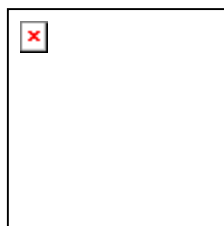




AUSTRALIAN CAPITAL TERRITORY

SUBMISSION TO THE COMMONWEALTH GRANTS COMMISSION'S STAFF DISCUSSION PAPER 2006/07: *DISAGGREGATING REVENUE*

October 2006



INTRODUCTION

The 2005 Ministerial Council (MinCo) accepted the Heads of Treasuries (HoTs) recommendation for the Commonwealth Grants Commission (the Commission) to undertake work on simplification of the methodology used to determine the annual GST relativity, consistent with the existing equalisation principles during the 2010 Review process.

The agreed Terms of Reference (ToR) directed the Commission to undertake work on simplification utilising a number of options, namely through:

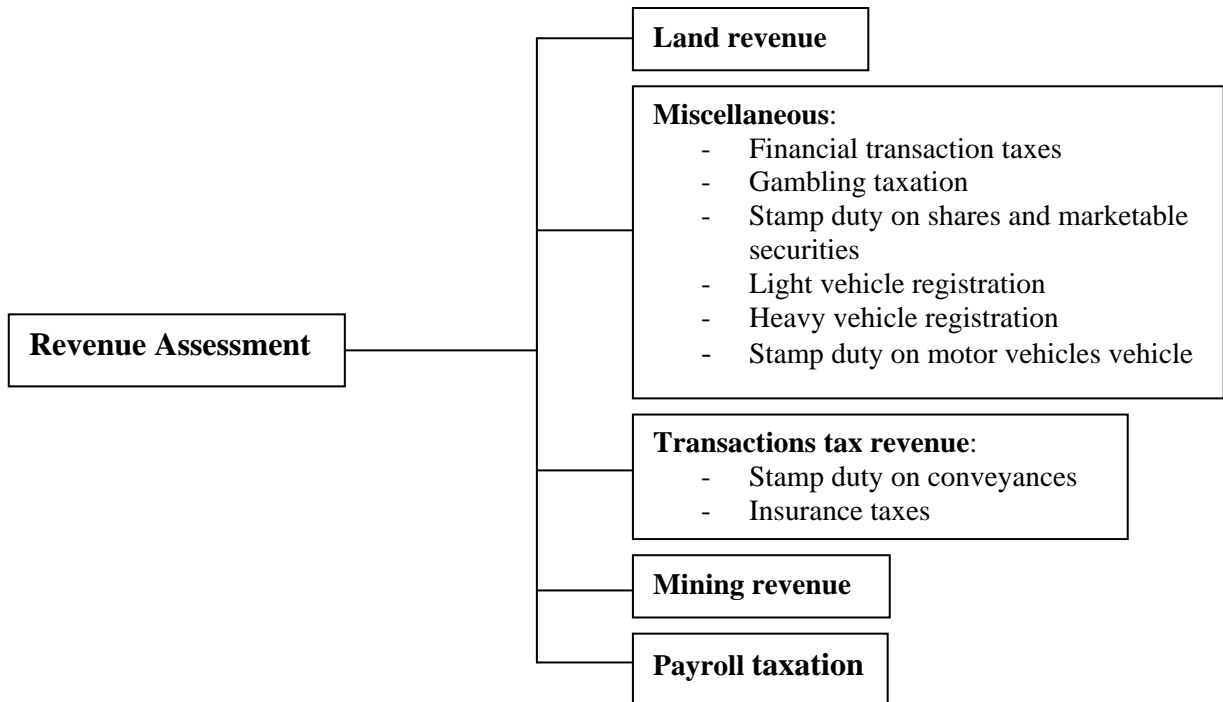
- aggregating existing assessment categories, components, and factors;
- eliminating category assessments found unreliable due to unsatisfactory data or methodology;
- reviewing the scope for the use of more general indicators of revenue capacity; and
- applying a materiality threshold to current and future assessments.

