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Tamara Hutcheon

From:	David Braines-Mead
Sent:	Wednesday, 26 July 2017 11:01 AM
To:	hfe@pc.gov.au
Cc:	Craig Graham; Nardia Harris; Catherine Weber
Subject:	Northern Territory Final Submission - PC Inquiry into HFE
Attachments:	Northern Territory Submission to the Productivity Commission Inquiry Int....pdf
Importance:	High

Dear Mary

Please find attached the Northern Territory's final submission to the Initial Guidance Note for the Inquiry into Horizontal Fiscal Equalisation.

Can you please confirm receipt of the submission at your earliest convenience.

Further I understand that the submission will be posted on your website by close of business today.

Regards

David Braines-Mead
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Horizontal Fiscal Equalisation Inquiry
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The Hon Scott Morrison MP
Treasurer
PO Box 6022
Parliament House
CANBERRA ACT 2600

Dear Commissioners and Treasurer

On behalf of the Northern Territory Government, I am pleased to provide a submission to the Productivity Commission's Inquiry into Horizontal Fiscal Equalisation (HFE).

The underlying principle of HFE is that all Australians, no matter where they live, should have equal access to the same critical government services, such as health and education.

That is why the Northern Territory strongly supports HFE as the most appropriate method of achieving a fair distribution of GST revenue across states. Further, the Territory's strongly held view is that HFE does not distort national productivity or impede economic growth. There are no known alternatives to HFE that better achieve efficiency, equity and simplicity objectives and promote national wellbeing.

Any move away from the principle of HFE, as championed by Western Australia, would be to the detriment of Australia's most vulnerable members of society and would widen the gap on Aboriginal disadvantage. It is in the interest of all Australians to close this gap. To do otherwise would be a national shame.

While we strongly and unequivocally support the principles of HFE as a method of GST distribution among states and territories, it is important to note that HFE only maintains the existing disadvantage gap by providing national average standards of services and infrastructure. This is why, beyond this inquiry, it is critically important the Commonwealth follow through on their own agenda to close the gap of Aboriginal disadvantage and develop Northern Australia.

We also note the current methodology employed by the Commonwealth Grants Commission (CGC) is not perfect, whereby the Northern Territory has little influence on the benchmark against which states GST needs are assessed. The benchmark is driven by the larger states. For example, in the CGC's 2017 assessment, a reduction in the cost of remote service delivery in some of the larger states contributed to the recent $2 billion cut in GST revenue to the Territory. This has had a very real and deep impact on the Territory's budget. The Territory will continue to call on the CGC to ensure the methodology continues to be refined, including the current 2020 CGC review.

The Northern Territory is available to clarify its views in this submission or otherwise provide further comment that would assist the Commission in its inquiry.

Yours sincerely

NICOLE MANISON

cc: Senator the Hon Nigel Scullion

Northern Territory Government Submission to the Productivity Commission Inquiry into Horizontal Fiscal Equalisation

July 2017

NORTHERN TERRITORY GOVERNMENT

Contents

Northern Territory Context

The Commonwealth Grants Commission's (CGC's) assessment of state revenue capacities reflects the Northern Territory's significant levels of socio economic disadvantage compared to other states and territories (states), and the consequent above-average demand for government services and infrastructure in the Northern Territory. The costs of delivering services in the Northern Territory are also higher than other states due to its large remote population being dispersed over a large area.

As a result of these factors, the Northern Territory receives the highest per capita share of the GST pool of all states, with a current per capita relativity of 4.6602, as recommended by CGC in its Report on GST Revenue Sharing Relativities 2017 Update (2017 Update). All other jurisdictions receive a share of the GST pool that is closer to their population share.

The relatively high level of redistribution of GST revenue to the Northern Territory compared with an equal per capita distribution reflects the Northern Territory's significantly higher than average expenditure needs, due to factors outside Government's control, and is vital to ensuring the Northern Territory's population can access services comparable to the rest of the country.

The key determinants of the Northern Territory's assessed expenditure needs include:

- Location – the Northern Territory's small population of 245 000 (1 per cent of Australia's population), is dispersed over a large landmass isolated from the main population centres in Australia.
- Diseconomies of small scale – despite its small population, the Northern Territory needs to fund the same range of services as large states, so it faces higher per capita costs.
- Indigeneity – Aboriginal people make up about 30 per cent of the Northern Territory's population (about 3 per cent of the national population), with about 80 per cent residing in remote and very remote areas. The Northern Territory's Aboriginal population uses mainstream services more intensely compared with the non-Aboriginal population.

The calculation of current GST relativities is illustrated in Table 1. A common misconception is that the Northern Territory's relativity indicates it costs 4.66 times more to deliver services in the Northern Territory. As shown in Table 1, the Northern Territory is assessed as needing to spend 2.01 times the national average in order to provide a standard level of services and infrastructure, whereas the other states are assessed as needing to spend around the national average to deliver the same standard of services and infrastructure.

On the revenue side, the Northern Territory has an assessed revenue-raising capacity on par with the national average, with a revenue relativity of 0.98. This reinforces that the primary determinant of the Northern Territory's per capita GST share is the comparatively high demand for, and costs of government services, rather than a failure to raise revenues through developing taxable resources.

Table 1. Comparing fiscal capacity and GST requirements, 2017-18

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	$ pc	$ pc	$ pc	$ pc	$ pc	$ pc	$ pc	$ pc	$ pc
Assessed expenditure	9 163	8 865	9 786	10 198	9 520	10 025	8 977	19 072	9 470
Expenditure relativity	0.97	0.94	1.03	1.08	1.01	1.06	0.95	2.01	1.00
and assessed Investment	355	435	313	392	214	71	236	- 10	349
less									
Assessed revenue	5 127	4 688	4 960	7 364	4 241	3 847	4 275	5 029	5 121
Revenue relativity	1.00	0.92	0.97	1.44	0.83	0.75	0.83	0.98	1.00
Assessed net borrowing	363	377	362	368	342	326	360	334	364
Assessed Commonwealth payments	1 662	1 657	1 741	1 659	1 631	1 706	1 597	3 033	1 688
GST requirement	**2 011**	**2 143**	**2 723**	**808**	**3 307**	**4 146**	**2 745**	**10 675**	**2 297**
Per capita relativity	**0.8767**	**0.9324**	**1.1877**	**0.3443**	**1.4400**	**1.8048**	**1.1950**	**4.6602**	**1.0000**

Source: CGC 2017 Update Report on GST Revenue Sharing Relativities, Department of Treasury and Finance

Executive Summary

The Northern Territory is a staunch supporter of horizontal fiscal equalisation (HFE), which is part of the bedrock of the Australian federation. It enables eight diverse states and territories (states), with different resource endowments, population characteristics and physical sizes to provide a comparable range of government services at similar standards, an achievement that should not be understated.

This concept of equity is central to the application of HFE in the national context and has been a long-standing feature of federal financial relations in Australia. The Northern Territory's view is that the underlying goal of equity of access to services for all Australians is the most important feature of the current form of HFE.

However, HFE only provides states with the financial capacity to maintain existing differentials in outcomes, including between Aboriginal and non-Aboriginal Australians. That is, the amount of GST revenue redistributed to the Northern Territory as a result of its Aboriginal population is determined largely by the expenditure patterns of New South Wales and Queensland, and does not provide the Northern Territory with the financial capacity to 'close the gap' in outcomes between Aboriginal and non-Aboriginal Territorians.

The Northern Territory notes that because HFE only provides states with the capacity to deliver the national average standards of services, there is a need for significant additional investment by the Northern Territory and Commonwealth governments to close the gap in outcomes between Aboriginal and non-Aboriginal Territorians. It is important that funding provided for this purpose is excluded from HFE, so the intent of this funding is upheld, not redistributed to other states through equalisation.

While the Northern Territory strongly supports HFE, the reduction in its relativity recommended in the Commonwealth Grants Commission's (CGC's) 2017 Update Report caused significant fiscal challenges for the Northern Territory, with an estimated $2 billion reduction in revenue over the forward estimates. Despite this, the Northern Territory Government has managed these financial difficulties without reducing service levels or cutting jobs.

Despite the recent reduction in its relativity, which was significantly affected by changes to other states' expenditure policies, the Northern Territory's strong view is that the current approach to HFE is the most appropriate way to distribute GST revenue between the states. However there are refinements to the methodology that could be implemented to better reflect the costs associated with remote service delivery, particularly in remote Aboriginal communities.

The Northern Territory strongly supports the current basis for the distribution of the GST pool and that it should not be altered with a view to achieving a range of national economic priorities. These imperatives are better pursued through cooperative federalism and more targeted policies. HFE is not a catch-all policy tool intended to solve the nation's economic and social issues. Its purpose is to provide equity of access to government services for all Australians, not to drive national productivity. Extending the purpose of HFE beyond its current remit would significantly put at risk the equitable access to government services that currently exists across Australia.

The level of interstate equity provided through HFE is remarkable when considering the amount of GST revenue redistributed through the process is modest relative to the size of the national economy. HFE does not distort economic growth and resource allocation but rather supports efficient flows of labour and capital between jurisdictions by providing states with the capacity to provide infrastructure, and services and levy taxes at comparable levels, largely removing these considerations from decisions on settlement and private investment. Further, while HFE is not the appropriate tool to drive efficiency, it does not inhibit it, due to CGC's use of internal standards to determine national average policy and expenditure patterns, which means the national average is driven by the most populous, most efficient states.

Equalisation does not impede or provide disincentives for states' participation in productivity-enhancing reforms, nor get in the way of decisions to pursue reform. There is evidence that states pursue productivity-enhancing reforms at the national and state levels in order to support economic growth and ultimately the prosperity of their citizens, irrespective of the HFE implications.

There is no evidence that states' decisions to restrict extraction of resources are related to HFE. States' recent restrictions and moratoriums on hydraulic fracturing are in place because the environmental, economic, cultural and social impacts of fracking are still being investigated and assessed.

The current GST distribution methodology has been reviewed and refined over many years, with decisions on the balance between contemporaneity and reliability, including the decision to adopt a three-year rolling average, being informed by weighing the pros and cons of previously adopted alternatives. The Northern Territory strongly supports the institutional rigour and experience of the CGC in this regard.

The two-year lag between the data underpinning assessments and the application year of relativities is a necessary feature of the current system, which has had both up and downside revenue implications for Western Australia preceding and following the resources boom. The Northern Territory acknowledges the significant volatility of GST revenue shares experienced by Western Australia in recent years, but considers this volatility to be a reflection of Western Australia's own-source revenue capacity, not a flaw in HFE or its execution.

There is no evidence to suggest that HFE produces disincentives for states to develop potential industries or raise the royalty rate for an existing industry at an appropriate time. State governments pursue industry development as a means of driving economic growth, to support employment, create a conducive operating environment for businesses and ensure ongoing improvements in incomes and living standards.

While there may be GST revenue implications of states undertaking unilateral tax reforms, these will generally be minor, due to the marginal impact on the standard, and are not the determinant of whether or not states pursue reforms in practice.

How does the current HFE system impact the Australian community, economy and state and territory governments?

The Northern Territory's view is that:

- Australia's form of equalisation supports, rather than hinders economic growth.
- All states, regardless of whether they are a donor or recipient state, actively pursue economic efficiency and productivity enhancing reforms.
- Equalisation allows the wealth of the nation to be shared in such a way that supports comparable standards and scope of government services nationally.
- The amount of GST redistributed through HFE is modest relative to the size of the national economy, therefore does not distort economic growth and resource allocation, but provides the smaller states with capacity to deliver vital social and economic services and infrastructure.
- Allocative efficiency is primarily a function of the responsiveness of labour and capital to changes in conditions of domestic and global markets, not equalisation.
- Equalisation supports efficient flows of labour and capital between jurisdictions by providing states with the capacity to provide infrastructure and services at comparable levels.
- HFE does not impede states' pursuit of tax reform or the efficient delivery of government services and infrastructure.
- There is no evidence that states' decisions to restrict extraction of resources are related to HFE, but rather broader environmental, economic, cultural and social considerations.
- Equalisation only provides states with the financial capacity to maintain existing differentials in outcomes, including between Aboriginal and non-Aboriginal Australians, but it does not provide the financial capacity to 'close the gap'.
- The current three-year averaging process provides an appropriate balance between precision and timing. It smooths out volatility that might arise from alternative processes, affording states a level of reliability and stability.

