New South Wales

Submission to the CGC 2015 Methodology Review

July 2013

NSW GOVERNMENT

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Executive Summary

The 2015 Methodology Review is being conducted by the Commonwealth Grants Commission (CGC) following a separate Review of the GST Distribution conducted at the request of the Commonwealth Government by an independent Review Panel. In its final report the Review Panel raised several methodological issues which the Commonwealth Government referred to the CGC for consideration in the terms of reference provided to the CGC for this Methodology Review.

A Methodology Review also affords the Commonwealth, states and the Commission the opportunity to review the interpretation and implementation of the horizontal fiscal equalisation (HFE) principle that underlies the distribution of GST revenue between the states.

Problems with the current interpretation and implementation of HFE

New South Wales believes that the current HFE system:

- tries to do too much
- reduces incentives/creates disincentives for states to undertake economic reform and improvements in revenue raising capacity or service delivery
- is too complex
- is not sufficiently transparent
- is too volatile, producing large year to year variations in a key revenue source for states and
- is too reliant on judgement.

The CGC seeks to achieve full equalisation of state government fiscal capacities, i.e. equalisation of revenues, expenses, and investment in infrastructure and financial assets to give states the capacity to provide services and associated infrastructure at the same standard. Equalisation, or equity, is the underlying principle, with little attention to the effects this has on incentives for states to improve revenue raising capacity or service delivery practices to improve economic efficiency or minimise divergences.

This contrasts with the income tax/welfare system in Australia which aims only to moderate rather than equalise the income distribution of individuals. It also contrasts with the equalisation practices of other federations which pursue a lesser coverage of equalisation and/or equalisation to comparable rather than the same standards.

New South Wales considers that the alternative definition of HFE often used by the Commonwealth Government is much more suitable than the CGC's definition because it allows for the importance of efficiency effects and productivity growth. That definition is:

> Horizontal fiscal equalisation provides the necessary budget support so that all States have the capacity to provide services at a comparable standard, while ensuring that the interstate transfers are not so large that they would significantly distort economic behaviour and reduce productivity growth.[1]

The current system creates incentives for states to expand activities in areas where they are assessed as having below average revenue raising capacity or above average costs of service provision since states will continue to receive above equal per capita (EPC) GST share as well as the direct returns from the policy. On the other hand, states can have an incentive to scale back activities in areas where they are assessed as having relative strengths.

The interaction of policy decisions and GST outcomes leads to an incentive for states to analyse the net outcome of policy decisions, i.e. calculate the direct impact of the policy decision as well as the impact of the policy decision on its GST share. This can influence a state's willingness to implement a policy decision and the timing of that decision. In recent years, states have been very much aware of and interested in the ramifications for their GST revenue shares of national reform proposals in relation to hospitals, school education and disability care.

New South Wales considers that the current interpretation and implementation of HFE provides disincentives to states to pursue nationally important state tax reform. It can provide a disincentive for a state to act unilaterally to abolish inefficient taxes. Even when tax reform is being undertaken by all states there can be significant disincentives in the HFE system, and the system can have a marked influence on the timing of the implementation of the joint policies.

The current system of fiscal equalisation can provide disincentives for states to alter their mix of taxation where a state is assessed to have a less than average capacity to raise revenue in one form of taxation and a higher than average capacity to raise revenue in a possible substitute form of taxation. The more a state dominates the 'average' tax base in particular types of taxation, the larger these incentive effects can be.

An alternative distribution of GST revenue

New South Wales considers that the GST revenue should be distributed to the states in full, untied and on an equal per capita (EPC) basis.

An EPC distribution automatically includes an element of funds transfer from stronger to weaker states. It is administratively simple, transparent and more predictable. It is more contemporaneous than the current system and is relatively stable over time. An EPC distribution

[1] Commonwealth of Australia, *Australia's Federal Relations*, 2011-12 Budget Paper No. 3, p.106.

would not have the data requirements of the current system. Importantly an EPC system is policy neutral, providing no disincentives for tax or service delivery reform.

Adoption of an EPC model would strengthen the framework for intergovernmental financial relations, clarify the operation of funding agreements and government accountability, and restore confidence in the system.

New South Wales believes the Commonwealth should support this objective through taking responsibility for funding any additional financial assistance to the fiscally weaker states so no state is worse off.

The Commonwealth has access to more broadly based revenue sources than the states, giving the Commonwealth greater fiscal capacity to provide additional payments to the smaller states. Assuming that an EPC system would need to be phased in over a five to ten year time horizon, any immediate commitments by the Commonwealth for equalisation payments would be limited.

This position was endorsed by the GST Distribution Review Panel's final report.

The Review Panel concluded in **Finding 12**:

> While the Commonwealth continues to have greater budget capacity than the States it would be best placed to take on the funding of equalisation payments to the smaller States to ensure they continue to have the capacity to provide comparable (State) services to those of the larger States. Commonwealth transfers to States could then largely address VFI, and be weighted more towards general revenue assistance (funded by GST) than tied funding. In such a world, the simplest way of allocating the general revenue assistance would be on an EPC basis. The amount of equalisation funding for the smaller States could be a guaranteed proportion of GDP. The Commonwealth would fund the smaller States collectively the difference between this guaranteed amount of GST and their EPC share of general revenue assistance.[2]

Transitional measures may be necessary in the lead up to this preferred outcome. Possible transitional measures include:

- distribute a proportion of the GST pool EPC with the remainder distributed using relativities
- partial equalisation based on a 'comparable' level of services
- separate funding for Indigeneity
- partial equalisation based on a smaller pool.

[2] GST Distribution Review, *Final Report*, October 2012, p.175.

NSW views on the GST Distribution Review's methodology recommendations

In relation to the methodological issues raised by the GST Distribution Review and referred to the CGC in the terms of reference for the 2015 Review, New South Wales considers:

- further analysis is needed to determine the impact of changing materiality thresholds in the absence of making discrete changes to the assessment structure
- rounding relativities to two decimal places will not remove false precision from the process in the absence of any other changes to methodology, and may increase volatility. Further analysis is also needed to determine the calculation point at which rounding would occur
- New South Wales agrees that all Commonwealth payments relating to infrastructure of national significance should be separately identified and separately assessed but does not support the adoption of an arbitrary 50 per cent weighting. New South Wales believes that the consideration of the appropriate treatment of transport infrastructure should include consideration of treating all infrastructure grants to the states by exclusion
- New South Wales agrees the CGC should allow newly available data which is updated or released annually with a lag, or updated or released less frequently than annually, to only inform changes in States' circumstances in the most recent assessment year and not be used to revise previous estimates for earlier assessment years
- New South Wales considers that, in the absence of a move toward an EPC distribution of GST revenue, the CGC should examine the adoption of a simplified and integrated assessment framework as a matter of priority in the 2015 Review
- New South Wales has previously expressed concerns about the calculation and size of both interstate and intrastate cost differentials. It is important for the credibility and integrity of the HFE process that there is confidence around the methodology and estimates used in deriving these factors. The current non-wage interstate costs assessment needs to be re-examined to ensure that it is based on clear evidence of differential costs between states and reliable data
- New South Wales notes that the CGC has issued a Staff Discussion Paper (CGC 2013-02-S) on the treatment of iron ore fines in the 2014 Update. We will provide a submission in response to that discussion paper
- achieving a mining revenue assessment that is policy neutral will be difficult given the tax base is dominated by two jurisdictions. It may be possible to reduce the sharpness of the impact of policy changes by moving to a more graduated assessment structure with a number of royalty tiers, rather than the current two-tiered structure

- on the perception that some mining related costs may not be fully recognised, it is not clear what spending is not fully recognised in the CGC's current assessments. Previous attempts to evaluate any economic development costs have not been conclusive. In particular, New South Wales has significant concerns over the impact of policy decisions on mining related expenditure.

HFE treatment of National Education Reform and DisabilityCare

Clauses 5 and 6 of the Terms of Reference ask the Commission to give particular attention to the appropriate treatment of disability services and National Education Reform Agreement (NERA) funding arrangements.

In some respects detailed arrangements for the two reforms are not yet finalised, so it is difficult to be too prescriptive in relation to CGC treatments at this stage. However, there are two main principles that should be borne in mind.

- For both reforms, it will be important to ensure that the CGC's assessments do not unwind any built-in loadings designed to take account of student needs, based as in the education arrangements for example, on the above national average occurrence of higher-cost populations in some states.
- From a GST distribution perspective it will be important to ensure that States which have signed up to DisabilityCare and/or NERA do not have their GST share reduced by their participation in either arrangement. On the other side of that coin, it will be important to ensure that States that do not participate in the arrangements do not have their GST share increased by their non-participation.

There are a number of common factors – Indigeneity, low SES, small school size, remoteness, low English fluency – used to determine the loadings under the NERA and used by the CGC in the schools education assessment.

The loadings determined under NERA will need to be excluded from the HFE process otherwise NERA's recognition of educational disadvantage could be unwound by the CGC. This raises issues in relation to base funding also, and the funding to be provided by States under NERA. If Commonwealth funds provided in response to perceived need through loadings on top of base funding meet the equalisation needs of the States in relation to school education, what is the appropriate treatment of base funding?

New South Wales considers that the appropriate treatment might be an equal per capita assessment of all school expenses and Commonwealth funding, or the exclusion of all funding and expenditures related to schools education from the HFE process.

Similar considerations apply to some degree in relation to DisabilityCare, though there are added considerations in relation to treatment during the launch and transition phases of the scheme.

Other assessments needing particular attention in the 2015 Review

In addition to the methodological issues noted in the GST Distribution Review's final report and referred to the CGC, there are other many other assessments that need attention in the 2015 Review. The following list includes those assessments that New South Wales believes are in most need of improvement, if the CGC does not consider a move to an EPC distribution of GST revenue appropriate.

Insurance taxation assessment

New South Wales has concerns with the insurance tax assessment where the size of a state's tax base (premiums paid) is clearly heavily influenced by the state's policy on the rate of insurance duty. The current form of HFE produces disincentives for the abolition of inefficient taxes such as insurance taxes.

In the absence of fundamental reform to the HFE system, New South Wales considers the insurance taxation assessment needs to be adjusted to remove the policy influences on assessment of state tax bases. This can be done using data from the Australia's Future Tax System Review on the impacts of policy on the insurance tax base, possibly combined with discounting consistent with those applied in other cases where data is thought to be deficient.

Administrative scale assessment

The assessment of administrative scale costs needs to be reconsidered to ensure that it truly assesses the 'minimum costs of administration' needed to provide the normal array of state services totally independent of the scale at which states need to deliver services.

Basing the assessment on the 'minimum administrative cost that would be incurred for a State with a population size of the smallest State' risks including costs related to the scale at which that state provides services. 'Minimum administrative cost' is a concept related to theoretical 'minimum functions of government' rather than the scale at which those functions need to be provided. If an assessment of those costs is to be made, it needs to be totally independent of any scale of operations.

Payroll tax assessment

The tax-free threshold adjustment adds unnecessary complexity to this assessment.

New South Wales recommends that the CGC remove the threshold adjustment from the payroll tax assessment. This would allow States' widely different payroll tax thresholds, which are matters of policy choice, to be averaged in the overall average tax rate in the same way that the other main aspect of payroll tax policy – varying State tax rates – is averaged.

Community and other health assessment

New South Wales does not support the use of the 'subtraction model' to determine the need for State-funded community and other health services in the current assessment.

The overall validity of the subtraction model depends on the assumption of perfect substitutability – i.e. that a dollar of funding provided from a non-State source means the State is relieved of the need to provide a dollar of funding. The CGC has not provided clear evidence of this relationship.

The assessment should also capture the higher unit costs of culturally and linguistically diverse patients to recognise the need for longer consultations, use of interpreters and the special needs of humanitarian refugees.

Capital assessment

New South Wales recommends that the CGC use the holding cost approach to assess States' capital needs in place of the current 'direct' approach.

New South Wales has several major concerns with the current capital assessments:

- the CGC's approach is inconsistent with 'what States do' in relation to investment in physical capital assets and financial assets. There is no need to equalise 'up-front' spending that in a sense is not paid for 'up-front'. Capital is acquired and used over time, and an approach to equalising capital spending along those lines is more appropriate

- upfront equalisation in the year it occurs is not appropriate for spending that is influenced by factors extending both backward and forward in time well beyond the current and previous years. For very good reason, pricing authorities do not allow public utilities to reflect the costs of capital investment solely in the year in which it occurs

- there is no direct annual causal relationship between population growth and investment in physical assets. The lumpiness of capital spending and its 'history' means that capital spending does not smoothly adjust year by year to population growth.

A simple holding cost model which attributes the opportunity cost of capital and depreciation to the period in which the capital is used overcomes these conceptual problems. It is simple, transparent and consistent with conventional and widely understood economic and accrual accounting concepts.

Cultural and linguistic diversity (CALD)

New South Wales recommends the inclusion of a CALD disability for the individual assessment categories of admitted patients, community and other health services, welfare and housing and justice services.

The inclusion of CALD could be based on judgements of the unit cost disabilities of servicing non-English speaking clients derived from Census data on the proportions of State populations that speak English poorly or not at all and from any available qualitative data.

