

# E – BRIEF



## NSW Parliamentary Library Research Service

February 2010 E-Brief 6/2010

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# New Recommendations to Share GST Revenue

by John Wilkinson

## 1 Re-emergence of Controversy in Determining GST Revenue Shares

In January of this year the NSW Business Chamber attempted to have a billboard erected at Brisbane Airport, with the caption “Welcome to Queensland: Subsidised by the Taxpayers of New South Wales.” While Brisbane Airport refused to display the billboard, the episode nevertheless brought to the public’s attention the perceived impacts of the Commonwealth Grants Commission’s proposed changes to the distribution of GST revenue on NSW.<sup>1</sup> This E-Brief briefly reviews the role and operation of the Commonwealth Grants Commission, and discusses draft recommendations on the distribution of GST revenue.

## 2 Emergence of the Commonwealth Grants Commission

Originally the Commonwealth Grants Commission was established after Western Australia (in 1932) held a referendum to secede from the federation (on the grounds that it was being unfairly treated, financially). To bolster the “no” vote in the referendum the then Prime Minister Joe Lyons visited WA and promised that, if a majority of Western Australia voted “no”, he would set up a commission to consider the case for special grants.

Although a majority of Western Australians voted to secede, a state government was elected (later in the year) which repudiated secession and Lyons, in 1933, established the Commonwealth Grants Commission (CGC).<sup>2</sup>

The purpose of the CGC was to determine grants that, according to Professor Peter Groenewegen, would: “be large enough to allow the poorer states to provide the same standard of services as the wealthy ones.” The term for this objective was “horizontal fiscal equalisation” (HFE).<sup>3</sup>

Between the 1930s and the 1940s, the role of the CGC was to recommend to the federal government the extent of small, special grants which could be made not only to WA, but to South Australia and Tasmania as well. In the 1950s the Queensland government also convinced the (then) Menzies government that it too should be eligible for a special grant. WA’s prosperity during the late 1960s made it no longer eligible for such grants, but Queensland, South Australia and Tasmania continued to be “claimant” states through to the 1970s.

Prime Minister Malcolm Fraser introduced a new and predominant position for the Commission: ushering in a prime role for the CGC in assessing all the states’ grants (on the

basis of HFE) – employing an average of 5 years data to do so.

The first year that Fraser's tax sharing was determined, according to the Commission's HFE principle, was in 1981. In 1985 newly elected Prime Minister Bob Hawke replaced Fraser's income tax sharing with financial assistance grants (previously introduced by Menzies during the 1950s). The CGC was retained to determine the level of these grants, again on the basis of fiscal equalisation.<sup>4</sup> In 2000 the Howard government, after gaining passage of legislation for a goods and services tax (GST), abolished the FAGs and replaced them with shares of the revenue raised by the GST. Again the CGC was retained to determine how the GST revenue should be distributed between the states and territories.<sup>5</sup>

### **3 The Emergence of the Commonwealth Grants Commission Latest Innovation in Determination: Capital Assessment**

Fundamentally, most of the GST revenue is effectively distributed to the states on a per capita basis. In 2008-09, \$41 billion in GST was distributed to the states and territories. Of this amount, \$37.6 billion (approximately 91.5%) was distributed on the basis of the population resident within the boundaries of each state and territory.<sup>6</sup> It is true, nonetheless, that variations in the shares of the remaining 8.5% can be significant to an individual jurisdiction's budget.

In implementing horizontal fiscal equalisation, the CGC assesses the relative costs States incur in providing standard services while operating at the same level of efficiency, and the relative capacity of States to raise their

own revenue while implementing average State revenue policies. The CGC's cost and revenue assessments are combined into a single measure for each State, called the relativity. The "average" for the relativity is one.

A relativity above one means a State is assessed as facing above average per capita costs to provide services and/or as having a below average per capita capacity to raise revenue. Such a State is considered to require above average per capita amounts of GST revenue to achieve fiscal equalisation with the other States. A relativity below one means a State is considered to require below average per capita amounts of GST revenue.<sup>7</sup>

In establishing relativities the CGC's approach is to look in detail at: a jurisdiction's revenue (such as payroll tax, gambling tax, land tax, stamp duty and the like); and at a jurisdiction's expenses (such as education, health, transport etc).<sup>8</sup>

Predominantly the CGC looks at disabilities affecting states and territories. A disability can be a handicap in regard to revenue raising (such as an inadequacy in a particular tax base) or a handicap in relation to costs. For instance, as the CGC has stated: "States are assessed to have a disability if the groups that make most use of a service are a larger proportion of their population than they are of the national population."<sup>9</sup>