Of particular note, the ToR did not specify a target level of category aggregation, leaving greater scope for further deliberation as to what an appropriate category structure should comprise. In fact, the ToR specifically states that aggregation should only be undertaken provided that to do so would be consistent with fiscal equalisation. The ACT has taken the ToR to imply that the achievement of equalisation should be the criteria for evaluating alternative levels of aggregation.

In 2006 the Commission presented a progress report to MinCo that outlined its clean slate top down approach it planned to take in its review of the current assessment category structure.

The proposed guidelines to the disaggregation process were presented to States in the Commission's Issues Paper 2006/02 '*Approach to Disaggregation*'. The ACT response outlined continued support for the simplification of assessment categories whilst expressing the need to ensure the methodology achieves a comprehensive level of Horizontal Fiscal Equalisation (HFE).

The Staff Discussion Paper CGC 2006/07 '*Disaggregating Revenue*' presented the proposed structure of the revenue assessment as outlined in the below diagram.



Furthermore, the paper queried the States on their position relating to the:

- use of a global (single) measure such as Gross State Product (GSP);
 - further discussion during the disaggregation forum (held on the 7 September 2006) identified an additional approach using a composite of several global measures;
- use of a series of broad measures. Initially proposed is a category for:
 - income, such as labour, some or all factor incomes, or total income;
 - economic rent, such as from mining, gambling and possibly other activities; and
 - wealth, including all forms of private or natural economic wealth, such as land;
- use of a series of sub-global bases (top down disaggregation). Initially proposed is an assessment for:
 - income, limited to payroll tax revenue;
 - economic rents, limited to profitability type measures for mining;
 - wealth, limited to land tax revenue;
 - turnover values, limited to transfer values of property and vehicles, and insurance transactions;

- miscellaneous, including motor vehicle registration fees, gambling taxes, investment earnings, and other minor revenues to be assessed as equal per capita; and
- data sets to be used in the preferred category structure.

The proposed general category structure of 5 revenue assessments is broadly supported. However, removing motor vehicle related taxes from the miscellaneous revenues category and assessing this on a differential basis, thereby increasing the number of revenue categories to 6 is supported.

The submission has been structured along similar lines.

SIMPLE POLICY APPROACH TO CATEGORY STRUCTURE AND ASSESSMENTS

A top down approach to aggregation will by necessity be an iterative process, in that various levels of disaggregation will need to be tested for similarity of capacity measures and materiality to determine if aggregation is suitable. Because the standard budget data for revenue items are normally reliable, there is no undue pressure for greater levels of aggregation. Even if disaggregated assessments are not material according to the materiality guidelines, simplicity and transparency may still be enhanced by not aggregating. Simplicity may be better achieved by simplifying assessments rather than reducing the number of categories.

Aggregation by itself does not provide simplicity, given that even if the assessment bases used are the same, it may lead to more complex, less transparent assessments. Where adequate tax or expenditure data exists to allow separate identification of function or revenue lines these should be retained.

Consistent with the views expressed in the ACT's expenses disaggregation submission, it is critical that consideration be given to how average policy is specified, as this will determine the number and type of disability adjustments that should be made (and thus the extent of simplification that is achievable). The more broadly the average policy is specified the less adjustments that will be required. Throughout the paper this is referred to as the 'simple policy approach'.

As such, the Commission's preference to assess the revenue raising capacity (RRC) of each State at a broad level, such as by using sub-global measures, is supported. By way of an assessment structure, it makes sense for the assessments to be based on the highest common policy between jurisdictions *that achieves HFE*, rather than adjusting to incorporate intricate policy differences when assessing each State's RRC.

This simple policy approach sits comfortably with the suggested options put forward in the Staff Discussion Paper *Disaggregating Revenue*. It increases simplification through the assessments themselves rather than specifically dictating overall category structure, in that this approach moves away from making threshold, exemption, and value distribution adjustments (VDA). Not only will this simplify the assessments, it will remove concerns with the data reliability problems of VDA adjustments particularly for land tax.