New South Wales believes that the data on which to base a CALD assessment is no more tenuous than the data on which the interstate non-wage costs assessment is based. An appropriate and consistent discount can be used if thought necessary.

Physical environment

New South Wales has concerns about the CGC's consideration of a physical environment factor. We do not consider the case for such an assessment has been proven. The CGC has appointed a consultant to investigate a physical environment factor. The consultant's report has been circulated to states and New South Wales will provide its views on this report in the near future.

1. Introduction

Horizontal Fiscal Equalisation

New South Wales believes that the current HFE system:

- tries to do too much
- reduces incentives for states to undertake economic reform and improvements in revenue raising capacity or service delivery
- is too complex
- is not sufficiently transparent
- is too volatile, producing large year to year variations in a key revenue source for states and
- is too reliant on judgement.

The definition and practice of horizontal fiscal equalisation in Australia have evolved progressively – largely embodied in the work of the Commonwealth Grants Commission (CGC).

The CGC seeks to achieve full equalisation of state government fiscal capacities – revenues, expenses, and investment in infrastructure and financial assets. Equalisation, or equity, is the underlying principle, with little attention to the effects this has on incentives for states to improve revenue raising capacity or service delivery practices to improve economic efficiency.

This contrasts with the income tax/welfare system in Australia which aims only to moderate the income distribution of individuals. The CGC's approach also contrasts with the practice of other federations, which do not pursue full equalisation to the same degree as Australia.

The Commission currently defines horizontal fiscal equalisation (HFE) as:

> State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue and operated at the same level of efficiency.[3]

[3] CGC, *Report on GST Revenue Sharing Relativities, 2011 Update*, p.31.

To put fiscal equalisation into effect, the Commission developed a set of supporting guidelines. These guidelines were updated in the 2010 Review. The principles now indicate equalisation should be implemented through methods that:

- reflect what states collectively do
- are policy neutral
- are practical
- deliver relativities most appropriate to the application year.4

It is important in any discussion of HFE to be clear on what the current system is designed to achieve.

The system does not seek to ensure the same standard or range of government services across Australia. HFE provides for the equalisation of each state's fiscal capacity to provide the average standard of services, after allowing for the non-policy related differences in costs associated with providing those services or raising the revenue.

The current system of fiscal equalisation is not based on any principle of interpersonal or interregional (i.e. sub-state) equity, nor is it directed towards achieving increased efficiency in the delivery of government services. Rather, it is directed towards providing states with the capacity to perpetuate average levels of efficiency and average levels of service delivery. The CGC has stated:

> Equalisation does not attempt to equalise the capacity of States to provide services to a standard required to achieve an external policy objective – for example, reducing hospital waiting lists or increasing literacy and numeracy levels. Such an approach would require judgments about matters that are the province of Government. Governments have not asked us to do that.
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> Similarly, equalisation is not directed to interpersonal, community or regional equality because States do not follow such policies. States do not provide residents of rural and remote areas with the same access to services as people in metropolitan areas. Accordingly, the equalisation standards reflect the different amounts States spend per person in different areas and on different groups of people. Equalisation is not intended to provide States with the capacity to implement policies they do not, on average, already follow. The Australian Government has other policy measures such as the tax and social security systems to address interpersonal equity.5

The equalisation system does not seek to provide states with the means to address the issues confronting them or, in CGC terminology, the disabilities they face. Rather, the equalisation system is viewed by the CGC as a mechanism for providing retrospective compensation to states

[4] CGC, *Report on GST Revenue Sharing Relativities, 2010 Review*, Vol.1, p.35.

[5] CGC, *2010 Review*, Vol.1, p.36.

for the relative disabilities they suffer. This was expressed most clearly by the CGC in its 1999 Review, but the sentiments have continued to be echoed up to the present time:

> It was said to us in this review that Tasmania suffers from …[an economic] decline, and that the Commission should give it special consideration on that account. Assuming that Tasmania's economic performance is indeed in long-term decline, the equalisation system can compensate it retrospectively so far as the decline has given rise to relative reductions in its income bases and relatively greater calls on State resources to provide welfare payments and other outlays. … [It] is far from clear that attempts to reverse such a decline (as opposed to coping with some of its symptoms) could, or indeed should, be financed through the equalisation system. Other forms of Commonwealth-State co-operation would be needed.6

In its 2010 Review report, the CGC noted that 'the relativities we recommend should be based on a single objective, fiscal equalisation.' While acknowledging that redistributive processes such as fiscal equalisation may affect aggregate national welfare, the CGC suggests that without specific directions by government it was not the CGC's concern to take account of what those affects might be.[7]

An alternative definition of HFE is provided in the Commonwealth's Budget Paper No. 3:

> Horizontal fiscal equalisation provides the necessary budget support so that all States have the capacity to provide services at a comparable standard, while ensuring that the interstate transfers are not so large that they would significantly distort economic behaviour and reduce productivity growth.8

New South Wales considers that this definition is much more suitable than the CGC's definition because it allows for the importance of efficiency effects and productivity growth. There is little in the current HFE system to ensure that the pursuit of equity is not at too great a cost to overall economic efficiency. This will become increasingly important as the Australian economy grapples with the challenges of structural change and entrenched disadvantage.

New South Wales considers that the GST revenue should be distributed to the states in full, untied and on an equal per capita (EPC) basis.

An EPC distribution automatically includes an element of funds transfer from stronger to weaker states since GST revenue is not collected on an equal per capita basis. It is administratively simple, transparent and more predictable. An EPC distribution would not have the data requirements of the current system.

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[6] CGC, *Report on State Revenue Sharing Relativities 1999 Review*, Vol.1, p.12.

[7] CGC, *2010 Review*, Vol.1, pp.30-31.

[8] Commonwealth of Australia, *Australia's Federal Relations*, 2011-12 Budget Paper No. 3, p.106.

Importantly an EPC system is policy neutral, providing no disincentives for tax or service delivery reform. It would establish a sound basis for interstate comparison of government services, bringing pressure to bear on the efficiency of state government service delivery. EPC distribution would focus States on good spending and revenue raising decisions rather than tending to consider possible impacts on GST share of policy decisions.

Adoption of an EPC model would strengthen the framework for intergovernmental financial relations, clarify the operation of funding agreements and government accountability, and restore confidence in the system.

An EPC distribution would be contemporaneous. It would not depend on data which can only be produced with, at least, a two-year lag. It would use, as does the current system, current year ABS population estimates, with ex-post adjustment, as is also currently the case for variation of outcomes from population estimates.

Most significantly, though contemporaneous, an EPC system would be stable. Being objective and dependent on demographic data, its outcomes would not be affected by changing perceptions of political exigencies and judgements. Any judgements can then be reserved for the nature, extent and any applicable conditions for additional support for the smaller states and territories.

The Commonwealth's revenue base is much larger and more efficient than the states' revenue base. The Commonwealth should support this EPC objective through taking responsibility for funding any additional financial assistance to the fiscally weaker states so no state is worse off. Based on the results of the current HFE system, the magnitude of such payments would not exceed one per cent of total Australian tax revenue.

The Final Report of the GST Review Panel found that in a longer term scenario in which federal and state revenue raising capacity were better aligned with service provision responsibilities and there were a reduced level of vertical fiscal imbalance, the current concept of HFE need not necessarily apply.

The Review Panel concluded in **Finding 12**:

> While the Commonwealth continues to have greater budget capacity than the States it would be best placed to take on the funding of equalisation payments to the smaller States to ensure they continue to have the capacity to provide comparable (State) services to those of the larger States. Commonwealth transfers to States could then largely address VFI, and be weighted more towards general revenue assistance (funded by GST) than tied funding. In such a world, the simplest way of allocating the general revenue assistance would be on an EPC basis. The amount of equalisation funding for the smaller States could be a guaranteed proportion of GDP. The Commonwealth

> would fund the smaller States collectively the difference between this guaranteed amount of GST and their EPC share of general revenue assistance.[9]

New South Wales believes that the CGC should consider implementing Finding 12 of the GST Distribution Review in this methodology review. This would establish a system that would both assist Australia meet the challenges of structural, climate, demographic and technological change and enhance confidence in Australia's federal financial relationships.

[9] GST Distribution Review, *Final Report*, October 2012, p.175.

2. Disincentives in the Current HFE System

The CGC seeks to distribute the GST pool in a policy neutral manner. That is, it aims to ensure that a state's own policies do not directly affect its GST share. Equally, the CGC's decisions should not affect a state's policy decisions.

However, examination of incentive and disincentive effects of the current system of fiscal equalisation in the context of tax reform led Professor Neil Warren to conclude: 'there is no incentive for [States] to pursue any of the Henry reforms given their impact on State tax revenue and grants'.[10] This is of particular concern, given the large efficiency costs many state taxes impose on the economy.

There are two aspects to the CGC's approach to determining policy neutrality:

- whether a policy is average state policy11
- if a policy is average state policy, determining the measurement of that average policy.

A state may be able to influence the determination of whether a particular policy is the 'average state policy' – and hence assessed for equalisation purposes – or is not average state policy – and hence is excluded from the equalisation process. This can occur through analysis of how many other states apply that policy and whether that state's decision will cause the status of the policy to change. The state retains all of the revenue, without any equalisation, if a policy is not 'average state policy'.

The gradual abolition of some state financial transactions taxes with the introduction of the GST provides an example of where particular State decisions can influence whether a tax is regarded as average state policy.

The CGC uses a weighted average across all states to measure the size of an average policy. All else being equal, states assessed as having below average revenue capacity or capacity to deliver a service (in the sense of above-average costs) receive an above equal per capita (EPC) GST share and states assessed as having an above average revenue capacity or capacity to deliver a service receive a GST share that is less than their EPC share.

This can create an incentive for states to expand their activities in areas where they are assessed as having below average capacity as they will continue to receive above EPC GST share as well as the direct returns from the policy. For example, if a state faces the need to raise a certain amount of revenue for whatever reason, other things being equal, doing so in a tax for which it is

[10] Warren, N (2010), *Intergovernmental fiscal arrangements as a constraint on State tax reform under Henry*, Paper presented at Conference on Australia's Future Tax System: A Post-Henry Review, 21-23 June 2010, Sydney.

[11] Typically, a policy is determined to be average state policy if it is applied in the majority of states and to the majority of the tax base.

assessed to have a below average capacity to raise revenue will be more attractive than doing so in a tax where it is assessed to have an above average capacity to raise revenue when the GST share effects are taken into account. On the other hand, states can have an incentive to scale back activities in areas where they are assessed as having relative strengths.

The interaction of policy decisions and GST outcomes leads to an incentive for states to analyse the net outcome of policy decisions, i.e. calculate the direct impact of the policy decision as well as the impact of the policy decision on its GST share. This can influence a state's willingness to implement a policy decision and the timing of that decision.

The interaction of states' policy decisions and HFE is illustrated by the examples in the following sections.

Unilateral State Tax Reform

The current form of fiscal equalisation can provide a disincentive for a state to act unilaterally to abolish inefficient taxes.

Under the Intergovernmental Agreement (IGA) associated with the introduction of the GST, states agreed to abolish certain inefficient taxes on particular dates and abolish others following reviews of their need to retain them.

The Victorian Government decided on the early elimination of some of the financial transactions taxes (FTT) due for abolition under the IGA (stamp duty on leases, mortgages, debentures, bonds and other loan securities, and a number of other minor duties).

Victoria's decision had two impacts on its budget:

- it reduced its own-sourced revenue
- it changed the GST share it received.

The first impact was clearly a reflection of its own policy choice. The second, however, requires further consideration.

The Commission assessed Victoria as having an above average capacity to raise FTT and requiring less GST as a consequence – in fact $48 million less GST than its population share in 2003-04. Victoria's abolition of FTT changed its GST share because:

- Victoria's abolition of FTT reduced national FTT collections by around $284 million
- the FTT tax base remained unchanged, as FTT was still average policy, and the average rate of FTT fell
- the lower average FTT rate caused each state's assessed FTT revenue to fall

- states with an above average capacity to raise FTT – essentially New South Wales and Victoria – found their GST 'losses' from the FTT assessment reduced and states with a below average capacity saw a fall in their GST 'gains'
- Victoria improved its GST share by around $9 million ($39 million loss of GST revenue after abolishing FTT compared to a $48 million loss had it not abolished FTT)12
- Victoria would have gained $48 million if the tax was no longer assessed by the CGC.

Victoria received a marginal increase in its GST, but was still $39 million below the level that would have applied if the tax was no longer assessed, which could be achieved by guidance given to the CGC in its terms of reference, or if all states had simultaneously abolished their financial transactions taxes.

Victoria had acted in the interest of productivity and welfare enhancing reform (by the early abolition of inefficient taxes), but still received less than EPC GST revenue (though marginally higher than previously) on account of taxes it no longer levied.

There would be a greater incentive for states to undertake reform if, after abolishing a tax, the state did not continue to lose GST because of a tax they no longer imposed.

New South Wales faced a similar situation when it abolished debits tax ahead of other states on 1 January 2002. As well as losing its own tax revenue, it continued to lose GST revenue because of a tax it did not levy, until all states abolished the tax from 1 July 2005.

