South Australian Government Submission to the GST Distribution Review Panel

Response to Supplementary Issues Paper

March 2012

SA Government Submission to the GST Distribution Review Panel – Response to Supplementary Issues Paper

Key Messages

- The South Australian Government is prepared to explore tax reform options which are beneficial to the community.
- There are a range of factors that are important to facilitate pursuit of a more efficient tax system - these include revenue neutrality, community preferences, equity considerations and transitional impacts particularly in relation to those who may be made worse off as a result of reforms.
- The South Australian Government does not consider that the current HFE system is an impediment to achievement of a more efficient tax system, as outlined in our earlier submission.
- The best way for State tax reform to be achieved is through multilateral negotiation between the Commonwealth and the States, culminating in an Intergovernmental Agreement which addresses budgetary impacts including any HFE consequences to the extent that they exist for the specific tax reform initiatives involved.
- The South Australian Government increased mineral royalty rates from 1 July 2011, and has no plans to make further adjustments in the foreseeable future. Frequent adjustment to royalty rates are likely to be damaging to investor certainty.
- The MRRT as implemented is not the mining tax regime envisaged by the Australia's Future Tax System Review. The Review proposed that the Australian and State governments should negotiate an appropriate inter-governmental allocation of the revenues and risks from the resource rent tax.
- The problems associated with the interaction between royalties and the MRRT could potentially be addressed by assigning MRRT revenues to the States and Territories (offset by reductions in other Commonwealth payments to the States), but there are some drawbacks to this proposition.

Introduction

As indicated in its initial submission to the GST Distribution Review, the South Australian Government believes that the current, comprehensive, system of fiscal equalisation in Australia is a fundamental strength of the Australian federation.

The South Australian Government submission also noted that the terms of reference require that the Review must be guided by the principle that "*jurisdictions should have equal capacity to provide infrastructure and services to their citizens*".

The new terms of reference do not alter this requirement. Nor do they introduce new or previously unconsidered issues associated with HFE. Rather the new terms of reference simply seek to highlight specific issues – namely State tax reform and the interaction between the Mineral Resource Rent Tax and State royalties – and seek to place them within the context of HFE.

The Government of South Australia is open to considering state taxation reform proposals on the basis that any reforms are revenue neutral and beneficial to the community. While there are a range of impediments to delivering a more efficient taxation system, the South Australian Government does not consider that HFE is among those impediments.

The expanded terms of reference for the Review appears to contradict one of the most important rules of good policy making – which is to first articulate the nature of a problem (in this instance describing what is required to address inefficiency in the tax system), then consider the full range of options to address this problem before proposing a policy solution. Appropriately considered in this manner, HFE would not be considered among the key policy levers that would be pursued to successfully achieve a more efficient taxation system. Other strategies would be pursued. As set out later in this submission these strategies would include multilateral negotiations between the Commonwealth and the States culminating in an Intergovernmental Agreement.

The South Australian Government does not consider that Australia's current system of HFE requires amendment to achieve tax reform imperatives. These objectives should be tackled directly. HFE should remain focussed on its primary objective to equalise State fiscal capacity as required by the Terms of Reference - multiple objectives would significantly undermine its ability to achieve equalisation.

Does HFE provide a disincentive for States to undertake Tax Reform?

Australia's Future Tax System (AFTS) Review concluded that many State taxes are highly inefficient – eg, insurance taxes and conveyance duties - because they are narrowly based transaction taxes, and payroll tax - because of the narrowing of the tax base due to the small business tax exemption.

The existence of these taxes in their current form reflects a range of factors, notwithstanding the fact that numerous reviews by economists

and other taxation experts have routinely concluded that they have negative efficiency consequences. These factors include:

- community acceptance – for example the <u>relative</u> acceptability of incurring an irregular, albeit large, tax liability when purchasing a property (given that this occurs at a time of liquidity) as compared with a regular annual tax impost imposed on the site value of the family home;
- equity motivations – eg conveyance duty being applied to improved property values including the family home in light of income tax, capital gains tax and means testing concessions for the family home; or perceived equity motivations as between small and large businesses;
- revenue issues (eg the relative stability associated with a sales based royalty regime as compared with the more volatile and unpredictable revenue streams associated with a mineral rent tax); and
- the difficult transitional issues associated with large scale reform, including compensating those who suffer adverse impacts.

It has been suggested that, in addition to these issues, HFE also creates disincentives to reform inefficient State taxes. The South Australian Government believes that this is not the case to any material degree, and factors such as those listed above are, along with well established efficiency considerations, the key determinants of decision making in relation to tax mix.

1. Multilateral Tax Reform Incentives

To explore the role of HFE in this context further, firstly consider a national, multilateral, tax reform initiative. This will have HFE implications where it involves a tax being abolished (which means it is no longer part of the assessment of what States do in the CGC assessments), and/or a new revenue base being assessed. State GST shares would be altered by this, but the effects would be the mirror of the changes in each States' relative revenue raising capacity resulting from the tax mix switch. Ignoring differences in relative tax effort (which are a policy choice), such a scenario would leave State shares of combined own source tax revenue and GST grants unchanged.

As noted in the South Australian Government's original submission, the AFTS Review report confirmed this point, highlighting that HFE ensured that States had no incentives to "resist or favour" tax reform proposals on the basis of differing tax capacities.