To illustrate a simple policy approach, the assessment of land tax revenue could take into account the entire land endowment of each State (thereby assessing primary residential, non primary residential, rural, agricultural, and commercial and industrial), with the various land tax exemptions treated as policy differences.

Naturally, a trade-off between what States do and simplicity needs to be made. The move towards simplicity is reasonable if:

- a simple average policy is consistently applied to both the revenue and expenditures sides of the equalisation process; and
- it achieves HFE (consistent with the 2010 Terms of Reference).

ECONOMIC EFFICIENCY

Broader level suggestions that HFE is a disincentive to pro-growth policies such as infrastructure development and deregulation is rejected as they are not supported by the facts.

All governments seek to maximise the economic growth potential of their jurisdiction by undertaking reform and infrastructure investment as they deem necessary.

There appears to be an undue concern that existing revenue assessment methods provide incentives for some jurisdictions to alter their tax policies to influence their shares of GST revenues. While it may be technically possible for jurisdictions to have a limited influence over its relativity, there is no evidence to indicate that in practice this is done. In fact, the evidence would suggest the opposite – that is, jurisdictions frequently change tax policy in a way that adversely impacts on their revenue shares. The impacts, either positive or negative, are immaterial and this is why States do not set out to ‘game’ the system.

It should be noted that the OECD, in its recent report *‘Economic surveys: Australia’*, did not find the current interpretation of Horizontal Fiscal Equalisation (HFE) to have a negative effect on Australian economic efficiency.

USE OF GLOBAL MEASURES

In terms of the two distinct proposed global measures, this submission addresses the single global measure (as documented in the discussion paper) and the composite global measure based on regression analysis (as discussed at the disaggregation forum on the 7 September 2006) separately.

Single global measure

The Discussion Paper’s conclusion that global measures fail to capture the relative RRC of the States is supported. Data problems are inherent in global measures such as Gross State Product (GSP) as they do not:

- reflect actual activity – for instance in the case of the ACT:

- a relatively large level of Australian Government activity is allocated to the Territory, particularly, defence salaries and non-defence expenditure even though the activity occurs elsewhere in Australia or overseas;¹
- the inadequate construction of the Territory State accounts by the ABS, and consequently Gross State Product (GSP – which is derived from State accounts), occurring as a result of poor data quality relative to other larger States; high standard errors; and large frequent revisions due to a small number of survey respondents;
- reflect actual policies of the States and differences in the propensity of individuals to engage in taxable activities; and
- take account of the problems associated with highly mobile taxes.

Conversely, in terms of determining an assessment structure, conceptually, a State's capacity to raise own source revenue should be based on a number of drivers, namely;

- the underlying industry structure and characteristics of each State's economy;
- economic factors, such as volume of transactions; and
- natural advantages and wealth endowments, such as mineral deposits and property values.

Within this framework, the ability of States to raise revenue from specific taxable activities differs greatly between jurisdictions. Global measures fail to account for the differing revenue drivers and the changing importance of these individual drivers throughout time. External influences, such as the proportion of Australian Government employment in the labour force, play a large part in determining State own source revenue and should be reflected in the assessment methodology.

Furthermore, changing market conditions can effect State revenue collections disproportionately to the relative changes in global measures. A prime example is mining revenues. When commodity prices shift, royalty collections for those jurisdictions with large endowments change accordingly, however, this change may not be proportional to changes in broad indicators such as GSP.

Composite global measure

A composite global measure approach, which uses regression analysis to determine which global measures provide the closest fit to previous assessment results, is not supported.

In the search for broader/simpler indicators it is tempting to adopt some general relationships which may work for most jurisdictions but conveniently ignore any outliers. However, it is the 'outliers' that fiscal equalisation is designed to address.

¹ To allocate defence salaries and defence other, the ABS use the ratio of defence employment numbers by state, to total employment numbers. This means the ACT is allocated around 14 per cent of total defence salary expenditure. To allocate all non-defence Australian Government expenditure, the ABS use the ratio of civilian gross salary earnings by state to total civilian gross salary earnings, meaning the ACT state accounts get credited with around 24 per cent of all non-defence Australian Government expenditure.

