NORTHERN TERRITORY VIEWS ON CGC ISSUES PAPER 2006/07

DISAGGREGATING REVENUE

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COMMONWEALTH GRANTS COMMISSION
GENERAL REVENUE GRANT RELATIVITIES
2010 REVIEW

KEY POINTS

- The Commission's current revenue assessments are relatively straight forward and present a transparent picture of states revenue raising capacities.
- Perceptions that states do not pursue growth policies as a result of the Commission's assessment methodology are unproven and unrealistic.
- The current tax-by-tax approach which measures actual tax bases as defined under state tax legislation best reflects the relative capacities of states to raise revenue.
- The Territory strongly supports the retention of 'what states do' as a pillar of horizontal fiscal equalisation and does not support a move to a 'what states could do' approach.
- An approach that disregards thresholds and exemptions would not be consistent with assessing relative capacity. It would also not recognise state sovereignty in determining tax policy.
- A 'what states do' approach limits the potential for simplification of category structure but promotes much greater transparency.
- Global and sub-global indicators are poor measures when vertical fiscal imbalance exists and tax bases are not aligned with sub-global measures. This issue is particularly evident in the Territory.
- The Territory supports the Commission's conclusion that global indicators fail to differentiate between the capacity of the community to pay taxes and the capacity of state governments to raise taxes.
- Simplicity does not necessarily require fewer categories. It is unclear that the proposed five category structure will, of itself, simplify the assessments. The structure has the potential to significantly reduce transparency of the Commission's assessments.
- The use of sub-global bases in a policy-free and comprehensive manner suffers similar limitations to measuring revenue capacities through broad measures.
- Current and future tax reform at the state level will inevitably see further simplification of revenue assessments through the abolition of additional relatively minor state taxes and policy harmonisation.
- The Territory considers that simplification can be achieved through reviewing current methodology and through the application of materiality thresholds which will involve aggregation of smaller taxes.
- If a miscellaneous category is included in the final structure, any material disabilities should be assessed on merit rather than an assumption that equal per capita is appropriate.

INTRODUCTION

The Commission has sought state views on a top-down approach to disaggregating revenue categories. The top-down approach seeks to simplify and improve reliability of assessments.

This submission broadly follows the structure of the Commission's paper and responds to questions that the Commission has sought specific State comments on. The views contained in this submission are qualified to the extent that the category structure is yet to be finalised and methodology to calculate assessments is yet to be determined.

In addition, the Commission's approach to category structure appears to be heavily influenced by regression analysis that has not been made available to states. Particular concerns with regression analysis include, suitability of coefficients, whether such models can capture all material differences, and the inconsistency with the pillar 'what states do'.

Consequently the views expressed in this submission are not necessarily indicative of a final Territory position.

ALTERNATIVE APPROACHES TO DEVELOPING THE SCOPE AND STRUCTURE OF REVENUE ASSESSMENTS.

To what extent would the approaches suggested in the Issues Paper:

- *Reduce the perception in some quarters that equalisation creates disincentives for adopting pro-growth policies in some states?*
- *Improve economic efficiency in any manner?*

The Northern Territory agrees with the broad framework that, given primacy of equalisation, any alternative category approach should seek minimal disaggregation, be simple and have reliable and robust methodology.

However, the Territory considers that any alternate methodology should continue to be based on actual tax practices of states (i.e. what states do) which is consistent with the three pillars of horizontal fiscal equalisation. The Territory does not consider that any changes to the three pillars are appropriate.

Using the pillar of 'what states do' provides some limitations as to the level of simplicity that can be achieved while maintaining the primacy of horizontal fiscal equalisation. A move towards an approach that reflects 'what states could do' effectively disregards a range of thresholds and exemptions determined by states as reflecting an appropriate policy mix. A 'what states could do' approach would effectively place the Commission as arbiter of states taxation policy by ignoring policies across all states in preference to an external standard.

The Territory's views in relation to disincentives for growth and economic efficiency were outlined in its response to the Commission's issues paper 2006/03 but are restated below for completeness. The Territory does not consider that the Commission should base its assessments around unproven perceptions that states do not pursue growth policies as a result of the Commission's assessment methodology.