> *"A change in tax mix adopted by all States will change their relative revenue-raising capacities, therefore affecting the*

distribution of GST revenue. A change in tax mix might be revenue-neutral to the States in an aggregate sense, but an individual State might have one of their relatively stronger bases replaced with a relatively weaker base, such that revenue from their own taxes is lower. However, this loss in revenue could be made up through the HFE process, as the loss of their relatively stronger tax base means that their revenue needs are higher. In theory, if all States apply the same revenue-raising effort, no State would have a financial incentive to resist or favour a revenue-neutral reform of State tax base composition on the basis of the local strength or weakness of particular tax bases.

In practice, however, the States will be affected differently because they apply different policies to their existing tax bases and are likely to continue to do so in regard to tax bases they have access to in the future. The redistribution of GST revenue will not take into account the impact of changes to tax bases on a State where it does not apply the average policy. That is, if a State is raising more than the average revenue off a base that is abolished, HFE will not compensate for revenue lost above the average, just as if a State was making a below-average effort that State would not be penalised. This may cause difficulties for some States, particularly if the States do not have the same ability to raise marginal revenue from the new tax base as they did with the old one."[1]

The second part of the above quote highlights the fact that States may still face hurdles in respect of particular tax reform options on account of differences in tax policy (effort) for relevant taxes. This is not, however, a consequence of HFE.

Contrary to the above assessment, the Victorian Government has argued that it was "penalised" for taking early action to abolish financial transaction taxes ahead of other States as part of the multilateral GST indirect tax reforms. While South Australia considers that the Victorian argument regarding early action is misleading – it is instructive in a policy sense.

Essentially Victoria made a deliberate policy decision to forgo revenue earlier than was required by the Commonwealth, including for inclusion in budget balancing assistance calculations. Because Victoria had an above average capacity to raise these revenues, it had more to lose than other jurisdictions from abolishing such taxes (at the national standard effort), but more to gain from such taxes no longer forming part

---

[1] Australia's future tax system, Report to the Treasurer, December 2009, Part Two Volume 2, page 685

of the CGC assessments. For some other jurisdictions (those with below average capacity), the reverse would hold true. Either way the combined impacts are neutral to decision making as per the AFTS Review conclusion.

The Victorian argument rests on the fact that the CGC was still assessing capacity when Victoria abolished some of the financial transactions taxes due for abolition under the IGA (stamp duty on leases, mortgages, debentures, bonds and other loan securities, and a number of other minor duties). This was because it still represented average tax policy across most jurisdictions.

The argument that this highlights a disincentive for tax reform arising from HFE does not stand up to scrutiny. When the Commonwealth, States and Territories negotiated the revised indirect tax reform agreement following the removal of food from the GST base, a delayed abolition timetable was negotiated in order to protect both Federal and State fiscal positions. Abstracting from this point, however, Victoria's argument implies that if the CGC had ceased assessments in this revenue category at an earlier time then this would have removed an impediment to more rapid tax reform. However:

- Victoria still proceeded with abolition in any event, highlighting the relatively greater importance of other factors in the decision to reform the tax base (eg marketing benefits as a location for business in terms of Victoria being a "reform leader").

- If the CGC had been instructed to bring forward the cessation of revenue capacity assessments in this area, Victoria would have experienced a gain in GST grants share but a number of other jurisdictions (those with below average capacity) would have experienced adverse budget (GST share) impacts (which would have flowed to the Federal Budget under the budget balancing assistance arrangements).

- Under this agreement, States had a window of time in which to abolish the financial transaction taxes. Even if the timing of the CGC's decisions as to whether or not to continue to assess capacity was altered (bringing forward GST share impacts which may be positive or negative depending on the jurisdiction), this would not necessarily alter the decision as to when to abolish the relevant tax so long as flexibility is allowed under the relevant intergovernmental agreement (the changed CGC assessment impact is essentially a "sunk" gain or loss).

Ultimately no jurisdiction failed to meet their reform commitments to achieving a more efficient tax system. The timetable ultimately reflected the mutually desirable pace and scope of reform for both the

Commonwealth and the States given that the amendments to the GST base which were required to achieve passage of the legislation reduced the fiscal capacity available to abolish other taxes. If it is considered that the pace of reform should have been hastened, this could have been achieved through a more ambitious abolition timetable being enshrined in the IGA (subject to mutually agreed mechanisms to address the fiscal impacts). It is difficult to envisage how any changes to HFE could have delivered greater incentives given that any such changes would have had differential impacts on each jurisdiction and would have been one-off changes in GST shares unlinked to the decision as to whether or when to abolish the relevant taxes.

2. Unilateral Tax Reform incentives

The second perspective is unilateral tax reform within a single jurisdiction. One proposition which appears to have been floated in relation to this (most notably in the Commonwealth Treasury submission to the Review) is that the CGC revenue capacity assessments could be streamlined and based on broad indicators such as household income, land value and mineral production. The South Australian Government would argue that this proposition would not enhance the operation of HFE in any way:

- Simplicity – the current revenue assessments are not complex, or numerous. The revenue assessment comprises only 7 revenue categories, and accounts for only 71 pages of Volume 2 of the *CGC Report on GST Revenue Sharing Relativities – Assessment of State Fiscal Capacities* compared to the expenditure assessment of 19 expenditure categories which comprises 415 pages.

  In its original submission to the Review the South Australian Government stated that it did not believe that the CGC assessments generally were unduly complex given the importance of the HFE objective. However if the Review did wish to focus on achieving greater simplification within the current HFE arrangements it should focus its efforts on expenditure assessments. The investment assessments are particularly complex. Population growth related needs buried in the investment assessment, in combination with the net lending assessment, could be recognised in an alternative and greatly simplified way. The (non-mining) revenue assessments are the least complex assessments currently undertaken.