1a. Is the current HFE system getting in the way of states pursuing higher economic growth and productivity, and at the expense of higher national prosperity? If so, how?

1a.1 The Northern Territory's view is that Australia's form of equalisation supports rather than hinders economic growth and does not impede states' pursuit of economic growth and development. Equalisation allows the wealth of the nation to be shared in a way that supports comparable standards and scope of government services nationally, which is a foundation of Australia's federation and prosperity.

1a.2 The amount of GST redistributed through HFE compared with an equal per capita distribution is modest relative to the size of the national economy, but provides the smaller states with the capacity to provide vital social and economic infrastructure and services, which supports more broadly distributed economic growth. Over the period 2011-12 to 2015-16, an average of around 10 per cent of the total GST pool has been redistributed between the states compared with an equal per capita distribution.

HFE impact on states' pursuits of economic growth

1a.3 While certain critics of the current form of HFE have called for changes to equalisation in Australia on the basis it impedes growth, none have been able to demonstrate that the economic gains from reducing equalisation in Australia would be material or outweigh the economic and social disadvantage a change to the current system would impose on the recipient states.

1a.4 Economic growth is primarily driven by private investment opportunities, consumer spending and expectations, the exchange rate, interest rates, commodity prices and global demand for Australian products and commodities.

1a.5 State governments' pursuit of economic growth is driven by the need to support employment, create a conducive operating environment for businesses and ensure ongoing improvements in incomes and living standards. This was recognised by the Commonwealth Grants Commission (CGC) in a discussion on the impact of equalisation on economic growth and efficiency:

> *State governments are not corporations driven by a profit motive. They seek to improve conditions for residents and a strong and growing economic base is seen as an important element in that approach.* (Commonwealth Grants Commission The Last 25 Years, CGC 2008, page 11)

1a.6 Economic development has been a major policy imperative of successive Northern Territory governments since self-government in 1978. Northern Territory governments have continued to implement policies to improve the competitiveness of the Northern Territory economy and attract private investment despite being the largest per capita beneficiary of HFE. Recent initiatives have included:

- securing the $34 billion INPEX project;
- structural reform of input markets, including energy, water, transport and infrastructure;
- supporting the development of pipeline infrastructure connecting the Northern Territory to the east coast gas market, providing increased national energy security;
- championing the development of Northern Australia to unlock its economic potential; and
- pursuing a strong program of deregulation and business red-tape reduction.

1a.7 The Northern Territory Government has also recently held a series of economic summits, which have informed the Northern Territory Economic Development Framework. This framework establishes the strategy for the long-term development of the Northern Territory.

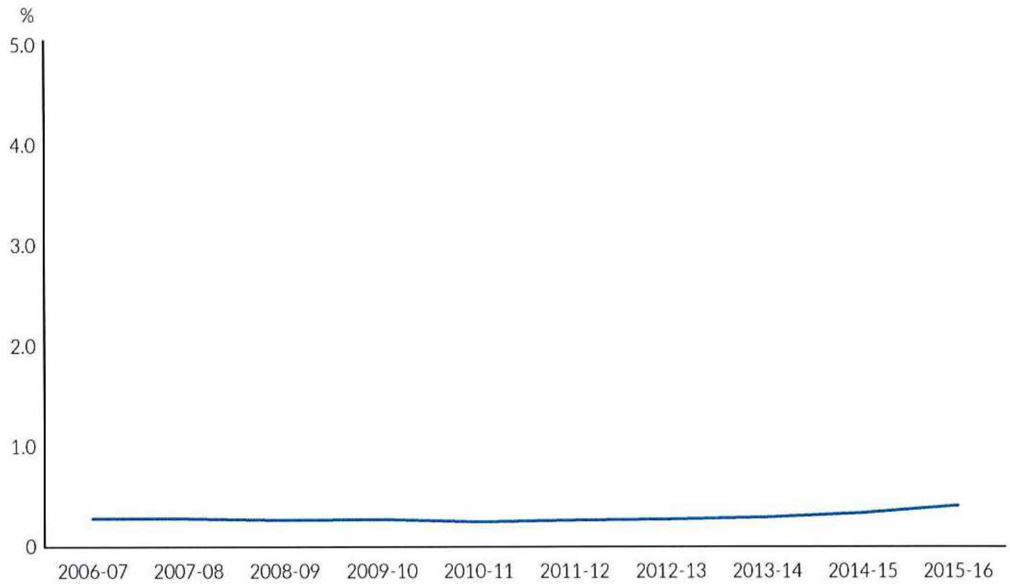
Impact of equalisation on national economic growth

1a.8 It is important to consider the amount of GST redistributed between states, compared with an equal per capita distribution in the context of the national economy. In 2015-16, only $6.9 billion (12 per cent) of the $57.4 billion GST pool was redistributed compared with an equal per capita distribution. This equates to just 0.41 per cent of Australia's $1.7 trillion gross domestic product (GDP)[1].

1a.9 Although relatively small, this redistribution is used to achieve HFE between the states while avoiding significant distortions to economic growth or resource allocation, which is a remarkable outcome.

1a.10 Chart 1a.1 shows the GST redistribution compared with an equal per capita distribution as a percentage of GDP over the past 10 years and that it remained low and stable. The slight increase in the redistribution as a percentage of GDP from 2014-15 to 2015-16 reflects the easing of GDP growth and a larger than average redistribution in those years, predominantly as a result of significantly increased mineral royalties to Western Australia during the peak of the mining boom flowing through the equalisation process.

Chart 1a.1 GST Redistribution[1] as a Percentage of GDP, 2006-07 to 2015-16



1 Compared with an equal per capita distribution.
Source: Northern Territory Department of Treasury and Finance

1a.11 Table 1a.1 shows the GST redistributed for each state compared with an equal per capita distribution in 2015-16 in terms of gross state product (GSP) and total general government expenses. While the table shows the redistribution of GST represents a small component of state economies, it is significant to small states' budgets, particularly for the Northern Territory.

1 GDP data for 2016-17 is not yet available. Comparison uses most recent final financial year data for both GST redistribution and GDP.

Table 1a.1 Significance of GST Redistribution to State Economies, 2015-16

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
GST Redistribution ($M)	- 889	- 1 479	1 521	- 4 490	1 475	1 012	98	2 752
GSP (%)	0.2	0.4	0.5	1.9	1.5	3.9	0.3	11.9
Budget (%)	1.2	2.7	3.1	15.8	8.6	18.7	1.9	46.5

Source: Commonwealth Grants Commission; Australian Bureau of Statistics Cat No 5220.0; Northern Territory Department of Treasury and Finance

1a.12 Despite the redistribution of GST being small in the national context, a less comprehensive form of HFE in Australia would significantly reduce the smaller states' capacity to provide nationally comparable scope and quality of government services and infrastructure, and would significantly reduce employment and investment prospects in these states.

1a.13 Table 1a.1 shows if an equal per capita distribution was adopted, New South Wales would receive a 1.2 per cent increase to its general government expenditure capacity, or a 0.2 per cent contribution to GSP. Conversely, for the Northern Territory, an equal per capita distribution of GST would reduce its total budget by about half.

1a.14 The amount of GST redistributed to the Northern Territory compared with an equal per capita share represents about 47 per cent of the Northern Territory's general government sector expenditure ($5.9 billion in 2015-16). GST revenue is essential for ensuring services are provided to the entire Northern Territory population. Without this critical budget support, the Northern Territory would be unable to provide many services, particularly to its remote population.

1a.15 If this revenue was replaced through other tied funding arrangements with the Commonwealth, while it may represent an overall improvement in the Northern Territory's budget capacity, it would likely lead to other challenges such as: a reduction in the Northern Territory's autonomy to determine how services are delivered; an increased administrative burden due to additional reporting requirements; and potential financial uncertainty, with the Commonwealth able to unilaterally adjust the level of tied funding each year.

1a.16 The relatively high level of redistribution towards the Northern Territory reflects circumstances over which the Northern Territory Government has no control but result in higher than average per capita costs or use of government services and infrastructure. The Northern Territory has a relatively small but highly dispersed population over a large and remote geographical area, and a relatively large Aboriginal population that uses mainstream services more intensely. Without equalisation, Northern Territorians would not have access to services that other Australians enjoy.

1a.17 To provide further perspective, in 2015-16, the $2.75 billion in GST redistributed to the Northern Territory compared with an equal per capita distribution is greater than the Northern Territory's entire health and education budgets, whereas for Victoria, $2.75 billion only equates to 6.9 per cent of its health and education budgets. The impact the redistribution has for service delivery standards for Territorians far outweighs the impact of a relatively small increase in large states' budgets arising from less-than-full equalisation.

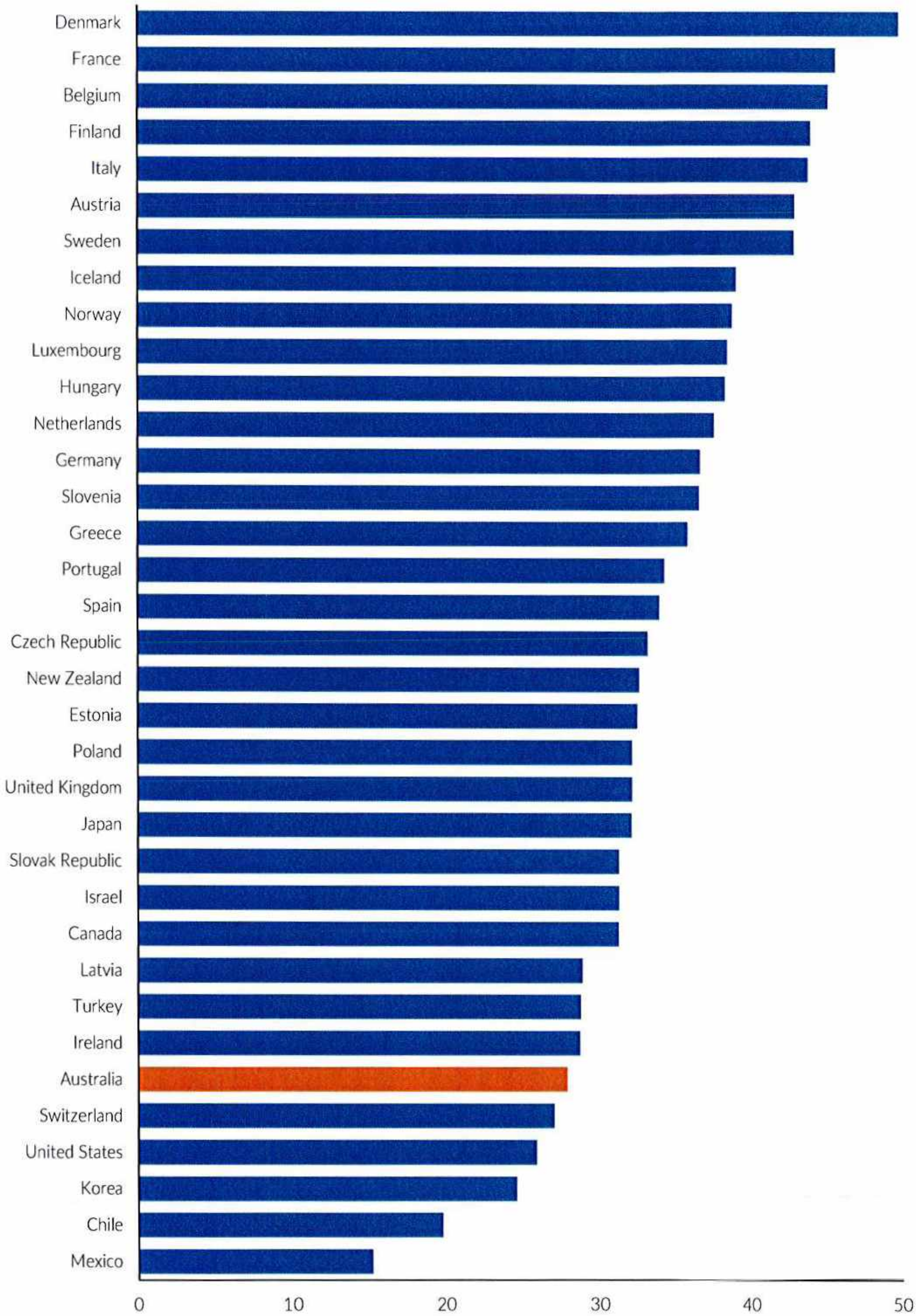
Australia's form of equalisation in an international context

1a.18 The Australian economy is among the most stable and prosperous in the world, highlighted in particular by Australia's continued economic growth and stability during and since the global financial crisis. Australia also has the most comprehensive form of fiscal equalisation. There is no evidence to suggest that equalisation has impeded Australia's economic wellbeing, and perhaps the stability in the Australian economy is in part due to its system of equalisation, which provides fiscal sustainability to the states by enabling the benefits of economic upturns and the load of economic downturns to be shared among all states.

