under this approach, the GST distribution system would deliver equity outcomes to allow all states to have the fiscal capacity to deliver an acceptable, comparable

level of service delivery. The Commonwealth would then provide additional funding to recipient states so they have the fiscal capacity to provide the average level of services, thus ensuring that no state is worse off.

59. This would share the load of lifting the service delivery capacity of recipient states between the donor states and the Commonwealth.
60. Every state faces a reasonable public expectation that they will provide an acceptable level of services, comparable to that provided in other states. This is reinforced by the need to meet performance targets set in National Agreements, which ensure that no state's effort is unacceptably low and that all states have an acceptable standard of service delivery.
61. A reasonable method for defining a "comparable" level of service delivery is therefore to use the minimum service delivery effort of any state, after allowing for the CGC's assessment of the impact of underlying disabilities.
62. The minimum service delivery effort (as measured by the level of service delivery ratios calculated by the CGC) could imply that a state has a "comparable" level of services relative to the average, or could equally imply that a state is providing the same level of services more efficiently. In either case, this is a more appropriate standard than the average effort for the purposes of determining the level of redistribution from the donor states and therefore the distribution of GST.
63. The Commonwealth would provide additional funding, over and above the GST, to recipient states to lift their service delivery capacity to the average level, thus ensuring no state or territory is financially worse off and greater equity of service delivery across the nation.
64. The basic methodology of determining the discount on which the GST distribution would be based would consist of applying the following steps:
  - First, as now, use actual expenditure for each jurisdiction to calculate the average expense standard per capita.
  - Second, as now, assess the expenditure needs for each jurisdiction and the resultant redistribution from the average expenditure standard.
  - Third, determine the 'effort' level for each jurisdiction, comparing what they actually spend against what they are assessed to need to spend to achieve the average expenditure standard.
  - Fourth, calculate the revised expenditure needs and the resultant redistribution if they were scaled by the minimum effort level as the new standard. For example, if the minimum effort level is 0.90 (of the average), the assessed expenditure needs and the redistribution is scaled by 0.90, that is, discounted by 10% (for the purposes of this calculation).
  - Fifth, a general discount is derived by undertaking the above steps for each major expenditure category, then comparing the aggregation of the assessed expenditures under the minimum effort standard against the aggregation of the assessed expenditures under the average standard.
  - Last, the same general discount is applied to each assessment – including all expenditure and revenue assessments – or, equivalently, to the overall

redistribution for each jurisdiction, to determine the distribution to apply to the GST.

### **Methodological issues**

65. It is envisaged that an approach to applying a minimum effort standard would be refined by the CGC, in consultation with states. Queensland considers that a reliable methodology is achievable.
66. The CGC currently measures expenditure effort implicitly, by comparing the actual expenditure of states with their assessed expenditure needs under average policy. That is, the current methodology measures the impact of underlying disabilities on expenditure requirements, and effectively attributes any remaining difference in actual expenditure per capita to differences in service delivery effort. While these level of service delivery ratios may give a broad indication of the relative expenditure efforts of states, some adjustments would be required to make them fit for purpose, for example:
  - removing the impact of differences in effort where expenditure requirements are not assessed by the CGC. In these cases it may be unclear whether differences in expenditure levels are due to differences in effort, or to capacity differences that are not measured (for instance, where a reliable data source for measuring underlying differences in expenditure requirements does not exist); and
  - removing the impact of discounts to the CGC's assessment of underlying expenditure requirements. Discounts reduce the difference between the assessed expenses of individual states and the average, which in turn impacts on the assessed level of service ratio. If a discount is made to lessen the impact of a particular disability on capacity (usually due to concerns over data reliability), a symmetrical discount could be applied to effort, in recognition that a degree of uncertainty exists as to the reason for differences in expenditure levels.
67. Queensland considers that the adjustments described above could be applied simply, and would be sufficient to make assessed level of service ratios fit for the purpose of measuring a minimum effort standard of services. However, if other jurisdictions are in favour of different adjustments, these could be developed further in consultation between the CGC and states.
68. Another methodological issue that would need to be resolved is the disaggregation level of service delivery at which the minimum effort would be calculated. The minimum effort calculated for all expenses in aggregate would be significantly different to the minimum effort calculated at an individual CGC expense category level.
69. Queensland's preference would be for disaggregation to be applied using a broad, high level disaggregation of functions. Preliminary calculations at this broad level applied to recent years suggest a discount of between 15% and 20%.
70. A broad disaggregation would allow for differences in states' preferences for substituting services that meet similar needs – for example, a state may have a relatively low level of effort in roads services because it chooses to prioritise transport services. At a broad disaggregation level, the minimum effort standard would allow for differences in states' service delivery preferences while at the

same time, only redistributing what is needed to provide a comparable level of services overall.

### **Practical application**

71. Queensland's preference for the application of the minimum effort standard to achieve a "comparable" degree of equalisation is for:
- the minimum effort to be applied as a general discount, both to expenditure and revenue assessments. Applying the same discount to all expenditure categories is simple and policy neutral, as it recognises that states have different expenditure priorities. Also, if a standard different to the average is applied to expenditure assessments, a matching adjustment is necessary for revenue assessments. To not apply the same discount to both revenue and expenditure would be to effectively give a higher weighting to one over the other in the assessment of states' needs, and there is no conceptual basis for this; and
  - for the discount to be fixed between CGC reviews. It is not expected that the minimum effort standard would have significant annual changes, and a fixed discount would ensure that a minimum effort approach does not increase the complexity of the system, and that outcomes are predictable and stable.
72. To complement the reform, the Commonwealth would provide additional funding to the recipient states, equivalent to the cost of the discount to them, to ensure that no state or territory is financially worse off and can provide services to the average level.

## 4.2 BROAD INDICATORS – REVENUE

*The Panel's view:*

*The Panel is highly attracted to the use of broader indicators, as they could offer significant simplification and may equalise to a similar extent as at present. Broader indicators would also reduce the scope for State policy changes to affect the GST distribution (see Chapter 4). However, the Panel recognises that using broader indicators could be seen by some States as a less precise measure of 'what States collectively do'.*

*The Panel therefore seeks further information, evidence and views from States about:*

- *what broader indicators could apply, especially on the expenditure side, where the proposals are less well developed, and*
- *on the revenue side, why broader indicators, such as those described above, would not produce appropriate outcomes.*

**Queensland response:**

**A global revenue measure using an indicator such as household disposable income has the potential to achieve a similar outcome to the current system while being simpler, more stable and more robust.**

73. A global measure of revenue raising capacities has several key advantages over the current revenue methodology:
- A global measure is arguably a better indicator of states' underlying revenue raising capacities, as it can reflect the economic incidence of taxes, rather than the particular policy mechanisms used by states.
  - Global measures have increased policy neutrality and reduced potential for grant design effects compared with the current methodology. They are generally less sensitive to policy change than disaggregated factors, and assessments are not affected by the choices of states to rely more heavily on particular revenue sources, or place greater emphasis on particular expense functions. Being more policy neutral, a broad indicator is far less likely to provide incentives or disincentives for tax reform.
  - Global indicators are more simple, transparent, robust and predictable than the current methodology, relying on fewer sources of data and fewer adjustments.
74. Queensland does not consider that a broad indicator would be less reflective of "what states do" than the current methodology. Rather, a global indicator would measure the underlying factors influencing states' revenue raising capacities as a whole, recognising that revenue is derived from a range of sources, and that the level of reliance on particular taxes is a policy decision.

**Economic incidence**

75. Rather than trying to directly emulate the structure of average state tax bases, global indicators reflect the tax base according to the economic incidence of state taxes, and the state's capacity to raise tax from this base.