Walsh (2011)[2] states:

> *"While judgements are replete in any practical systematic approach to equalisation, those on the revenue-raising capacity side are clear-cut — such as with the case of heterogeneous tax structures — and judgements about how to deal with them fairly straightforward. It is on the expenditure side of assessments that more intractable issues arise."*

- Equity – the proposition would be detrimental to equity and at odds with the terms of reference requirement to ensure that jurisdictions continue to have equal capacity.

  Walsh (2011)[3] states:

  > *"….it is sometimes suggested that revenue-raising capacity assessments should be based on global or macro measures such as household incomes. The major problem with this suggestion is that it confuses households' capacity to pay with States' capacities to raise revenue, in two senses. First, if the tax bases actually available to the states are not related to incomes, nor will be their actual capacity to raise revenue from them. Second, and perhaps even more significantly, household incomes or any other reasonably measurable macro indicator would, at best, capture only the capacity of States to raise revenue from residence-based taxes. It would not reflect any differences in different States' relative capacities to raise revenue from source-based taxes."*

  For example consider the Commonwealth Treasury proposal that ABS estimates of household income by State be used to assess the relative capacity of each jurisdiction to raise revenue from insurance duty. This ignores the significant contribution of commercial insurance in the tax base, and in practice household income does not correlate closely with relative capacity in the household component of the tax base:

---

[2] C Walsh, The Equity Case for Equalising Fiscal Capacities: Rationales, value-judgements, compromises and their implications, A discussion paper prepared for the Department of Treasury and Finance, Government of Victoria, September 2011, pg 22 http://www.dtf.vic.gov.au/CA25713E0002EF43/pages/publications-victorias-submission-to-the-gst-distribution-review. Accessed 23 January 2011.

[3] C Walsh, The Equity Case for Equalising Fiscal Capacities: Rationales, value-judgements, compromises and their implications, A discussion paper prepared for the Department of Treasury and Finance, Government of Victoria, September 2011, pg 15 http://www.dtf.vic.gov.au/CA25713E0002EF43/pages/publications-victorias-submission-to-the-gst-distribution-review. Accessed 23 January 2011.

- Table 1 provides an estimate of 2009-10 commercial and non-commercial insurance premium revenue for States, derived from Australian Prudential Regulation Authority (APRA) statistics. The data indicates that nationally, commercial insurance premiums accounted for about 45 per cent of gross insurance premium revenue in 2009-10, with the importance of commercial insurance premiums as a source of insurance revenue ranging from 38 per cent to 71 per cent, depending on the jurisdiction. Household income would not measure the relative capacity of jurisdictions to raise revenue from commercial insurance premiums.

  Table 2 shows the distribution of commercial and non-commercial insurance revenue across States and the distribution of gross household income. The distribution of States' gross household income does not measure the strength of the NSW tax base for whatever reason (possibly including some extra territoriality) with NSW accounting for 36.5 per cent of Australia's insurance revenue but only 33.2 per cent of Australia's gross household income.

  Table 1: Insurance tax assessment, commercial and non-commercial insurance premium revenue, 2009-10.

Insurance type	NSW	VIC	QLD	WA	SA	Tas	ACT	NT	Total
Non-commercial									
Houseowners/householders	1,845	1,135	1,123	479	337	98	86	15	5,118
Domestic motor vehicle	2,388	1,683	1,202	641	395	101	89	17	6,516
Travel	310	59	44	35	48	4	4	1	505
Mortgage (50% non-commercial)	179	117	137	58	29	8	7	5	540
Other accident	350	221	171	115	103	17	15	5	997
Total non-commercial	**5,072**	**3,215**	**2,677**	**1,328**	**912**	**228**	**201**	**43**	**13,676**
Proportion %	*55%*	*57%*	*62%*	*44%*	*58%*	*46%*	*46%*	*29%*	*55%*
Commercial									
Commercial motor vehicles	617	425	274	212	132	30	26	10	1,726
Fire and ISR	1,272	826	433	287	201	51	45	12	3,127
Marine and aviation	259	98	97	61	33	10	9	7	574
Mortgage (50% commercial)	179	117	138	57	28	8	7	6	540
Consumer credit	96	67	82	39	22	8	7	3	324
Public and product liability	875	458	288	191	130	27	24	7	2,000
Professional indemnity	556	286	166	122	66	12	11	5	1,224
Employers' liability	178	49	7	680	13	110	97	52	1,186
Other	185	134	128	56	34	7	6	3	553
Total Commercial	**4,218**	**2,460**	**1,613**	**1,705**	**659**	**263**	**231**	**105**	**11,254**
Proportion %	*45%*	*43%*	*38%*	*56%*	*42%*	*54%*	*54%*	*71%*	*45%*
Total	**9,290**	**5,675**	**4,290**	**3,033**	**1,571**	**491**	**432**	**148**	**24,930**

Source: Australian Prudential Regulation Authority (APRA) Statistics – Half Yearly General Insurance Bulletin, June 2010, revised 27 May 2010, Table 10.

Notes: (1) NSW and ACT data has been disaggregated as APRA combines the data for these states. ACT total insurance revenue base is assumed to be 88% of Tasmania's revenue base, as per the CGC proportion for 2009-10. (2) CTP premium revenue has been excluded as only NSW and Qld data is collected.