1a.19 Fiscal sustainability is a determinant of investor confidence, necessary to drive long-term growth and development. Consequently, HFE helps to underpin economic growth and prosperity across Australia, rather than detracting from it, and has been refined to respond appropriately and consistently to changes in economic circumstances. There is no evidence to suggest that if an alternative form of HFE had been in place, it would have provided greater national prosperity.

1a.20 Australia provides a comprehensive range of government services while maintaining an overall tax burden below most Organisation for Economic Cooperation and Development (OECD) countries, as shown in Chart 1a.2. This low tax environment is significant in facilitating domestic investment and maintaining relatively high net household and business income, and hence facilitating economic growth.

Chart 1a.2 OECD Member Countries' Total Tax as a Percentage of GDP, 2014

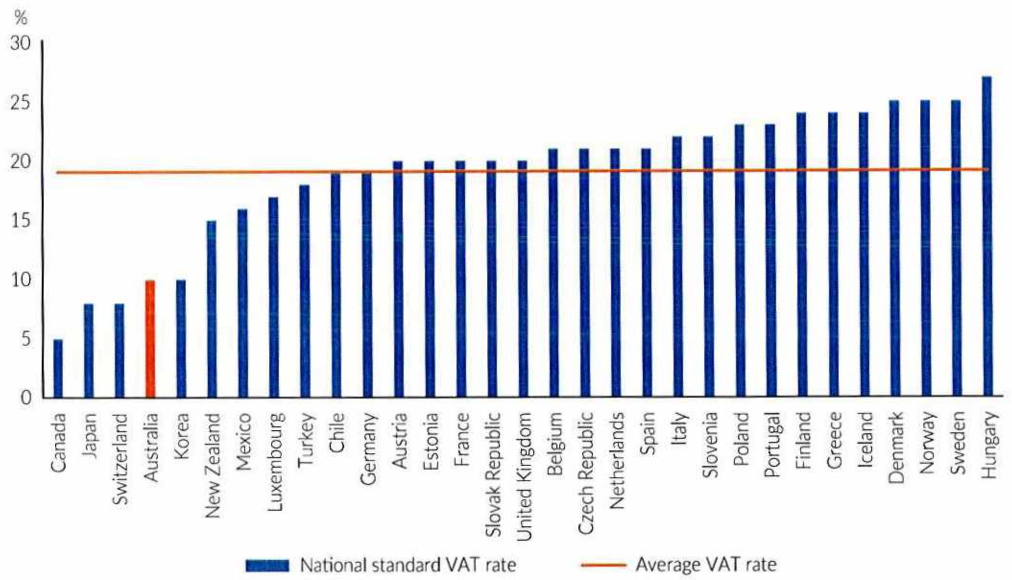


Source: OECD Revenue Statistics 2016; Northern Territory Department of Treasury and Finance

1a.21 There is a common misconception that Australia is a high taxing nation in terms of overall tax incidence. Although Australia does levy higher than average income and corporate tax rates than the OECD averages, this is offset by a relatively low value added tax (VAT) rate and social security taxes.

1a.22 Australia's GST rate is one of the lowest VATs among developed countries and is roughly half the average rate among OECD countries. Of the 33 countries in the OECD that operate VATs like the GST, only Canada, Japan and Switzerland have lower rates, as shown in Chart 1a.3.

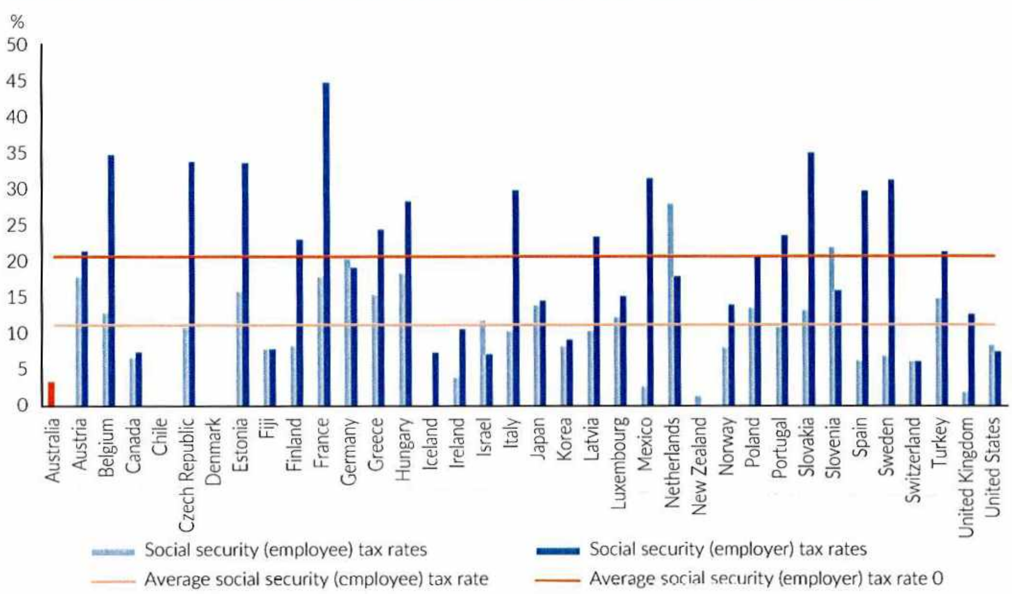
Chart 1a.3 VAT rates in OECD Countries, January 2015



Source: Ernst and Young 2017 Worldwide VAT, GST and Sales Tax Guide; Northern Territory Department of Treasury and Finance

1a.23 Similarly, Australia has significantly below-average social security (employee) tax rates and does not levy social security (employer) tax, as shown in Chart 1a.4.

Chart 1a.4 Employer and Employee Social Security Tax Rates, January 2015



Source: KPMG 2015 Global Tax Rate Survey; Northern Territory Department of Treasury and Finance

1a.24 The comparatively low tax burden in Australia contrasts with the quality and scope of universally accessible government services, including public school education and public hospital access, a fair and balanced justice system and a comprehensive welfare safety net.

HFE impact on states' pursuit of productivity

1a.25 The Northern Territory contends that equalisation does not impede or provide a disincentive for states' participation in productivity-enhancing reforms and does not get in the way of decisions to pursue reform. There is evidence that states pursue national productivity-enhancing reforms at the national and state levels in order to support economic growth and ultimately the prosperity of their citizens.

1a.26 In the main, national reforms in Australia have been pursued through multilateral and bilateral agreements, negotiated through the Council of Australian Governments (COAG), which has been an effective means of delivering a significant range of national productivity-enhancing reforms.

1a.27 Over three decades, a broad-reaching raft of national reforms have been implemented by states, including Seamless National Economy, National Competition Policy (NCP), Competition and Infrastructure Reform Agreement, Australian Energy Market Agreement and the National Water Initiative.

1a.28 In some instances the Commonwealth has provided financial incentives or support to facilitate reforms, with the level of support often not reflective of the level of benefits accrued to Australia or the Commonwealth as a result of the reforms implemented by the states.

> *An important feature of the NCP institutional framework is the competition payments made by the Australian Government to the states and territories for satisfactory progress in implementing their reform commitments. The payments are a recognition by COAG (1994a) that all governments should share in the benefits of economic growth and the associated higher taxation revenue resulting from the reform program and that, with the high degree of vertical fiscal imbalance, much of the increase in tax revenue would initially accrue to the Commonwealth.* (Productivity Commission Inquiry Report – Review of National Competition Policy Reforms, April 2005, page 29)

1a.29 There is no evidence that HFE has affected states' pursuits of microeconomic reforms. For most reforms, implementation costs are relatively high in the Northern Territory and, as a result of small and fragmented markets, the associated benefits are more diffuse. However, this has not prevented the Northern Territory from being an active participant in national microeconomic reform initiatives. For example, the Northern Territory is one of the early signatories to the Intergovernmental Agreement on Competition and Productivity Enhancing Reforms and is developing a schedule of reforms as part of this agreement.

1a.30 In addition to these national reforms, the Northern Territory has an ongoing program of productivity-enhancing reforms, for example:

- reforms to make it simpler to do business, including online licensing and compliance transactions, which reduce costs to government, businesses and individuals;
- reforms in the building and construction sector, including being the first jurisdiction in Australia to have development, building and survey approvals transacted online;
- online transactions for many government services and fees, including vehicle registration, environmental licences and approvals, and extending licence terms to create efficiencies for government and licensees;

- reforms to the way government transacts with the non-government organisation (NGO) sector, including extending the terms of funding agreements and moving to an outcomes-based approach to minimise the administrative burden on NGOs and government, and to generate efficiencies by having greater coordination and reduced duplication across government agencies;
- deregulating retail trading hours, the Northern Territory is the national leader in this regard;
- streamlining environmental approvals to support economic development and reduce costs of investment and development;
- moving towards a single point of information on land tenure, soil and water;
- implementing a water licence and data portal; and
- establishing an open data and data analytics work program.

1a.31 The fact that all states pursue economic and productivity-enhancing reforms, regardless of whether they are a donor or recipient state, merely reinforces the point that HFE is not a key consideration in deciding to undertake reform.

1b. What evidence is available on whether and how the current HFE system affects the movement of labour and capital across state borders, particularly if a region is experiencing high labour demand?

1b.1 It has been argued that HFE distorts settlement and capital investment decisions, by encouraging investment in the smaller, less productive states.

1b.2 Much of the debate around the impact of HFE on the movement of labour and attraction of investment to 'efficient' areas has centred on the mineral and resource industry. It has been suggested that without HFE, the resources boom would have led to increased population movement and investment in Western Australia and, to a lesser extent, Queensland.

1b.3 The Commonwealth Treasury submission to the 2012 Review of GST Distribution noted:

> *In the case of individuals, it would seem that the amount of funding redistributed by the current system, and therefore the differences in government services, infrastructure and taxes resulting from the redistributed funds, are likely to have a small impact on their decision to migrate...In the context of all of the other factors at play, the influence of HFE on a potential worker's decision whether or not to move to Western Australia to take advantage of the mining boom is likely to be small.* (Commonwealth Treasury Submission to the 2012 Review of GST Distribution, page 32)

1b.4 The 2012 Review of GST Distribution Panel concluded:

> *...the current system creates perverse theoretical incentives in some instances, but they cannot be meaningfully reduced without significant reductions in equalisation outcomes, which would be unacceptable, given there is little practical evidence of efficiency losses.* (2012 Review of GST Distribution, Review Panel Final Report, page 7)

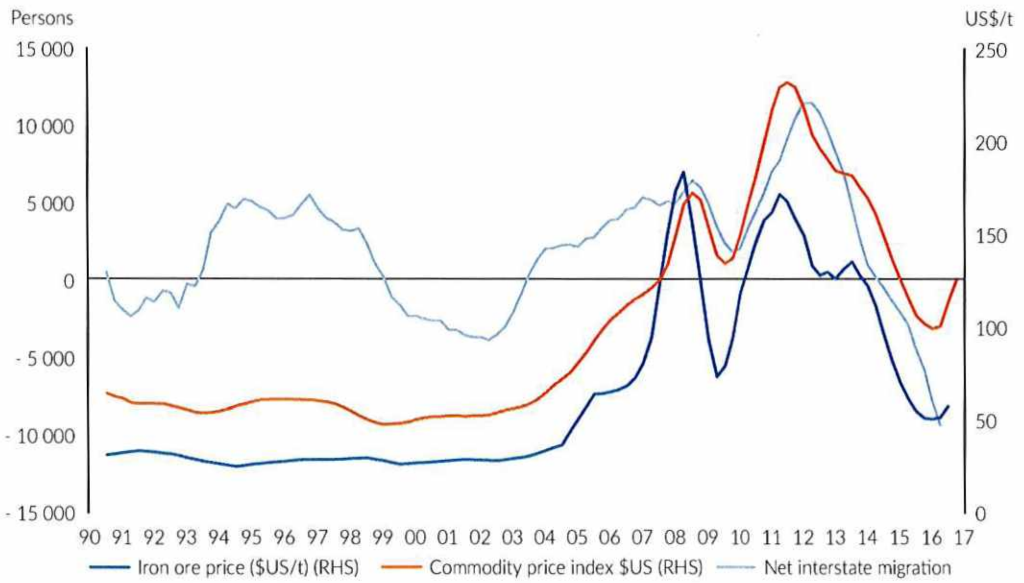
1b.5 In its considerations of the impact of equalisation on allocative efficiency, the CGC found:

> *...equalisation did affect the allocation of resources, but the effects were not serious enough to warrant changes in the way equalisation was implemented...any equalisation system would have implications for efficiency, but a study done for it suggested that the effects would be small.* (Commonwealth Grants Commission The Last 25 Years, CGC 2008, page 44)

1b.6 The Northern Territory contends that the impact of HFE on investment and labour movement are minimal, and the most significant contributing factors to allocative efficiency are the responsiveness of labour and capital to changes in market conditions. The significant inflows of capital and labour into Western Australia during the mining boom demonstrated this responsiveness.