The benefits of economic growth are widespread and generally supported in the electorate. If one state's growth rate is higher than in other states, additional benefits (such as increased business investment and a relative decrease in unemployment) may also accrue. For these reasons, governments in any jurisdiction would not implement policies that aim to hinder economic development over the long term and are likely to prioritise the encouragement of economic growth (through reform and other mechanisms) above virtually all other considerations. Further, the Territory is unaware of any empirical or practical evidence that exists to support the perception in some quarters that states may be impeding economic reform in order to maximise GST revenue.

The Territory believes criticisms of the current approach significantly overstate any potential negative economic impact thereof and discount its economic and social benefits, which also promote increased output. Queensland's submission in response to 2006/03 also refuted the claims more generally that horizontal fiscal equalisation acts as a drain on economic growth.

APPLYING THE ASSESSMENT FRAMEWORK – TOP DOWN

GLOBAL ASSESSMENTS

States may wish to comment on the conclusion that a global revenue approach should not be adopted

The Territory supports the Commission's conclusion that neither equal per capita or actual per capita assessments are appropriate tools for an aggregated revenue category. This reflects the broad differences in capacities to raise revenue and policy differences between states. However, this would not preclude the use of either tool for a disaggregated category where it was demonstrated to be consistent with equalisation.

The Northern Territory supports the Commission's conclusion that a global revenue approach should not be adopted. Global measures do not align with actual tax bases which are often influenced by vertical fiscal imbalance. This issue is particularly evident in the Territory where Gross State Product is strongly influenced by off-shore oil and gas activity. The revenue base related to this activity is the Australian Government's not the Territory's. Many sub-global measures, particularly those that are income related, better reflect Australian Government tax bases rather than state tax bases.

Global indicators attempt to measure states' revenue capacities using broad measures of economic activity and fail to differentiate between the capacity of the community to pay

taxes and the capacity of state governments to raise taxes. This distinction is critical to equalisation as political realities often limit the theoretical taxation possibilities implied by global measures. The disconnect between global measures and what states do or even what states can do, has a material impact on revenue capacity. Further, the Territory has concerns about the volatility in outcomes, which may result from such an approach due to the large standard errors associated with some Territory related data. Differences in the ability of states to tax off-shore versus on-shore developments also make it difficult to use global indicators.

FURTHER DISAGGREGATION AND MEASURING REVENUE BASE

Whether broad measures of revenue capacities would on balance meet equalisation objectives. States are also invited to indicate what broad measures might be examined.

The proposed disaggregation of revenue into five categories and the possible approaches to measuring the revenue bases

Does the five category structure achieve simplification?

Using the top-down approach and focusing on minimal disaggregation the Commission tests a range of broader bases relating to measures such as income, economic rent and wealth. These have then been further disaggregated into a five-category revenue structure, including income, economic rent, wealth, turnover values and miscellaneous, which is suggested as a suitable starting point for category structure. Either global measures or sub-global measures could be used to determine a revenue base.

The proposed category structure would still assess payroll, mining and land taxes separately but would combine stamp duties on property, vehicles and insurance under a turnover values category and combine the remaining taxes including gambling taxes and motor vehicles registration fees into a miscellaneous category to be assessed on an equal per capita basis.

However, it is unclear how a basis for disaggregation that does not directly reflect the legislative tax framework offers any significant prospects of simplification.

For instance, under the proposed transaction taxes category, a series of calculations could be required to calculate revenue bases for each of conveyancing, motor vehicle and insurance duties, which would then be combined to form a larger category.

It seems illogical to have an aggregated category structure such as turnover values which weights together separate broad indicators of sub-global bases such as conveyance and insurance duties to calculate a total category factor as this would be aggregation in presentational form only. Therefore, in the absence of a single broad indicator for turnover values, the proposed structure would need to be disaggregated further.

Graph 1 shows that each of the taxes appears to respond to different drivers. Thus it is unlikely that a single broad indicator will be found for this category. In a single category

structure, it is likely that weightings would change between years given that the drivers are different and regression analysis could also be problematic in that co-efficients are unlikely to be stable given relatively short time periods for analysis.