76. Measures based on economic incidence provide a more appropriate indicator of revenue capacity than measures based on legal incidence. Ultimately, economic factors, such as income, determine the capacity of governments to raise revenue, even though they may not tax that base directly.
77. This view is supported by the Productivity Commission (2008). In relation to the revenue capacity of local governments, the Productivity Commission indicates that income is a better measure of revenue raising capacity than property values, even though local governments do not levy income taxes but are heavily dependent on municipal rates:
- Although obtaining fully comprehensive measures of income at the local government level is difficult, the arguments in support of using income as an indicator are more compelling than those in support of using property values. This includes the fact that a substantially large proportion of local governments' own-source revenue, at a national level, is from fees and charges.
- Moreover, the reality is that ratepayers pay their rates and charges out of their incomes and probably think in those terms when confronted with their rates notices. Indeed, local governments, at least implicitly, acknowledge this when they set their rates, fees and charges. Councils are required under State legislation to provide concessions to pensioners, and also voluntarily offer their own concessions to people facing hardship in paying rates. In times of rapidly rising property values, councils often decrease the rate in the dollar, so as to reduce the revenue raised to match the revenue required to fund the budget.
- Although there is likely to be a link between property values and incomes, property values are an imperfect and incomplete indicator of the incomes of residents and hence of their ability to pay rates. (p.53-54)
78. The Productivity Commission's arguments not only apply to property taxes, on which states are also heavily dependent, but also to other state taxes.

### **Household Disposable Income as a broad measure of revenue**

79. The March 2010 KPMG paper *The Excess Burden of Australian Taxes* identifies the final economic incidence of major taxes. According to this analysis, the burden of the majority of taxes, including those raised by states, is borne by labour. States employ varying tax mixes to access the same general base of households and individuals. Because states are able to raise taxes across the entire tax base from a variety of mechanisms, a global revenue indicator such as household disposable income (HDI) reflects what states do.
80. Abelson (2011) argues that 'a jurisdiction's revenue-raising capacity is primarily a function of the real household disposable income after allowances for major cost-of-living differences, such as housing and journey-to-work costs, and tax exportation.' This is supported by research on the Canadian system of HFE (Barro, 2002) which argues that revenue measures should 'reflect the economic or financial resources or revenue bases on which the province can draw but should not reflect decisions of the provincial government or local governments about how much revenue to raise or in what forms to raise it', and suggests that a macroeconomic measure should be used.
81. In Australia, the most suitable global revenue indicator may be HDI. By basing the measurement of state revenue raising capacity on HDI, which reflects labour's capacity to pay tax, the GST distribution would better reflect the capacity of states to raise revenue based on economic incidence.

82. A broad indicator such as HDI reflects a wider base than the current methodology as it includes revenue not currently assessed, such as gambling taxes, making it a more robust measure. It is more flexible in dealing with varied tax mixes and changes in tax mix, such as changes through tax reform, than the current methodology.
83. One aspect of the revenue base that HDI may not capture is “exported taxes”, that is, taxes on non-resident households and businesses. In Australia, this is principally a capacity to tax corporate surpluses that accrue to non-residents (Abelson 2011). Of the exported taxes, the ability of states to raise revenue on natural resources is the most significant, and therefore there may be a need for an assessment of mining revenue to be included with the broad indicator of revenue. However, the mining revenue assessment, in its current flawed form, would not be satisfactory for this role and would need to be reformed as outlined in Section 5 of this submission before it could be considered suitable to be part of a broad based revenue assessment.
84. Although some portion of other state revenues may be attributed to non-residents of a state, these are unlikely to be significant for revenue other than mining royalties. For example, for land tax revenue in Queensland, the proportion of resident individual taxpayers with an address outside of Queensland is less than 8%.
85. Queensland’s preference is for a measure of revenue raising capacity through HDI and, if necessary, a reformed mining revenue assessment, to reflect both the capacity of labour to pay tax, and the capacity of states to raise revenue from “exported taxes”. This produces a relativity distribution that is not dissimilar to that derived from the current methodology, while being far simpler and more robust.

#### 4.2.1 Rejecting a broad indicator for Total Budget

*The Panel’s view:*

*While the Panel is keen to explore the use of global indicators, it acknowledges potential difficulties with the approach. For example, if GSP per capita was used as a proxy for States’ fiscal capacity, would States with lower GSP per capita receive additional GST payments? Alternatively, if growth in GSP was the proxy, would States with high rates of GSP growth, and possibly greater infrastructure demands, need additional GST payments?*

*The Panel would like proponents of the use of global indicators to provide further ideas and information on the implementation of the approach, and how it could achieve appropriate outcomes.*

**Queensland response:**

**While supporting consideration of broad indicators, particularly for revenue, Queensland does not believe that a broad indicator for the total budget, such as GSP per capita, would appropriately reflect the expenditure needs facing a state.**

86. Queensland considers that while gross state product (GSP) per capita may reflect states’ revenue raising capacities at a very broad level, it does not reflect expenditure needs. Expenditure needs and revenue capacities together represent

the overall fiscal pressure facing a government. It is important that expenditure needs are properly represented in the assessment of fiscal capacity.

87. This is recognised when long term intergenerational budget forecasts are prepared – the impacts of population ageing and other drivers on revenues and expenses are separately assessed and then combined to determine the total fiscal pressure facing governments. To assess one but not the other, or to suggest that forecasting GDP or GSP alone as being adequate to assess the fiscal pressure facing governments is fundamentally flawed.
88. State expenses are primarily driven by demographic, socio-economic and location factors, such as a state's population age profile, income and wealth distribution and dispersion of population, as well as the degree of Indigeneity of the population. The direct link of these drivers with GSP is tenuous.
89. In Queensland's case, dispersion of the population (which increases the cost of regional and remote delivery of services), strong population growth (which requires increased infrastructure provision) and a relatively large Indigenous population are important drivers of the state's need to spend more than other states to provide equivalent services.
90. An HFE system that redistributed the revenue raised from mining royalties but did not recognise factors affecting states' underlying expenditure disabilities would be inappropriate.
91. At this stage of the Review, a strong case has not been made for the application of a broad indicator at the total budget level. The onus should be on those advocating the need for total fiscal measures to suggest why this is appropriate and how it could be made workable.
92. The CGC has previously attempted to simplify the expenses assessments by reducing the less material ones. Further simplification is possible, for example by removing those less material disability assessments which do not have a strong evidence base (see Section 4.3). However, to replace all the expense assessments, let alone the revenue assessments as well, with one or a few indicators would lead to a significant loss of precision of the overall GST relativity assessment.