That is, equalisation is about addressing the special circumstances that materially impact on service delivery costs or capacity to raise revenue.

A further concern involves how separate components will be weighted within a composite global measure. The current method for determining weights of a category, namely through applying standard revenue to individual assessment categories is supported. In contrast, the use of a composite global measure, which utilise weights derived from regression analysis, will significantly reduce the transparency of the revenue assessment. This is due to a heavy reliance on judgement in determining the weights of individual components within the composite global measure. Such a measure fails to capture the standard policy weightings of each major revenue stream.

The importance of maintaining a revenue equalisation methodology that is responsive to changes in the composition of State revenue collections should not be understated. Unless weights adjust automatically, the relative importance of an assessment, and therefore assessed State needs, will be eroded over time, leading to an assessment which fails to achieve HFE.

USE OF BROAD MEASURES

An assessment of RRC using broad measures is possible. Revenue assessments are well suited to broad measures as they identify broad policy neutral drivers to States' revenue collections whilst increasing simplicity and utilising robust data sources.

However, although this approach is less general than using global measures, the proposed three category structure, namely income, economic rent, and wealth, remain quite removed from the HFE pillar of what States do. More importantly, HFE is not achieved primarily because it fails to measure transaction generated revenue (such as motor vehicle registrations and insurance duties) directly.

On balance the use of broad measures within the proposed three category structure does not fully nor accurately capture the relative differences between States.

USE OF SUB-GLOBAL MEASURES

Disaggregation to the sub-global level is the preferred approach to revenue assessments.

The sub-global level of disaggregation provides a good foundation to capture the material differences between State RRC. Furthermore, the use of standard revenue policy to determine component weights is more reflective of what States do and responsive to change in policy over time compared to the proposed composite global measure.

A 'simple policy approach' is proposed as the basis of assessing State RRC. That is, viewing revenue policy at the highest common factor level (such as 'States levy payroll taxes'), rather than seeking to adjust for the minutiae of standard policy, such as standard exemptions and thresholds (which in many instances is just an 'average' of a number of different policies). Practically, this approach allows underlying

revenue bases to be assessed at a broader level and will significantly simplify the assessments.

PROPOSED DATA SETS FOR USE IN THE SUB-GLOBAL CATEGORY STRUCTURE

The challenge for all parties is to identify data that reasonably reflects the relative capacities of all jurisdictions within the proposed assessment category and whether it is robust in nature.

Payroll

The scheduled abolition of State taxes will remove most duties on financial transactions leaving payroll taxation revenue as the most significant form of own source revenue driven by income.

A ‘simple policy approach’ to assessing relative RRC of incomes involves identifying the predominant revenue raising method, namely payroll taxation, then measuring the revenue base, i.e. payrolls or some reasonable proxy, without making adjustments for differences in rates, thresholds or exemptions. This approach significantly reduces the complexity of the assessment.

Total State private sector wages (as currently used in the payroll tax assessment, sourced from *ABS Business Indicators 5676.0., tab. 19, June 2005 issue*) is the preferred data set for assessing relative differences in revenue raising capacity (attributable to income).

Total private sector wages closely corresponds to the revenue base readily available to States. The fact that all jurisdictions choose to exempt some portion of that base through the application of thresholds, exemptions and progressive rates should be treated as policy differences.

Mining

To maintain consistency throughout the entire methodology, the assessment of relative mining revenue capacity by measuring the revenue base then applying the standard revenue to determine the redistribution is supported. As a suggestion, initial consideration could be focused on using a value of production measure, such as *ABS cat no.8415.0. Mining Operations, Value of Minerals Produced*, although a number of shortcomings may need to be overcome in order to increase the reliability of the data.

Land tax revenue

Notwithstanding limitations in the available data, the proposed inclination to assess the entire revenue base exclusive of exemptions and thresholds is supported. This is consistent with a ‘simple policy approach’, which identifies the common policy of levying taxes on land, whilst considering the specific rates of taxation, thresholds, and exemptions as policy choice. In terms of developing assessments, this approach extends to removing value distribution adjustments.