The application of assessed capacities of other broad based taxes such as land and payroll tax to the transaction tax base is also questionable given the lack of similarity in drivers. Graphs 1 and 2 demonstrate the changes in actual tax revenue and tax bases for the Territory and at a national level from 2000-01 to 2004-05. The results clearly illustrate the disparities in the underlying drivers of payroll, land and other taxes.

It should be noted that motor vehicle duty on its own would not pass the Commission's materiality tests. It may be more appropriate to include this taxation in a separate category of miscellaneous taxes which are relatively small and do not redistribute significant amounts of GST.

The Territory does not support the broad statement that the miscellaneous category be assessed on an equal per capita basis. The category should be assessed on its merits with material differences between states reflected in any assessment.

Use of legislated tax base

The Territory strongly supports the use of detailed tax bases in a tax-by-tax analysis, which reflects 'what states do' in terms of actual tax bases, tax rates, thresholds, exemptions, concessions and rebates. This approach offers the simplest, most accurate and transparent depiction of states' revenue raising capacities.

It also has the advantage of having a large volume of readily available, comparable, reliable and robust data. Therefore, the Territory strongly supports the continued use of the tax-type structure as it facilitates greater transparency and accords with the pillar of what states do.

The Commission acknowledges in paragraph 16 on page 6 that detailed tax bases have a better potential than broad indicators to reflect and track changes in what states do in terms of actual bases, rates, thresholds, exemptions, concessions and rebates.

The Territory acknowledges the data comparability and consistency difficulties inherent with an individual tax-based approach and supports the use of proxy tax bases where actual tax base data is unreliable or overly policy contaminated. It should be noted that there is currently broad agreement at the state government level for harmonisation of state tax legislation. This may result in improved comparability between jurisdictions in terms of how bases are defined and what concessions and rebates are applicable. If successful this would diminish potential policy contamination and enhance the attractiveness of using actual tax bases in the Commission's assessments.

Use of broad indicators

The Territory considers that broad indicators generally fail to capture differences in revenue capacity between states. This is illustrated by the following examples.

A broad indicator of conveyancing duties which is based on a sub-global measure of the notional rather than actual tax base would ignore differences in the distribution of property values between states. States generally apply a progressive tax structure to these transactions which results in states with larger proportions of relatively high value transfers experiencing a revenue capacity advantage. A measure which does not account for this incorrectly assumes the value distribution of Tasmania's housing stock is similar to that in New South Wales.

An indicator of payroll tax which is based on a sub-global measure of the notional rather than actual tax base would ignore exempt entities in the public sector when calculating revenue capacity. There are substantial differences between states in terms of the ratio of private to State or Australian Government enterprises which materially influences states' abilities to raise payroll tax. For example, in the Australian Capital Territory the Commission estimates that around 43 per cent of compensation of employees' expenses is attributable to the private sector compared to 82 per cent in New South Wales and 80 per cent nationally.

As acknowledged by the Commission, broad indicators move away from what states do and are less robust in reflecting changes in revenue capacity at times of rapidly changing patterns of economic activity or tax systems. The inability of broad indicators to track changes in economic activity is of particular concern given the recent property and mining booms that have occurred in various states and their material impact on state budgets. It is also unclear how broad indicators would capture the effects of further abolition of state taxes as proposed by various jurisdictions. An assessment which is unable to capture the effects of changes in economic activity or tax policy would seem to serve the principles of equalisation poorly.