### 4.3 A SIMPLER, MORE ROBUST EXPENSES ASSESSMENT

*The Panel's view:*

*The Panel is highly attracted to the use of broader indicators, as they could offer significant simplification and may equalise to a similar extent as at present. Broader indicators would also reduce the scope for State policy changes to affect the GST distribution (see Chapter 4). However, the Panel recognises that using broader indicators could be seen by some States as a less precise measure of 'what States collectively do'.*

*The Panel therefore seeks further information, evidence and views from States about:*

- *what broader indicators could apply, especially on the expenditure side, where the proposals are less well developed.*

**Queensland response:**

**Broad or global indicators for expenses are unlikely to deliver greater simplification in a practical sense. A less complex methodology could be achieved by reducing the number of factors in the current process, emphasising reliability and robustness rather than simply materiality. At the same time, more could be done to improve the reliability of some expense assessments.**

#### 4.3.1 Practical application of global expense disabilities

93. Queensland considers that, in general, global measures have the potential to improve simplification and policy neutrality.
94. In the case of expenses, we recognise that the practical implementation of global measures may be less straightforward than that of revenues. Analysis suggests that the global application of expense factors may require a similar level of detail and data collection as the current process. While this may improve simplicity in a presentational way, the underlying assessment would remain complex.
95. Queensland understands that if the Panel decides to recommend global measures for the revenue categories, the Panel may also wish to treat expenses globally for consistency.
96. However, in Queensland's view there is a much stronger rationale for applying global indicators to revenue categories than to expense categories – that is, the current method, which measures the bases of specific revenue mechanisms, is not the best indicator of capacity. This rationale does not apply to the expense categories, where underlying expense needs are most appropriately captured by the kinds of factors currently used, such as socio-demographic composition and location costs.
97. In addition, the current expense assessments are arguably more policy neutral than the revenue assessments, in the sense that changes to individual state policies do not in general have a significant impact on GST outcomes. The policy neutrality benefits of moving to a broad indicator for expenses would be less pronounced than for revenue.
98. The main rationale for applying global indicators to expenses is therefore simplification, if this can be achieved.

99. One possible approach to implementing a global assessment of expenses is to use those factors which affect the cost of services globally. For example, rather than calculating a separate socio-demographic composition factor for each category, the total additional cost of providing services to particular segments of the population could be estimated and applied to all expenses.
100. While this approach is conceptually sound, it may be difficult to put into practice.
101. It is likely that a similar level of detail (and data collection) to the current approach would be required to measure the global impact of disabilities. For example, if the Indigeneity factor were to be applied globally, it would still be necessary to collect data showing the additional cost of providing Indigenous services for each state government function. Any improvements to simplicity may therefore only be presentational.
102. Queensland does not believe that applying a broad indicator to the revenue categories necessarily means that a broad approach must be used in the expense categories, if there is a stronger rationale for one than the other. Moreover, practical difficulties in implementing broad indicators for expenses should not preclude the implementation of broad indicators for revenue, where these would improve the measurement of fiscal capacity and greatly reduce complexity.
103. However, if a means of overcoming practical issues with the implementation of global expense indicators is suggested, Queensland would support further work in this area.

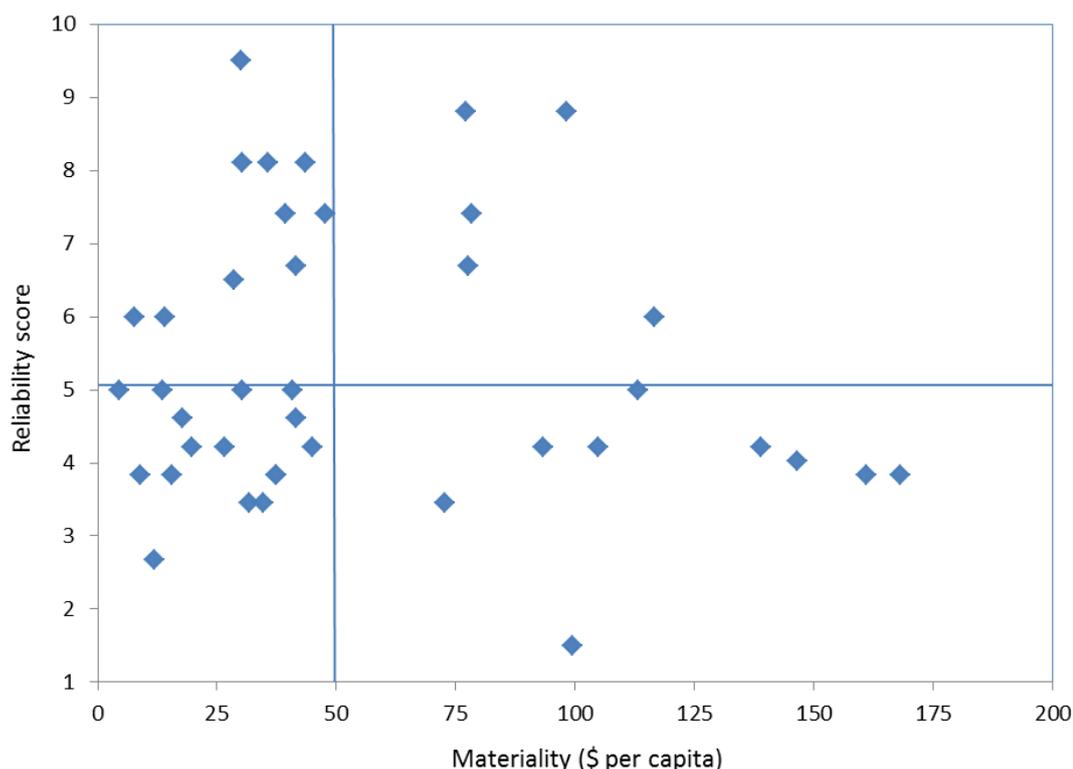
#### **4.3.2 Simplification of current assessments**

104. Queensland considers that greater simplicity may be achieved more effectively by focusing on the reliability and materiality of the current expense assessments.
105. The current interpretation of the “what states do” principle assumes that a greater level of detail in the assessment of service delivery will result in an assessment that better reflects the underlying differences in fiscal capacity.
106. In the 2010 Review, materiality thresholds were well defined, but reliability thresholds were not (a specific threshold being more subjective and difficult to define for reliability than for materiality).
107. This can create a preference for making an assessment wherever there is a conceptual case, and such an assessment would be material, despite inadequate data or concerns over the reliability or comparability of data. Queensland’s view is that, in effect, materiality considerations are given greater weighting in the current methodology than reliability considerations in cases where a trade-off is necessary.
108. An alternative approach to simplification would be to consider materiality and reliability equally. Although a specific ‘threshold’ for reliability is difficult to define, it would be possible for the CGC, in consultation with states, to rate the reliability of assessments against criteria such as data reliability, comparability and robustness.
109. Increased simplification could then be achieved by analysing disabilities against materiality and reliability criteria simultaneously rather than simply raising materiality thresholds – for example, some disabilities may only marginally

satisfy current materiality thresholds, but be highly reliable. It is appropriate for these kinds of disabilities to remain in the assessment process, but it may be preferable to remove other disabilities that are more material but less reliable.

110. Queensland's preliminary work suggests that this kind of analysis has the potential to improve simplicity in the expense assessments, while increasing the reliability of outcomes. Chart 1 compares the materiality of current disabilities with their reliability.<sup>1</sup>

**Chart 1 – Reliability and Materiality of Assessment Factors**



111. A general approach to improve simplicity based on this kind of analysis would be to:

- remove disability factors that have both low materiality and reliability (the lower left quadrant);
- retain disability factors that have relatively low materiality, but are highly reliable (upper left quadrant); and
- focus on improving the reliability of factors that are highly material but unreliable (lower right quadrant), if this is possible. Otherwise, consideration may also need to be given to removing these factors from the assessment.

112. Queensland considers that a reasonable starting point (in terms of materiality) for considering the removal of factors is around \$50 per capita. Subject to reliability considerations, this has the potential to produce significant simplification.

<sup>1</sup> A score of 1-10 has been assigned to each factor as an estimate of its reliability – one implies the lowest level of reliability, and 10 the highest. Materiality levels are not available for each individual disability. This chart is based on data for 56 of the 93 expense disabilities. Disabilities that redistribute more than \$200 per capita for any state are not included in Chart 1.

113. Although the analysis of reliability is likely to be more subjective than that of materiality, Queensland considers that it is important to retain disabilities that are highly reliable, even while others that are more material but less reliable are removed from the assessment process.