These effects could be eliminated if the CGC were given a direction on how to handle these policy decisions in their terms of reference.

Joint State Tax Reform

Even when tax reform is being undertaken by all states there can be significant disincentives in the HFE system, and the system can have a marked influence on the timing of the implementation of the joint policies.

The smaller states lost both their own tax revenue and the positive GST effect they had previously enjoyed when they abolished the financial transaction taxes as agreed under the IGA. The size of the GST loss also can be affected significantly by the abolition timetable.

South Australia included the following tables in its 2005-06 Budget showing the impact on its revenues from the abolition of the IGA taxes.

[12] These figures are taken from CGC, Effect of Victoria abolishing FTT, cgc.gov.au/gst_distribution/presentation_on_the_work_of_the_Commission.

Under the original Commonwealth timetable for the abolition of the taxes, South Australia calculated that it would lose significant GST revenue as a result of the abolition of the taxes, as well as the direct tax revenue.

Table 1: Estimated impact on South Australia of Commonwealth's proposal for abolition of IGA taxes ($m)

	2006-07	2007-08	2008-09	2009-10	2010-11
State tax revenue	-91	-137	-146	-153	-159
Indirect CGC effects	-32	-54	-54	-59	-62
Total impact	**-123**	**-191**	**-200**	**-212**	**-221**

Source: Table 4.1, 2005-06 South Australian Budget.

The 'Indirect CGC effects' row in the table shows the effect on states' GST revenues associated with the abolition of the agreed taxes in accordance with the Commonwealth's proposed timetable.

Six states wrote jointly to the Commonwealth proposing an alternative schedule of tax abolition. The impact on South Australia of the alternative schedule is shown in the table below.

Table 2: Estimated impact on South Australia of State's proposal for abolition of IGA taxes ($m)

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
State tax revenue	-24	-28	-51	-78	-128	-159
Indirect CGC effects[(a)]	-	-2	-3	-8	-39	-41
Total impact	**-24**	**-29**	**-54**	**-86**	**-167**	**-220**

(a) Reflects later timing of abolition of taxes compared to Commonwealth proposal
Source: Table 4.2, 2005-06 South Australian Budget.

The phased reduction shown in the second table considerably reduces South Australia's loss of GST revenue.

This example shows clearly the incentive effects of the current system of fiscal equalisation on a state's decisions. The impact was sufficiently powerful to motivate a number of states to approach the Commonwealth seeking a delay in the abolition of taxes that they all recognised as having undesirable characteristics.

The HFE system clearly can have an effect on a state's policy decisions.

Changing the Tax Mix

The current system of fiscal equalisation can also provide disincentives for states to alter their mix of taxation.

Property transfer (conveyances) duty is widely regarded as one of the most inefficient of current state taxes, given its narrow base and impact on transactions. Land tax is regarded as a much more efficient tax. Therefore, even if the overall revenue take remained the same, there would be a net efficiency gain to the Australian economy if a state reduced revenue from the inefficient tax and switched revenue raising to the more efficient tax.

However, in a purely hypothetical example, such a switch would result in deterioration in the NSW GST position.

Table 3 shows that New South Wales currently is assessed to have an above average capacity to raise land tax revenue. An increase in New South Wales' land tax revenue from a higher tax rate on existing taxable properties would increase aggregate land tax revenue. This would increase assessed revenues for all states, with New South Wales maintaining its above average capacity. New South Wales would receive less GST.

Table 3: NSW land tax and transfer duty capacity ratios 2007-08 to 2009-10

	Land tax	Property Transfer duty
2007-08	107.44	92.26
2008-09	100.43	96.69
2009-10	99.77	100.59
3 year average	**102.55**	**96.52**

Source: CGC, www.cgc.gov.au, 2011 Update, Supporting Information, Data downloads – Excel spreadsheets supporting the relativities, Revenue and Expense Ratios, Table S3-1.

New South Wales is currently assessed as having a below average capacity to raise transfer duty revenue, so New South Wales receives above average GST revenue on this assessment. If New South Wales reduced transfer duty revenue, total transfer duty revenue would fall and New South Wales would receive less GST.

While the switch from transfer duty to land tax would be revenue neutral in terms of direct revenue, the overall revenue result from the substitution of a more efficient tax for a less efficient tax would be undermined by the loss of GST revenue.

One State Impacting the Tax Base

The impacts of state tax policy decisions on the GST distribution are generally slight. But there can be larger influences when one state's activities are large enough for its tax policies to affect the assessed tax base.

Western Australia's recent changes in its tax rates on iron ore fines illustrates how tax policy can impact on assessed tax bases in a situation where one state dominates a tax base.

The 2010 Review mining revenue assessment essentially divided the mining revenue base into two categories: a high royalty (rates above five per cent) mineral category and a low royalty (rates less than five per cent) mineral category. Iron ore fines (with an average effective rate of 4.69 per cent in 2008-09) were placed in the low royalty rate group and lump iron ore (with an average effective rate of 6.79 per cent) in the high royalty rate group.

From 1 July 2010, Western Australia – the dominant producer of iron ore – removed the concessional iron ore fines royalty rates (3.75 per cent) applying to two producers, covering about half of total iron ore fines production in that State. This took the royalty rate for these producers to the general fines royalty rate of 5.625 per cent, in turn taking the average effective iron ore fines royalty rate above five per cent.

Removal of the concessions raised the issue of whether iron ore fines should be moved from the low royalty rate mineral category to the high royalty rate category in the assessment of mineral revenues.

Doing so would produce a significant redistribution of GST revenue through its impacts on the assessed tax bases. It would move a large proportion of Western Australia's mineral revenue tax base to the category where higher average rates of royalty are applied to assess mineral revenue capacity, thereby increasing Western Australia's assessed mineral revenue and reducing its assessed need for GST revenue payments.

When removing the concessional rates on iron ore fines from 1 July 2010, Western Australia sought an indication from the Grants Commission of its attitude to the reclassification of iron ore fines to the high royalty rate group, though the policy change would not affect the GST relativity calculations until the 2012 Update. Western Australia argued that reclassifying iron ore fines would cause the State to lose more GST revenue than it raised by removing the royalty concessions.

The appropriate treatment of iron ore fines is to be considered in the 2014 Update (Staff Discussion Paper CGC 2013-02-S).

The Disincentive to Expand Capacity

If a state government adopted policies that successfully promoted economic development, it could reasonably expect to receive a boost to its financial position by way of a growth dividend in its revenue collections, without any need to vary tax rates. There would also be a growth dividend to the Commonwealth through higher Commonwealth tax revenue.

The current system of HFE can redistribute the effects of an increase in assessed revenue raising capacity, with no change in the tax rate. This can be particularly the case with a small state that levies a tax at a below average rate, for example, payroll tax in Tasmania.

Table 4 shows the effect on states' revenues of economic growth in Tasmania (i.e. an increase in assessed revenue capacity in Tasmania) which leads to an increase of $5 million in its payroll tax revenue, assuming no other changes. The result is a reduction of $5.4 million in Tasmania's assessed GST share, giving a net loss of revenue to Tasmania of $0.4 million.

Table 4: Impact on state revenues of economic growth in Tasmania[a]

	NSW	Vic	Qld	SA	WA	Tas	NT	ACT	Total
Change in:	$m	$m	$m	$m	$m	$m	$m	$m	$m

Payroll tax revenue	..	..	..	..	..	5.0	..	..	5.0
Assessed GST share	1.8	1.4	1.1	0.4	0.6	-5.4	0.1	0.1	..
Total	**1.8**	**1.4**	**1.1**	**0.4**	**0.6**	**-0.4**	**0.1**	**0.1**	**5.0**

(a) Differences in own payroll tax revenues and assessed GST shares resulting from economic growth in Tasmania that yields an additional $5 million of payroll tax revenue in that State, assuming no change in the structure of payroll tax or changes in rates, based on the Grants Commission's assessments for 2008-09 contained in its 2010 Review Report. For the purposes of calculation, no progressivity in the incidence of the tax has been assumed, i.e. the increase in tax yield has been assumed to be proportional to the overall increase in compensation of private sector employees.

However, if Tasmania's payroll tax base were to decline, and this decline were to result in a reduction of its payroll tax revenue by $5 million, the effect on states' revenues would be as shown in the table (Table 4) with the signs reversed. Thus a decline in Tasmania's assessed revenue capacity would lead to a net improvement in its total revenues as the decline in its payroll tax revenue would be more than offset by an increase in its GST share.

In a similar vein, if a small State such as Tasmania were to lag behind growth in the rest of the economy, it would receive a net boost to its revenues, greater than it would if its economy kept pace with the rest of Australia.

For the larger states, there are also offsets to the impact of economic growth on their own revenues, but these are generally of a lesser magnitude. Table 5 below shows the impact of growth in New South Wales above the national average, which results in additional payroll tax revenue of $100 million above that which would be produced by growth at the average rate, again assuming no change in tax rates. In this case, $62.5 million would be equalised away, leaving New South Wales with a net benefit of $37.5 million.

Table 5: Impact on state revenues of economic growth in New South Wales[(a)]

Change in:	NSW $m	Vic $m	Qld $m	SA $m	WA $m	Tas $m	NT $m	ACT $m	Total $m
Payroll tax revenue	100.0	..	..	..	..	..	..	..	100.0
Assessed GST share	-62.5	22.9	18.7	7.0	9.3	2.2	1.0	1.5	..
Total	**37.5**	**22.9**	**18.7**	**7.0**	**9.3**	**2.2**	**1.0**	**1.5**	**100.0**

(a) Differences in own payroll tax revenues and assessed GST shares resulting from economic growth in New South Wales that yields an additional $100 million of payroll tax revenue in that State, assuming no change in the structure of payroll tax or changes in rates, based on the Grants Commission's assessments for 2008-09 contained in its 2010 Review Report. For the purposes of calculation, no progressivity in the incidence of the tax has been assumed, i.e. the increase in tax yield has been assumed to be proportional to the overall increase in compensation of employees.

Conclusion

Despite the neutrality objective of the Commission, states can affect whether a policy is deemed to be average policy or not, and states can affect the measurement of that average policy. Both of these factors can distort state decision making and lead to sub-optimal outcomes.

The current HFE system incorporates disincentives for states to undertake various efficiency enhancing taxation changes and or policies designed to boost their state's fiscal capacity.

The effect of HFE is to redistribute the benefits of reform across all the states, reducing the benefit to the state which undertakes the initiative. Strengthening the incentive for reform will lead to higher productivity growth and make the HFE system consistent with the microeconomic reform agenda of other arms of government policy.

The HFE system needs to remove the disincentives for states to undertake reform and should not distort state decision making. A system based on an equal per capita distribution of the GST pool is consistent with these objectives.

3. Alternative Distribution of the GST Revenue

New South Wales considers that the GST revenue should be distributed to the states in full, untied and on an equal per capita (EPC) basis.

An EPC distribution automatically includes an element of funds transfer from stronger to weaker states. It is administratively simple, transparent and more predictable. It is more contemporaneous than the current system and is relatively stable over time. An EPC distribution would not have the data requirements of the current system. Importantly an EPC system is policy neutral, providing no disincentives for tax or service delivery reform.

Adoption of an EPC model would strengthen the framework for intergovernmental financial relations, clarify the operation of funding agreements and government accountability, and restore confidence in the system. It would establish a sound basis for interstate comparison of government services, bringing pressure to bear on the efficiency of state government service delivery.

- an EPC distribution would focus States on good spending and revenue raising decisions rather than having to consider possible impacts on GST share from policy decisions.
- an EPC distribution would be contemporaneous. It would not depend on data which can only be produced with, at least, a two-year lag. It would use, as does the current system, current year ABS population estimates, with ex-post adjustment, as is also currently the case for variation of outcomes from population estimates.
- an EPC system would be stable. Being objective and dependent on economic data, its outcomes would not be affected by changing financial or political influences and judgements. Any judgements can then be reserved for the nature, extent and any applicable conditions for additional support for the smaller states and territories.

The Commonwealth should support this objective through taking responsibility for funding any additional financial assistance to the fiscally weaker states so no state is worse off. Based on the results of the current HFE system, the magnitude of such payments would not exceed one per cent of total Australian tax revenue.

The Commonwealth could translate its broader based revenue position into increased support for service delivery in the States. Assuming that an EPC system would need to be phased in over a five to ten year time horizon, any immediate commitments by the Commonwealth for equalisation payments would be limited.

Transitional Measures

New South Wales recommends moving to an EPC distribution of the GST pool, with the Commonwealth providing any additional assistance necessary to the fiscally weaker states. However, New South Wales recognises that this may not be able to be achieved immediately. Accordingly, transitional measures may be necessary in the lead up to our preferred outcome. Possible transitional measures include:

- distribute a proportion of the GST pool EPC with the remainder distributed using relativities
- partial equalisation based on a 'comparable' level of services
- separate funding for Indigeneity
- partial equalisation based on a smaller pool.

Something considerably less than pursuit of absolute equality between jurisdictions can result in a fair outcome and produce confidence in federal financing arrangements.[13]

This methodology review provides the opportunity to commence the long run transition to an EPC distribution by dividing the GST pool into two parts, one of which would be distributed by applying relativities, while the other is distributed EPC. The EPC component could be progressively increased to achieve the long term goal of the whole pool being distributed EPC, with the Commonwealth contributing to redistribution funding.