Thus in 2008-09, after \$37.6 billion of GST revenue was distributed on the basis of the states' and territories' populations, the other \$3.4 billion was distributed on the basis of disabilities – with the Northern Territory receiving half that amount.<sup>10</sup> Indeed during the 1990s Richard Rye and Bob Searle

(then chair and secretary of the CGC) wrote that, in their estimation:

in the Northern Territory. . .The costs of providing. . . services to Aboriginal settlements in remote. . . areas are very high. . .the territory's relative per-capita cost of service provision is nearly three times the average for the other states.<sup>11</sup>

In 1999 the CGC introduced an innovation: the inclusion of depreciation expenses in their assessment. The purpose of which was to allow jurisdictions to fund the annual depreciation of the capital stock required to provide the average level of services.<sup>12</sup> As Don Challen (Secretary of the Tasmanian Treasury) later explained: "Capital shows up in state operating statements as depreciation and leasing costs".<sup>13</sup> Subsequently, as Challen also related:

Western Australia proposed a new approach – rather than try to capture the cost of capital purchases through their indirect impact on the operating statement, why not assess capital needs upfront. . .<sup>14</sup>

In their draft report for 2010 (issued in July 2009), the CGC endorsed the Western Australian proposal, declaring that:

Just as states need the average per capita expense, adjusted for their disabilities, to provide the same level of services, they need the average per capita stock of infrastructure adjusted for disabilities to provide the average level of services.<sup>15</sup>

The key consideration, in this new category of evaluation, is population growth. As the CGC also commented:

In 2007-08, most states with above average population growth were assessed as needing to spend more

than average on the acquisition of new infrastructure.<sup>16</sup>

#### **4 The Impact on NSW of the CGC's Recommendation**

The inherent problem for NSW in the Commonwealth Grants Commission's proposal, is that (in recent years) NSW has had a lower rate of population growth than most of the states and territories. Between financial years 2007-08 and 2008-09, the states and territories had the following rates of population increase:

- Western Australia: 3%
- Queensland: 2.6%
- Northern Territory: 2.3%
- Victoria: 2.1%
- New South Wales: 1.7%
- ACT: 1.6%
- South Australia: 1.2%
- Tasmania: 1%<sup>17</sup>

Applying capital assessments based on population growth, would inevitably lead to a reduction in the NSW share of GST revenue. As Don Challen explained:

The states that suffered most [on this basis of assessment] were the states that had slower population growth, because the Commission's method recognised that the faster your state's population grows, the faster your stock of physical capital and financial assets are diluted, and the more capital expenditure you need to maintain average levels of growth.<sup>18</sup>

Indeed, in its draft review of state revenue sharing relativities for 2010, based only on 1 year's data (2007-08), the CGC estimated that an introduction of this type of capital assessment could redistribute over \$500 million of GST revenue away from NSW (compared to a population-based distribution).<sup>19</sup>

## 5 NSW Response to the CGC Proposal

In its response to the CGC's draft, the NSW government did not object to the principle of changing the existing assessment of capital expenses. What the NSW government did object to was the form of capital assessment that the CGC wished to adopt. In response, the NSW government indicated a preference for a *holding cost* approach. As summarised by the CGC:

An assessment of the holding cost of capital. . .recognises the impact of expense disabilities, with or without an assessment of the effect of population growth on net worth.<sup>20</sup>

The advantage seen by NSW in adopting this approach, according to Don Challen, is based on the premise that:

[whereas] the commission's method implied that the acquisition of infrastructure and financial assets were distinct activities in themselves. . .in reality governments acquire infrastructure only to deliver services.<sup>21</sup>

## 6 Contrasting Arguments of the CGC and NSW

### 6.1 CGC

In chapter 5 of its 2010 Review, the CGC put forward the reasons why it preferred its direct approach:

- states use their revenue (including GST revenue) to provide investment in new infrastructure. State policies show this to be the preferred mode of funding (although at times states also borrow to fund investments). How investments are funded does not affect state needs for investments.
- the CGC approach is more consistent with the move by the states to evaluate their fiscal positions on the basis of broader considerations than simply the "bottom line" outcome of their operating budgets. In recent years, they have also placed emphasis on their credit ratings which reflect their financial worth.
- the CGC's proposal is responsive to changes in state populations and other key drivers of the need for investment in new infrastructure.
- the CGC's approach is more contemporaneous. It is aimed at providing states with the capacity to fund investments in new infrastructure when the need arises.
- the CGC's proposal is policy neutral - recognising that states fund infrastructure in a number of ways (including public-private partnerships) and allowing the states the capacity to do this.<sup>22</sup>

