



COMMONWEALTH GRANTS COMMISSION

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GLOBAL REVENUE ASSESSMENTS

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INTRODUCTION AND ISSUES

1. In their submissions to the 2004 Review, New South Wales and Western Australia proposed that the Commission assess revenue capacity by using a global approach instead of a tax by tax approach. The global approach, first proposed in the 1981 Review, raises the key issue of what horizontal fiscal equalisation (HFE) aims to achieve. The HFE principle says that:

State governments should receive funding from the Commonwealth such that, **if each made the same effort to raise revenue from its own sources** and operated at the same level of efficiency, each would have the capacity to provide services at the same standard¹.

2. The principle is supported by three pillars which were outlined by the Commission at its Priority Issues Conference in September 2001.

- (i) **Capacity equalisation** — through the distribution of untied financial grants, HFE enables each State to provide the same level of services to its population: but there is no compulsion on States to match what is done elsewhere, there is no performance equalisation.
- (ii) **Policy neutrality** — a State's share of the untied grants is determined independently of its policies. A State's policies only have an impact on the average policies of the States and the financial standards that result from those average policies. A State's policies do not directly influence its measured revenue capacity or cost of service provision.
- (iii) **Internal standards** — the average revenue effort and the average standard of services of the States are the benchmark for all Commission assessments. Measured in either financial terms or in terms of average policies, they reflect what State governments actually do and are the points from which revenue bases or expenditure disabilities are measured. The Commission's assessments do not, either explicitly or implicitly, direct (or assume) that States will act in a particular way. To do otherwise would diminish the sovereignty of the States.

3. State governments are the entities being assessed. It is their capacity to raise revenue that has an influence on their measured fiscal capacities.

¹ *Report on General Revenue Grant Relativities 1999, Volume 1 Main Report*, Commonwealth Grants Commission, page 4. References to States should be understood to include the ACT and the Northern Territory.

4. In past Inquiries, revenue capacities have been measured tax by tax (or tax group)². Wherever possible, revenue bases have reflected the range of activities, transactions and assets that States actually tax as such bases capture the revenue raising advantages and disadvantages ('disabilities') that States face. In cases where a direct policy neutral measure of the legal revenue base is not possible, the Commission has used a broad measure that encompasses the underlying revenue base³ of the particular tax (it calls these sub-global measures). For example, in gambling tax the legal revenue base would be an indicator of gambling turnover, but it is not possible to measure turnover in a way that is free of the influences of the policies of individual States on what forms of gambling are legal and other regulatory (or promotional) policies. In this case, the Commission has used household income as a broad measure of the underlying tax base.

5. A global revenue approach reflects a view that a single broad measure could provide a good indicator of the capacity of States to raise revenue from the multiple and quite different revenue bases they actually use. It would seek to apply such a single measure irrespective of the relative importance of the different sources of tax actually being accessed in each State and the legal incidence of each tax.

6. A global assessment approach would imply that equalisation is about measuring the capacity of a community to pay taxes, whereas the present approach measures the capacity of State governments to raise taxes. The two approaches are based on different theoretical constructs.

THE 2004 REVIEW SUBMISSIONS

7. In their submissions to the 2004 Review, two States have encouraged the Commission to move to a global assessment of revenue capacities. New South Wales submitted that:

- (i) narrowly defined tax bases were not truly policy neutral;
- (ii) the tax by tax approach induced States to reduce taxes in areas of relative advantage and discouraged them from devising taxes that more efficiently tap their potential revenue bases; and
- (iii) revenue assessments should be independent of the particular structure of taxes adopted by States.

² Most federations use a tax by tax approach (often called a representative tax system) to measure capacity in their equalisation systems. For instance, the U.S.A. and Canada have about 30 separate revenue categories and measure revenue capacity in each by applying the average tax rate to an activity or asset type tax base.

³ The Commission uses a broad indicator of taxable capacity, similar to a global measure, where data limitations preclude the use of a tax base, or where it is impossible to measure the tax base in a way that removes the effect of differences between the average tax policy and the actual policies of the States.