Table 2: Insurance tax assessment, Distribution of insurance revenue and distribution of gross household income

	NSW	VIC	QLD	WA	SA	Tas	ACT	NT	Total
Non-commercial insurance revenue	36.3%	25.7%	20.6%	7.3%	7.6%	1.5%	1.4%	0.4%	100.0%
Commercial insurance revenue	36.7%	23.9%	15.1%	11.5%	6.6%	2.1%	1.9%	1.3%	100.0%
Total insurance revenue	36.5%	24.9%	18.1%	9.2%	7.2%	1.8%	1.6%	0.8%	100.0%
Gross Household Income 2009-10 ($m)	33.2%	23.8%	19.2%	11.1%	7.0%	2.1%	2.5%	1.1%	100.0%

Source: Australian Prudential Regulation Authority (APRA) Statistics – Half Yearly General Insurance Bulletin, June 2010, revised 27 May 2010, Table 10.
ABS Cat no 5220.0, Australian National Accounts - State Account 2010-11, Table 43

Notes: (1) NSW and ACT data has been disaggregated as APRA combines the data for these states. ACT total insurance revenue base is assumed to be 88% of Tasmania's revenue base, as per the CGC proportion for 2009-10. (2) CTP premium revenue has been excluded as only NSW and Qld data is collected.

Efficiency - tax reform incentives. The South Australian Government believes that the broader indicators assessment proposal would not create greater incentives for tax reform.

For example, consider the potential incentives to replace conveyance duty with a broader land tax as proposed in numerous tax reviews including AFTS.

Figure 1 shows the proportion of Australia's conveyance duty base and land tax base calculated firstly as a flat rate of urban land tax and secondly as a progressive rate of land tax by square metre (as recommended by the AFTS) that would have been available to each State over the period 2001-02 to 2009-10. While Queensland and WA were both assessed by the CGC in the 2010 Review to have above average revenue capacity for both the conveyance duty and land tax assessments, figure 1 shows that, with the exception of 2009-10, Queensland has a higher relative capacity to generate revenue from conveyance duty than from land tax.

Replacing the separate assessment methodologies with a combined new land value assessment for both conveyance duty and land tax would financially benefit Queensland through a permanent adjustment to their GST share. There would be an equivalent windfall loss for Victoria.

The size (and possibly direction) of these windfall gains and losses may be different in the future, but in any event would have no effect on motivations to change the mix of state taxes. The degree of community acceptance of land tax applied to owner occupied housing in return for abolition of conveyance duty, and the transitional issues associated with such a change, would remain the predominant hurdles to achieving such a tax mix switch irrespective of how the CGC assessments are handled.

Reliability and validity of assessments would not be enhanced and indeed the reverse outcome is likely. For example consider the proposal to replace the ABS compensation of employees with gross household income to measure the relative capacity to raise payroll tax revenue base. Gross household income does not necessarily match the compensation of employees in large firms tax base very well. The current approach starts with the ABS compensation of employees data and deducts an estimate of the compensation of employees earned in small firms and the general government sector where payroll tax does not apply. The proposed alternative approach starts with the ABS compensation of employees data, as currently, but then **adds** other household income and then **deducts** government transfer payments. The end result is the addition of items which are not taxed, such as gross mixed income, which includes farm income. This could not be judged to represent an advance in any dimension.

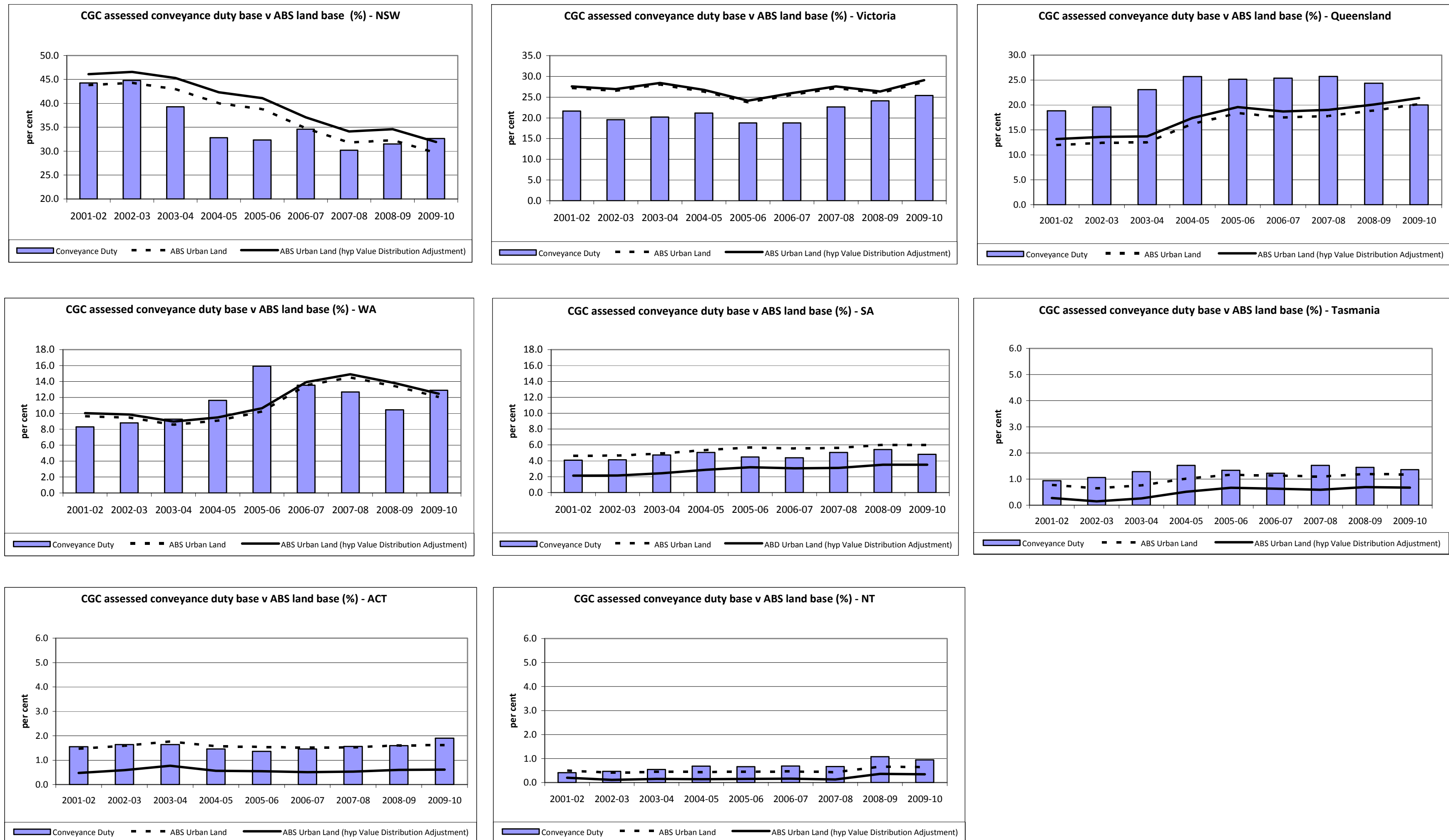
For some States, such as SA, gross household income is a more volatile data series than the ABS compensation of employees data, because it includes farm income, which is volatile. Figure 2 shows the annual percentage point change in SA's share of national gross household income and national compensation of employees, respectively. Over the period 1995-96 to 2010-11, SA's share of gross national household income fluctuates more than SA's share of the national compensation of employees. Sometimes the direction of change is even different.