Partial Equalisation Based on a 'Comparable' Level of Services

Changing the equalisation objective, so that equalisation is directed towards enabling states to deliver services of 'comparable' standards rather than the 'same' standard, would offer an alternative transition path. Under this alternative, minimum acceptable service standards would be adopted as equalisation benchmarks.

An approach based on a comparable level of services would better place Australia to meet the economic and social challenges it is facing. This approach would promote a better balance of equalisation and efficiency considerations and encourage greater State responsibility and self-sufficiency.

This could be achieved by setting the standard for determining the redistribution of GST revenue across all assessments at the minimum levels of effort of jurisdictions in major expense categories and redistributing GST to meet that standard, rather than the average standard.

[13] GST Distribution Review, *First Interim Report*, p.22.

This standard would base the GST redistribution on minimum standards and minimum efforts, scaling down assessed expenses and revenues, thereby reducing the amount of GST redistributed. Revenues as well as expenses would need to be subject to the same discount to ensure the balance between the two is retained.

It is important to note that a jurisdiction with the 'minimum' effort does not necessarily mean that that State has a lower standard of service outcome. It may mean that the State achieves the service standards of the other States more efficiently.

This would provide an incentive for efficiency, but still allow all jurisdictions to fund service provision consistent with acceptable levels.

Separate Funding for Indigeneity

Under the current HFE system, the major difference in expense relativities reflects the influence of the 'Indigeneity' disability factor. For 2013-14, this disability factor is estimated to redistribute $2,196 million of GST revenue among the states.[14]

However, there are difficulties in the current system in obtaining reliable and comparable data relating to the Indigeneity disability factors. It is also arguable whether HFE is the best approach for addressing long term, entrenched disadvantage in one section of the community or whether alternative funding arrangements might provide better outcomes.

New South Wales considers that funding for services to Indigenous people needs to be better targeted to address indigenous disadvantage and so achieve the most effective outcomes. The Commonwealth has clear responsibility for Indigenous matters and should provide direct funding for this purpose, subject to full consultation between governments and Indigenous communities.

Removing the Indigeneity disability factor from HFE assessments would provide a useful transition step towards an EPC distribution, which could be taken in its own right or coupled with one of the transition paths outlined above.

4. Recommendations of the GST Distribution Review Specified in the Terms of Reference

Recommendation 3.1 on materiality thresholds

To ensure the system is not driven to become falsely precise, the Panel recommends that materiality thresholds for the next review be set at:

[14] CGC, *2013 Update*, Data Supporting the Calculation of the Relativities, Table S4-6.

- Category total expense or revenue average of $200 per capita
- Category redistribution $120 per capita for any State
- Disability $40 per capita for any State
- Data adjustments $12 per capita.

Further analysis is needed to determine the impact of changing materiality thresholds in the absence of making discrete changes to the assessment structure.

There is a need to settle the category structure for equalisation in advance to ensure clarity on the application of these thresholds and New South Wales agrees with the Panel's observation that, because of volatility, materiality should be evaluated over a number of years rather than simply in one year.

New South Wales notes that the introduction of materiality thresholds for the CGC's 2010 Review substantially reduced the level of complexity in equalisation assessments.

New South Wales agrees with the GST Distribution Review Panel's view that a large increase in the threshold for disabilities would be required in order to further reduce the number of assessments significantly and that, because of the need to check whether a particular disability level meets a materiality threshold, a further increase in these thresholds would provide limited simplification gains.

New South Wales is also concerned that the impact of materiality thresholds on the complexity of assessments ultimately depends on the classification scheme for assessment categories adopted by the CGC.   For this reason, New South Wales considers that, to be effective, an increase in materiality thresholds would need to be coupled with measures designed to reduce the number of assessment categories.

Recommendation 3.2 on rounding relativities

To ensure the system does not appear to be falsely precise, the Panel recommends that relativities produced from the CGC's process can be rounded to two decimal places in the annual Updates and Reviews.

New South Wales agrees that false precision is a concern with the current HFE process. Rounding relativities to two decimal places will not remove false precision from the process in the absence of any other changes to methodology. It is also possible that rounding to two decimal places would lead to an increase in volatility. Further analysis by the CGC is required to determine the effect of this proposal.

Further analysis is also needed to determine the calculation point at which the rounding occurred, that is, whether all calculations are rounded to two decimal places, or only the final relativity obtained after all other calculations occurred.

Recommendation 6.1 on the treatment of Commonwealth payments

In recognition of the inter-related nature of transport networks and the national benefits that accrue from increasing the efficiency of these integrated transport networks, the CGC should identify all Commonwealth payments relating to the national network road infrastructure and rail based transport infrastructure.

All identified payments should affect the relativities on a 50 per cent basis, to recognise their dual national/State purpose. To ensure that States that have previously received rail based transport payments are not disadvantaged, this change in treatment should apply from the CGC's 2013 Update.

New South Wales agrees that all Commonwealth payments relating to infrastructure of national significance should be separately identified and separately assessed. However, there need to be clear criteria determining what constitutes infrastructure of national significance. These criteria would need to be agreed between the states and the Commonwealth and could include input from Infrastructure Australia, Infrastructure NSW and the various other state infrastructure bodies.

This should include the development of rules for the treatment of infrastructure which has dual national/State purposes.

New South Wales does not support the adoption of an arbitrary 50 per cent weighting.

New South Wales believes that the consideration of the appropriate treatment of transport infrastructure should include consideration of treating all infrastructure grants to the states by exclusion.

Treating all infrastructure grants by exclusion would remove the arbitrary nature of the current system whereby different types of infrastructure grants are treated in different ways. Exclusion would reduce complexity and aid transparency as well as, arguably, implement the Commonwealth's intentions when providing an infrastructure grant to a state.

Recommendation 6.2 on data revisions

Where data are updated or released annually with a lag, or updated or released less frequently than annually, the CGC should allow the newly available data to only inform changes in States' circumstances in the most recent assessment year and not be used to revise previous estimates of earlier inter-survey years.

New South Wales agrees the CGC should allow newly available data which is updated or released annually with a lag, or updated or released less frequently than annually, to only inform changes in States' circumstances in the most recent assessment year and not be used to revise previous estimates of earlier inter-survey years.

The magnitude of revisions to equalisation outcomes attributable to data revisions highlights the dependence of the current equalisation system on unreliable data. The most appropriate remedy is to reduce such dependence by adopting an alternative approach.

Table 6 shows the effect of data revisions on the relativities for the three years 2010-11 to 2012-13. Relativities for 2010-11 are affected by both data revisions and changes to assessment methods arising from the 2010 Review (excluding the shortening of the review period from 5 to 3 years). For 2011-12, the figures reflect primarily the effect of back casting from the then recently available update to the ABS Survey of Education and Training (SET) data for the calculation of relative state wage rate disabilities. For 2012-13, the figures reflect the use of newly available data on Commonwealth and privately funded service provision in the community and other health assessment, the correction of several errors and other data revisions.

Table 6: GST Impact of Data Revisions

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	$m	$m	$m	$m	$m	$m	$m	$m	$m
2010-11[(a)]	-701	-35	879	108	21	-1	-84	-186	1,007
2011-12	-385	-219	99	345	52	26	-1	83	605
2012-13	-235	251	32	-77	17	7	5	1	312
Cumulative Impact	**-1,321**	**-4**	**1,009**	**375**	**89**	**32**	**-79**	**-101**	**1,505**

(a) Includes the effect of 2010 Review changes to assessment methods, not including the effect of changing to a 3 year averaging period.

Source: CGC, *2010 Review, 2011 Update, 2012 Update.*

The absolute impact on state relativities has been significant, with a total negative impact on NSW GST share of $1.3 billion over three years. The largest per capita impact was on the Northern Territory in 2010-11, with a reduction in GST revenue of more than $800 per capita in that year.

As the Panel indicates, a key effect of such data revisions is to reduce states' ability to predict GST revenues. States should be reasonably confident of their forecast relativities for the next year because it is based on an average of three assessment years, two of which have already been dealt with by the CGC. However, data revisions have the effect of undercutting certainty for those two years.

The use of new data, coupled with back casting, has the effect of shifting estimated relativities for the three assessment years in the same direction, with the result that the smoothing effect of the three year averaging process is largely negated.

When data (such as the SET data used for the calculation of relative state wages disabilities) that are available only at widely spaced intervals are used in assessments, the result is, in effect, a partial 'freezing' of the relativities. When new data become available, there is then likely to be a disproportionate shift.

If back casting is used, calculated relativities which may be subject to back casting can only be regarded as provisional. This has similarities with the 'advances and completions' approach considered and rejected by the CGC in the course of its 2010 Review. The provisional nature of the initial assessment of relativities means that the full force of any discrepancy is felt in the 'completions' stage when the back-casting 'corrects' the 'error' in the earlier data.

Recommendation 6.3 on simplified assessment framework

That the CGC examine the merits of adopting a simplified and integrated assessment in its next methodology review.

New South Wales considers that the CGC should examine the adoption of a simplified and integrated assessment framework as a matter of priority in the 2015 Review.

New South Wales believes that there should be a return to an operating statement framework.

New South Wales recommends the distribution of GST on an equal per capita basis, with the Commonwealth providing additional funding to recipient States as the appropriate long term policy position. This would provide a highly simplified approach to GST distribution.

Recommendation 6.4 on cost equalisation

That the CGC investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis. This investigation should occur in the context of the assessment of other cost disability factors including costs of remote locations, and administrative scale.

New South Wales has previously expressed concerns about the calculation and size of both interstate and intrastate cost differentials.

Table 7: Contribution to difference between equalisation and equal per capita distribution of the 2013-14 GST, disability factors

Effects on expense requirements	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
Population dispersion ($m)	-606	-866	398	732	171	-90	-215	477	1,777
Interstate wage levels ($m)	446	-637	-451	722	-165	-103	97	91	1,357
Population dispersion ($pc)	-82	-150	85	289	102	-175	-560	2,025	77
Interstate wage levels ($pc)	60	-111	-96	285	-99	-200	253	388	59

Source: CGC, *2013 Update*, Data Supporting the Calculation of the Relativities, Table S4-6.

Table 7 shows the effect on the redistribution from both intrastate (population dispersion) effects and interstate (primarily wage differentials) effects. These two effects have respectively the second and third largest effect on the expenditure requirements; Indigeneity is the largest effect.

It is important for the credibility and integrity of the HFE process that there is confidence around the methodology and estimates used in deriving these factors.

The current non-wage interstate costs assessment needs to be re-examined to ensure that it is based on clear evidence of differential costs between states. In the 2010 methodology review the Commission stated:

"We could find no comprehensive, comparable data that would allow us to make a reliable policy neutral measure of the disabilities. Nevertheless, the strength of the conceptual case for interstate non-wage cost differentials and the evidence and data that were available lead us to conclude that they have a large effect. We are convinced that a better equalisation outcome would be delivered by making an assessment than not.

We have made an interstate non-wage assessment, but restricted it to measuring cost differences relating to interstate freight and travel costs. We consider they are most affected by interstate non-wage cost differentials. The interstate non-wage assessment is, by its nature, approximate. We do not believe that including other small assessments with very different redistributive patterns would necessarily increase the accuracy of the overall assessment."[15]

New South Wales does not agree that a strong conceptual case has been made for interstate non-wage costs having a differential impact across the states. Given the possibility of multiple

[15] CGC, *2010 Review*, Vol.3 - Supporting Information, pp.509-510.

sources of supply for different states, e.g. proximity to Asia for the Northern Territory and Western Australia, larger centres of domestic production in New South Wales and Victoria, it is not clear that freight costs have a significant differential impact.

In addition, even if there were a conceptual case, there is no clear evidence as to the size of this influence, as the CGC acknowledges. This lack of certainty leads to the high discount (50 per cent) that is applied to this factor. However, given the degree of uncertainty, it would be preferable for this factor not to be included at all unless clear and convincing evidence emerges of its influence.

The analysis of intrastate cost differentials reflects many of the same concerns as the interstate assessment. The CGC acknowledges that the wages data that was used in deriving the cost gradients in this assessment were not directly comparable across states.

"The data on average wages per full-time equivalent (FTE) employee were comparable across regions within each State (except for the schools data from New South Wales) but they were not directly comparable across States."[16]

It is also unclear how much policy differences across states may influence this assessment. For example, policies on the seniority and/or staffing levels of police and teachers in areas further from the capital may vary across states, with consequent impacts on costs. But any cost impact would be based on policy differences, rather than a policy neutral assessment of the disability.

New South Wales also is concerned about possible double counting that may occur in this assessment, particularly in relation to socio-demographic factors. It is possible that factors influencing the socio-demographic factor, such as low SES and low English proficiency, would also be factors in more remote areas.

This possibility was dismissed by the CGC in the 2010 Review: 'As the regional costs assessment measures costs per staff member, we do not believe any double counting would be significant.'[17]

However, there was no analysis or evidence provided in the 2010 Review to support this assertion. The possibility of double counting, and the interaction between regional costs and SDC factors, should be analysed more closely in this review to ensure that there is no double counting.