### 4.3.3 Indigeneity and the Northern Territory

*The Panel's view*

*The Panel believes that Indigeneity (and, indeed, the Territories) should continue to remain in the HFE system, noting that the Terms of Reference state that GST revenue will continue to be distributed to the States as untied payments.*

*The Panel considers that where additional measures to address disadvantage are required, these measures would best be undertaken outside the HFE system through other mechanisms.*

**Queensland response**

**Queensland considers that Indigeneity issues unduly increase the complexity of the HFE system, and may be dealt with more effectively through other mechanisms, such as additional tied funding provided by the Commonwealth.**

114. Queensland supports the untied nature of GST funding, and the aim of the HFE process being to give states the capacity to provide services at a comparable standard. Queensland does not believe it is the purpose of HFE to require GST to be spent by states in any particular way or in any particular area.
115. However, HFE is not designed to give states the capacity to reduce the expenditure impact of disabilities (such as Indigeneity) over time, but only to maintain the standard level of expenditure.
116. National initiatives aimed at addressing Indigenous issues may be better achieved through a different mechanism than the CGC process, possibly through additional tied funding provided by the Commonwealth over and above the GST. This could take the form of a specific purpose payment or national partnership payment.
117. A separate treatment of Indigeneity may be preferable for the following reasons:
- Indigeneity may be regarded as an "outlier" assessment, where unique circumstances prevail. Such assessments may distort the HFE process and equalisation outcomes.
  - Indigenous factors are applied to the majority of expense assessments in the current HFE process – their removal would greatly reduce the complexity of the methodology.
  - As the HFE process distributes untied GST revenue, it is not necessarily the best mechanism for addressing national initiatives such as *Closing the Gap*. HFE is not designed to give states the capacity to reduce the expenditure impact of disabilities such as Indigeneity over time, only to maintain the current standard level of expenditure. National initiatives aimed at

addressing Indigenous issues are better achieved through tied Commonwealth funding.

118. Any change to the current process should not reduce GST grants, or impact on the discretion of states to allocate GST revenue to expenditure areas as states see fit.
119. Some states have suggested that removing Indigeneity would not improve simplification in HFE, because Indigenous needs would still have to be calculated to determine the size of the additional funding. Queensland does not agree – the size of additional tied funding could be determined through negotiation by COAG. The additional funding would be designed to give states the capacity to reduce the impact of underlying disabilities, as well as provide states with the capacity to maintain the current standard levels of expenditure.

## 5. FIXING THE MINING ASSESSMENT

120. Australia is blessed with vast reserves of iron ore, coal and gas. This, in combination with high and growing demand from rapidly industrialising Asian economies, makes Australia a world leader in the mining and energy export industry.
121. World energy demand is projected to increase by over 39% from 2009 to 2035. Asian economies will experience the most robust growth with energy demands expected to more than double by 2035. China and India, two of Australia's key trading partners, are expected to drive this growth in demand (International Energy Agency, 2011).
122. Demand for Australia's two key commodities, coal and iron ore, will continue to grow in the future. Liquefied natural gas (LNG) production is a developing industry that is expected to be a growing source of exports for the nation. All indicators see Australia's coal production expanding substantially over the next 20 years.
123. With ample reserves of metallurgic coal, thermal coal and LNG, Queensland can expect to be at the centre of these developments (Queensland Government, 2011).
124. Australia faces a number of challenges in ensuring it realises the full benefits of the mining boom. The domestic challenge is to plan and to build additional infrastructure on time to ensure growing export volumes are unconstrained by bottlenecks. In the global context, this is doubly important if Australia is to maintain its competitive position in international commodity markets. Failure to do so will see competing countries increase their exports at Australia's expense; Indonesia, Columbia and Mongolia for coal; Brazil and West Africa for iron ore, and Qatar, the Russian Federation and North America for LNG. Further to this, Australia must continue to compete with low cost domestic producers in China and India (Bureau of Resources and Energy Infrastructure, 2012).

### 5.1 WHY IS MINING DIFFERENT?

125. Every jurisdiction has industries to regulate and manage. So why is mining different?
126. **The mining industry is concentrated in a few states.** When an assessment has a common base in every state it can be assumed that where there are costs arising from the required development and maintenance of associated economic and social infrastructure, each state will have incurred these costs. In these cases, it is not relevant whether the assessment process considers these costs as the treatment will be consistent across states. However, it is relevant in cases such as the assessment of mining revenue, where only two or three states have significant costs from associated economic and social infrastructure and regulation. If the assessment process does not consider these costs, as is currently the case, these states are effectively treated inconsistently.
127. **The mining assessment redistributes a State asset.** As Pincus and Ergas (2011) point out, royalties are payments for the extraction of an exhaustible resource, whose offset is a reduction to the jurisdiction's assets. In redistributing the financial benefits of the royalty through the GST, a State asset is also being

redistributed. If the redistribution were to be limited to the income component, then only the revenue associated with indefinitely holding the asset intact should be redistributed, which is likely to be less than the royalties revenues.

128. It is difficult to think of other cases where state assets – as opposed to the revenue derived from them – are redistributed. The proceeds of asset sales are not redistributed and there is no assessment on the physical asset holdings of states, even though these can generate service benefits to their citizens. It may be argued that mineral deposits represent a windfall gain to the owning states and that their ownership was not ‘earned’. However, this argument could apply to other state assets – for example, roads and buildings in the more established, wealthier states were acquired before the current system of HFE commenced and represent a ‘windfall’ to the current generation, and assets such as real property may have acquired a large ‘windfall’ increase in their value since their acquisition.
129. **Mining development can be problematic.** The existence and scale of most state revenue sources are not subject to difficult policy choices by government. The economic bases of payroll tax, conveyance duty, land tax and motor vehicle taxes – paid employment, property market values and activity, and vehicle ownership and use – are accepted as part of modern life. There are choices to be made that can affect the size of these bases – for example, restrictions on pollution emissions by factories near residential areas or waterways, or zoning of land. But in the main, these decisions have impacts only at the margins of the relevant economic bases.
130. In contrast, the development of the mining industry often requires difficult policy choices to be made. Mining operations can have large environmental and social impacts and often trade-offs are required against other industries, such as agriculture and tourism, and other land uses, such as residential housing. Public provision of economic and social infrastructure is required and the industry needs to be regulated and managed.
131. In making these policy choices in relation to the mining industry, governments need to carefully consider costs and benefits and strike balances between competing interests to a degree much greater than is associated with most other industries.

## 5.2 WHY IS THE MINING ASSESSMENT BROKEN?

132. The revenue base for mining activity is dominated by two states, Queensland and Western Australia. This appears to impact on the existing process in a number of ways, producing outcomes that are arguably inappropriate, and which compromise the policy neutrality of the assessment.
133. The flaws in the assessment of mining revenue were discussed in more detail in Queensland’s October 2011 submission, but can be summarised as follows.

### Problem 1 - Level of redistribution

134. Mining revenue comprises around 9% of all state revenue in aggregate, yet represents 85% of the GST redistributed as a result of revenue assessments. This suggests the current approach places undue emphasis on mining revenue, when

other revenues, such as stamp duty on conveyances and payroll tax, are arguably more important sources of state revenue.

135. In net terms, the majority of mining royalties raised by Queensland and Western Australia were offset by the redistribution in the CGC's 2012 Update. As a result, all other states gained more from mining royalties than Queensland and Western Australia on a per capita basis.