1b.7 Charts 1b.1 and 1b.2 show the net inflows of capital and interstate migration to Western Australia are highly responsive to increases and decreases in global commodity prices, particularly iron ore.

Chart 1b.1 Western Australia Net Interstate Migration, Iron Ore Prices and Commodity Price Index, 1990-2017



Source: Australian Bureau of Statistics Cat No 3101.0, World Bank, Reserve Bank of Australia, Northern Territory Department of Treasury and Finance

Chart 1b.2 Net Interstate Migration and Net Business Investment, Western Australia, 1995 to 2017

Source: Australian Bureau of Statistics Cat. Nos 3101.0 and 5206.0, Northern Territory Department of Treasury and Finance

1b.8 The Northern Territory contends that equalisation does not impede efficient labour and capital movement decisions by providing states with the capacity to provide infrastructure and services at comparable levels. In this way, HFE assists allocative efficiency by removing factors that could otherwise distort decisions on whether to migrate to or invest in areas of greatest demand for labour, or with the greatest potential returns on investment.

1b.9 This is supported by a study commissioned by South Australia for its submission to the 2012 Review of GST Distribution. The study found that:

> *...the existing HFE system provided an annual consumer benefit of $295 million, compared to a situation in which all equalisation adjustments, except on account of Indigeneity, were abandoned.* (Independent Economics, Horizontal Fiscal Equalisation: Modelling Update and Scenarios, 19 May 2015)

1b.10 The South Australian report noted this consumer benefit:

> *...arises because the equalisation system removes the incentive for fiscally induced migration between states. For example, without equalisation, a state with a high endowment of mineral resources will have a fiscal advantage, allowing it to offer lower taxes and higher government services. This leads to fiscally induced migration from states with lower fiscal capacity to states with higher fiscal capacity...(and that) Australia's equalisation system aims to even out the differences in fiscal capacities between states. This allows interstate migration to be driven instead by economic opportunities, resulting in a better performing national labour market. Economically induced interstate migration leads to higher national income, while fiscally induced migration leads to lower national income.* (Independent Economics, Horizontal Fiscal Equalisation: Modelling Update and Scenarios, 19 May 2015)

1c. Does the current HFE system create perverse incentives or unintended consequences for reform at the state level? What evidence is there on how these incentives affect state policies and ultimately outcomes for the Australian community?

1c.1 The Northern Territory does not consider that HFE creates perverse incentives or unintended consequences for reform at the state level. As discussed in section 1a, there is no evidence that HFE has affected states' pursuits of national and unilateral microeconomic or productivity-enhancing reforms, and as discussed below, there is no evidence that HFE has impeded state tax reform or the pursuit of increased efficiency in government service delivery.

Does the HFE system impede state tax reform over time, including states' decisions on developing their revenue bases and rates? If so, how and to what extent?

1c.2 The Northern Territory does not consider HFE to be an impediment to tax reform or a significant consideration as to whether or not states develop their revenue bases and rates. Although there may be GST revenue implications of unilateral tax reforms, these will generally be minor, due to the marginal impact on the standard, and are not the determinant of whether or not states pursue reforms in practice.

1c.3 The overall fiscal impact of unilateral tax reforms tend to weigh more highly than GST revenue implications in the decision-making process, including level of additional tax revenue to be raised, revenue stability and the increased efficiency of a state's tax regime.

1c.4 Tax reform is a challenging undertaking that involves significant economic, financial, administrative and political considerations. For the Northern Territory, the primary considerations in developing tax policy are the economic and financial impacts, given the structure of the Northern Territory economy.

1c.5 For example, the Northern Territory's decision to levy a profits-based mining royalty regime was driven by the economic imperative of facilitating investment by smaller mining operators. As a result, industry surveys such as the Fraser Institute's Annual Survey of Mining Companies continue to rank the Northern Territory highly in a global comparison for mineral potential, investment attractiveness and policy settings.

1c.6 The Northern Territory notes, as it does not apply average mineral royalty policy, it is assessed based on value of production, which can disadvantage the Northern Territory from an HFE perspective during start-up phases of mining operations. Despite this, the Northern Territory maintains a profits-based regime because it best fits the structure of the Northern Territory economy and is more economically efficient.

1c.7 A further example of the structure of the economy affecting the Northern Territory's revenue policy is its relatively high thresholds for payroll tax. The Northern Territory economy comprises primarily large and small businesses, with few in the middle tier. To enhance the efficiency of payroll tax application, the Northern Territory's high threshold, targets the large business sector, which is predominantly interstate businesses that operate in two or more jurisdictions.

1c.8 However, the Northern Territory's assessed capacity to raise payroll tax is calculated based on the lower national average threshold. As a result, the GST revenue gain of applying national average policy is outweighed by the inefficiencies of increasing the tax burden on small and medium-sized Northern Territory businesses.

1c.9 The Northern Territory also does not levy a land tax, despite being assessed through HFE as though it does. Therefore to levy a land tax would have no HFE impact on the Northern Territory. In the CGC's 2017 Update, the Northern Territory is assessed as if it raised $72.0 million in land tax in 2015-16, although it raised no land tax revenue.

1c.10 There are also numerous examples of where states have pursued a range of tax reforms unilaterally, with little if any, regard to equalisation impacts or despite the potential equalisation impacts, including:

- South Australia – reform as part of the 2015-16 Budget aimed at restructuring business taxes to help business investment, grow and create jobs across the full spectrum of existing industries including mining, agriculture, retail, construction, service delivery and new industries through start-up businesses.
- Australian Capital Territory – long-term reform as part of the 2012-13 Budget aimed at making the tax system fairer, simpler and more efficient. Reform included abolishing and reforming a number of inefficient taxes, replacing them with more efficient taxes.
- Northern Territory – introduced landholder stamp duty conveyance measures from May 2009; increased mineral royalty rates from July 2010; payroll tax threshold and rate changes from July 2011; abolished stamp duty on life insurance from July 2015; and increased motor vehicle registration, conveyance stamp duty rate for high value transactions and gaming machine tax from July 2017.

1c.11 The abolition of taxes by these states, including the Northern Territory, has occurred for efficiency reasons, notwithstanding that the imposition of the taxes remains average state policy and the jurisdictions continue to be assessed as having capacity to raise these taxes.

Multilateral reforms

1c.12 Multilateral tax reform requires considerable coordination by states and the Commonwealth. There is no evidence to suggest that if there was no HFE, states would undertake additional tax reform. The Northern Territory's view is that the likelihood of significant multilateral tax reforms would be reduced in the absence of equalisation, which provides a level of fiscal certainty for all states.

1c.13 Under a coordinated approach, the CGC would change its assessment of states' capacities to raise the new or reformed tax based on average policy and states' capacities to raise the new tax. In this way, multilateral tax reform can be revenue-neutral, if all states apply average policy.

1c.14 That is, although HFE may cause changes to states' assessed GST needs arising from reform, with the mix of 'winners' and 'losers' from a GST perspective, dependent upon the tax in question and each state's relative capacity to raise the tax, the GST implications will be offset by changes in own-source tax revenue, if states apply average policy. Therefore, implementing multilateral tax reform, which would increase efficiency, would have a zero net revenue impact if states take a coordinated approach.

Does the HFE system impede the efficiency of state service delivery, infrastructure investment and policies affecting where people live? If so, how and to what extent?

1c.15 HFE's influence on the efficiency of government services can be considered in two contexts: first, whether or not HFE provides incentives for governments to reduce service delivery costs; and second, whether or not HFE should impose efficiency dividends or output-based benchmarks to drive improvement in social outcomes.

Incentives for governments to reduce service delivery costs

1c.16 The CGC's approach to HFE includes various means of driving efficiencies in parallel with achieving equalisation. The supporting principles of 'what states do' and 'policy neutrality' remove the ability and incentives for states to game the HFE process through unilateral changes to tax and service delivery policies. In addition, the use of the internal standard means national average expenditure and tax rates reflect the policies of the largest, most efficient states. It is argued that equalisation provides incentives for states to over or under-supply services to select population groups as a means of increasing their GST shares. For example, the Northern Territory has been accused of maintaining high service delivery costs and oversupplying government services in remote areas to increase its GST revenue.

1c.17 This view is not credible due to the implicit efficiency mechanism built in to the current HFE model through the use of an internal standard. The internal standard is calculated individually for each government function as the national average per capita expenditure. Because it is a per capita average, the most populous states' service delivery costs and tax policies drive the result. It follows that states delivering services at below the national average cost retain the benefits, while states with costs above the national average do not receive additional GST to meet this shortfall. For example, Table 1c.1 shows that across all CGC expenditure categories except services to communities, expenditure in New South Wales and Victoria equates to over 50 per cent of the national total and, including Queensland, increases the percentage to over 70 per cent. Based on the assumption of economies of scale, whereby larger states are able to achieve more efficient service delivery, this is reflected in the national average.

1c.18 Despite the Northern Territory having the highest state population share of Aboriginal people (30 per cent, of whom around 70 per cent live in remote or very remote areas), only 10 per cent of the national Aboriginal population live in the Northern Territory. Around 60 per cent of all Aboriginal Australians reside in either Queensland or New South Wales, with expenditure patterns in these states driving the average expenditure on Aboriginal programs.

1c.19 As a result, equalisation only provides states with the financial capacity to maintain existing differentials in outcomes, including between Aboriginal and non-Aboriginal Australians. That is, the amount of GST revenue redistributed to the Northern Territory as a result of its Aboriginal population is determined largely by the expenditure patterns of New South Wales and Queensland and does not provide the Northern Territory with the financial capacity to 'close the gap' in outcomes between Aboriginal and non-Aboriginal Territorians. This is discussed further in section 2a.

1c.20 The cost of delivering services in the Northern Territory has very little influence on the standard, due to the Northern Territory's small population size. This is demonstrated in Table 1c.1, which shows that if the Northern Territory increased its health expenditure by 20 per cent, average expenditure (the standard) would only increase by $10 per capita. On the other hand, if New South Wales increased its spending on health by 20 per cent, the average expenditure would increase by $136 per capita.

1c.21 This is reflective of the influence that larger states have on the average level of services, which had a significant impact on the reduction in the Northern Territory's assessed GST needs in the 2017 Update, with reductions in expenditure in the community health, schools education and roads categories nationally, contributing to the $2 billion reduction in estimated GST revenue to the Northern Territory over the forward estimates period. The impact of the 2017 Update on the Northern Territory is further discussed in Box 1, section 1e.

Table 1c.1: Calculation of average health category expenditure, 2015-16

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Actual, $B	16.4	12.6	12.8	7.3	4.4	1.3	1.0	1.2	57.1
% of total	28.7	22.0	22.5	12.7	7.8	2.3	1.8	2.2	100%
Standard, $pc									**2 387**
Scenario 1: 20% increase in NT health expenditure									
Revised, $B	16.4	12.6	12.8	7.3	4.4	1.3	1.0	1.5	57.4
% of total	28.5	21.9	22.4	12.6	7.7	2.3	1.8	2.6	100%
Standard, $pc									**2 397**
Scenario 2: 20% increase in NSW health expenditure									
Revised, $B	19.7	12.6	12.8	7.3	4.4	1.3	1.0	1.2	60.4
% of total	32.5	20.8	21.3	12.0	7.3	2.2	1.7	2.1	100%
Standard, $pc									**2 523**

Note: Sum of rows may not add due to rounding.
Source: Commonwealth Grants Commission, Northern Territory Department of Treasury and Finance

Output-based standards or efficiency

1c.22 The current form of equalisation provides states with the capacity to deliver the national average level of services but does not seek to determine the standard of services each state should provide or what each state would need to do to achieve desired social outcomes, nor should it. There are a number of issues preventing equalisation from being an appropriate means to drive outcomes or reach externally determined standards, which would:

- be inconsistent with the terms of the Intergovernmental Agreement on Federal Financial Relations (IGA), which specifies that GST revenue is to be provided to states on an untied basis;
- create complexities surrounding how standards should be determined, and by whom, and whether standards should be a national or state-specific;
- require analysis and judgement on the quantum of funding each state would require to meet the set benchmarks; and
- require acknowledgement of the different starting points in achieving outcomes between states, which could lead to states being rewarded or penalised for their poor or good performance preceding the initiative.