Options for simplification

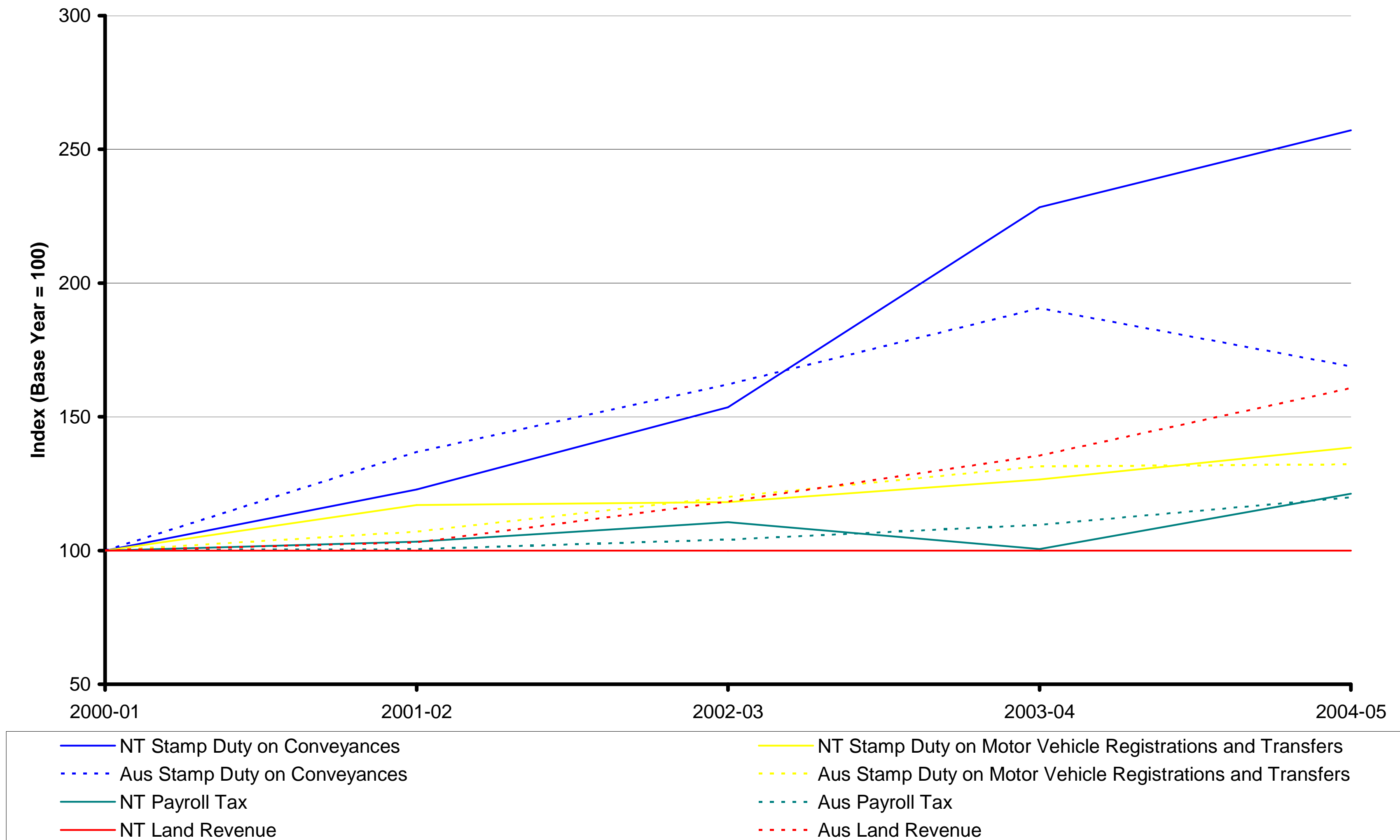
Current and potential future tax reform at the state level will inevitably see further simplification of the assessment process through the abolition of additional state taxes. However, the greatest scope for simplification of the Commission's revenue capacity calculations lies within the individual methodologies behind the existing assessments. Some grouping of taxes that fall beneath the materiality thresholds may also be appropriate.

The proposal to assess taxes using sub-global bases in a policy-free and comprehensive manner would result in all adjustments to the tax bases made by states being interpreted as policy decisions. The approach suffers similar limitations to measuring revenue capacities through broad measures discussed already in that it:

- would be based on what states could do and not what states actually do;
- implies states set tax policy according to these sub-global bases;
- implies that states are actually able to access the underlying tax bases (unless adjustments are made), for example, charge payroll tax on Australian Government or Local Government entities;
- ignores the rationale for the adjustments made by the states to their tax bases such as thresholds and concessions, which may have been designed consistent with the principles of good tax policy (which are highlighted in the Issues Paper).

Given the above issues the Territory does not support the use of broad measures to determine an aggregate revenue base and supports the continuation of the Commission's existing standardised legal incidence tax-by-tax approach.

Graph 1: NT and National Average Actual Tax Revenues from 2000-01 to 2004-05



Graph 2: NT and National Average Tax Bases from 2000-01 to 2004-05