### **Problem 2 - Comparison to revenue raising effort**

136. In the current assessment process, differences in the mining revenue raised by states can be caused by differences in:
- underlying revenue raising capacity (level of mineral wealth); or
  - revenue raising effort (the actual royalty rates chosen by states).
137. Because the intention of the current assessment process is to equalise for differences in capacity only, the differences in net mining revenue could be due to differences in the actual royalty rates of states (their level of revenue "effort"). That is, states with lower net mining revenue could simply be setting their royalty rates at lower levels than those with higher net mining revenue. However, this does not appear to be the case.
138. In Queensland's October 2011 submission, it was demonstrated that Queensland and Western Australia dominate the average mining royalty rate, yet both states are well below the average net revenue per capita.
139. For most states the difference from average net revenue per capita is in the opposite direction than that implied by effort ratios. For example, Western Australia's net revenue per capita is far lower than the Australian average, yet its average revenue raising effort is higher than the Australian average. Queensland's revenue raising effort ratio is slightly below average, but its net revenue per capita is far below the average.
140. Similarly, states with lower than average mineral wealth, such as Victoria, have higher than average net revenue per capita despite a far lower than average revenue raising effort.
141. This suggests the current assessment of mining revenue is overemphasising the revenue raising capacity of states with high levels of mineral wealth.
142. A similar analysis of the 'stamp duty on conveyances' assessment (where every state has a similar revenue base) does not display the same problems. Where a state's "net revenue per capita" is lower than the Australian average so is its average revenue raising effort ratio (NSW and Queensland), and vice versa.
143. A reasonable conclusion is that the current processes are generally functioning as intended, but that they do not work for cases such as mining, where the revenue base is dominated by a small number of states.

### **Problem 3 - Policy neutrality and grant design effects**

144. Ideally, policy choices by individual states should have no impact on the distribution of GST.

145. However, Queensland's October 2011 submission's examination of the impact of policy changes by the resource states demonstrates serious policy neutrality issues in the assessment of mining revenue and the incentives (or "grant design effects").
146. The difficulties Western Australia and the CGC have faced with addressing the increase in the state's iron ore royalty rates highlight one of the critical issues with the assessment of mining revenue, that the current design of the assessment can influence the policy choices of states.
147. Queensland also suffers from grant design effects, whereby 30 to 50 per cent of the additional revenue from a coal royalty rate increase is effectively redistributed to other states.
148. Finally, the current mining assessment does not address the unique economic and social infrastructure costs the resource rich states face to sufficiently support the mining industry.

### 5.3 MINING ASSESSMENT REFORM – A SINGLE RATE SYSTEM

*The Panel's view:*

*The Panel notes that the current mining revenue assessment has the potential for Western Australia to lose more revenue than it raises from a change to its royalty rate for iron ore fines, with effect from the 2014 Update, if the CGC chooses to move iron fines into the high rate category. Whatever the original justification for the two-rate structure, this outcome seems to be a perverse and inappropriate result.*

*The Panel encourages the CGC and other stakeholders to review the current mining revenue assessment method at the earliest opportunity. This may involve reconsidering whether the two-rate model is appropriate.*

**Queensland response:**

**The current assessment of mining revenue is the clearest case of the principle of policy neutrality being violated, and creates serious incentive problems for the resource rich states. This is not a sustainable situation and the Panel should recommend it be addressed immediately. The solution to this problem is to assess mining royalties using a single rate system, along with a discount to mining.**

149. Unlike other categories, the outcome of the mining assessment is heavily influenced by the policies of individual states. These policy neutrality issues result in part from the mining revenue base being concentrated in a small number of states, but much of the potential for grant design is caused by the two-rate structure of the current assessment.
150. Examples of the way the current mining assessment adversely impacts on policy neutrality are the assessment of Western Australia's iron ore fines (as detailed in Queensland's October 2011 submission) and the impact of Queensland's policy changes on our GST share (if Queensland increased its coal royalty rate, between 30-50% of additional royalties would be redistributed through the GST).
151. Following the royalty rate of iron ore fines being increased into the high royalty rate range, the CGC was issued with a terms of reference directive to continue assessing iron ore fines in the low royalty rate category.. If iron ore fines had been

assessed in the high royalty rate category, Western Australia would have lost more in GST than it had gained in own-source revenue.

152. With further increases to the iron ore fines rate expected, a terms of reference directive is not a long term solution, is basically an admission that the current assessment has serious problems and does nothing to address policy neutrality issues more generally.
153. A far better solution for the longer term is to remove the high/low value split and assess mining as a single category. This would greatly enhance policy neutrality in the mining assessment, and remove the potential for grant design effects similar to the iron ore fines issue. The impact of individual states' policy decisions on their GST shares would be dampened.
154. If a single rate system is in place when Western Australia increases its iron ore fines rate, the increase will have far less impact on Western Australia's GST share than if iron ore fines is moved from the low royalty rate category to the high royalty rate category as must eventually happen.
155. A single rate system would also alleviate the grant design effects facing Queensland should it increase its coal royalty rate.
156. The Panel has been correct in calling attention to the problems with the two rate system by recommending it be reviewed at the earliest opportunity. However, with no set date for a review of the current methodology by the CGC the flaws in the mining assessment will persist. The Panel should go further and recommend a single category assessment of mining revenues to help address one of the flaws of the mining assessment.
157. An aggregated mining assessment would also be consistent with a broader approach (such as the application of a broad revenue indicator of revenue capacity) for the other revenue categories and complement the application of a discount to mining, discussed in section 5.4.

## 5.4 MINING ASSESSMENT REFORM – APPLICATION OF A DISCOUNT

### *The Panel's view*

*While it seems clear that all States accept that the benefits of mining should be shared, the extent to which this currently occurs, and how it is done, needs to be reconsidered. Specifically, the Panel is inclined to the view that not all mining related infrastructure, mining expenses and economic development costs are appropriately recognised in current arrangements. As the degree and effect of this omission is open to debate, the Panel has identified more detailed information that could be provided by States on these costs and ways an alternative assessment might be implemented.*

*Should it not prove possible to adequately recognise the costs faced by resource-rich States within the current system, the Panel would be inclined to further investigate other possible approaches that might indirectly achieve that aim.*

### **Queensland response:**

**Queensland strongly agrees that not all mining related infrastructure, mining expenses and economic development costs are appropriately recognised in current arrangements. There are also significant mining related costs that are not quantifiable. In addition to identifiable costs, provision should be made in recognition of the ownership of mineral and petroleum assets by states and to ensure that states with natural resources retain a strong incentive and capacity to exploit them in the national interest. Appropriate recognition of these factors in the mining assessment should consider Canada's 50% discount to mining royalties to be an appropriate benchmark.**

158. Queensland believes that the mining assessment is seriously flawed, but that these flaws could be largely addressed through the application of an appropriate discount and by assessing mining royalties through a single rate system. The latter issue was addressed in section 5.3.

159. There are four broad justifications for a discount to be applied to mining royalties:

- resource deposits are finite assets owned by the state;
- governments incur infrastructure costs in the development of the mining industry;
- government incur costs in the regulation of the mining industry; and
- the incentive to develop the mining industry needs to be preserved.

### **Resource deposits are finite assets owned by the State**

160. As discussed earlier, resource deposits are the only state owned asset of which the proceeds of its sale is redistributed to other states. Consistent treatment with other assessments would have only the revenue component, not the capital component of mining royalties, subject to equalisation.

161. Identification of the capital and revenue components of mining royalties would be difficult, although the revenue could be approximated to the imputed interest accruing if the royalties were placed in a wealth fund (Ergas, 2012).

162. If this argument were accepted, even in part, the redistribution of mining royalties through the GST distribution system would be significantly reduced.