### 6.2 NSW

In its response to the CGC's draft, the NSW government argued that:

- the CGC approach was based on a misguided and misleading view of what states do – failing to recognise that the primary purpose of states is service delivery (and that the acquisition of capital is undertaken as a means to providing services *rather than* as an objective in its own right).
- adding in the holding cost of physical assets recognised the opportunity cost of having funds tied up in physical capital and takes into account all the costs of investing in capital to provide services.
- population growth *per se* did not change the per capita cost of providing services – jurisdictions do not make decisions on capital investment based on population growth simply from year to year (previous population growth, and its impact on existing capital assets - such as roads, schools and hospitals – is equally as important, as are future population growth forecasts).
- adoption of the CGC's approach towards capital investment involves equalising stocks of physical and financial assets amongst jurisdictions - extending equalisation into areas where it has never previously been applied.<sup>23</sup>

## 7 Conclusion

Even if the attempt to highlight this issue (erecting a billboard at Brisbane Airport) is viewed as a stunt, the fact is that the CGC proposals have some serious ramifications for NSW. A possible reduction of around \$½ billion

would be of substantial budgetary significance for the state.

At this stage, however, the CGC 2010 review only contains proposals (albeit in a well-substantiated form) and Victoria, South Australia, Tasmania and South Australia are also challenging the CGC's suggestions.<sup>24</sup> The final CGC report is due to be presented to the federal government on 26 February 2010.

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<sup>1</sup> Brian Robins, "Ad with a Sting in the Tail Strikes Raw Nerve" in the *Sydney Morning Herald*, 30 January 2010.

<sup>2</sup> Commonwealth Grants Commission, *Equality in Diversity: Fifty Years of the Commonwealth Grants Commission* (Australian Government Publishing Service, Canberra, 1983), pp.6-16.

<sup>3</sup> Peter Groenewegen, *Public Finance in Australia: Theory and Practice*, third edition (Prentice Hall, Sydney, 1990), p.255.

<sup>4</sup> Commonwealth Grants Commission, *The Commonwealth Grants Commission: the Last 25 Years*, (Commonwealth Grants Commission, Canberra, 2008), p.135.

<sup>5</sup> *Ibid.*, p.136.

<sup>6</sup> Don Challen, "Can the Policy Thrust of HFE Survive the Politics of Tougher Fiscal Challenges?," speech delivered at the *National Local Government Conference*, Hobart, 11 November 2009.

<sup>7</sup> NSW Government, [Budget Statement 2009-2010](#), at 6-10.

<sup>8</sup> Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities: 2010 Review* (Commonwealth Grants Commission, Canberra, 2009), p.24.

<sup>9</sup> Commonwealth Grants Commission, "Achieving Equalisation" in House of Lords Select Committee on the Barnett Formula, *The Barnett Formula: Report With Evidence* (House of Lords, London, 2009), p.288.

<sup>10</sup> Challen, *op.cit.*

<sup>11</sup> Richard Rye and Bob Searle, "The Fiscal Transfer System in Australia" in Ehtisham Ahmad (ed.), *Financing Decentralised Expenditures: An International Comparison of Grants* (Edward Elgar, Cheltenham, 1997), p.156.

- <sup>12</sup> Commonwealth Grants Commission, *The Commonwealth Grants Commission: the Last 25 Years*, p.17.
- <sup>13</sup> Challen, op.cit.
- <sup>14</sup> Ibid.
- <sup>15</sup> Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities: 2010 Review*, p.35.
- <sup>16</sup> Ibid., p.445.
- <sup>17</sup> Australian Bureau of Statistics, *Australian Demographic Statistics*, ABS Catalogue 3101.0 (Australian Bureau of Statistics, Canberra, 2009), p.6.
- <sup>18</sup> Challen, op.cit.
- <sup>19</sup> Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities: 2010 Review*, p.449.
- <sup>20</sup> Ibid., p.38.
- <sup>21</sup> Challen, op.cit.
- <sup>22</sup> Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities: 2010 Review*, pp.38-39.
- <sup>23</sup> NSW Government, *Commonwealth Grants Commission 2010 Review of State Revenue Sharing Relativities: Submission on the Draft Report* (NSW Government, Sydney, 2009), pp.6, 198.
- <sup>24</sup> Ibid., p.15.

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