More fundamentally the reliability and validity of the assessments cannot be improved through the use of approximate indicators when pertinent statistics are, and will continue to be, available.

A tax by tax approach based on what States do ensures that the magnitudes of HFE transfers are adapted to changes in actual tax mix or actual tax design, including those which might involve expansion or contraction of States taxes as compared with user charges and Commonwealth grants, and whether or not tax mix and design decisions are regarded as ideal or preferable.

If household income is thought to represent a measure of underlying revenue raising capacity on what basis would gambling tax revenues, miscellaneous revenues and particularly user charges continue not to be subject to differential assessment, as implied by the depiction in the Commonwealth Treasury Submission? Would not all household impacting forms of revenue raising be subject to differential assessment under this underlying income capacity model?

Figure 1: Proportion of Australia's conveyance duty base and broad-based urban land tax base, by state, 2001-02 to 2009-10



Furthermore, proposals that alternative measures of revenue capacity should be utilised, whether the motivation is allegedly further simplification or tax reform, are more properly handled as a methodological issue considered through the regular CGC reviews, rather than this high level Review.

For example, during the 2010 Review the CGC raised the possibility that conveyance duty be assessed using secured financing commitments for owner-occupied housing. Secured housing finance loan commitments loan data were to be adjusted for 'gearing behaviour' to measure the conveyances revenue base. Through its formal methodological review process, with contested submissions taken from all States, the CGC acknowledged that such a base would not capture all transactions actually taxed because the measure excluded non-residential transactions, non-mortgage financed residential transactions and residential investment transfers.

It has also been argued by the New South Wales Government[4] that the substitution of an efficient tax for a less efficient tax could be undermined by loss of GST grants from "feedback" effects. A State can, in theory, (slightly) affect its GST grant share via the impact of its spending and revenue raising decisions on the state average standard. The argument is often developed in terms of say Queensland experiencing a positive GST share effect from spending more on indigenous services, and NSW experiencing a negative GST share effect from spending more on indigenous services.

This represents only a partial analysis because the effects of either reducing other spending, or increasing taxes to maintain budget bottom line objectives, also needs to be considered.