1c.23 Extending the role of equalisation to achieve specified outcomes is beyond its remit and would extend the principle of HFE beyond its capabilities. A preferable approach exists outside equalisation arrangements, where governments address specific priorities and outcome objectives, which can be designed to suit the needs and priorities of local populations. For example, there are incentive mechanisms within tied funding arrangements whereby states must use funds in specific sectors or meet prescribed output performance measures in order to receive funding.

Is policy neutrality adequately addressed under the average state policy approach? Why or why not?

1c.24 The Northern Territory considers that policy neutrality is adequately addressed under the average state policy approach. As mentioned earlier in this section, the supporting principles of 'what states do' and 'policy neutrality' remove the ability and incentives for states to game the HFE process through unilateral changes to tax and service delivery policies.

1c.25 Where policy neutrality issues have arisen, particularly in relation to Western Australia's influence over the mining revenue assessment, CGC has adapted its assessment methodology to overcome the issue. This is testament to the flexibility of HFE to respond to changes in states' circumstances.

1c.26 The Northern Territory also notes the issues associated with policy neutrality during the recent past are becoming less significant as Western Australia's policy influence over the mining revenue assessment reduces, in line with easing global commodity prices, particularly for iron ore.

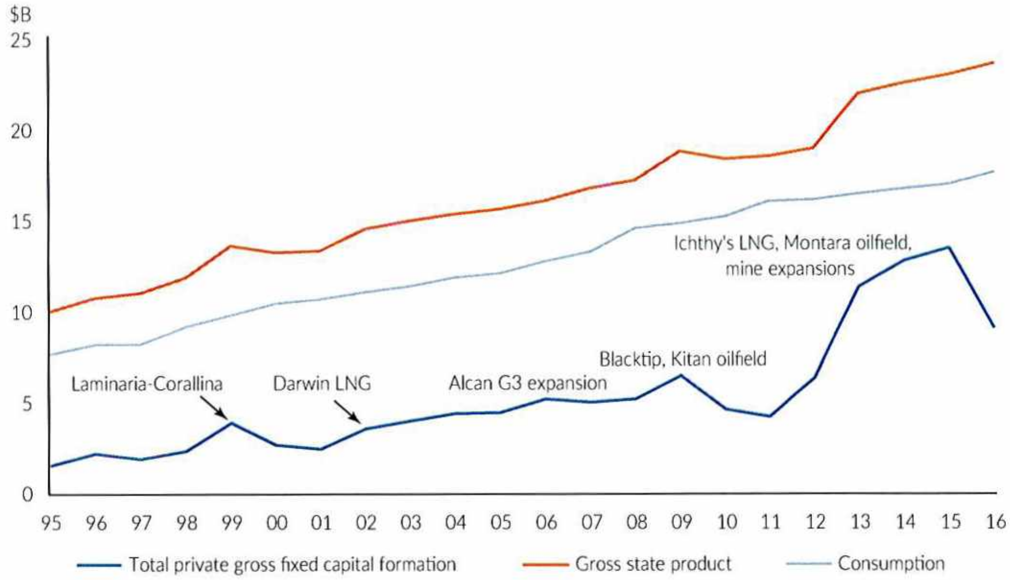
1d. Does the current HFE system influence state policies to facilitate, restrict or tax the development of economic activity and, in particular, energy and mineral resources?

There is no evidence that HFE influences state policies to facilitate, restrict or tax the development of economic activity, including energy and mineral resources.

1d.1 The Northern Territory Government facilitates major mining projects and seeks private investment in the Northern Territory as a means of pursuing economic growth and employment, which is the case for all states. The types of potential resource projects are driven by the Northern Territory's natural resource endowments and the economic viability of prospective projects, which is largely dependent on international commodity prices. Decisions on which projects to facilitate are based on the returns to the Northern Territory and the environmental, economic, cultural and social impacts of proposals.

1d.2 Chart 1d.1 shows the major projects facilitated by the Northern Territory Government as components of GSP. It shows major private sector investments in resource projects have consistently been pursued and facilitated by the Northern Territory Government in order to provide stable and continued economic growth in the Northern Territory.

Chart 1d.1 Components of GSP in the Northern Territory, 1995 to 2016



Source: Northern Territory Department of Treasury and Finance, ABS Cat. No. 5220.0

1d.3 The Ichthys liquefied natural gas (LNG) field in the Browse Basin is one of the most significant oil and gas projects in the world, which led to record private investment in the Northern Territory. In addition, the Gemco manganese mine on Groote Eylandt is one of the world's largest producers of manganese. There are also significant bauxite, gold, zinc and lead mines in the Northern Territory.

What evidence is there for the HFE system affecting state policy choices relating to resource extraction (including regulatory restrictions on development)?

1d.4 There is no evidence that states' decisions to restrict extraction of resources are related to HFE. The recent restrictions and moratoriums on hydraulic fracturing (fracking) in some states are in place in order to provide sufficient time to fully investigate the environmental, economic, cultural and social implications of fracking, not as a means of gaming the HFE system.

1d.5 On 3 December 2016 the Northern Territory Government announced an independent Scientific Inquiry into Hydraulic Fracturing in the Northern Territory.

1d.6 As per the terms of reference, the inquiry is to investigate the environmental, economic, cultural and social risks and impacts of hydraulic fracturing of onshore unconventional shale reservoirs and associated activities in the Northern Territory, having regard to any scientific, technical, policy or regulatory requirements or resources. There is no reference to fiscal equalisation, demonstrating that HFE is not a primary consideration of governments in deciding whether or not to facilitate or restrict the extraction of resources.

1d.7 The CGC assesses states' capacity to raise mining revenues based on the value of production and average royalty rates. All states except the Australian Capital Territory are assessed as having capacity to raise royalties from onshore oil and gas. Seeking to penalise states that choose not to adopt a particular extraction method, due to environmental, economic, cultural or social concerns of their constituents, would open up all revenue sources to scrutiny regarding whether or not states are fully exploiting all options to broaden their revenue bases.

1d.8 In addition, changing the form of equalisation to reflect what states *could* do would require an unacceptable level of judgement by the CGC, including assessment of all resource reserves and whether or not government policy was impeding extraction.

1d.9 If HFE was based on what states *could* do, rather than what they actually do, in terms of mining production, there would be an implicit incentive to extract all resources today, to be assessed as having zero capacity tomorrow. This is not an appropriate outcome of HFE and ignores the many other considerations factored into whether or not states adopt facilitative resource extraction environments.

1d.10 The Northern Territory is investing around $24 million over four years (2014-18) in the Creating Opportunities for Resource Exploration (CORE) initiative, which is designed to maximise opportunities for the exploration and discovery of new mineral and petroleum resources. The focus of the initiative is the acquisition of new precompetitive geoscience information to stimulate exploration, improved online delivery of information and data, as well as industry grants for high-risk exploration and programs to attract international investment to projects in the Northern Territory.

1d.11 Notwithstanding what states may do to facilitate economic development through resource extraction, the key determinant of activity in this sector is the interaction between global commodity prices and the economic viability of extracting the resource.

1d.12 The cost of extracting the gas reserves in the Northern Territory can be relatively high, particularly in remote, greenfield locations where there is a lack of enabling infrastructure. This is evidenced by no commercial development of the Northern Territory's unconventional gas reserves prior to the Northern Territory's moratorium.

1d.13 As noted in the Scientific Inquiry into Hydraulic Fracturing in the Northern Territory: Background and Issues Paper:

> *Shale gas is found in several basins throughout the Northern Territory. To date, notwithstanding ongoing exploration, only the Beetaloo Sub-basin of the Greater McArthur Basin has demonstrated any potential economic viability for shale gas extraction and production.*
> (Scientific Inquiry into Hydraulic Fracturing in the Northern Territory: Background and Issues Paper 20 February 2017, page 11)

1d.14 The Northern Territory contends that facilitation of economic development, particularly resource extraction, is based on overall economic growth prospects, including private investment decisions, population growth, employment outcomes, multiplier effects and environmental impacts – land access, water security, impacts on resident populations, community support, and other economic imperatives such as costbenefit and opportunity costs – and that these issues have a far greater weighting on government decisions in relation to resource extraction than any HFE impact.

1e. How does the current CGC relativity process affect states' fiscal management from year to year and over time? How does this affect policy outcomes and economic activity in each state?

1e.1 The current CGC relativity process affects all states' fiscal management from year to year through the release of annual relativities prior to the release of state budgets. States are also required to determine best estimates of states' share of the national population, and expected growth in the GST pool in order to arrive at GST revenue estimates for the coming financial year.

1e.2 As discussed below, while large annual fluctuations in states' relativities, as occurred for the Northern Territory between 2016-17 and 2017-18, can have significant budgetary impacts on states' capacities to affect policy outcomes and economic activity, states draw on a range of fiscal measures to manage these fluctuations, which are a necessary and unavoidable consequence of HFE, due to its responsiveness to changes in states' circumstances over time. However, the Northern Territory is more exposed to these fluctuations than other states, given its reliance on GST revenue for about half of its total revenue.

Does the current process impact the ability and propensity for states to manage budgets through cycles, especially for those states relatively more reliant on large and volatile revenue streams?

1e.3 As a general principle, the current HFE process applied by the CGC does not affect the ability and propensity of the Northern Territory to manage its finances through the budget cycle to a greater extent than any other revenue and expense variables. However, the Northern Territory is more exposed to changes in its share of GST revenue than other states due to GST revenue comprising around 50 per cent of its total general government revenue.

1e.4 The issue of the timing of the release of relativity updates is particularly pronounced on state budgets given the difficulty in forecasting relativities when compared to the other GST revenue parameters (population shares and GST pool).

1e.5 As indicated previously, the Northern Territory has minimal impact on national average expenditure and has an average capacity to raise own-source revenue but well above-average expenditure needs due primarily to relative differences in its demographic and geographic circumstances. This means the expenditure decisions of the most populous states have a significant impact on the Northern Territory's assessed GST revenue needs, as evidenced by the results of the 2017 Update. The impact of the CGC's 2017 Update on the Northern Territory is discussed in Box 1.

1e.6 Although Western Australia also has above-average expenditure needs (although much lower relative to the Northern Territory's expenditure needs), the key driver of movement in its relativity has been the increase in its fiscal capacity from other sources, in particular mining royalties. Given the volume of information available through third-party economic forecasters, macroeconomic indicators and the fact that mining revenue reflects the royalty regime of the state, it is not unreasonable to expect Western Australia to have been well placed to predict and model changes in its relativity in recent years.

> *A factor that has heavily influenced the GST share for WA has been its revenue strength. Since 2008 and 2008-09 WA has been the fiscally stronger state in our process. Up until 2008 at various times in our history it has been New South Wales or Victoria. In 2008-09 WA became the fiscally stronger state. Notwithstanding the fact that the commission assesses WA as having very significant spending requirements that are beyond its control, reflecting the fact that it is a very large state with a small population spread over large areas and with a large Indigenous population—there are a number of factors there that more than explain why the cost of delivering government services in WA is quite large and higher than the average. That has been more than offset by the fact that WA has considerable capacity to raise revenue on its own account. That is the mining royalty issue that has helped explain why WA is a fiscally stronger state and therefore, in the commission's assessment, has less need for GST than other states.* (Michael Wilcock, Senate Economic Legislation Committee Estimates, 31 May 2017, Canberra)

How does data reliability and the three-year averaging process affect fiscal management? Is there a better trade-off between GST relativity precision and timeliness?