Transaction taxes

To maintain consistency within the assessment methodology, a preference exists for using a measure of the underlying revenue bases available to States. Primary examples include total value of property transfers for measuring conveyance revenue and total insurance premiums charged for assessing insurance tax revenue.

Reliability of data and the added complexity of measuring two distinct revenue drivers within the one assessment method are significant constraints which will need to be overcome.

If these data constraints are insurmountable, the use of the land and payroll tax assessments as proxies for determining relative capacities in terms of transaction tax revenues could be supported.

Miscellaneous taxes

The aggregation of these taxes into a single category and, in the absence of a reliable measure, assessing revenue capacity using the EPC method is supported. However, in relation to motor vehicle tax and registration revenue, reliable measures of revenue capacity do exist and that these differ materially from EPC. Accordingly, a separate category for motor vehicle taxes and registration, as discussed below, is supported.

CASE FOR DIFFERENTIAL ASSESSMENT OF MOTOR VEHICLE TAX REVENUE

The rationale for a separate motor vehicle category is predicated on:

- the contribution of these taxes to the standard budget is considerable;
- the needs assessed for the taxes in question are material;
- consistency between the revenue and expenses assessments is required; and
- reliable data are available to assess a differential assessment.

The relative importance of the tax revenue generated by motor vehicle duties and registration charges equates to between 10 to 15 per cent of all State own source revenue, making them a considerable driver of State revenues.

The needs assessed for motor vehicle related taxes are important given that they range from -\$42.46 pc (WA) to +\$42.82 pc (ACT).² This is driven by large differences in the non-policy driven stock of vehicles and new sales of vehicles. The combined assessment of motor vehicle related revenue is material under the current 2006 Update assessment methods, in that it redistributed more than \$30 per capita to or from four jurisdictions, namely NSW, WA, ACT, and the NT.

Importantly, needs should also continue to be assessed because consistency is required between the revenue and expenses assessments. The assessment of costs

² Combined redistribution of Light vehicle registration fees and taxes, Heavy vehicle registration fees and taxes, and Stamp duty on motor vehicle registrations and transfers, 2006 Update, as reported in the Staff discussion paper 2006/07 *Disaggregating Revenue*.

associated with the stock of heavy vehicles on the expenses side,³ such as through the roads assessment (currently a greater per capita number of heavy vehicles results in greater road pavement maintenance), should be at least partly offset by the larger per capita revenues associated with the stock of heavy vehicles.

Under a simple policy approach States have common methods for levying taxes on motor vehicles, namely through taxes on new vehicle sales and annual registration charges.

The measurement of relative fiscal capacities can be undertaken in a number of ways at differing levels of complexity. However, in the context of determining an appropriate level of disaggregation, the use of motor vehicle stock as a starting point to craft an assessment based on broad indicators is supported.

The inclusion of individual vehicle weights within the assessment methods provides the most comprehensive approach, and is thus the preferred option. Furthermore, in the case of heavy vehicles, a standard charge exists (notwithstanding subsidies on the National Transport Research Centre charge provided by some States) and thus robust weights can be applied. However, it is conceded that in the context of simplification, the removal of individual vehicle weights, whilst still assessing each component by its standard revenue, would meet the simplification criteria.

It is suggested that a vehicle taxes assessment would require three components (heavy vehicles, light vehicles, and new vehicle sales), based on their standard budget contribution in order to achieve HFE. Without this component structure, differences between States in the mix of vehicle types would not be recognised, and HFE would not be achieved.

However, upon initial examination, the relative capacities applying to new vehicle sales would not appear to be materially different from those applying to the total stock of light vehicles. In this event, it may be feasible to combine these two revenue items and assess using the total stock of light vehicles, thus reducing the number of components to two (see table).

³ This could be assessed either directly through explicit, detailed disability factors, or implicitly by way of broad indicators.