### **Governments incur infrastructure costs in the development of the mining industry**

163. The development of mining in Queensland has proceeded as a partnership of industry and government, with government playing an important role in the provision of economic and social infrastructure.
164. The cost to government of providing economic and social infrastructure can manifest itself in the forms of direct expenditure, opportunity cost and risk.
165. **Direct expenditures** can be significant. Over the last four years, the Queensland Government has spent the following amounts in mining regions and areas that have linkages to the mining regions:
- \$460 million on the construction and improvement of roads and bridges. These roads directly service the mining industry, both for the transport needs of the mines themselves and for the drive in/drive out workforce, and are not cost recovered.
  - \$730 million on health infrastructure, including the redevelopment of hospitals and health centres in mining towns, and expansions of hospitals and other health services in regional centres with links to the mining industry.
  - Around \$280 million for infrastructure in areas such as education, water, community safety, police and justice services to provide for regional population growth.
166. Over the same four year period, an average of \$2.8 billion per year was collected in mining royalties.
167. These costs are not temporary and are likely to continue as long as the mining industry has a strong presence in Queensland. For example, the Queensland Government recently announced a ‘Royalties for the Regions’ program to give back to the communities that support resource projects through three schemes:
- Resource Community Building Fund - to deliver improved community infrastructure such as education and health facilities, community centres and sporting facilities (\$170 million over four years);
  - Roads to Resources – to enhance the safety, connectivity and capacity of roads servicing resource communities (\$285 million over four years); and
  - Floodplain Security Scheme – to build levees, flood bypasses, flood mitigation dams, flood retention basins and other key projects to protect Queensland communities from flooding (\$40 million over four years, with \$40 million funding to be sought from the Commonwealth and \$20 million from local governments).
168. A portion of this expenditure would be related to factors other than the existence of the mining industry. For example, there may still have been population growth in those areas requiring additional infrastructure to support it, and some of the infrastructure represents service quality improvements rather than being industry or population growth driven. However, the importance to the mining industry of the availability of high quality social infrastructure should not be underestimated – while it may be high paid employment that initially attracts workers to mining regions (or, in the case of fly-in/fly-out or drive-in/drive-out workers, nearby regional centres), it is often the quality of the lifestyle that provides the crucial

incentive for them to bring their families and keep them there in the longer term. Overall, it is difficult to disentangle the components that underlie the reason for increased infrastructure provision as it requires knowledge of the counterfactual – the infrastructure requirement in the absence of the mining industry.

169. Although the current process includes an assessment of infrastructure costs, this is based on the relative growth of each state's total population. The direct costs of the mining industry and additional costs associated with regional population growth are not sufficiently taken into account.
170. At the same time, even where the Commonwealth Government provides funding for a project, under the current CGC methodology much of the funding is equalised away and so, effectively, the project remains predominantly funded by the state.
171. Some costs may also be recovered by the government over time if they are directly industry related. However, there is a real **opportunity cost** for governments in undertaking the initial capital expenditure. Governments face budget constraints and spending on mining related infrastructure means less infrastructure spending in other areas, including social infrastructure such as hospitals and schools. For many projects directly related to assisting mining industry development, such as land acquisitions for state development areas, the expected timeframes for cost recovery are extremely long (sometimes decades). The opportunity cost of this use of limited funds is a real cost to government and the community.
172. There are also **risks** associated with expenditure on this infrastructure that must be borne by government. The continuation of the mining boom is not guaranteed. World demand for Australian resources is dependent on a number of factors, including international economic conditions and the development of alternative suppliers. The risk faced by the large mining states is that the assumptions on which infrastructure planning was based fail to eventuate, leading to an over-allocation of resources to the mining regions and under-utilisation of infrastructure.
173. Costs associated with direct expenditure, opportunity costs and the risks associated with infrastructure provision are difficult to calculate for the purposes of a discount. In Queensland's case, the direct expenditure mentioned earlier probably represents an upper bound, but even allowing for the qualifications discussed above, and adding in the opportunity costs and risks associated with this spending, the overall infrastructure cost to government is substantial.

#### **Governments incur costs in the regulation of the mining industry**

174. Governments also incur significant costs in the regulation and management of issues related to the mining industry. As mentioned earlier, the mining industry interacts with a diverse range of Queensland interests, including the environment, (for example, the Great Barrier Reef), communities (for example, on residential housing and native title), and other industries such as agriculture and tourism. These issues need to be managed and the industry needs to be regulated.
175. The cost to the Queensland Government of administration for the mining sector was \$100 million in 2008-09, rising to \$120 million by 2011-12. This includes

departmental head office costs, planning and project costs and safety and health expenses.

176. As well as these direct costs, there is an opportunity cost to government – attention directed towards mining issues means that its attention is diverted from other issues. Governments – ministers and senior officials – face a time constraint as well as a financial constraint and therefore must set policy priorities. Without doubt, tending to issues related to the mining industry has been and will continue to be a major focus for Queensland.

**The incentive to develop the mining industry needs to be preserved**

177. The main benefits of the mining industry to the nation include:
- economic benefits, particularly increases in employment and wages; and
  - the government revenue from both mining royalties and the economy activity generated by the industry.
178. The economic benefits of the mining industry are shared across the nation. For example, even states without significant mining industries may benefit from higher demand for manufactured goods or financial and engineering expertise, and mining company shareholders live throughout Australia.
179. The Commonwealth Budget papers make clear that resources sector investment is expected to be a major driver of national economic growth for at least the next two years, and it is this economic growth that underpins the Commonwealth's projected fiscal surpluses.
180. However, in the case of state government revenue, the implications are more significant, with the resource owning state missing out on a substantial part of the increased revenue, despite being the owner of the resource.
181. First, the Commonwealth is a major beneficiary of revenues from the mining industry through company tax receipts and, from 1 July this year, the Minerals Resource Rent Tax and the extension of the Petroleum Resource Rent Tax.
182. Second, the HFE system equalises through GST much of the increase in royalties from an expansion of the revenue base, so if the government works to support an expansion of the industry, it only retains its population share of the increased royalties (about 20% in Queensland's case, 10% for WA and 1% for the NT).
183. Third, the economic growth benefits that would normally translate into higher revenues for the state in which the activity is taking place mostly accrue to other governments. The high level of vertical fiscal imbalance in Australia means that the Commonwealth government is the major beneficiary of this revenue windfall. Further, to the extent that the owning state's revenues, such as payroll tax, do grow, all but the state's population share is redistributed away through the HFE process.
184. While the costs to the government of supporting the development of the mining industry are apparent and significant, the HFE system diminishes much of the revenue benefit to the government. The risk to the national interest is that the HFE system reduces the incentives to a state government of supporting the development of the mining industry to such a degree that the industry will not receive the support that it should be receiving, to the detriment of the nation.

185. The policy neutrality issues discussed in the previous section, whereby mining states lose a significant part of the financial benefit from a royalty rate increase, create another incentive problem and the associated risk that mining companies will be undercharged for commercial exploitation of minerals and petroleum. A mining assessment discount would assist in reducing this grant design effect.

#### **A discount for the mining assessment**

186. At the present time, these four justifications for applying a discount to the mining assessment are not recognised in any way in the mining assessment.

187. In 2006, a Canadian review of their HFE system also considered the issue of whether a discount for mining was appropriate. Their conclusion was that a 50% discount for mining revenues was appropriate and a 50% discount is now incorporated into the Canadian HFE system. (Refer Box 5.1.)