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[16] CGC, *2010 Review*, Vol.3 - Supporting Information, p.515.

[17] CGC, *2010 Review*, Vol.3 - Supporting Information, p.515.

Recommendation 7.1 on the mining revenue assessment

That, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to:

- continue to ensure that Western Australia's removal of iron ore fines royalty rate concessions in 2010 does not cause iron ore fines to move into the high royalty rate group in the 2010-11 or 2011-12 assessment years
- consider the appropriate treatment of iron ore fines for the 2012-13 assessment year and future years, in light of Western Australia's decision to bring the iron ore fines royalty rate to the same level as that for iron ore lump.

The 2012-13 assessment year will not affect the relativities until the 2014 Update.

New South Wales notes that the CGC has issued a Staff Discussion Paper (CGC 2013-02-S) on the treatment of iron ore fines in the 2014 Update. New South Wales will provide a submission in response to that discussion paper.

Recommendation 7.2 on the mining revenue assessment

That the CGC and other stakeholders develop a new mining revenue assessment at the earliest opportunity. The new assessment should:

- avoid excessively large GST share effects, such as when a commodity moves between groups under the current assessment
- treat iron ore, coal and petroleum differently to minerals that are not subject to Commonwealth resource rent taxes.

The current mining revenue assessment is responsible for the largest redistribution of all the assessments, revenue as well as expenses, in the HFE process, so it is important that the assessment be well-founded and generally accepted.

Table 8: Contribution to difference between equalisation and equal per capita distribution of the 2013-14 GST

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
Mining revenue ($m)	1,755	2,383	-833	-4,041	433	162	166	-25	4,899
Mining revenue ($pc)	238	413	-177	-1,597	259	314	431	-107	211

Source: CGC, *2013 Update*, Data Supporting the Calculation of the Relativities, Table S4-6.

The mining assessment has a number of significant issues which will need to be addressed in this methodology review.

One of the basic tenets of the HFE process is that the assessment should be policy neutral. However, this can be difficult to achieve in an assessment category, such as mining, which is dominated by two jurisdictions, in this case Western Australia and Queensland.

Policy changes, for example changes to royalties, for iron ore in Western Australia or coal (particularly coking coal) in Queensland, will lead to changes in the outcome of the mining assessment.

The impact of the policy changes is exacerbated by the current two-tier royalty structure of the mining assessment. This structure can exaggerate the effects of a relatively minor policy change. For example, a relatively small change in the iron ore fines royalty rate could move iron ore fines from the low royalty category to high royalty tier, leading to a significant loss of revenue for Western Australia.

The unequal distribution of mineral resources around the states means that policies in the two key states will continue to influence this assessment. However, it may be possible to reduce the sharpness of the impact of policy changes by moving to a more graduated assessment structure with a number of royalty tiers, rather than the current two-tiered structure.

Recommendation 7.3 on the mining related expenditure needs

The Panel recommends that, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to add an amount to its expenditure assessments equivalent to a 3 per cent discount of the mining revenue assessment in order to compensate for the fact that some mining related needs of the resource States are not fully recognised. This interim assessment should remain in place until the next methodology review is completed.

Previous attempts to evaluate any economic development costs have not been conclusive. In particular, New South Wales has significant concerns over the impact of policy decisions on mining related expenditure.

Any adjustment of this nature should be based on clear evidence that there are mining related expenditure needs that are not currently recognised and that any needs were not the result of a state's policy choice.

5. Other Specific Issues in the Terms of Reference

HFE Treatment of NERA Funding

Clause 6 of the Terms of Reference states:

> The Commission will ensure that the GST distribution process will not have the effect of unwinding the recognition of educational disadvantage embedded in the National Education Reform Agreement (NERA) funding arrangements. The Commission will also ensure that no State or Territory receives a windfall gain through the GST distribution from non-participation in NERA funding arrangements.

This clause is consistent with clauses 76 and 77 of the NERA.

New South Wales agrees strongly with this clause in the terms of reference. NERA arrangements for some States are not yet finalised, so it is difficult to be too prescriptive in relation to CGC treatments at this stage. However, there are two main principles that should be borne in mind.

- Under the NERA Commonwealth funds are to be provided to states on a base funding per student basis, which is then augmented by a number of loadings that seek to compensate schools for a range of factors that give rise to educational disadvantage. The CGC's assessment will need to ensure it does not unwind the loadings built into NERA funding.

- It is conceivable that some States will not participate in NERA. From a GST distribution perspective it will be important to ensure that States that sign up to NERA do not have their GST share reduced by their participation in NERA. On the other side of that coin, it will be important to ensure that States that do not participate in NERA do not have their GST share increased by their non-participation in NERA.

On the first issue, the factors that NERA will take into account for loadings in addition to base funding comprise:

- Indigenous students
- remoteness
- small school size
- low socio-economic status (SES)
- students with low English language proficiency.

The factors currently used by the CGC in its assessment of schools education include:

- socio-demographic composition taking into account Indigeneity, low SES, and non-government students
- service delivery scale, taking into account small school size in smaller communities
- location costs, taking into account differences in the unit costs of providing services in different areas
- low English fluency, although this is not included as a specific factor in the school education assessment but rather included in an aggregate allowance in the Other Expenses category
- transport expenses to recognise the differences between states in the cost of providing transport services to school students
- administrative scale and
- non-government SPP (though this is only included to ensure that overall the National Schools SPP payment for non-government schools has no impact on the distribution of GST revenue since the non-government schools payment provided 'through' the states in the National Schools SPP is assessed actual per capita in the assessment of Commonwealth payments).

There are a number of common factors – Indigeneity, low SES, small school size, remoteness, low English fluency – used to determine the loadings under the NERA and the factors used by the CGC in the schools education assessment.

The loadings determined under NERA need to be excluded from the HFE process. If the NERA loadings are not excluded from the HFE process it could have the effect of unwinding NERA's recognition of educational disadvantage due to differences in either the factors taken into account by the CGC or by different weights provided to those factors by the CGC compared to the weighting in NERA. Adjustments will need to be made to both the revenue and expenditure sides of the assessments in order to ensure that the NERA loadings are treated symmetrically.

Excluding the NERA loadings will require a clear differentiation in the Commonwealth funding to the states between the base Schooling Resource Standard funding and the loadings.However, this raises issues in relation to base funding also, and the funding to be provided by States under NERA. If Commonwealth funds provided in response to perceived need through loadings on top of base funding meet the equalisation needs of the States in relation to school education, what is the appropriate treatment of base funding?

The terms of reference do not provide any guidance on the HFE treatment of the base funding to be provided under NERA.

There are two possible methods of treating the base funding:

- exclude the base funding from CGC considerations, as well as the loadings
- equalise the base funding.

The purpose of equalisation is to provide states with GST revenue so that they have the fiscal capacity to provide services at the same standard if each operated at the same level of efficiency.

The current schools education assessment is responsible for the largest redistribution of GST of all the expense assessments.

Table 9: Contribution to difference between equalisation and equal per capita distribution of the 2013-14 GST

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist.
Schools education ($m)	-18	-935	418	254	-86	105	-51	312	1,090
Schools education ($pc)	-2	-162	89	101	-51	203	-132	1,327	47

Source: Commonwealth Grants Commission (CGC), *2013 Update*, Data Supporting the Calculation of the Relativities, Table S4-2.

The largest factors leading to this redistribution – Indigeneity, low SES, location, service delivery scale and (though occurring through a different channel) non-proficiency in English– are the factors which are incorporated into the NERA loadings.

In the case of schools education, the NERA loadings provide the states with the additional fiscal resources to provide education at the same standard, given their student mix. The loadings are essentially undertaking the role usually played by HFE in the case of schools education. If remaining differences in State spending on schools education reflect State policy differences alone, there is no need for any further equalisation to be undertaken by the CGC.

If the CGC decided to equalise the base funding this could lead to double counting of the same factors considered in the NERA loadings, leading to some possible unwinding of the factors in the loadings and/or providing a windfall gain to non-participant states, contrary to the terms of reference and to Clauses 76 and 77 of the NERA.

Given the influence of these factors, the simplest solution might be an equal per capita assessment of all school expenses and Commonwealth funding or the exclusion of all funding and expenditures related to schools education from the HFE process, including for non-participant states which would continue to receive funding under the existing National Schools SPP.

HFE Treatment of DisabilityCare Australia

All states and territories have now signed up for DisabilityCare Australia.

There are differences between the states in the date for the launch of the program and the transition to the full program.

- New South Wales – the launch commences on 1 July 2013. From July 2016, DisabilityCare Australia will progressively roll out in New South Wales and by July 2018, all eligible residents will be covered.
- Victoria – the launch commences in July 2013. From July 2016, DisabilityCare Australia will progressively roll out in Victoria and by July 2019, all eligible residents will be covered.
- Queensland – from July 2016, DisabilityCare Australia will progressively roll out in Queensland and by July 2019, all eligible Queensland residents will be covered.
- South Australia – children with disability in South Australia will start to move into DisabilityCare Australia from 1 July 2013. From July 2016, DisabilityCare Australia will progressively roll out in South Australia and by July 2018, all eligible residents will be covered.
- Tasmania – participants aged 15–24 years as at 1 July 2013 will be able to access the scheme during the first stage of DisabilityCare Australia in Tasmania. Over the next three years, young people with significant and permanent disability will be able to access the scheme when they turn 15 years old. From July 2016, DisabilityCare Australia will progressively roll out in Tasmania and by July 2019, all eligible residents will be covered.
- Australian Capital Territory – the scheme will launch on 1 July 2014. DisabilityCare Australia will have full coverage across the ACT by July 2016.
- Northern Territory – people with a significant and permanent disability will be able to access the scheme from July 2014. From July 2016, DisabilityCare Australia will progressively roll out in the Northern Territory and by July 2019, all eligible residents will be covered.

The differences in timing in the commencement of the scheme and when full coverage will be implemented raise a number of issues for the CGC to consider in the 2015 methodology review:

- treatment of expenditure during the transition phase
- when does the transition phase end
- treatment of expenditure when the scheme is fully implemented
- treatment of non-participant states.

Treatment of expenditure during the transition phase

At least during the early stages of the transition phase most of the expenditure will be on the same basis as currently. New South Wales recommends that during this phase both state own expenditure and contributions to DisabilityCare Australia be assessed on the current basis using broadly the existing methodology. Any Commonwealth payments to States associated with launch sites would need to be excluded from the CGC's assessments, as payments for non-standard services.

When does the transition phase end

Ordinarily, a policy becomes common state policy when it is adopted by a majority of states covering a majority of the population, suggesting DisabilityCare was common policy from 2013-14 with, potentially, a shift to the full scheme funding model from that year.

However, given the time frame in extending coverage beyond the launch sites it may be more appropriate in this case for the transition treatment to be continued until the majority of the population is covered by the scheme. This could be 2016-17 onwards, but the precise timing will be dependent on the degree of scheme coverage.

Treatment of expenditure when the scheme is fully implemented

When the scheme is fully operational all participant states will be following similar policies, although the basis of the actual funding commitment may vary from state to state.

In these circumstances, an equal per capita assessment may be the most appropriate treatment so that GST redistribution is not affected by DisabilityCare Australia.

Alternatively, both the revenue and the expenditure could be excluded from the standard budget, again having no effect on GST redistribution.

Treatment of non-participant states

Following the transition period, DisabilityCare Australia becomes the average state policy. As such, non-participants should be treated as if they were participants. Non-participants could potentially gain a GST windfall if disability expenditure continued to be assessed by the CGC. Treating both the revenue and expenditure by EPC, or excluding it from the standard budget, would ensure that there were no windfall gains to non-participants.

6. Other Specific Assessments

INSURANCE TAX ASSESSMENT

New South Wales has concerns with the insurance tax assessment where the size of a state's tax base (premiums paid) is clearly heavily influenced by the state's policy on the rate of duty. The current form of HFE produces disincentives for the abolition of inefficient taxes such as insurance taxes.

This assessment category includes duties for various forms of insurance that are mostly levied on premiums. They are imposed on insurance companies, who pass the burden on to their customers.

In the 2010 CGC Methodology Review, the CGC considered that a separate insurance category is warranted because material amounts of revenue are collected from the tax and the interstate distribution of the revenue base differs from that of other taxes such as stamp duty on conveyances.

However, the Australia's Future Tax System (AFTS) Report suggests that insurance taxes are highly inefficient, with a marginal excess burden (deadweight loss) of 67 cents for each additional dollar of revenue raised. This means that the existence of the tax has an impact on economic decisions, in this case whether to insure or not.

The application of different rates by the states results in different amounts of shrinkage in their tax bases. The following table, based on Table 2.6 of the AFTS Report, shows the impact of removing these policy-induced differences on the insurance tax assessment.