COMPARISON OF THE IMPACT OF VEHICLE REVENUE MEASURES

| | NSW | Vic | Qld | WA | SA | Tas | ACT | NT |
|--------------------------|-----------|-----------|-----------|-----------|-----------|---------|---------|---------|
| Total Heavy Vehicles | 545,655 | 583,468 | 447,336 | 335,065 | 200,687 | 54,787 | 12,262 | 30,820 |
| Per capita | 0.0809 | 0.1168 | 0.1139 | 0.1680 | 0.1305 | 0.1132 | 0.0378 | 0.1533 |
| RRC (Volume only) | 74% | 107% | 104% | 154% | 119% | 104% | 35% | 140% |
| 2006 Update RRC | 69% | 111% | 115% | 144% | 117% | 99% | 27% | 139% |
| Total Light Vehicles | 4,734,096 | 4,045,191 | 3,252,118 | 1,782,239 | 1,333,396 | 432,228 | 244,747 | 124,090 |
| Per capita | 0.7015 | 0.8099 | 0.8284 | 0.8936 | 0.8674 | 0.8933 | 0.7541 | 0.6171 |
| RRC (Volume only) | 89% | 103% | 105% | 113% | 110% | 113% | 96% | 78% |
| 2006 Update RRC | 90% | 105% | 103% | 111% | 108% | 111% | 97% | 77% |
| New Vehicle Sales | 306,031 | 250,419 | 202,476 | 90,533 | 62,788 | 19,616 | 14,470 | 8,896 |
| Per capita | 0.0453 | 0.0501 | 0.0516 | 0.0454 | 0.0408 | 0.0405 | 0.0446 | 0.0442 |
| RRC (Volume only) | 96% | 106% | 109% | 96% | 86% | 86% | 94% | 94% |
| 2006 Update RRC | 90% | 104% | 111% | 121% | 85% | 91% | 79% | 97% |

In terms of data availability, the ABS collects robust data on the volume of new car sales and the vehicle stock across Australia. The key consideration is thus what level of detail is required to achieve HFE.

EPC ASSESSMENT OF GAMBLING TAX REVENUE

The ACT supports the proposal to aggregate ‘other’ revenues, subject to comments above regarding motor vehicle revenues, and to assess these on an EPC basis. In particular, the assessment of gambling revenues by EPC, while not ideal, would at least be an improvement on the existing method.

The current method for assessing gambling taxation, Gross Household Disposable Income (GHDI), fails to accurately reflect the propensity of various groups of individuals to gamble and thus relative State revenue capacities. As such, the finding that the GHDI measure “...provides at best a tenuous link between gambling propensity and taxing capacity”⁴ is supported.

The suggestions and inferences put forward by Professor Pincus⁵ for a more sophisticated and accurate gambling revenue base, combined with the assessment of socio-demographic influences are pertinent.

Pincus notes that gambling tends to vary with the aggregate income of consumers; the distribution of that income; and demographics and they should be taken into account as:

- the Productivity Commission results showed that the proportion of income spent on gambling varies inversely with income;
- SDC and geographic factors effect private spending on gambling; and

⁴ Staff Discussion Paper CGC 2006/07, Disaggregation Revenue, August 2006, page 24.

⁵ Jonathan Pincus, *Peer Review of Assessment Methodology for Horizontal Fiscal Equalisation*, January 2005, pages 9-10.

- the gambling tax assessment is currently inconsistent with the expense assessments as SDC and geographic factors are assessed in great detail on the expense side, but excluded from the revenue (gambling taxation) side.

The clear outcome of these suggestions is that a more sophisticated gambling revenue base is required to fully achieve equalisation.

This is consistent with past comments made by the ACT that the only way a differential gambling assessment could achieve HFE is for a detailed methodology (similar to the efforts put into other revenue assessments) to be developed that captures the different propensities of various groups to engage in gambling activities.

It is notable that CGC staff have previously suggested that: “...*a sound method would be too complex for the relatively small amount currently redistributed*”.⁶ In this context, an EPC based assessment is the most applicable approach.

⁶ Staff Discussion Paper CGC 2006/07, Disaggregation Revenue, August 2006, page 24.