1e.7 The Northern Territory highly values the stability provided through the three-year averaging process. The three-year averaging process provides some stability and ability for a state to plan for changes in its GST share, particularly where this is driven by cyclical changes impacting its revenue capacity. It is a simple and appropriate balance between precision and timeliness in the calculation of GST relativities. Any change to this process would increase volatility and reduce reliability of the HFE system.

1e.8 The Northern Territory is not convinced that trading precision for timeliness would improve states' fiscal management and considers increased volatility, through either the use of forecast data or only one year's worth of data in the assessments for the distribution of the GST pool, would hinder states' fiscal management.

1e.9 Forecast data would potentially lead to the need for GST revenue adjustments in subsequent years to reflect actual data outcomes, adding an increased level of complexity to the CGC calculations, including the need for states to repay overpayments in subsequent years. Further, an unacceptable level of uncertainty would result from the annual revisions to states' GST revenue, making state budgeting significantly more difficult.

1e.10 Although changes in state fiscal and economic circumstances are not immediately reflected under the current approach to HFE, they are reflected two years later. This provides a level of stability and predictability of states' GST shares, and achieves the best possible balance between accuracy and contemporaneity.

1e.11 The CGC also uses a range of data sources in its assessment methodology including national datasets and state administrative data. In this regard, the use of the most up-to-date data, provided it is reliable and fit for purpose, is appropriate. Annually updated data released after a lag, or less frequently updated data should not be dismissed over concerns it is not contemporary. To do so would significantly restrict the data available to the CGC for use in the assessment process and the rigour of its assessments.

What is the ability (and track record to date) of states to project and anticipate their own GST relativities, including any impacts of major state initiatives?

1e.12 All states estimate their GST relativities and it is understood there are varying degrees of complexity in each states' modelling underpinning these estimates. Some states publish their estimates.

1e.13 As previously noted, the Northern Territory has very limited influence on national average policy determined through the CGC's assessment method which is driven by the larger states. Given the Northern Territory has relatively high expenditure needs as reflected in its GST relativity above its population share, any material change in the larger states' expenditure patterns can significantly impact the Northern Territory's GST requirements and therefore its GST relativity.

1e.14 Estimating such changes in other states' expenditure patterns is difficult. Consequently, the Northern Territory recognises this risk, which can affect its ability to accurately estimate its annual GST relativity. Despite this, the Northern Territory has generally been capable of projecting the directional change in its relativities, though most recently not necessarily the magnitude (as outlined in Box 1).

Box 1. Impact of CGC's 2017 Update on Outcomes in the Northern Territory

- Although the Northern Territory strongly supports the current form of equalisation, the reduction in its assessed GST needs in the 2017 Update report has had a significant budgetary impact, with implications for the Northern Territory's capacity to invest in closing the gap in outcomes between Aboriginal and non-Aboriginal Territorians.
- As outlined in section 1c, although the Northern Territory is a staunch defender of the current form of HFE in Australia, it is highly exposed to changes in the expenditure decisions of the largest states as they have the largest influence on determining national average expenditure, which is used in turn to determine states' GST needs.
- In the CGC's 2017 Update, reductions in national expenditure in the community health, schools education and roads categories were key contributors to the reduction in the Northern Territory's assessed GST needs for 2017-18, and the consequent $2 billion estimated reduction in GST revenue to the Northern Territory over the forward estimates.
- Table 1e.1 shows the estimated GST revenue impact of the 2017 Update relativities applied in 2017-18 compared with those applied in 2016-17. It shows that the Northern Territory was the only state to receive less GST between these years.

Table 1e.1 Estimated GST revenue to states, 2016-17 and 2017-18

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	$M	$M	$M	$M	$M	$M	$M	$M	$M
2016-17	17 369	13 717	14 075	1 976	6 000	2 278	1 136	3 190	59 740
2017-18	17 680	14 829	14 963	2 354	6 360	2 403	1 230	2 921	62 740
Change $M	**311**	**1 112**	**889**	**378**	**360**	**125**	**94**	**- 269**	**3 000**
Change $pc	**39**	**178**	**180**	**141**	**208**	**239**	**233**	**- 1 094**	**122**

Note: CGC estimates are based on GST parameters in the Commonwealth's 2016-17 Mid-Year Economic and Fiscal Outlook.
Source: Commonwealth Grants Commission's 2017 Update Report

- An important feature of HFE is reflecting 'what states do' which removes the scope for gaming the system in order to influence GST shares and maintains states' sovereignty. Consequently, HFE only reflects what states actually spend, not what they would need to spend to improve outcomes. Further, HFE does not provide states with the funds required to improve outcomes, but only to maintain existing standards of services, as determined by national average expenditure.
- Similarly, the existing approach to achieving HFE does not capture historical under-investment in services and infrastructure. The distribution of GST is only enough to maintain national average service standards and provide infrastructure in response to population growth. This is discussed further in section 2a.
- Given the significant level of socioeconomic disadvantage experienced in the Northern Territory it is vital the calculation of per capita relativities does not diminish the its capacity to fund unmet demand and improve service standards in remote Aboriginal communities. This requires the Northern Territory and Commonwealth governments to jointly invest in closing the gap in outcomes above and beyond average state policy, and for Commonwealth funding provided to address Aboriginal disadvantage to be excluded from HFE, to ensure the purpose of such funding is upheld and not redistributed to other states.

1e.15 Changes in states' revenue capacities drive changes in most states' relativities, and these changes are easier to foresee and factor in to relativity estimates.

1e.16 A review of Western Australia's budgets demonstrates it had forecast a decline in its GST revenues, due to its above average capacity to raise mining revenue as a result of increased iron ore prices and production, and more recently is forecasting its GST revenues to increase following declines in global iron ore prices.

> *General government sector revenue is forecast to decline by a further $720 million or 2.7% in 2015-16 (relative to 2014-15), before recovering to average growth of 8.4% per annum across the remainder of the forward estimates period as domestic economic conditions improve and as Western Australia's share of GST revenue starts increasing from 2016-17 (as a lagged response to the recent decline in iron ore prices).* (Western Australia 2015-16 Budget Paper No. 3, page 43)

What resources do individual states expend dealing with HFE matters?

1e.17 Given the importance of GST as a key revenue source to the Northern Territory, HFE matters are relevant across the whole of government.

1e.18 The Northern Territory's Department of Treasury and Finance is the lead agency on HFE matters. Similar to other states, it has an intergovernmental relations unit that deals with, amongst other things, issues specifically concerning HFE including contributions to the CGC annual update and review processes, co-ordinating input from across government.

1e.19 Frontline and service delivery agencies also play a vital role in ensuring the Northern Territory's interests are appropriately captured in the equalisation assessment by contributing to the annual CGC GST Revenue Sharing Relativities Updates and Review processes.

1e.20 HFE, particularly in terms of the broader federation, is also a key focus of all first minister departments across Australia, with the Northern Territory's Department of the Chief Minister allocating resources to HFE matters as part of its intergovernmental work.

What preferable alternatives are there to the current HFE system of equalising states' fiscal capacities?

The Northern Territory's view is that:

- There are no other alternatives to HFE that would better achieve efficiency, equity, and simplicity, and promote national wellbeing in Australia. Equalising the fiscal capacities of states so they have the capacity to deliver the national average level of services is, and should remain, the sole objective of HFE.
- The erosion of equity in favour of efficiency as an objective of equalisation would result in an increase in inequity between states and regions in Australia, and would likely require sustained additional Commonwealth funding that would come at a greater cost to the Commonwealth and Australia's economic growth than the current system of equalisation.
- HFE is dynamic and responsive to both structural and cyclical changes affecting state economies, notwithstanding the lagged effect.
- Notwithstanding the concentration of resource endowments and other revenue bases outside government control, HFE ensures the whole federation shares in the nation's economic booms and busts.
- Past policy decisions to invest in large infrastructure projects of national significance or to undertake unilateral tax reforms should not have a long-term influence over states' GST shares and should only impact shares to the extent they are reflected in the data underpinning CGC's assessments.
- Any move away from the current full equalisation would have an adverse and disproportionate impact on small states' sovereignty and the achievement of equity across similar regions.
- Proposed alternatives to the current form of HFE would result in a more complex and less administratively efficient system.
- All states are already subject to various legislative and administrative frameworks, ensuring they are accountable to the constituents they serve.
- Any objectives in addition to fiscal equalisation should be pursued outside the current system of HFE.
- The current form of HFE, including the three-year averaging process, best achieves fiscal equalisation across states by achieving a balance between accuracy and responsiveness to changes in states' circumstances.

2a. What should be the objective of HFE?

2a.1 The Northern Territory strongly supports the objective of the current HFE system, which aims to provide states with the capacity to provide the same standards of services and associated infrastructure, if they made the same efforts to raise revenues. The Northern Territory supports the widely held view that achievement of equity is the most important outcome of HFE and considers the CGC's current definition of HFE as appropriate.

2a.2 Since 1983, the current form of HFE has served the federation well. It provides a balance between upholding state sovereignty, through ensuring the service delivery, infrastructure and taxation imperatives of state are uninhibited by HFE, while providing states with the capacity to provide the national average level of services. It is not a recommendation of how states should spend GST revenue or how they should raise own-source revenue. Such recommendations would disregard state sovereignty and there is nothing to suggest that the CGC is the appropriate body to make such recommendations.

2a.3 Equalisation is designed purely to compensate states for unavoidable factors that result in differences in states' costs of delivering services and capacities to raise revenue. In doing so, equalisation is a pillar of social equity and inclusion, by providing states with the fiscal capacity to deliver comparable standards of services to constituents in similar locations.

2a.4 Further, a less comprehensive system would either result in a significant share of the Northern Territory's revenue comprising tied Commonwealth grants, which would impinge on its sovereignty and severely restrict its ability to determine expenditure priorities, or result in an increased tax burden on Northern Territory citizens and businesses in order to maintain current or reduced levels of service delivery. These effects would have a damaging impact on the Northern Territory's economy.

2a.5 An important feature of the HFE system is the ability for each state to determine its policy priorities independently of other states and the Commonwealth according to its own particular needs and economic and social structures.

2a.6 The distribution of GST revenue based on the current principle of HFE is just one institutional setting underpinning the shared objective of all Australian governments of collective and individual equity across Australia, but it is a key component. HFE seeks to achieve horizontal equity, complementing other policies aimed at enhancing interpersonal equity between citizens, such as progressive income tax rates.

2a.7 HFE complements government policies aimed at addressing unmet need by providing all states with the capacity to deliver a stable foundation of services for all Australians to access, no matter what their location or circumstances. HFE is not designed to close the gap in unmet need, or address extreme disadvantage, backlogs in service provision, infrastructure deficits or economic efficiency. These are important issues and there are more appropriate means of pursuing these objectives from outside HFE, through targeted funding, incentive payments and nationally coordinated reform agreements that do not impact on the distribution of GST. In particular, Commonwealth funding provided to closing the gap in outcomes between Aboriginal and non-Aboriginal Australians should be excluded from equalisation.

2a.8 Tasking HFE with achieving national economic efficiency as well as ensuring states have the fiscal capacities to provide a national average standard and range of services is unachievable. The erosion of equity in favour of efficiency as an objective of equalisation would result in greater inequity between regions in Australia and would likely require sustained additional Commonwealth funding that would come at a greater cost to the Commonwealth and Australia's economic growth than the current system of equalisation.

Should HFE address fiscal divergences across states due to both structural factors (beyond state influence) and cyclical factors (beyond state influence)? If so, over what time period should this be achieved?

2a.9 Although the Northern Territory acknowledges that, due to the lagged effect of GST relativities, cyclical factors may run ahead of GST relativity adjustments on the downside, the reverse also applies on the upside with GST relativity adjustments running ahead of cyclical factors. The Northern Territory considers these swings and roundabouts are appropriately addressed through the current three-year averaging process, which provides an appropriate balance between precision and contemporaneity in the calculation of GST relativities, and smooths the volatility of a revenue stream due to cyclical movements.

2a.10 Although in recent years Western Australia has been experiencing both a decline in its GST relativity and a decline in its mining royalty revenues, in the early days of the mining boom Western Australia reaped the rewards of the sharp rise in the demand for and price of iron ore and enjoyed the impact of the lag effect on its GST relativity.

> *The lags in the assessment system have provided a large and likely ongoing benefit to Western Australia (at the expense of other states) while cyclical developments (around the trend) provide broadly offsetting short term gains and losses.* (CGC 2015 Review Response to the Commonwealth Treasurer on GST shares in the Presence of Large and Volatile State Revenues, page 8)

Should HFE compensate states for fiscal divergences where a state has by choice diverged from efficient tax arrangements and service delivery?