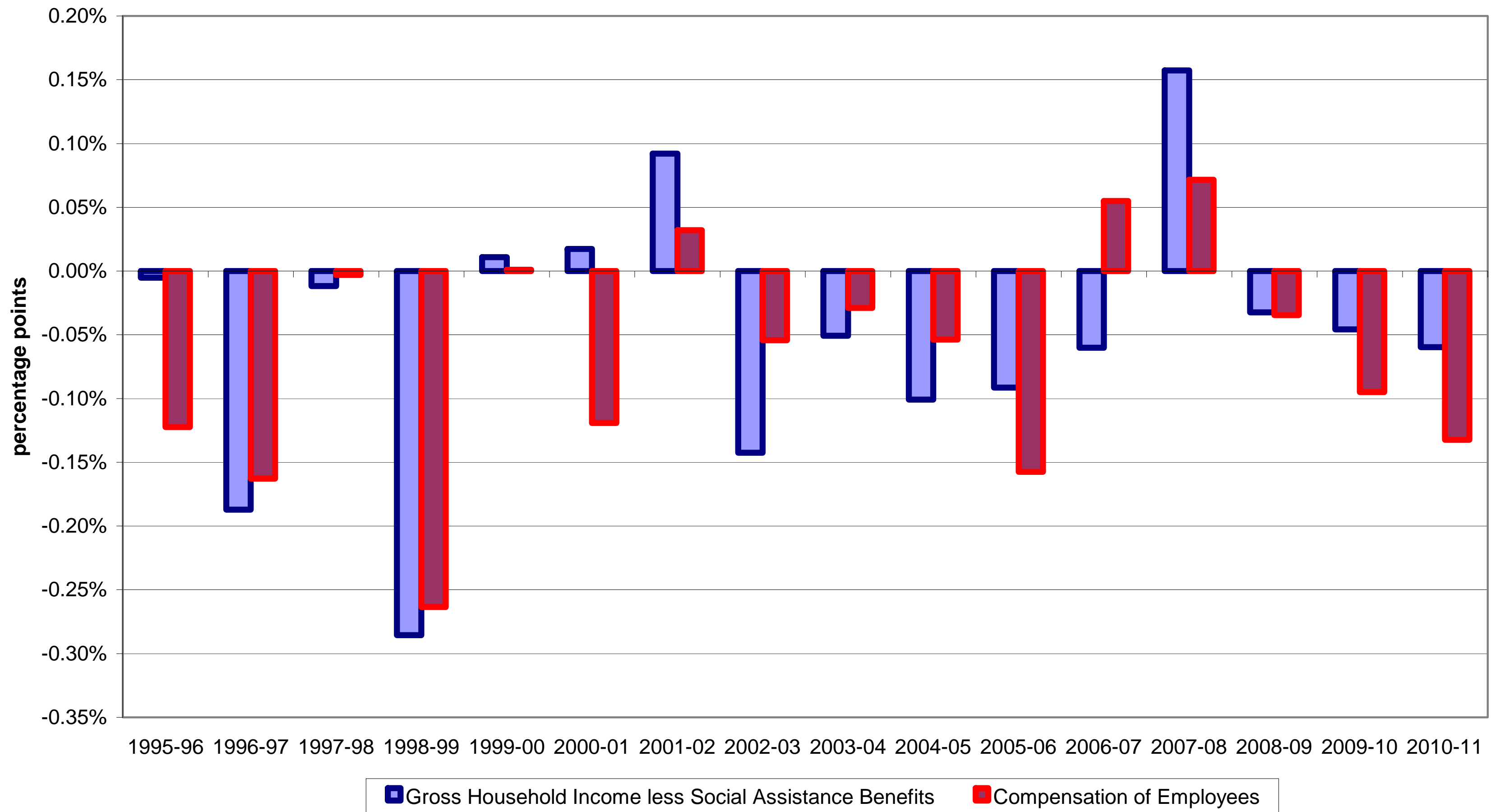
Nevertheless it is true that a change in composition of revenues, a change in composition of spending, or a change in level of spending matched by a change in level or revenue raising will all have *net* effects on GST shares. That is to say HFE transfers adapt to the changes in the structure of state budgets.

By definition a change in HFE transfers means a higher GST grant share for some states and a lower GST grant share for other states. All states will experience the consequence of other states' budget structure decisions.

---

[4] NSW Submission to the GST Distribution Review, November 2011,"Changing the tax mix" Pgs 24-25, http://www.gstdistributionreview.gov.au/content/Content.aspx?doc=submissions.htm, accessed 13 February 2012

Figure 2: Annual percentage points change of South Australia's proportion of Australian total.



For those states which experience an increase in grant share from a change in its *own budget structure,* separated from the effects of other states budget structure decisions, a positive incentive effect can be said to exist. For those states which experience a decrease in grant share from a change in its own budget structure, a disincentive effect can be said to exist.

The NSW argument amounts to singling out that in some instances of change in own budget structure which could be regarded as constituting ‘tax reform’, some states will experience a ‘disincentive effect’.

This is the inevitable result of assessing relative capacity on a fit for purpose revenue by revenue head basis, or expenditure category by category basis. A wide variety of incentive and disincentive effects exist eg revenue side donor states have an incentive to switch to user charges, poll taxes and gambling tax because these categories are not differentially assessed.

Some states will have an incentive to switch from insurance duty to conveyance duty etc and some will have a disincentive. A different set of states will have incentives to switch from insurance duty to payroll tax.

The only way to avoid this is to have a needs assessment which does not distinguish one category from another. Taken to its logical conclusion to avoid this situation all categories of revenue would need to be assessed in the same way. Anything less than a single indicator for all categories of revenue will create positive and negative incentives for various budget structure changes.

Clearly this is likely to mean that something other than actual revenue needs (ie the relative capacity of states to raise the type of revenues that they do raise) would be assessed.

In theory it is possible to conceive of a ‘reduced form’ assessment formula which if applied to all or a number of different revenue assessments, might produce a similar outcome as a fit for purpose assessment at a point in time. But inevitably it won’t keep track of emerging developments in budget structure, and won’t be relevant to future circumstances.

When the CGC examined this question closely in the 2010 Simplification Review no reliable reduced form assessment could be identified.

As pointed out by Walsh (2011)[5] for the incentive effect to have a practical impact it must mean that politicians are motivated by GST grant share effects at the expense of community preferences as to the mix and design of taxes levied[6].

A very pertinent case in point is the payroll tax tax-free threshold. All states have a tax-free threshold, and the taxable proportion of wages is determined using a weighted average threshold. Because of the relatively weaker small business share of NSW and Victoria, those states would gain GST share if they abolished their tax free thresholds. It can't be GST share effects holding them back. (At the same time it can be noted that implementing a what states *don't* do approach to the taxable proportion assessment, would provide windfall gains to the two largest states, at a cost to equalisation equity and efficiency, with no tax reform action to expand the payroll tax base having occurred or likely to occur in those states.)

It would be a peculiar idea to give up on the equity and efficiency of fit for purpose revenue (what states actually do) assessments for the unknown benefit that removing minor incentive and disincentive effects might have on tax reform.