As a global tax base, it proposed either population or a measure of the capacity of a State's economy to pay taxes, such as Gross State Product (GSP). In an earlier review, New South Wales had proposed an income measure⁴.

8. Western Australia submitted that by using mainly legal incidence bases, with their associated complexity and false precision, the Commission:

- (i) overlooked the importance of public policy choice in explaining States relative economic performances⁵;
- (ii) overlooked consideration of the underlying capacity to pay that governments took into account in framing tax policy;
- (iii) used policy-contaminated and otherwise suspect data in the major revenue categories and failed to adjust data for the effort of States to develop the bases; and
- (iv) wrongly assumed that the standard tax mix was applicable to all States, rather than a mix that reflected each State's circumstances and discouraged States from exploiting unused or under-utilised tax bases.

Western Australia proposed a single broad measure of the underlying potential of States to raise revenues, though it did not make a specific suggestion about what that measure should be. We note that, in its latest budget documents, it uses GSP as a measure of the relative capacities of the States.

9. No other State commented specifically on global revenue assessments and we believe they broadly support the current approach. Victoria supported a global approach in previous reviews, but now proposes a greater use of sub-global measures within the tax by tax approach. South Australia and the ACT expressly opposed sub-global bases and, by extension, a global assessment.

DISCUSSION

10. At the Priorities Issues Conference in 2001, the Commission stated its intention to interpret HFE in the way that was current when the States signed the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*. That position had the general support of a majority of the States.

⁴ The original proposal by David Collins started with household income less income tax paid by households plus undistributed profits of companies, income paid overseas on foreign investment in Australia, mining royalties, State and indirect taxes net of gambling taxes.

⁵ It cited opinions expressed in a study by Jeffrey Rae, *The Tasmanian Experience*, New Zealand Business Roundtable, January 2002.

11. The Commission's position implied that equalisation based on capacity to pay rather than capacity to raise revenue was thought to be inconsistent with the terms of reference for the 2004 Review. This ruled out a global approach to revenue assessments.

12. In any case, we think the tax by tax approach correctly focuses on measuring the capacity of States to raise revenue from the taxes they actually impose. It does so by choosing revenue bases that reflect the tax bases States use with the aim of ensuring that, as far as possible, the measure of financial capacity reflects the differences between States in the size of those bases. The definition of each revenue base takes account of the policies applied by the States — derived from their legislation, regulations and practices.

13. There are some difficulties in implementing the tax by tax approach. They arise because of difficulties of obtaining data to measure some tax bases in a way that ensures they are not affected by differences between the standard policy and the policy applied by individual States. However, on the whole, the tax by tax approach is pragmatic, non-judgemental and practical. It also accords with the third of the three pillars — it is based on internal standards which reflect what States do.

14. By contrast, a global approach may not equalise the capacity of State governments to raise revenue because the States may not be able to access their underlying global capacity using the instruments available to them. States cannot levy income tax or sales tax for example. New South Wales and Western Australia say that the current approach discourages States from devising innovative forms of tax,⁶ but they make no suggestions as to what those forms might be. In reality, the States do not have complete freedom to impose any tax they may wish and have a very narrow range of things they can legally tax. The High Court has ruled invalid some past attempts by States to expand their tax bases, such as through franchise fees and pipeline fees⁷.

15. Efforts to expand the range of State taxes face legal and other hurdles, including the practical constraints imposed by interstate tax competition and the potential for tax bases to shift jurisdiction to avoid liability. It is also noted that the *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations* requires the States to review the need to retain several taxes.

16. Some States say that the Commission's approach to measuring relative revenue raising capacities (and expenditure disabilities) allows too much room for State policies to influence the assessments. They argue that a global approach would be more policy neutral than the existing approach because it would not be affected by the decisions any State makes on the taxes it imposes or the relative severity of each tax. However, by departing from how States actually raise revenue, a global approach would:

- (i) measure revenue raising advantages and disadvantages on a theoretical basis, rather than in the context of the practical constraints States face in raising revenue and the tax instruments they use; and

⁶ The Commission's assessments do not prescribe what States should or should not do. A State can design its tax structure as it sees fit.