2a.11 Although the Northern Territory is not aware of when a state has chosen to become more inefficient in either taxation arrangements or service delivery, it should be noted HFE does not compensate states for fiscal divergences arising from differences in policy. As previously noted, the principle of policy neutrality seeks to avoid individual states being able to significantly influence their GST revenue shares through unilateral policy decisions.

2a.12 As discussed in section 1c, the Northern Territory's view is that HFE does not compensate states for inefficient service delivery due to the CGC's adoption of the internal standard approach and reflecting average state policy, and it incentivises levying taxes at the national average (efficient) level, after taking into account differences in states' relative tax bases.

Should past state policy decisions (such as on economic development, revenue bases and rates, or budget provisioning) influence the form or degree of fiscal equalisation? If so, how?

2a.13 The Northern Territory's view is that past policy decisions should only influence states' GST shares since expenditure or revenue effects are incorporated into the assessment system through the usual processes.

2a.14 States that have undertaken large infrastructure projects or reformed taxes should not be 'compensated' on an ongoing basis through equalisation. The Northern Territory notes that states' consideration of whether or not to undertake such reforms and projects are driven by expectations of long-term benefits to the state, which apply outside the equalisation system, in the form of growth in employment, productivity, exports, own-source revenues and economic activity.

2a.15 In the Northern Territory's view, recommending that HFE should 'reward' states for undertaking reforms or investing in long-term economic infrastructure is extending the capabilities of HFE beyond its remit.

2a.16 Western Australia has previously argued the mining revenue assessment should recognise the contribution of past and present state policies on the development of revenue bases, for example, from the North West Shelf. To account for this, Western Australia suggested the mining revenue assessment should be discounted.

2a.17 Apart from the fact that discounting the mining assessment would further dilute equalisation, the CGC found that the higher share of production of a state is not necessarily the result of the pro-mining effort of a state but could also be due to differences between states in the quality and grade of a mineral, social, economic and environmental values of a mine area, and access to infrastructure and associated costs to the private sector of developing the mine.

2a.18 The CGC also noted applying a discount would imply states with relatively higher production are all pro-development and, if a discount was applied to the mining assessment for this reason, it would then have to consider whether states with relatively larger tourism industries or education sectors for example, require a discount because the size of their sector implies a difference in policy effort.

What are the advantages and disadvantages of targeting full versus partial fiscal equalisation across states?

2a.19 Full equalisation is appropriate for the Australian federation given the level of vertical fiscal imbalance that exists, and the significant differences between states in population characteristics, natural resource endowments and economic circumstances, which change over time, resulting in unavoidable and material differences in states' capacities to deliver government services and infrastructure.

2a.20 The current HFE system is termed full equalisation, as it takes into account states' expenditure needs and revenue-raising capacities. Although it seeks to take into account unavoidable factors affecting states' service delivery costs and revenue-raising capacities, this is not the case in practice, due to data limitations, materiality thresholds, the adoption of average state policy, number of equal per capita assessments, and use of discounting.

2a.21 For example, in the CGC's 2015 Review methodology, around 36 per cent of states' revenue and 14 per cent of expenditure was assessed on an equal per capita basis, which has no redistributive effect on states' GST revenue shares.

2a.22 In addition, not all possible disability factors for all unavoidable differences between states are assessed. There are a number of reasons for this, including the CGC's pursuit of simplicity, lack of available or comparable data, the adoption of materiality thresholds and the use of discounting. Discounts are applied where the CGC questions the reliability of data or nationally consistent data is unavailable, however the Northern Territory opposes the use of discounts because they always assume the data overestimates the impact of a disability, when the Northern Territory would argue that in some cases, a disability is underestimated by incomplete or unreliable data.

2a.23 For example, the CGC discounts the interstate wages assessment due to data concerns, which reduces the amount of GST redistributed as a result of the assessment. In the case of wages, there is no evidence to suggest the Survey of Education and Training data used in the assessment, which is based on private sector wages, overstates the differences in wages between states, but this is implied by the use of a discount.

2a.24 Any further erosion of fiscal equalisation (partial equalisation) would introduce subjectivity and uncertainty, and would require a high degree of judgement by the Commission, without any evidence to suggest this would enhance national efficiency or productivity or achieve any other policy outcome other than increasing GST revenue to the largest states.

2a.25 Further, partial equalisation may have a significant disproportionate impact on the smaller states, undermine their sovereignty through increased reliance on Commonwealth funding and may not result in any improved administrative efficiencies due to the need for the Commonwealth or another body to assess fiscal needs in some other way. Failing this, it would result in a significant divergence between service standards across state borders. As mentioned above, it may also result in 'inefficient' fiscally induced interstate migration to the fiscally stronger states.

2a.26 One proposal often suggested as a means of adopting partial equalisation is to discount the average by a set percentage. Under this approach, the CGC would determine, through judgement, the degree to which states are equalised, which the Northern Territory does not accept is an appropriate role for the CGC to take. The 2012 GST Distribution Review concluded that discounting "could only be considered minimal – perhaps even symbolic – from the large States' point of view, while having a significant impact on small states..., the panel has decided, on balance, not to recommend adopting discounts to reflect minimum effort".

2a.27 An alternative form of partial equalisation proposed by some parties is to increase the use of broad indicators in the CGC's assessments, particularly in the assessment of states' revenue-raising capacities. While the Northern Territory would not be opposed to the use of broad measures as a means of improving simplicity of the CGC's methodology, there is no evidence to date that broad indicators, such as GSP, accurately reflect differences in states' fiscal capacities. This view was supported by the findings of the 2012 GST Distribution Review, which found that:

> *...adopting broad cut-through indicators that can produce closely comparable results to those under the present arrangements remains elusive.* (GST Distribution Review Final Report, October 2012, page 11)

2a.28 For its upcoming 2020 Review, the CGC released a paper 'Achieving HFE – Other Approaches to Distributing the GST' modelling the GST revenue impacts of a range of options for partial equalisation, including an equal per capita distribution, a partial equal per capita distribution, and an actual per capita distribution.

2a.29 It shows an equal per capita or partial equal per capita distribution would result in fiscally weaker states being under-equalised and fiscally strong states being overequalised, which would ultimately lead to divergences in tax rates and the scope and quality of services and infrastructure between states.

2a.30 Advocates of an equal per capita distribution have acknowledged that this would not be reasonable in the absence of a further funding source to meet the gap between an equal per capita share and current equalised shares of GST. If additional Commonwealth funds were available to meet this gap, a process similar to the current CGC methodology would be required in order to distribute the funds based on expenditure needs, and hence, there would be no simplicity or administrative gains. Such funds would also be tied to the achievement of particular outcomes, reducing the level of autonomy of those states receiving the additional Commonwealth funds (also refer to 1a.15).

To what extent should states be held accountable for how they use funds received via equalisation?

2a.31 The Northern Territory Government is held accountable for its expenditure and revenue, including from GST, by its *Fiscal Integrity and Transparency Act*. This legislation requires:

- Government fiscal policy to be based on principles of sound fiscal management;
- Government fiscal policy and performance to be published for public scrutiny; and
- accountability measures to be strengthened for economic and financial projections underlying fiscal reporting and policy making.

2a.32 As part of these requirements, the legislation specifies that the Government produces, annually:

- a Budget;
- a Mid-Year Report; and
- an outcomes report (the Treasurer's Annual Financial Report).

2a.33 The Government is also held to account through the Budget Estimates process, and recently made changes to the parliamentary system to allow the Estimates Committee to scrutinise Government's annual reports, which track the government's delivery of programs against the budget.

2a.34 Further, the Northern Territory is an active member of various intergovernmental working groups and councils in this regard. The Northern Territory continues to meet its accountability and performance reporting requirements to various external bodies, including the Australian Bureau of Statistics; Australian Institute of Health and Welfare; Australian Curriculum, Assessment and Reporting Authority (ACARA); and to the Commonwealth as required under national partnership agreements. The Northern Territory also actively contributes in an open and transparent manner to a number of national data reports including the Report on Government Services, Overcoming Indigenous Disadvantage, Indigenous Expenditure Report and the COAG Report on Performance around national agreements and significant national partnerships.

HFE and incentives to improve outcomes

2a.35 As previously noted, expanding the role of equalisation to provide incentives for states to achieve specified outcomes is beyond its scope, and such goals are more appropriately pursued outside the equalisation process.

2a.36 A common misconception is that equalisation provides states with the fiscal capacity to improve outcomes over time. The equalisation process provides states with the capacity to deliver the average level of services, which maintains existing differences in outcomes between population groups and regions. This is due to the application of the equalisation principle of 'what states do', which was affirmed in the CGC's 2008 submission to the Senate Inquiry on Government expenditure on Indigenous Affairs and Social Services in the Northern Territory, which noted that:

> *...the Commission makes no independent assessment of what would need to be spent to address disadvantage. At an extreme, if the average policy of the states was to cease assisting a particular disadvantage group then the problems of that group would have no impact on the distribution of the pool* (page 3).

2a.37 An alternative approach would be to pursue equity through tied funding arrangements, however this would increase the number and complexity of tied funding arrangements and involve assessing each jurisdiction for each agreement, requiring a level of detail and expertise comparable to the detail included in the CGC's current methodology.

2a.38 Specific purpose payments are provided on an equal per capita basis, which is accepted by states because they are included in the HFE process. If equalisation was achieved through tied funding arrangements, it would require the Commonwealth to determine the cost of delivering government services to population subgroups and account for higher costs associated with location and scale. In addition to the potential increased complexity that would arise under this approach, there would also be significant risks to states in terms of their overall sovereignty.

2b. What are some alternatives to the current system and how would they affect states' incentives to pursue higher prosperity? How would the alternatives perform, relative to the current system, in terms of efficiency, equity and simplicity, and ultimately, which approach is best for national productivity and wellbeing?

2b.1 The Northern Territory contends there is no known alternative form of HFE that would better achieve efficiency, equity and simplicity, and promote national wellbeing compared with the current form of HFE in Australia.

2b.2 As noted by German Economist Paul Spahn:

> *Despite shortcomings such as a high degree of complexity, the Australia system has become the model for an ideal equalisation system. The basic approach is sound, complete, feasible, and reasonably transparent...the unique benchmark against which all equalisation mechanisms have to be compared in terms of their vulnerability to manipulation and perverse incentives.* (Paul Bernd Spahn 2007, 'Equity and Efficiency Aspects of Interagency Transfers in a Multigovernment Framework', Chapter 3 in Intergovernmental Fiscal Transfers: Principles and Practice, Boadway, Robin and Shah, Anwar (eds.), The World Bank)

2b.3 Various alternative forms of equalisation have been proposed over time, and examined by the CGC, various review panels, economists and other academics. These include an equal per capita or partial per capita distribution (discussed in section 2a), relativity floor and removing the influence of outliers from the distribution pool. None have been found to achieve the same degree of interpersonal equity across the nation, while providing inbuilt incentives for efficient service delivery and taxation policy, and maintaining state sovereignty and promoting general national wellbeing.

2b.4 Below is the Northern Territory's analysis on selected proposed alternatives to the current system raised during discussions with the Productivity Commission. This analysis shows any alternative would lead to disparities in the level and standard of services across state borders by facilitating divergence in states' fiscal capacities over time.

Setting GST relativities for five years

2b.5 The idea of introducing a system where relativities are held constant for a period of time may result in less administrative burden on an annual basis and provide greater certainty and stability in states' GST revenue shares for the years the relativity is held constant, but would not improve states' fiscal management or HFE outcomes over time. Fixing relativities for a set period would lead to significant divergence in states' fiscal capacities over time and result in over and under equalisation over the period, with variability in these consequences subject to the starting year used.

2b.6 Fixing relativities would be a more viable option if the relative fiscal positions of the states did not vary significantly over time. As states' economic circumstances change, they are likely to seek updated relativities to ensure these reflect current circumstances, as states will be differentially affected by external shocks or changes to economic conditions during the fixed relativity period, to say nothing of pre-existing economic, service and infrastructure deficits in some states.

2b.7 In addition, locking in relativities is likely to result in large changes in relativities between reviews, with the potential for significant budgetary impacts far in excess of those arising from annual updates.