Table 10: Insurance tax assessment with policy-neutral tax base, 2010-11

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Actual revenue ($m)	918	912	546	468	371	49	45	33	3,342
Revenue base ($m)	10,456	6,783	5,706	2,978	2,146	517	426	255	29,267
Average tax (%)	8.78	13.45	9.57	15.72	17.29	9.48	10.56	12.94	11.42
Difference from Average (% pts)	-2.64	2.03	-1.85	4.30	5.87	-1.94	-0.86	1.52	0.00
Impact on revenue base $m (a)	-970	483	-371	450	443	-35	-13	14	0
Pol. Neutral Revenue Base ($m)	9,486	7,266	5,335	3,428	2,589	482	413	269	29,267
Assessed Revenue ($m)	1083	830	609	391	296	55	47	31	3342
Population (mill)	7.3	5.6	4.5	2.3	1.6	0.5	0.4	0.2	22.4
Assessed Revenue ($pc)	149.19	148.70	134.17	169.13	179.15	108.08	130.34	133.70	148.89
Revenue Capacity	1.00197	0.99873	0.90111	1.13593	1.20320	0.72590	0.87542	0.89798	1.00000
GST effect ($m)	-2	1	67	-47	-50	21	7	3	0
CGC Result ($m)	-113	56	25	5	1	17	5	5	0
Difference ($m)	111	-55	42	-52	-51	4	2	-2	0

(a) Based on the AFTS estimate of marginal excess burden of 0.67.

The current insurance tax assessment leads to a redistribution of $113 million away from New South Wales. However, the NSW tax rate is significantly less than the average, which, ceteris paribus, leads to a larger tax base.

The NSW tax rate is 2.64 percentage points below the average rate applied by all the states. Tasmania, Queensland and the ACT also have below-average rates.

Adjusting the tax base for the impact of the below average tax rate in New South Wales leads to a reduction in the NSW tax base of $970 million. The lower tax base results in a much lower

GST redistribution. After adjusting for the policy-induced effect of the tax rate on the tax base, the revised assessment shows that only $2 million of GST revenue should be redistributed away from NSW. This is $111 million more in GST revenue than assessed by the CGC.

If New South Wales were to abolish insurance taxes, its capacity to raise revenue from these taxes would continue to be assessed by the CGC. According to the AFTS, the average excess burden of insurance taxes is 47 cents for each dollar of revenue raised. This means that the abolition of insurance taxes by New South Wales would lead to a doubling in the size of its tax base over time. The effect of this on NSW assessed GST revenue is shown in the table.

Table 11: Insurance tax assessment with insurance taxes abolished in New South Wales

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Revenue after abolition ($m)	0	912	546	468	371	49	45	33	2,424
Adjusted Revenue Base ($m)[(a)]	18,404	6,783	5,706	2,978	2,146	517	426	255	37,215
Tax Rate (%)	0.00	13.45	9.57	15.72	17.29	9.48	10.56	12.94	6.51
Assessed Revenue ($m)	1,199	442	372	194	140	34	28	17	2,424
Population (mill)	7.3	5.6	4.5	2.3	1.6	0.5	0.4	0.2	22.4
Assessed Revenue ($pc)	165.09	79.18	81.85	83.82	84.72	66.16	76.65	72.39	107.99
Revenue Capacity	1.52870	0.73323	0.75794	0.77618	0.78448	0.61266	0.70980	0.67035	1.00000
GST effect ($m)	-415	161	119	56	38	21	11	8	0
CGC Result ($m)	-113	56	25	5	1	17	5	5	0
Difference ($m)	- 302	105	94	51	37	4	6	3	0

(a) Based on the AFTS estimate of average tax burden of 0.47.

The net effect would be to redistribute an additional $302 million away from New South Wales to other states. This is a considerable disincentive to tax reform.

The CGC acknowledges that these 'elasticity' effects should be taken into account in its tax assessments, but has not done so because it regards the data necessary for the calculations to be unreliable.

New South Wales considers that the disincentive effects of HFE can only realistically be removed by the adoption of a new approach that does not rely on category-by-category assessments. In the absence of fundamental reform to the HFE system, tax reform will create winners and losers, making agreement difficult in the absence of additional Commonwealth incentive funding.

ADMINISTRATIVE SCALE ASSESSMENT

The assessment of administrative scale costs needs to be reconsidered to ensure that it truly assesses the 'minimum costs of administration' needed to provide the normal array of state services totally independent of the scale at which states need to deliver services.

Basing the assessment on the 'minimum administrative cost that would be incurred for a State with a population size of the smallest State'[18] risks including costs related to the scale at which that state provides services. 'Minimum administrative cost' is a concept related to theoretical 'minimum functions of government' rather than the scale at which those functions need to be provided. If an assessment of those costs is to be made, it needs to be totally independent of any scale of operations.

The Commission considers that States with small populations have intrinsically higher per capita costs because the minimum functions of government have to be spread over a smaller number of residents.

The assessment is said to capture the minimum administrative cost that would be incurred for a state with a population size of the smallest state. It includes costs associated with:

- core head office functions of departments (for example, corporate services, policy and planning functions, but not all staffing and other resources delivering these) and
- services that are provided for the whole of the state (for example, the legislature, the judiciary, the Treasury, the revenue office, and a state museum, but not all staffing and other resources delivering these).

Each state is said to have the same requirement for minimum administrative costs, that is, the level of expenses incurred by a state with a population size of the smallest state. Since the absolute amount of minimum administrative costs is assumed to be the same for all states, the per capita cost is higher for the less populous states.

New South Wales has argued in the past that the minimum cost of administration as measured by the CGC cannot be assumed to be the same across all states because in practice the measurement would be heavily dependent on the scale at which services have to be delivered, which itself is heavily dependent on population size.

If minimum costs of administration are independent of population, the estimate of their level would not need to be based on the level of expenses incurred by a state with a population size of the smallest state. They could be based on the level of expenses for the minimum cost of

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[18] CGC, *2010 Review*, Vol.2, p. 492.

administration incurred by any state, and according to the Commission this level should be the same as for the smallest state.

In the 2010 Review, the Commission notes that New South Wales argued that the Commission should recognise that the minimum cost of the bureaucracy required before a unit of service is delivered is heavily dependent on the scale at which the service has to be delivered. Therefore, the minimum cost of bureaucracy is not the same across all States and an equal per State assessment is not appropriate.'[19]

The Commission argues that its approach assesses state expenses in two parts – the administrative scale part and the service delivery part. The service delivery part itself comprises certain fixed costs (which are total fixed costs less administrative scale costs) and variable costs. The Commission considers that this approach already recognises the NSW concern 'that larger states have bigger fixed costs than smaller states.'[20]

The Commission argues that '[c]onceptually, the fixed cost recognised for a State is the sum of administrative scale and other fixed costs multiplied by the size of its service population (its population adjusted for disabilities). The inherent fixed cost rises with a State's population, but still declines on a per capita basis.'[21]

New South Wales' concerns with the current administrative scale assessment include

- what are the basic, 'administrative' fixed costs that are truly independent of the size of the service task, and how can they be estimated appropriately by reference to the state with a population size of the smallest state?
- how is it determined what fixed costs are 'variable', or rise with a state's population, and what fixed costs are strictly independent of the size of the population? If the line is drawn at 'the level of expenses incurred for a state with a population size of the smallest state', how can we be sure that level is not influenced by population size (i.e. would not be lower or higher for a state with a lower or higher population)?

Currently, the level of administrative scale costs is based on costs estimated for the ACT and NT. However, if there were no ACT and NT, and administrative scale costs were based on Tasmania, would they be estimated at the same level, or higher? Conversely, if there were states smaller than the ACT and NT, would administrative scale costs be estimated at the same level, or lower?

[19] CGC, *2010 Review*, Vol. 2, p. 492.

[20] CGC, *2010 Review*, Vol.2, p.493.

[21] CGC, *2010 Review*, Vol.2, p.493.

New South Wales considers that those fixed costs that are truly independent of the size of the service population could be quite small given the divisibility of the inputs that constitute minimum administrative cost. As noted previously by the CGC, the administrative scale assessment captures mainly salary related costs, and does not include the costs associated with providing floor space or capital equipment, which are covered indirectly elsewhere[22] or directly in the capital investment assessment (where population plays a major role).

The Commission also has noted previously that while it '… sometimes refers to Administrative scale as fixed costs, the cost of the minimum level of administration is quite different from the usual economic concept of fixed costs. The Commission is not seeking to identify and assess expenses that are fixed in the short to medium term. ….The Commission's concept of education fixed costs, for example, consists solely of the minimum cost of the education bureaucracy required before a unit of service is delivered.'[23]

The definition of this minimum cost of bureaucracy therefore becomes very important. Prior to the delivery of a unit of any state-type service there will be a basic need to determine policy for service delivery, have someone in a position to deliver the service and have someone to administer corporate service-type functions for the determiners of service delivery policy and deliverers of service.

The requirement to have any more than the basic units in place would reflect the scale at which the function needs to be delivered, and therefore would not be a 'fixed' cost.

- the Northern Territory, for example, employs 2,356 full-time and part-time classroom teachers in its government schools (at 20 June 2012, NT Department of Education and Training, Annual Report, 2011-12, p. 106). It obviously needs more than one teacher, more than one policy officer to determine what that number of teachers teach, and more than one 'administrative' person to look after payment of salaries, transfers, leave arrangements and other administrative needs for that number of teachers. However, the number of persons employed in those pursuits above the basic requirement would reflect the total number of teachers. Even for policy officers it could be expected that the larger the number of teachers, or the larger the education system, the larger the number of 'policy'-type issues that would be generated and need to be resolved. However, at the very basic level, the NT would need only one teacher to be in a position to deliver the first unit of teaching, only one policy officer to determine what, how, when and where that teacher would teach, and only one education administrator to look after the corporate service needs of that one teacher and one policy officer.

[22] CGC, *2010 Review*, Commission Position Paper CGC 2008/12, p.2.

[23] CGC, *2010 Review*, Commission Position Paper CGC 2008/12, p.2.

- New South Wales, on the other hand, employs 51,619 full-time and part-time classroom teachers in its government schools (at 30 June 2012, NSW Department of Education and Communities, Annual Report 2012, pp. 113-115). Like the Northern Territory it also obviously needs more than one teacher, policy officer and administrator, and many more of all those roles than the Northern Territory. However, at the very basic level, like the Northern Territory, New South Wales would need only one teacher to be in a position to deliver the first unit of teaching, only one policy officer to determine what, how, when and where that teacher would teach and only one education administrator to look after the corporate service needs of that one teacher and one policy officer.

In the education example it can easily be seen that New South Wales would have larger 'fixed' costs than the Northern Territory in education, if some fixed costs are said to be dependent on the size of the service population (and therefore, variable costs). NSW concern is, in a practical sense, where is that line drawn between 'administrative scale' costs and 'fixed but variable' costs?

New South Wales' concern is that basing an estimate of 'minimum administrative cost' – which should be entirely independent of population and service delivery task – on expenses incurred for a state with a population the size of the smallest state might actually be including some 'fixed but variable' costs that it is inappropriate to include, and which would not be an appropriate measure of the like-for-like costs that face states that are larger than the smallest state.

New South Wales considers that administrative scale costs are a purely theoretical concept, which cannot and should not be estimated by reference to any particular actual costs faced by any jurisdiction of a particular population size. Since administrative scale costs are a theoretical concept, they have to be estimated – if they can be estimated at all – theoretically.

This could be done by determining the minimum functions of state governments, and then determining the cost (adjusted for interstate wage differences) of the minimum labour resources required to put states in the position to provide those functions. NSW considers that this estimate of administrative scale costs would quite likely be significantly less than the $200 million plus per state currently estimated by the CGC.

A brief look at the history of how administrative scale costs have been derived indicates the definitional and measurement difficulties associated with this assessment.[24]

Initially, in the 1999 Review, the Commission calculated administrative scale disabilities for minimum fixed costs and scale-affected variable costs. Minimum fixed costs were defined as the costs of the minimum amount of corporate services and basic head office structures required to provide policy and planning for State-wide functions regardless of the size of the task. Scale-

[24] This summary of the methods underlying the administrative scale assessment in the 1999 Review is taken from CGC, *2004 Review*, Volume 7, Working Papers, Administrative Scale, paras. 4-13.

affected variable costs were expenses on corporate services and policy and planning additional to minimum fixed costs, but still subject to some diseconomies of small scale.

The estimates of fixed costs were based on 'judgements about the size of the smallest central office unit required in the smaller States to provide basic administration.' The variable scale-affected expenditures 'were based on judgement, after consideration of the nature of the services in each category and analysis of annual reports and budget papers.'

The amounts estimated in the 1999 Review were $114 million for minimum fixed cost and $102.9 million for scale-affected variable cost.

In the 2004 Review the Commission was not convinced of the conceptual case for scale-affected variable costs, since logically they varied with the size and complexity of the service being delivered. On the basis of judgement, the Commission considered that only about 10 per cent of these costs were in effect fixed costs.[25] So the scale-affected variable costs element was excluded, but 10 per cent of costs previously classified as scale-affected variable costs were added to fixed costs.

To estimate the impact on minimum fixed costs from changes in government functions since the 1999 Review the Commission used data which suggested the extra costs of new functions added around $10 million for the Education and Treasury departments of one State. It then assumed that other State government departments had been affected by similar cost increases, minimum fixed costs represented about 10 per cent of State head office expenses and the Education and Treasury minimum fixed costs were about 10 per cent of total minimum fixed costs. So in the 2004 Review the total increase in minimum fixed costs across all categories owing to changes in government functions was estimated to be $10 million since the 1999 Review.