Tax Reform Incentives - Summary

In summary the South Australian Government believes that fundamental objective of HFE (ie to equalise fiscal capacity) should not be confused with other possible policy objectives. Loading the equalisation system with multiple objectives would significantly undermine its ability to achieve any of those objectives fully or satisfactorily. If there are other policy objectives (such as achieving a more efficient tax system), specific policies and strategies should be developed to address these challenges without undermining longstanding equalisation arrangements.

Tax reform objectives should instead be pursued by a process which involves:

---

[5] "….grant maximising behaviour by State governments requires them to be willing to impose decisions on their resident-voters that might be politically adverse for the State governments themselves." C Walsh, The Equity Case for Equalising Fiscal Capacities: Rationales, value-judgements, compromises and their implications, A discussion paper prepared for the Department of Treasury and Finance, Government of Victoria, September 2011, pg 20 http://www.dtf.vic.gov.au/CA25713E0002EF43/pages/publications-victorias-submission-to-the-gst-distribution-review. Accessed 23 January 2011

[6] It is noted that the Commonwealth Government has not indicated support for the AFTS recommendation that supported land tax being applied to the family home.

- The establishment of desirable tax reform imperatives and directions – the AFTS Review and the recent Tax Forum have already established considerable direction setting in this area, and State and Territory Governments (led by the Queensland and NSW Treasurers) are currently considering a range of matters emanating from the Tax Forum.

- Once a package of desirable tax reforms has been identified and agreed, multilateral negotiations between the Commonwealth and States are required to consider the full range of fiscal implications including transitional protection of budget positions, HFE consequences on a case by case basis and transitional measures required to facilitate reform given the potential for winners and losers. Notwithstanding terms of reference 6B (c) there are strong arguments for Commonwealth financial facilitation of State tax reform initiatives on national interest grounds and given that (if truly welfare enhancing) such reforms will generate improved national economic capacity.

Changes to HFE to achieve unspecified tax reform objectives are unlikely to be effective or warranted, and could impose significant costs if equalisation outcomes were undermined as a result.

At this stage, the only implied guidance on tax reform objectives for the purpose of these terms of reference comes from the inclusion of Chart 3.1 ("Marginal welfare loss from a small increase in selected Australian taxes from KPMG Econtech (2009)")[7], in the Issues Paper ranking the efficiency of taxes.

However, ranking of taxes by efficiency cannot be the sole or primary basis for tax design decisions. For example, royalties are far from being 'first cab off the rank' for abolition, as indicated by the KPMG table. For a start, a tax efficiency calculation all depends on the rate of duty and the revenue amount collected as compared with the level of economic rent being earned, which in turn is highly dependent on commodity price levels. This will change over time. Presumably, only a switch from royalties to a mining profits tax would be proposed. The real advantage of a mining profits tax is that it will automatically and predicably adjust up or down and will avoid tax in excess of rents. This result would otherwise require discretionary adjustment to legislated ad valorem royalty rates.

---

[7] KPMG Econtech (2009) in Australia's Future Tax System Review: Report to the Treasurer in GST Distribution Review Supplementary Issues Paper, December 2011, pg 6l

The AFTS Review proposes that insurance duty be abolished. The welfare gain from abolishing insurance duty depends on the replacement tax implemented and from the KPMG table can be estimated as follows:

Replacement tax	*Average excess burden* *(Abolish insurance duty)*	*Marginal excess burden* *(replacement tax)*	*Net reduction in excess burden*
GST	47%	8%	39%
Labour income tax	47%	24%	23%
Payroll tax	47%	41%	6%

Increasing GST has been ruled out in the terms of reference. It remains clearly more advantageous to replace insurance duty with personal income tax than with payroll tax.

There has not been a clear statement from the Commonwealth Government about how specific tax reform proposals would be advanced by the GST Distribution Review. SA looks forward to considering the Commonwealth Treasury submission in response to the expanded terms of reference.

Do States have an incentive to reduce MRRT or PRRT revenue through increasing State mineral royalties?

The South Australian Government increased mineral royalties as part of the 2010-11 State Budget, effective from 1 July 2011. The rate of royalty applicable to processed (refined) minerals was left unchanged at 3.5%, but for unprocessed minerals the rate was increased to 5%. Adjustments are also being made to royalties paid by OneSteel under an Indenture Agreement to progressively bring them into line with those paid under the Mining Act provisions by other operators. And the concessional rate paid by new mines in their first 5 years of operation was lifted from 1.5% to 2%. South Australia has not changed its petroleum royalty regime in any way that has a bearing on the PRRT.

The MRRT applies only to iron ore and coal mines. There are only two operating iron ore mines and one coal mine in South Australia at present, although there are a number of emerging prospects. Mines which are not within the current mineral definition scope of the MRRT account for around 80% of total mineral (excluding petroleum) royalty revenues paid to the South Australian Government.

The South Australian Government has no plans to further adjust royalty rates. The decision to increase royalties in 2011 was taken in the

context of the high level of mineral commodity prices, the need to ensure that the South Australian community was receiving an adequate return from the commercial exploitation of their mineral resources, alignment with effective royalty rates in other comparable jurisdictions and the need to ensure that South Australia retains a competitive and stable environment for resource investment.

In making the decision to adjust royalty rates, the South Australian Government was mindful of the fact that frequent adjustment of tax rates is likely to be detrimental to investment certainty. The South Australian Government has actively pursued expansion of mining through investments in geological mapping and regulatory certainty. According to the Fraser Institute South Australia is the highest ranked Australian jurisdiction in relation to Government policy support for mining and the 10th highest ranked in the world. Frequent adjustments to royalty rates would be likely to jeopardise South Australia's relative attractiveness as a mining province, and having implemented changes to royalty rates in 2011 the South Australian Government has no plans to make further adjustments in the foreseeable future.