2b.8 A further disadvantage of fixing annual relativities is that existing errors identified post-publication would remain in the assessment system, which is a regular occurrence as state-provided data is often used for the most recent assessment year to fill data gaps pending the release of national datasets. For example, the Commission requires state-provided data for the most recent assessment year as part of the annual update process in order to calculate the standard budget as Australian Bureau of Statistics' government finance data is not available in time for release of the Commission's updates. Data is updated in subsequent annual updates as relevant national datasets become available. The existence of known errors would not be accepted in other forums.

GST Relativity Floor

2b.9 In the past Western Australia has proposed the application of a relativity floor. This was considered by the 2012 GST Distribution Review, which found there was no compelling case for a relativity floor, noting in particular it would cause a major disparity in the fiscal capacities of the states (GST Distribution Review, Interim Report, March 2012, page 41).

2b.10 Imposing a relativity floor would not only dilute equalisation outcomes, it would be less transparent compared to the current arrangements, not be premised on a sound conceptual case and be an arbitrary measure that could be subject to further change. Table 2b.1 shows the effect of a GST relativity floor of 0.75 would be to the benefit of one jurisdiction.

Table 2b.1 Impact of a 0.75 GST Relativity Floor, 2016-17

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	$M	$M	$M	$M	$M	$M	$M	$M	$M
GST revenue without relativity floor	17 180	13 619	13 939	1 944	5 920	2 255	1 126	3 157	59 142
GST revenue with relativity floor	16 228	12 870	13 343	4 593	5 711	2 191	1 077	3 127	59 142
Difference ($M)	- 952	- 749	- 596	2 649	- 209	- 64	- 49	- 30	0

Source: Northern Territory Department of Treasury and Finance; Commonwealth 2017-18 Budget

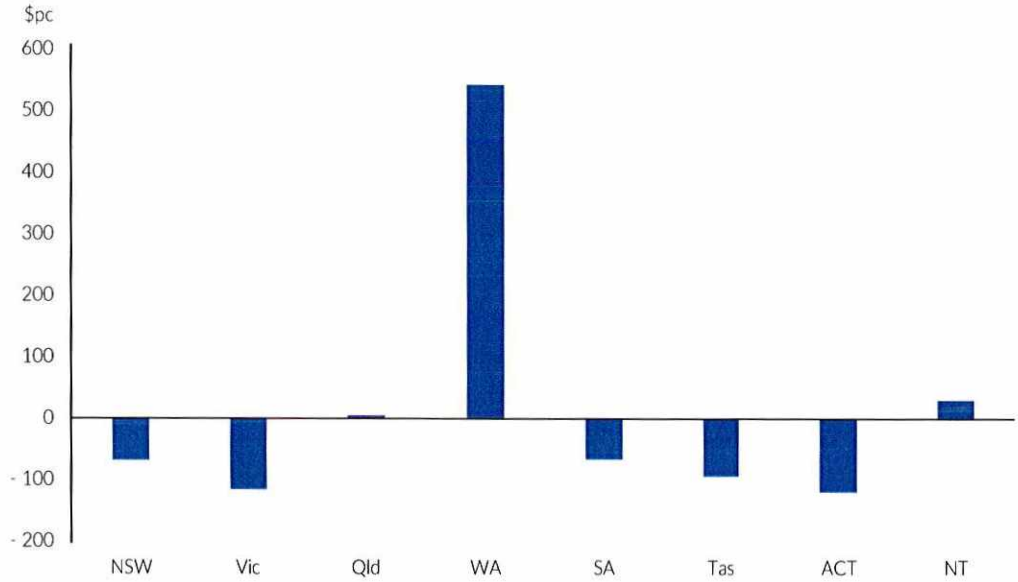
2b.11 In the above table, the redistribution of GST revenue towards Western Australia is shared among the other states on an equal per capita basis, however if this was shared on a GST relativity basis there would be a disproportionate effect on states, particularly the smaller states.

Discounting the mining revenue assessment by 25 per cent

2b.12 Western Australia has continually proposed a discount to the mining revenue assessment as a means of increasing its GST revenue share. While this proposal would benefit the Northern Territory, which in recent years has been assessed as having above-average capacity to raise mining royalties, the Northern Territory does not support it because it would not enhance HFE outcomes.

2b.13 Chart 2b.1 shows the GST revenue impacts of discounting states' assessed mining revenue capacity by 25 per cent compared with the estimated GST distribution in 2016-17. It shows that introducing the discount redistributes significant GST revenue to Western Australia and away from the non-mining states, predominantly Australian Capital Territory and Victoria when measured in per-capita terms.

Chart 2b.1 Per Capita Redistribution of GST Revenue due to a 25 per cent Discount to the Mining Revenue Assessment, 2016-17



Source: Commonwealth Grants Commission, Commonwealth 2017-18 Budget

2b.14 The Northern Territory's view is that structural changes in states' economies should be reflected in the GST revenue distribution. Arbitrarily altering the principles underpinning HFE in response to short-term changes in states' economic circumstances would risk the integrity of HFE in Australia. If the mining assessment is discounted in response to its increasing influence on the GST distribution, it would set a precedent for category discounts reflecting every market boom experienced in the future, for example, New South Wales seeking a discount to the stamp duty on conveyances assessment as its stamp duty revenues surge during the property price boom.

2c. How do these alternative approaches fit within the wider scheme of federal financial relations? Are some inequalities across states better dealt with outside the HFE system?

2c.1 As discussed in section 1b, the Northern Territory contends that Australia's form of equalisation levels the playing field in Australian federal financial relations, which promotes a collaborative and multilateral approach to national efficiency and productivity-enhancing reforms. Alternative forms of HFE intended to dilute HFE would hinder federal financial relations, as the smallest, fiscally weaker states would either face significant declines in their fiscal capacities or become increasingly reliant on the Commonwealth.

2c.2 As a federation, it would be inappropriate for certain states, sovereign entities, to become beholden to the Commonwealth to determine the majority of expenditure decisions, while other states have full policy reign, for example due to the incidence of resource endowments, which existed before state lines were drawn, providing them with the fiscal capacity to determine their own expenditure decisions.

Governance and communication

2c.3 The Northern Territory recognises a significant gap in public understanding of HFE and its importance for interpersonal equity in Australia. Indeed, very little about the principle of HFE, or its purpose is known outside the CGC and state and Commonwealth treasuries.

2c.4 In order to maintain public confidence in the financial relationships within Australia's federation, public understanding of the current HFE methodology and GST distribution relativities requires further attention.

2c.5 The Northern Territory's view is the recommended GST distribution between states is so poorly understood that it allows a degree of political gaming and misinformation, which can distort the public's views on HFE. For example, the consistent misinterpretation of relativities and statements such as "Western Australia receives 34 cents out of every GST dollar raised in the state" are misleading, incorrect and indefensible.

2c.6 Firstly, there is no measure of how much GST revenue is raised in each state, due to the impracticalities of estimation, particularly given the increase in domestic online purchases, as well as the need for national companies to allocate their GST liabilities by state, in order to give an accurate result. Secondly, the application of relativities is not directly used to determine state's GST shares. GST relativities are used to weight states' populations, which are summed into a national total weighted population, which is used to determine each state's percentage share of GST revenue.

2c.7 Public misinformation is promoted at the expense of a broader appreciation of the effects of any move away from the full or comprehensive form of equalisation, while misleading statements form the basis of the public's understanding of the system.

2c.8 Further, while equalisation is a central element of Australia's federation, the Commonwealth itself has rarely defended HFE and its intent, and more recently has blurred the conversation by talking about a possible relativity floor sometime in the future without outlining a clear case for such a proposition or stating why HFE is not achieving what it was agreed to achieve.

2c.9 Given the above, there is an obvious need for an advocate of HFE that is not aligned to any government and can explain the intent of equalisation and the distribution methodology to the general public in simple terms, rather than the complexities of its implementation. Without this, the ambiguity and perception that the system is not working will continue.

2c.10 The Northern Territory notes that complex economic concepts such as monetary policy and the consumer price index are publicly explained on a regular basis through agencies such as the Reserve Bank of Australia (RBA). The role of the RBA has done much to aid the public's understanding of the relevant impacts of monetary policy and inflation on the economy and people's day-to-day lives.

2c.11 The Northern Territory proposes that CGC should have a similar role to the RBA when it comes to equalisation and be given a clear mandate to regularly engage with the public on the purpose of the HFE distribution methodology and interpretation of GST relativities and their derivation, in order to strengthen public understanding and confidence in the system.

2c.12 This view was supported by the 2012 GST Distribution Review in its Final Report, which highlighted that:

> *...the CGC does not actively seek to promote the understanding of HFE within the states outside the various treasuries. A more widespread program of engagement (with states and the public) may help ensure that equalisation principles are better understood by politicians and throughout the bureaucracy, with the result that the GST distribution process is more widely supported.* (GST Distribution Review Final Report, October 2012, page 82)

2d. What practices in other federations offer pertinent evidence for the Commission's considerations?

2d.1 Although HFE is not exclusive to Australia, other federations implement it to different extents, reflecting the adaptability of the principle to different federal contexts.

2d.2 The extent of vertical fiscal imbalance (VFI) between levels of government in Australia's federal financial system is significant compared with other federations. That is, the Commonwealth's revenueraising capacity far exceeds its expenditure responsibilities while the opposite is true for the states, with the Commonwealth raising about 75 per cent of total national revenue and 25 per cent raised by states. Despite the states' small share of national revenues, they have primary responsibility for core government service and infrastructure provision for health, education, law and order, transport and public housing.

2d.3 Australia equalises for both expenditure needs and revenue-raising capacity. This is different from other federal systems, which adopt partial equalisation only equalising on the basis of revenue needs. Australia's form of equalisation is appropriate due to the combined effects of the acute level of VFI between the Commonwealth and the states and differences in population and geographic characteristics, natural resource endowments and economic conditions between states. The form of HFE adopted in Australia recognises these significant, unavoidable differences and the impact they have on states' revenue-raising capacities and expenditure needs.

2d.4 The COAG and Council on Federal Financial Relations Issues Paper, prepared in 2015 by the Commonwealth for input to the national discussion on reform of the federation, included information on a number of other federal systems around the world, including Canada, Germany, Switzerland and United States.

2d.5 As noted in the COAG and Federal Financial Relations Issues Paper:

> *Australia has a long history of applying equalisation. Its system is more comprehensive than those in other federations (with the possible exception of Germany), and it aims to achieve a high degree of equality in state and territory fiscal capacities. By contrast, while HFE is a feature of fiscal arrangements in other federations, most only provide some form of partial equalisation (for example, on the basis of revenue-raising capacity only).* (COAG and Federal Financial Relations Issues Paper, Reform of the Federation White Paper 2015, page 39)

2d.6 It is unclear to what extent these other forms of federation can inform discussions on fiscal equalisation here in Australia given the differences in the structure of each federation, the objectives of fiscal equalisations and approaches adopted to achieve this.

2d.7 According to the Issues Paper, Canada's provincial jurisdictions exhibit similar levels of diversity as Australian states, however they have access to Canada's three largest tax resources - personal income tax, sales tax and payroll tax, and are only equalised for revenue needs. That is, while Canada's system aims to provide provinces with a comparable level of services, differences in the costs of providing these services are not actually taken into account. There are also reasonable discounts applied to some revenue assessment calculations.

2d.8 In Germany, the federal government and the subnational jurisdictions share all the major tax bases and neither can unilaterally change the rate or base of the most important taxes. Further there is no clear delineation in terms of expenditure responsibilities, but rather a high degree of inclusion and cooperation between all levels of government. Germany's fiscal equalisation system focuses primarily on equalising revenue capacities of sub-national jurisdictions, with minor adjustments for expenditure needs. Of the proportion of the VAT used to achieve equalisation, 75 per cent is allocated on an equal per capita basis with the remaining 25 per cent paid to jurisdictions with below average revenue-raising capacity. There are also direct transfers between jurisdictions depending on relative financial capacity.

2d.9 States in the Swiss federation are reasonably autonomous in terms of their ability to raise revenue (including the power to tax income, wealth and capital) and their policies and expenditure responsibilities. This, combined with the small size of the country, leads to large differences in the tax load between states. There are also significant differences between states in terms of their geographic, demographic and economic structures. States with below average financial capacities receive funds from states with above average fiscal capacities and the federal government.

2d.10 In the United States there is substantial overlap and variety in the tax structures implemented by the states and the federal government. Intergovernmental financial arrangements are fairly limited in the United States, with states unilaterally advocating for support.