⁷ See www.geocities.com/CapitolHill/Lobby/2193/constitution.html#Tax.

- (ii) apply an artificial and external measure of revenue capacity that may not be achievable.

17. It is not clear what measure of the global base either New South Wales or Western Australia are putting forward for consideration. New South Wales suggested population as one possibility, but that denies the existence of any differences in capacities and is, we believe, inconsistent with equalisation. The two measures most often suggested are:

- (i) Gross State Product (GSP), since capacity to pay depends on a State's economic performance; or
- (ii) Gross Household Income (GHI) or Gross Household Disposable Income (GHDI), since taxes are ultimately paid from income.

18. Nor is it clear how such measures would overcome some of the alleged deficiencies of the tax by tax approach.

- (i) Using GSP or GHI may be no better than the tax by tax approach at allowing for the effects of good governance and State policies aimed at developing revenue bases. To the extent that differences between States in public policies, especially those aimed at developing revenue bases, affect the individual tax bases under the tax by tax approach, they are also likely to affect interstate comparisons based on GSP or GHI. For example, State policies that are successful in affecting payrolls of medium and large firms would also affect GSP (because wages paid by businesses are a large element of GSP) and GHI (because wages are also a large element of household income).
- (ii) It is not clear to what extent States use general State-wide measures of capacity to pay in reaching decisions on their overall tax policies or which taxes they will apply or vary.

19. Using GSP or GHI to measure State revenue raising capacity would also introduce some conceptual problems that are not present in the tax by tax approach. They include:

- (i) industry structure is hidden in an aggregate measure but may be relevant to the capacity of an economy to pay taxes from production;
- (ii) differences between States in the distribution of income among their residents do not show up in the aggregate measures, but they are relevant to capacity to pay taxes because many tax rates increase with the taxpayer's income;
- (iii) GSP and GHI measure the annual value of production in each State or the annual income of residents of a State — as such, they may not adequately reflect the effects of the stock of wealth on capacity to pay;

- (iv) non-residents pay taxes (for example gambling and property taxes) and a large proportion of State taxes is paid by companies which may pass them on to their consumers some of whom may live in other States — a State-based measure of production or income may not reflect this exporting of taxes; and
 - (v) it may be difficult to remove the effects of other taxes, such as income tax and company tax from income measures, and there is also the problem of how to deal with undistributed profits.
20. Some of these problems may be overcome by:
- (i) making adjustments to the potential global measures, but the rationale for such adjustments may be contentious and relevant data may not be available; or
 - (ii) having several measures, such as one intended to reflect the impact of income on capacity to pay and another to reflect the impact of the stock of wealth but, apart from the unimproved value of land, measures of wealth are not available.

21. However, the measures of revenue raising capacity that might result from such an adjustment process would not necessarily be more accurate, fair or robust than those produced by the tax by tax approach. Further, because a global measure is a theoretic construct, it would be difficult for parties to reach agreement on a measure to be used because different measures have different effects on the grant distribution.

PRELIMINARY DECISION

22. The arguments that have been raised so far do not demonstrate that a global approach to the revenue assessments would result in assessments of the relative capacities of the States to raise revenue that are conceptually superior to those produced by the tax by tax approach.

23. Our preliminary decision, therefore, is to retain the tax by tax assessment approach to revenue assessments. We believe it better achieves HFE as it is currently understood. A global assessment may appear simpler and produce less annual volatility in relativities, but a tax by tax approach better reflects what States actually do. State taxes and charges are generally not imposed on income and do not vary with changes in personal or company income. In addition, the tax by tax approach, with its separate assessment for each activity being taxed, better captures the impact of differences between States in: the wealth of their populations, the type of economic activities engaged in and the mix of household and personal income.