The MRRT as implemented is not the mining tax regime envisaged by the AFTS Review. Aside from the narrower base, and the more generous deductions, the AFTS Review recommended that a new federally based rent tax be introduced as a replacement for State based royalties, and that the Australian and State governments "*should negotiate an appropriate inter-governmental allocation of the revenues and risks from the resource rent tax*".

On the other hand it could be argued that optimal mining tax arrangements would contain a mix of resource rent taxation and ad valorem royalty. This would enhance revenue certainty and stability (rent taxation revenue streams may be highly volatile) and reduce community exposure to the quality of private investor decision making (relating to the management of costs and timing of investment decisions). A resources rent tax also creates a range of compliance issues which arguably are greater the more reliance is placed on that revenue stream. Ad valorem royalties ensure that the community always receives some return from the grant of exclusive extraction rights over its mineral assets. Modelling undertaken for the AFTS Review suggests that ad valorem royalties are highly inefficient, but the size of the welfare loss is highly contingent upon the level of commodity prices (as prices rise, the difference between the excess burdens of gross income (royalties) and net income mining tax structures diminish).

Ideally there would be agreement between all governments as to the preferred 'all-up' mining tax structure from a national viewpoint. The assignment of components and allocation of revenues from that

structure would then be an important, but secondary issue. A possible set of cooperative arrangements in response to the AFTS recommendation is outlined in Attachment A.

In the event, a two tiered system of State royalties and Commonwealth rent taxation is now where we find ourselves. It gives rise to potential Commonwealth - State conflict over the interaction between the two tax regimes (ie crediting of royalties against MRRT).

This is not a new issue in principle as there is already deductibility of State taxes against Commonwealth company tax liabilities for the full range of State taxes. The new elements are that a full credit of royalties paid (on an escalated basis) is now available against MRRT liability; and there is a policy commitment by the Commonwealth for that credit to be available for any future level of royalties.

As noted above the South Australian Government considers that sovereign risk factors tend to mitigate against frequent adjustments to royalty rates, even in an environment where they are creditable against the MRRT, reflecting investor perception issues and potential financial impacts where royalty credits may not be able to be utilised.

Nonetheless if the policy commitment to uncapped crediting of state royalties against MRRT (rather than permitted as a mere deduction against the calculation of the MMRT base) creates undesirable revenue shifting incentive effects between the States and the Commonwealth, a solution may be for the States to receive the MRRT revenues.

If the Commonwealth were to assign the MRRT revenues to the States this could be shared among jurisdictions on a per capita basis. Existing royalties would continue to be assessed by the CGC, achieving a per capita sharing at the national average royalty rate but allowing States policy flexibility to generate additional (or less) revenue from choices about their own effective royalty rates. The assignment of MRRT revenues to the States would require an offsetting reduction in some other Commonwealth payments to the States – most likely a National Specific Purpose Payment (NSPP), although there may be other options in respect of a re-allocation of roles and responsibilities. From the States perspective this would involve replacing a stable revenue stream (NSPP), with a potentially volatile one (MRRT). Some form of “no worse off” guarantee would need to be considered as was the case with the IGA reforms, at least for a transitional period.

Assigning the MRRT revenues to the States would remove any real or perceived incentive for States to increase royalty rates at the expense of Commonwealth revenue. However increases in royalty rates by an individual jurisdiction would under such an arrangement be to the

financial detriment of other States and Territories. Joint State and Territory management of this would be a challenging political exercise. Possible alternative solutions to this could be:

- An adjustment to State MRRT revenue shares when State royalties are adjusted to ensure that other jurisdictions are not adversely affected. This would, however, constrain revenue raising autonomy for individual States as adjustments to royalty rates would be offset by adjustment to MRRT shares producing a zero sum revenue outcome (and be difficult to administer over time depending on whether the nature of the adjustments were based on one off predictions or were readjusted over time).

- Any adjustments to royalty rates post the assignment of MRRT revenues to the States could be excluded from the MRRT royalty crediting arrangements. This would retain State revenue raising autonomy. While there would be potential risks to miners from increased State royalties, this is no different to the pre MRRT situation where States were required to balance mining investment certainty considerations with the need to ensure that the community was receiving an adequate return from mining investments. As part of this approach the balance between profits based tax and ad valorem royalty could be reviewed jointly by the Commonwealth and the States with a view to achieving an optimal (efficient) mix between the two at commencement of the new arrangements subject to revenue neutrality overall and for individual jurisdictions.

It is apparent that solutions are difficult to find in the absence of a cooperative joint States and Commonwealth context.

Attachment A

Cooperative model

It is worth reviewing a possible cooperative mining taxation model as a point of reference.

A reset might involve the following key features:

1. generally lower rates of State ad valorem royalty than now prevail
2. more revenue effective design of mining rent tax to ensure no overall loss in expected value of revenue
3. a standard uniform crediting rate of ad valorem royalties against mining rent tax liability differentiated by commodity (stylised average of new royalty rates)
4. the royalty crediting rate would be independent of individual state rates of royalty – no credit would be allowed for actual royalty in excess of standard, and no diminution of credit for actual royalty less than standard
5. the reduction in state ad valorem royalty revenues would be offset by Commonwealth grants (effectively from a first slice of mining rent revenue)
6. state mining revenues from all instruments would continue to be subject to equalisation
7. no limitation on individual states variances up or down, from the standard uniform rate of royalty credit against mining rent tax