188. It is important to note that the Canadian review gave weight not only to tangible and quantifiable factors, but also to the intangible and unquantifiable factors faced by the governments of the mining provinces in determining a discount. This may require the application of judgement in assigning weights to these components. However, to give little or no weight at all to factors such as resource ownership, opportunity costs, bearing of risk and the need to maintain appropriate incentives would undoubtedly be a gross underestimation of their significance.

189. Queensland believes that the Canadian's 50% discount to reflect the range of factors facing a mining state in the development of its resource industry is a good benchmark for consideration of a discount for the mining assessment in Australia.

190. Queensland and Western Australia share this view for the need for the introduction of a discount for the mining assessment.

#### Shared Position of Queensland and Western Australia

Queensland and Western Australia each consider that the equalisation of mining revenues is especially in need of reform.

Reform should include a substantial discount being applied to the mining revenue assessment, partly to recognise currently unequalised costs of enabling or supporting mining production (including infrastructure costs), but also to:

- preserve incentives to develop the mining industry and price minerals appropriately (these are currently diminished by the large redistribution of increases in royalties);
- provide increased capacity to help facilitate economic structural adjustment, in the national interest; and
- recognise issues associated with resource deposits being finite assets (owned by the States).

NSW, Victoria, Queensland and Western Australia jointly propose the GST be distributed on a population share basis, with the Commonwealth taking responsibility for funding the additional financial assistance required for states with lower fiscal capacities to ensure no state is worse off.

In the absence of this reform, Queensland and Western Australia propose the discount for the mining assessment be set at 50%, consistent with the Canadian fiscal equalisation system.

### **Box 5.1 Canadian treatment of natural resources**

In 2005, Canada established a panel to address key questions about the future of Canada's equalisation program. Based on consultations and a technical analysis, the panel prepared a package of recommendations to improve the Canadian system. These recommendations were adopted as part of reforms to the equalisation program in 2007. As part of this review, the panel investigated issues around the treatment of natural resources in the equalisation program (Finance Canada, 2006).

Canada reasons that the equalisation program should be structured to ensure that incentives are in place to support the development of resources by provinces. The dollar-for-dollar reduction in equalisation (that would result from full inclusion) clearly reduces a government's incentive to support resource activity.

In order for the equalisation program to accurately reflect the net provincial revenues that are left after incurring the costs associated with resource development, and to ensure that provinces have the incentive to invest money to support resource development, it is argued that the inclusion rate of natural resource revenues should be less than 100 per cent (Finance Canada, 2006).

The panel recommended a 50% discount on mining revenues for the following reasons:

- Constitutionally, provinces own the natural resources within their borders, and choose how they are developed. Other assessed sources of revenue are owned privately and taxed by the government. As owners, they should receive a net fiscal benefit from those resources. The workings of the equalisation program should not compromise this fundamental principle.
- Provinces that benefit from natural resources face considerable uncertainty due to large swings in prices, wide variations in costs of production, uncertainty over the potential volume of production, and significant changes in profitability.
- Public costs in providing necessary infrastructure to develop natural resources and monitoring and regulating environmental impacts.
- Policy neutrality - the equalisation program should not provide incentives or disincentives for provinces to develop natural resources or adjust their royalty programs.

## 5.5 REJECTING A RELATIVITY FLOOR

### *Panel's view:*

*While the Panel sees merit in exploring approaches that lead to increased predictability and stability in the distribution of GST revenue, it considers that there is no compelling case for adopting a floor at present. Moreover, a relativity floor of 0.75 would cause a major disparity in the fiscal positions of the States in the very near future.*

*On the other hand, 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), could increase stability without such extreme consequences.*

### **Queensland response:**

**Queensland agrees that there is no compelling case for adopting a relativity floor, and does not support the limiting of reductions in states' GST payments if this is at a cost to other states. If there is a problem with the GST distribution methodology then the flaws should be rectified rather than arbitrary floors being introduced. Queensland believes that rectification of the mining assessment would solve many of the concerns that are giving rise to calls for a relativity floor.**

191. Queensland agrees there is no compelling case for the introduction of a relativity floor, a proposal that implies that the current system is irrevocably broken.
192. Queensland believes that this option has been proposed as a substitute for fixing the disproportionate redistribution due to the mining assessment. Instead, the flaws with the mining assessment should be addressed directly. The mining discount and the single rate system proposed by Queensland in this submission are practical solutions to both the causes and the symptoms of the flawed mining assessment.
193. Queensland does not support a system where states cannot receive a share of GST that is lower (in nominal terms) than its share in the previous year, if that is at a cost to other states. Such a system would be arbitrary, and inconsistent with states' assessed GST requirements.
194. If stability is the aim of such an approach, the method could be adjusted to ensure that states receive appropriate shares of GST over time. For example, if a state is assessed as requiring a nominally lower share of GST than in the previous year, that state could receive additional funding from the Commonwealth to offset the decrease. The Commonwealth could choose to come to an agreement with the benefiting states on the timing of the repayment of the additional funding – for example, over a two to three year period. This would assist stability without making arbitrary adjustments to GST shares.
195. An alternative approach to increasing stability in state GST revenue would be to focus on the GST pool rather than changes in individual state GST revenues. A GST revenue floor could be applied that ensured that the total GST pool distributed to States by the Commonwealth did not fall either in nominal terms or below a set real growth rate compared with the previous year. By virtue of its larger scale and stronger revenue raising capacity, the Commonwealth is in a

better position to weather downward fluctuations in GST revenue collections than the states.

## 6. THE CAPITAL ASSESSMENT

### 6.1 CAPITAL – SIMPLIFICATION

*The Panel's view:*

*The Panel agrees that the capital assessments could be simplified. However, these issues are of a methodological nature and the CGC would be the appropriate body to consider how to further simplify these assessments.*

**Queensland response:**

**Queensland supports the current capital assessments, which recognise that population growth is the key driver of states' needs for new infrastructure. The population growth parameter is one of the simplest of the Commission's assessments.**

196. Queensland supports the current capital assessments, which recognise that population growth is the key driver of states' needs for new infrastructure. Population growth dilutes a state's given capital stock and is generally seen to be the primary driver of the demand for new infrastructure. For a state with high population growth to maintain the average level of service provision and infrastructure per capita it will require additional capital funding. States require comparable per capita stocks of physical assets to have the same capacity to provide services.
197. Equalisation must recognise the demands of rapid population growth on new infrastructure delivery. A major cause of Queensland's need for new infrastructure is population growth.<sup>2</sup> Queensland's growth has been above the national average for some time, and has placed increasing demands on Government to invest in infrastructure. It is necessary to fund a range of new infrastructure, from building new road and transport links to ease Queensland's burgeoning congestion issues, to delivering water and energy supplies and a number of other essential public services.
198. Queensland considers the current methodology of the capital assessment adequately identifies the demands that rapid population growth places on states and the need for infrastructure investment to keep pace with population growth. Queensland supports the current direct assessment as it appropriately delivers funding in a timely and contemporaneous manner that provides states with funding when it is most needed, namely when non-replacement or new capital has to be physically built or purchased. Equalisation is best achieved by providing states with above average capital needs with funding at the time that capital costs are incurred. This direct assessment methodology best reflects what states do.
199. The application of the population growth parameter to investment and net lending is arguably one of the simplest of the Commission's assessments. Complexity (in so far as it exists in the capital assessments) arises from the application of cost and stock disabilities, which are designed to approximate the impact of other factors, such as socio-demographic composition and location, on infrastructure. These are

<sup>2</sup> Another is growth in the mining industry, which was discussed earlier. Recognition of the infrastructure needs required for the mining industry should be reflected in a discount to the mining assessment.

calculated by aggregating the disabilities of recurrent expenditure categories, and are only applied to the infrastructure assessment.