On the basis of movements since 1999 in public sector wages (estimated as 80 per cent of fixed costs) and the CPI (estimated as 20 per cent of fixed costs), the Commission inflated the 1999 review minimum fixed costs to 2004 levels, and arrived in the end at $157.6 million as the administrative scale amount for the 2004 Review.

In the 2010 Review the CGC used the 2004 Review estimates, indexed to reflect price level changes. The index used this time was the chain price index for State and local government final consumption expenditure from the ABS National Accounts. The quantum was not increased in the 2010 Review for any increase in government functions.

The quantum of administrative scale costs was set at $213.5 million for each State in 2008-09, with a downward adjustment for the Australian Capital Territory (to $204.6 million) since it does not need to provide the average level of service in areas where it has zero or very low needs, and an upward adjustment (to $219.5 million) for the Northern Territory, since it

[25] CGC, *2004 Review*, Vol.7, Administrative Scale, para. 20.

operates dual service delivery models for its Indigenous and non-Indigenous residents in the areas of education, health, welfare and housing.

Indexation since the 2010 Review has now taken the quantum of administrative scale costs to $221 million in 2011-12.

The base administrative scale quantum (adjusted for the Australian Capital Territory and Northern Territory) is then adjusted for interstate differences in wage levels, to produce slightly different assessed amounts in each State.

The expenses themselves comprise only a small proportion of total state expenses, but because the assessed per capita differences are so large – as a result of dividing essentially the same quantum of costs for each state by very different populations – the assessment has a significant aggregate impact on the GST distribution.

Table 12: Impact on GST distribution of location adjusted administrative scale assessment, 2011-12

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Assessed administrative scale expenses ($m)	236.5	230.5	231.2	245.3	230.5	226.8	232.9	255.3	1,888.9
Population ('000)	7,247.7	5,574.5	4,513.0	2,387.2	1,645.0	511.7	370.7	232.4	22,482.2
Assessed administrative scale expenses ($pc)	32.63	41.35	51.22	102.75	140.11	443.19	628.10	1,098.57	84.02
Assessed difference ($pc)	-51.38	-42.67	-32.80	18.74	56.09	359.17	544.09	1,014.55	0.00
GST distribution impact ($m) (a)	**-372.4**	**-237.8**	**-148.0**	**44.7**	**92.3**	**183.8**	**201.7**	**235.7**	**758.3**

(a) Difference from equal per capita distribution.

Table 12 shows that in 2011-12 (the final assessment year of the 2013 Update) assessed administrative scale expenses were $1.9 billion, or only 0.9 per cent of total assessed State expenses of $209.6 billion. However, this assessment redistributed $758 million in GST revenue, or 13.8 per cent of the total GST redistributed ($5.5 billion) by all the expense assessments (excluding the investment and net lending assessments).

The tax-free threshold adjustment adds unnecessary complexity to this assessment and may influence State payroll tax policy. New South Wales recommends that the CGC remove the threshold adjustment from the payroll tax assessment. This would allow States' widely different payroll tax thresholds, which are matters of policy choice, to be averaged in the overall average tax rate in the same way that the other main aspect of payroll tax policy – varying State tax rates – is averaged.

In the payroll tax assessment the CGC uses an assessed tax base of employee remuneration paid to businesses, public trading entities and higher education institutions adjusted for a national average tax-free threshold.

The main policy choices States have in relation to payroll tax are:

- the rate of tax
- the tax-free threshold; and
- exemptions to the payment of payroll tax (which are fairly uniform across States).

Currently, it is the smallest jurisdictions (with the exception of Queensland, which progressively claws back its tax-free threshold) which have the highest tax free thresholds and the highest payroll tax rates (see Table 13).

Table 13: State payroll rates and thresholds, 2013-14

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Tax rate (%)	5.45	4.90	4.75	5.50	4.95	6.10	6.85	5.50
Threshold ($)	750,000[(a)]	550,000	1,100,000	750,000	600,000	1,250,000[(b)]	1,750,000	1,500,000

(a) Annual indexation of the threshold ceased from 1 July 2013.

(b) From 2013-14, a payroll tax concession at various rates for employers with taxable payrolls less than or equal to $1.2 million will be provided for two years. The concession will be determined by applying concessional tax rates to eligible employers' 2012-13 and 2013-14 taxable payrolls.

Thresholds and the rate of tax

New South Wales' view is that tax free thresholds are an element of policy for which the base should not be adjusted. While the payroll tax base is not adjusted for the different tax rates across the States, it is adjusted for the tax-free threshold.

The CGC includes an adjustment for the tax-free threshold to reflect 'what States do': the CGC argues it is common policy for States to exempt small employers from payroll tax and it is a material influence on State revenue raising capacities. However, the method of assessing the payroll tax base after adjusting for an average threshold may influence State payroll tax policies.

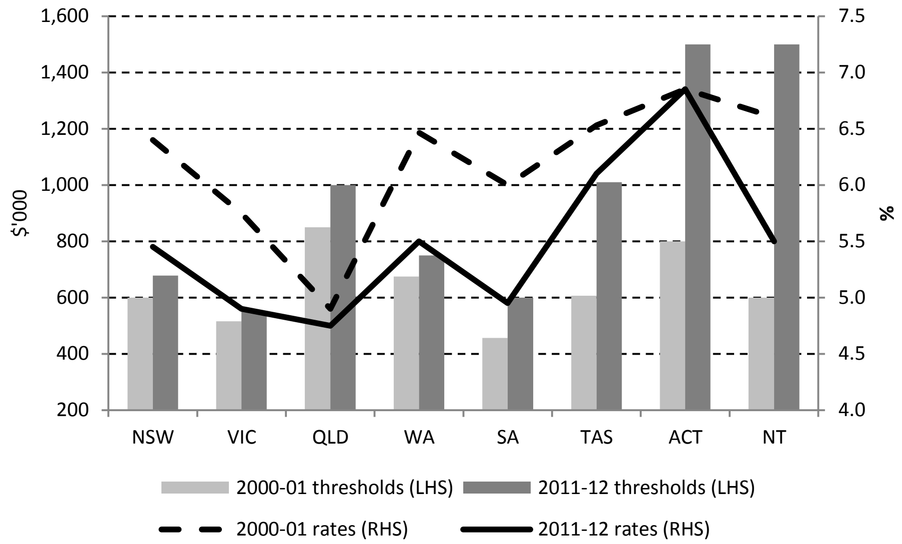
The average payroll tax-free threshold applied to all States is calculated as the weighted average of actual State tax-free thresholds, with the weights based on the total remuneration paid in each State. The percentage of a State's total remuneration above the average tax-free threshold is based on ABS advice.

The result of including an average is that certain percentage of States' total compensation of employees – that proportion paid in firms that are below the average payroll tax threshold and that proportion of payroll tax liable firms' payrolls under the tax free threshold – are deducted from the States' assessed payroll tax base.

Even for small states with relatively small shares of total Australian employee compensation, a change in a tax-free threshold of $250,000 would affect the average tax-free threshold by $2,500 to $7,000. Increasing the average threshold by this amount has the potential to reduce a State's assessed tax base by a degree sufficient to produce higher GST revenue, depending on the relative effects on States' taxable proportions of payrolls.

Given the relative effect of an increase in the average threshold on small States' taxable proportions of payrolls is likely to be higher than for large States, small States might have an incentive to pursue payroll tax reductions through increases in their tax free thresholds rather than cuts to payroll tax rates, which would have a much smaller impact on GST payments.

Chart 1: Payroll tax rates and tax-free thresholds, 2000-01 and 2011-12



Sources: NSW Treasury, *Interstate Comparison of Taxes 2000-01* (TRP00-3, December 2000), p. 9, and *Interstate Comparison of Taxes 2011-12* (TRP11-01, November 2011), p. 11. In 2000-01 Western Australia used a multiple marginal rate system for payroll tax – the representative rate shown is the simple average of the marginal rates; in 2001-12, Western Australia used a single marginal rate.

Chart 1 shows that the smaller states generally have higher payroll tax rates and higher payroll tax-free thresholds than the larger States, and that the smaller States have generally increased these thresholds by much more than the larger States since 2000-01.

This could simply reflect the greater significance of smaller employers in the smaller States; in the 2010 Review an average threshold of $720,000 in 2008-09 produced taxable proportions of private sector payrolls of between 62.40 and 65.64 per cent in the three smallest jurisdictions, compared to over 69 per cent in New South Wales and Victoria.[26]

However, this pattern is also understandable in light of the potential incentives provided by the CGC's payroll tax assessment. Queensland is an exception in having a tax-free threshold closer to the three smallest jurisdictions and a lower tax rate than the larger States; however, smaller employers are relatively more important in Queensland than in the other large States – its taxable proportion of private sector compensation was 64.58 per cent in 2008-09 – and it uses a deduction system for payroll taxation, under which the tax free threshold is gradually clawed back for payrolls in excess of $1 million (in 2011-12), with no deduction for payrolls of $5 million or more. The Northern Territory also introduced a deduction system in 2011-12.

A 2004 academic study concluded that '… [t]he CGC's present procedures discourage States from adopting efficiency enhancing pay-roll tax designs that are free of thresholds.'[27] The CGC's present procedures may be encouraging small States in particular to increase their tax free thresholds, rather than reduce tax rates, when contemplating payroll tax reductions.

In summary, the proposed assessment of payroll tax is inappropriate as a means of assessing revenue and as a means of contributing to equalisation for the following reasons:

- a complex method of averaging the tax free threshold and the removal of part of the payroll tax base from assessment;
- the separate determination of the threshold and tax rate effectively double counts the threshold;
- the complicated method requires adjustments to the average threshold for State policy changes;
- the need to use ABS data which may not be comparable between States and relies on State provided data; and
- the potential for the assessment to induce payroll tax setting behaviour changes by the smaller States.

[26] CGC, *2010 Review*, Vol.2, p.81.

[27] Peter B Dixon, Mark R Picton and Maureen T Rimmer, 'Payroll taxes: Thresholds, Firm Sizes, Dead-Weight Losses and Commonwealth Grants Commission Funding', *The Economic Record*, Vol.80 No.250, September 2004, p.301.

COMMUNITY AND OTHER HEALTH ASSESSMENT

New South Wales does not support the use of the 'subtraction model' to determine the need for State-funded community and other health services in the current assessment.

The overall validity of the subtraction model depends on the assumption of perfect substitutability – i.e. that a dollar of funding provided from a non-State source means the State is relieved of the need to provide a dollar of funding. The CGC has not provided clear evidence of this relationship.

The assessment should also capture the higher unit costs of culturally and linguistically diverse patients to recognise the need for longer consultations, use of interpreters and the special needs of humanitarian refugees.

The community and other health services category includes all health expenses except those relating to admitted patients and patient transport. It includes expenses on administration, inspection, support and operation of non-admitted patient services, community health, and public health.

The assessment uses a subtraction model in which the need for States to provide community and other health services is derived by subtracting from total State needs the needs that are met through Commonwealth and private provision.

The efficacy of this approach critically depends on two factors:

- an assumption that community and other health services provided by the States and by non-State providers are totally substitutable, i.e., that a dollar of funding provided from a non-State source means the State is relieved of the need to provide a dollar of funding
- accounting for all of the factors that impact on the distribution between States of the total national amount of spending on community and other health services and the distribution among States of non-State provided services.

In relation to the first point, New South Wales considers the use of Medical Benefit Schedule (MBS) payments in the current assessment as a poor proxy of the extent to which the Australian Government meets different amounts of State health and non-State community and health spending.

If the CGC subtraction model held in practice, there should be an inverse relationship between the use of Medicare-funded services and State-funded services. That is, the number of accident and emergency department presentations per capita should be lower than average for States where the number of Medicare-funded services is higher than average.

However, New South Wales has previously demonstrated that the number of presentations to accident and emergency departments in New South Wales is higher per capita than the Australian average, despite a higher per capita consumption of Medicare-funded services.

The quantity of health care services demanded is partly responsive to price. The quantity demanded will increase where patients face lower out-of-pocket expenses. It would be reasonable to assume that part of the higher than average per capita consumption of Medicare-funded services stems from more extensive bulk billing in New South Wales.

The lack of a simple explanation for relatively high per capita MBS payments in New South Wales suggests there may be interstate differences in the economic environment affecting private services provision which is not picked up implicitly in the subtraction model.

Socio-demographic composition

New South Wales has significantly lower assessed costs of providing services in this spending area than has been found in the related spending areas of the Admitted Patients assessment.

Similar factors such as an older than average population and higher than average socioeconomically disadvantaged population should also produce similar assessed costs for community and other health services.

However, this is not the case because of the assumption that a higher than average Australian Government provision of community and other health services in New South Wales, through Medicare, reduces the State's need to provide an equivalent amount of services.

NSW considers this to be a major flaw of the subtraction model and suggests that the higher than average per capita consumption of Medicare-funded services is attributable to a range of other factors.

CAPITAL ASSESSMENT

New South Wales recommends that the CGC use the holding cost approach to assess States' capital needs in place of the 'direct' approach.