200. There is therefore no simplification benefit of moving to a net worth/holding cost approach. The disabilities recognised by the cost and stock factors would be equally necessary under both methods. If greater simplification is to be achieved in the capital assessments, efforts need to focus on the parts of the assessments that are actually complicated.
201. Further, unlike the current model, a net worth/holding cost approach would rely heavily on assumptions for factors such as the holding cost rate. This kind of approach was examined at length during the 2010 Review but the current method was preferred because it provided a higher level of reliability, robustness and contemporaneity.
202. It is possible that an investigation by the CGC would find areas where the capital assessments could be simplified. Potential means of simplification should be analysed against materiality and reliability criteria, similar to other expenditure assessments.
203. Queensland's view on the simplification of expense assessments (that is, that reliability and materiality should be considered together) also applies to the capital assessments.
204. The reliability and materiality of the cost and stock disabilities should be considered relative to those of expenditure categories and the capital methodology reviewed on that basis if necessary. Queensland does not support making adjustments to the capital assessment purely on the basis of simplicity if these factors are found to be both highly reliable and material.
205. In Queensland's view, these factors are based on data that are comparable and highly reliable. A potential area for the improvement of cost and stock factors is the strength of the link between recurrent and capital expenditure – an assessment that calculates capital-specific disability factors may increase reliability. However, such an approach would be more likely to increase than reduce complexity.

## 6.2 CAPITAL – EQUALISATION OF COMMONWEALTH PAYMENTS

*The Panel's view:*

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

**Queensland response:**

**Lengthening of the averaging period is unnecessary. The predictable impact of Commonwealth payments on a state's GST distribution in combination with the use of a three year averaging period achieves an acceptable trade-off between of contemporaneity and stability.**

206. It has been suggested that equalising capital payments over a longer period would assist in reducing the volatility of the GST distribution. However, this overlooks that the impact of Commonwealth payments on a state's GST distribution is predictable since the receipt of Commonwealth capital payments are known. This in combination with the use of a three year averaging period achieves an acceptable trade-off between contemporaneity and stability.
207. Queensland is concerned that changes to the treatment of Commonwealth payments may be used to justify similar changes in methodology in the broader capital assessment. Queensland would oppose any changes to the capital assessment that would equalise new capital over the life of the assets. For the assessment to properly recognise state capital needs, equalisation needs to occur as close as possible to the period when the expense or payment occurs.

### 6.3 CAPITAL – NATIONALLY SIGNIFICANT INFRASTRUCTURE

*The Panel's view:*

*The Panel recognises that the current assessments do not recognise all the complex and multi-faceted factors that influence State infrastructure spending. This is more likely to create problems for infrastructure projects that seek to deliver national benefits or outcomes rather State specific benefits or outcomes. However, a difficulty with excluding these payments is that a satisfactory process to identify eligible projects does not currently exist. While the Infrastructure Australia priority list is a useful starting point, it cannot be regarded as a comprehensive list of all nationally significant projects.*

*The Panel sees potential in excluding capital payments for nationally significant infrastructure projects provided a workable process for identifying eligible projects could be developed.*

**Queensland response:**

**There may be a case for excluding some Commonwealth capital payments from the HFE process on the basis that they are to provide projects of national significance. However, any decision as to the national significance of a project should reflect the intentions of COAG. As such, the CGC may not be best placed to make a determination.**

208. The identification of nationally significant projects is likely to be highly subjective and controversial.
209. There may be conceptual merit in excluding Commonwealth capital payments for nationally significant infrastructure. Such projects may not directly relate to individual states' fiscal capacities, but to national initiatives which have been given priority by the Commonwealth. Some allowance for this is already made by the CGC in the capital assessment, where Commonwealth payments for roads that form part of the national network have only a 50% impact on relativities.
210. Identifying such payments is likely to be problematic. There does not appear to be a simple indicator as to the national significance of projects readily available, and Queensland agrees with the Panel's view in the interim report that the Infrastructure Australia priority list would be insufficient for this purpose. Decisions as to whether projects are of national significance should reflect the

intentions of COAG, as well as a variety of other criteria such as the level of economic benefit to the country as a whole.

211. It is likely that any criteria chosen to identify these projects will be highly subjective, meaning that decisions by the CGC as to whether payments are of “national significance” will be a subject of controversy amongst the states.
212. It is also conceivable that many projects will be both nationally significant and have an impact on individual states’ fiscal capacities. In such cases a partial assessment (similar to that currently applied to national network roads) may be the most appropriate.
213. Given the level of subjectivity in determining the degree to which projects are nationally significant, and the need to reflect the intentions of COAG, Queensland does not believe that the CGC is best placed to make this determination. Queensland’s view is that by default, the CGC should continue to determine the most appropriate HFE treatment for payments using its general criteria (based on whether needs relating to the payment are assessed, and whether the payment impacts on fiscal capacities).
214. If a state believes that a capital payment it received related to a project of national significance, that state could seek a terms of reference directive from the Commonwealth treasurer for the CGC to exclude that payment from relativities. In this way, decisions could reflect the intentions of COAG.
215. If changes are recommended, implementation should be applied to new projects, not existing projects.

## 7. CONCLUSION

216. This submission responds to the Review's two interim reports by:

- noting that HFE hinders structural adjustment across the economy, but there are ways this can be addressed, particularly through reform of the flawed mining assessment;
- arguing that the current form of HFE redistributes too much of the GST and that the operational definition of HFE be amended so the load of supporting service delivery in the lower fiscal capacity states is shared between higher fiscal capacity states and the Commonwealth.;
- supporting the Panel's view that the best approach to tax reform is cooperative agreement. If required, there are better ways to provide incentives for agreed reforms than to use the HFE system;
- agreeing that the responsibility for determining the objectives of the GST distribution and the definition of HFE should be separated from the responsibility of interpreting and implementing HFE; and
- calling on the Panel to recommend that more be done to protect the base of the GST.

217. The current system for delivering HFE in Australia is in need of repair. Specifically, Queensland believes that the system is too complex and redistributes too much. The simplest and fairest way to distribute the GST is to do so on a population share basis. However, this requires the federal government to recognise that it too has a role to play in supporting those jurisdictions that have lower fiscal capacities by providing additional financial assistance to them, over and above the GST, so no state or territory is worse off.

218. A package of specific reforms is proposed that will help address the flaws in the GST distribution system if the preferred model cannot be adopted in the short term.

- i. Most importantly, reform of the mining assessment through the application of:
  - a single rate structure to replace the current two rate structure; and
  - a discount to the mining assessment to reflect the ownership of resources by states and the tangible and intangible costs to government of the mining industry, and to restore the appropriate incentives to governments to develop the industry in their states.
- ii. The application of a general discount to reduce the redistributive churn that currently takes place through the GST. The discount would be based on the current 'minimum effort' of states with respect to expenses, and would reflect acceptable standards and efficient delivery of services while still being based on what states actually do. The Commonwealth would provide additional financial assistance to ensure that no state is worse off.
- iii. Application of broad indicators to the revenue assessment based on household disposable income and a reformed mining assessment. Such an approach would better reflect the true economic incidence of state

revenues, while being simpler and more stable, and would reduce any impediments to states undertaking tax reform.

- iv. A paring back of expense assessments by removing those assessments that lack a robust evidence base and are marginally material, with a greater research effort directed at those remaining. This will engender greater confidence in a simplified, more robust and more comprehensible set of expense assessments.
219. Queensland believes this is a constructive reform agenda that will deliver real benefits not only to the individual states and territories but to the nation as a whole.

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