A simple holding cost model which attributes the opportunity cost of capital and depreciation to the period in which the capital is used overcomes the problems with the current assessment. It is simple, transparent and consistent with conventional and widely understood economic and accrual accounting concepts.

New South Wales has made numerous submissions opposing the current CGC capital assessment which is based on the 'direct' method of assessing capital expenses.

The current approach requires assessments of:

- investment in new infrastructure to recognise differences between the States in the quantity of infrastructure required to provide services
- depreciation expenses, to capture State needs relating to the replacement of existing infrastructure. Depreciation expenses have been allocated to expense categories and are assessed as part of the cost of delivering services
- a net lending/borrowing assessment, to enable States to maintain the same net financial worth per capita, which aims to recognise disabilities relating to the capacity of States to raise revenue from unequal per capita net financial worth.

The capital assessment will, based on the CGC's estimated impact using 2009-10 to 2011-12 data and 2013-14 GST revenue, redistribute $913 million of GST revenue.

New South Wales has several major concerns with the capital assessment:

- the CGC's approach is inconsistent with 'what States' do in relation to investment in physical capital assets and financial assets
- upfront equalisation in the year it occurs is not appropriate for spending that is influenced by factors extending both backward and forward in time well beyond the current and previous years
- there is no direct annual causal relationship between population growth and investment in physical assets. The lumpiness of capital spending and its 'history' means that capital spending does not smoothly adjust year by year to population growth
- the impossibility of including in the capital expense disabilities all of the true factors that influence capital spending mean that the CGC's approach will be 'partial', despite the CGC's rejection of "partial" equalisation

- the use of recurrent expenditure disabilities to assess capital needs will not necessarily reflect the appropriate disabilities that should apply to the capital stock. Stocks and flows are affected by different influences, e.g. urban densities can affect capital stock needs differently to their effect on recurrent needs
- there is no need to equalise 'up-front' spending that in a sense is not paid for 'up-front'. Capital is acquired and used over time, and an approach to equalising capital spending along those lines is more appropriate.

The 2010 Review also acknowledges that a States' actual infrastructure stock and actual investment in new infrastructure may differ from the CGC assessed amounts.

The CGC argues that its direct approach to the assessment of capital expenses is more contemporaneous. 'It provides States with the capacity to fund investment in new infrastructure when the need arises and assets are acquired.'[28] This assumes that the demographic characteristics of each jurisdiction remain unchanged by population growth, e.g. the characteristics of migrants are similar to the existing population.

There are several ways of delivering the infrastructure needed to provide services: borrowing, leasing, private-public partnerships, use of accumulated or current revenue surpluses.

Alternative approach to assessing capital needs

New South Wales recommends that the CGC use the holding cost approach to assess States' capital needs in place of the proposed 'direct' approach.

The flaws in the current approach mean that it is not consistent with equalisation of States' capacity to provide services.

A simple holding cost model which attributes the opportunity cost of capital and depreciation to the period in which the capital is used overcomes these conceptual problems. It is simple, transparent and consistent with conventional and widely understood economic and accrual accounting concepts.

The simple holding cost approach recognises that by investing in physical capital, which mostly does not provide any monetary return, States forego the return on financial assets. This revenue foregone is the opportunity cost of holding physical assets and part of the true cost of providing services.

Total capital-related costs therefore include:

- the holding cost of capital, which is recognised in the period in which the asset is held

[28] CGC, *2010 Review*, p.440.

- depreciation, which attributes the purchase cost of capital to the period in which it is used over tits life.

New South Wales proposes that holding costs be included in the relevant expense categories (although they should be renamed cost categories) along with depreciation. The assessed cost of providing services for each State can then be based on the average per capita cost across all States, including depreciation and holding costs. Relevant disability factors can be applied to the total cost of providing services.

In practice, estimating the holding cost of capital each period requires two critical pieces of information:

- the value of the physical capital stock
- an appropriate rate of return to apply to the value of the capital stock.

The value of the physical capital stock can be obtained from Government Financial Statistics (GFS) data collected by the ABS. The value of produced non-financial assets (excluding land) is an appropriate measure of the value of the physical capital stock.

Advantages over the current approach

The simple holding cost method is simple, transparent and policy neutral. It has many advantages over the current assessment, principally by avoiding many of the conceptual problems associated with the CGC's approach. Specifically:

- the treatment of capital is consistent with standard and widely understood economic and accrual accounting concepts. In addition, all capital is treated in the same way. There is no arbitrary distinction between replacement and non-replacement capital
- the assessed cost of providing services is based on actual transactions, rather than a constructed concept of 'capital needs'. Measurement is therefore much more precise and less prone to error
- the simple holding cost method retains the operating statement as the focus of equalisation, rather than a mix of operating statement and balance sheet concepts. It therefore focuses on States' primary role of providing services – a flow concept – rather than changing asset balances which are a consequence of States efforts to provide services on a sustainable basis
- the simple holding cost approach makes no attempt to account for dilution effects. This is a deliberate omission. Population growth *per se* does not change the per capita cost of providing services in a holding cost model. There are no conceptual grounds to include physical capital stock dilution effects in the equalisation framework.

CULTURAL AND LINGUISTIC DIVERSITY

New South Wales recommends the inclusion of a CALD disability for the individual assessment categories of admitted patients, community and other health services, welfare and housing and justice services.

The inclusion of CALD could be based on judgements of the unit cost disabilities of servicing non-English speaking clients derived from Census data on the proportions of State populations that speak English poorly or not at all and from any available qualitative data.

The delivery of government services to a culturally and linguistically diverse population is a particular challenge in New South Wales. According to the 2011 Census:

- almost 40 per cent of Australian residents who speak a language other than English at home reside in New South Wales
- 27.5 per cent of the NSW population speak a language other than English at home, compared to 20.3 per cent for Australia
- Sydney is the capital city with the highest proportion of its population born overseas (33 per cent) and Hobart the lowest (12 per cent).

New South Wales also has a very high proportion of humanitarian migrants reliant upon on many services from NSW Government agencies. New South Wales is the second largest settlement location in Australia for humanitarian entrants from Iraq, Sudan, Afghanistan, Burma, Iran, Sierra Leone and Sri Lanka.

Over half of recent humanitarian entrants have settled in five NSW local government areas, many of which require additional support. A NSW Auditor-General's report notes that the State incurs considerable costs in settling humanitarian refugees:

> … New South Wales does not report specifically on expenditure relating to humanitarian entrants. However, we understand New South Wales incurs considerable expenditure on general services including health, language, education, housing and transport services. It also incurs expense for specific services. For example in 2011–12, NSW Health allocated $1.5 million to enhance Refugee Health services and improve health outcomes for refugees who settle in New South Wales. Understanding and accessing these services well directly impacts on humanitarian entrants' settlement experiences.[29]

[29] NSW Auditor-General (May 2012), *Settling Humanitarian Entrants in New South Wales*, p. 14.

In the 2010 Review the CGC acknowledges the conceptual case for inclusion of a disability reflecting the additional expenses incurred by States in providing services to migrants with low English fluency.

However, the CGC argues that extra expenses are not material in the individual categories, except for post-secondary education, and that it is not clear that extra costs are reflected in State resources allocation decisions and that higher unit costs involved in providing services to non-English speakers are offset by their lower use of services.

The CGC takes a combined approach for CALD expenses in the other expenses category covering the disability for schools education, admitted patients, and community and other health services. A more specific CALD adjustment to the post-secondary education category was made based on available data.

The CGC's analysis of CALD within the individual assessment categories is not consistent with its treatment of other disabilities, such as interstate non-wage costs. New South Wales accepts that it is difficult to provide data on the additional costs of CALD because in most circumstances non-English speakers are not provided with services in separately designated programs.

Productivity Commission: CALD costs

The 2011 Productivity Commission Report, *Caring for Older Australians*, indicates that language and interpretation services may significantly increase the costs of delivering appropriate CALD services:

> Aged and Community Services Australia illustrated that interpreter services can add significantly to service costs: … as at May 2007, the Telephone Interpreter Service (TIS costings via personal communication) provides on-site translator/interpreter services during business hours at a rate of $141 for the first 90 minute block plus an additional $46 for each subsequent 30 minute block. These rates increase to $225 and $74 respectively outside of business hours. These are substantial costs considering the (highest) day rate per person in residential aged care was funded at around $175/day in 2007 (Government contribution plus client contribution) and make the provision of such services 'cost prohibitive'. Some ACSA members have estimated the cost of providing the listed components at between three and five per cent of total budget, with community care estimated to bear the largest expense. (sub. 181, pp. 38–39)In order to attract staff with relevant language skills or promote the development of bi-lingual skills within staff, providers could consider a language allowance (along the lines of that provided by Centrelink) if these skills are used in the course of employment.[30]

While aged care is a Commonwealth responsibility the principle of CALD specific costs will apply in other service delivery areas such as those assessed by the CGC. New South Wales provided the CGC with data in 2010 on the extra costs of providing services to non-English speaking clients. For example:

[30] Productivity Commission Report (2011), *Caring for Older Australians*, p.250.

- in the Department of Community Services (DoCs) on average, caseworkers spend 40 per cent more time dealing with non-English speaking background clients than on other cases
- DoCs case worker costs (about half their total costs) were more than 50 per cent higher for non-English speaking clients
- the New South Wales Housing department spent $1.4 million on interpreters and its weekly subsidies to non-English speaking tenants were $134 compared with $118 for other tenants (about 14 per cent extra).

Victoria's response to the 2011 Report on GST Revenue Sharing (2011 Update) cited health services as one example where the CALD population impacts on service delivery costs. Victoria engaged a consultant to undertake a study into the additional cost of providing inpatient health care to CALD patients which found that CALD patients cost 42.8 per cent more than non-CALD patients. After adjusting for age and case complexity, the cost difference was 17.5 per cent.

In addition, Victoria has previously cited non-State data from Centrelink showing a 30 per cent higher cost of servicing people from non-English speaking backgrounds. However, the CGC considers the DoCs data is partial and the Centrelink data inappropriate because of the differences between Centrelink counter staff activities and State welfare and housing services.

The argument that Centrelink data is inappropriate is inconsistent with the CGC's decision to use the interstate distribution of recipients of Commonwealth pensions and benefits, paid through Centrelink, as a proxy of need for State housing and welfare services. This suggests some basis of similarity between the two services. Both Centrelink and State welfare agencies are engaged in providing services to clients.

New South Wales believes that this data provides the basis for an assessment.

PHYSICAL ENVIRONMENT

New South Wales notes the consultant's report on physical environment factors and will provide a submission on this report in the future.

7. Conclusion

New South Wales has long argued that the current system of horizontal fiscal equalisation (HFE):

- is complex, heavily dependent on judgement and lacking the transparency necessary to ensure that its outcomes are consistently accepted by states
- produces unacceptably large and unpredictable year to year variations in a key source of revenue for the states
- reduces incentives for states to undertake economic reform and improvements in revenue raising capacity or service delivery.

The current system of fiscal equalisation is not based on any principle of interpersonal or interregional (i.e. sub-state) equity, nor is it directed towards achieving increased efficiency in the delivery of government services. Rather, it is directed towards providing states with the capacity to perpetuate average levels of efficiency and average levels of service delivery.

There is little in the current HFE system to ensure that the pursuit of equity is not at too great a cost to overall economic efficiency. This will become increasingly important as the Australian economy grapples with the challenges of structural change and entrenched disadvantage.

New South Wales considers that the GST revenue should be distributed to the states in full, untied and on an equal per capita (EPC) basis with the Australian Government taking responsibility for funding any additional financial assistance to the fiscally weaker states so no state is worse off.

This objective is consistent with Finding 12.1 on the long term vision in the GST Distribution Review Final Report. New South Wales believes that the 2015 methodology review should be consistent with this objective.

If this objective is not introduced following this methodology review, New South Wales has provided comments on other specific matters raised in the terms of reference.

In particular:

- New South Wales believes that, in considering a new transport assessment, the CGC should consider the appropriate treatment of all infrastructure grants to the states, including treating all such grants by exclusion
- New South Wales has significant concerns about the current treatment of interstate and intrastate cost disabilities and considers these should be reconsidered and based on evidence of costs

- the mining assessment and the treatment of mining related expenditure need to be reconsidered to ensure that the assessment is based on evidence and is not prone to large changes based on a single state's policy
- the terms of reference specify that the loadings for educational disadvantage embedded in the National Education Reform Agreement will not be unwound by the GST distribution process. New South Wales believes that the best way to implement this objective is for all education funding and associated expenditure to be excluded from the standard budget.

At a fundamental level, the challenge for this methodology review is to decide precisely what fiscal equalisation, as a tool of government policy, is intended to achieve in terms of actual outcomes for the Australian community and what distribution system will best deliver those outcomes.

This review provides an opportunity for genuine reform of the HFE system necessary for improving overall efficiency in the Australian economy, in particular in removing disincentives for tax reform.

New South Wales supports an equal per capita distribution of the GST revenue, with any further equalisation funding necessary provided by the Commonwealth, as the best way forward, as concluded by the independent Review of the GST Distribution established by the Australian Government.