



COMMONWEALTH GRANTS COMMISSION

DISCUSSION PAPER CGC 2003/5

TREATMENT OF ECONOMIC DEVELOPMENT ASSISTANCE

JUNE 2003

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INTRODUCTION

1. The issue of the treatment of economic development was discussed at both the October and November 2002 conferences. The Commission prepared Discussion Paper *CGC 2002/6 - Economic Development Policies: How Should Equalisation Account for their Costs and Benefits*, prior to the conferences.

2. At the October 2002 Conference, the Commission indicated to the States another Discussion Paper would be prepared to outline its preliminary view on the economic development issue and to give States an opportunity to comment before the preliminary calculations. This paper outlines the Commission's preliminary views, building on the discussions at the conferences and States' rejoinder submissions.

THE 1999 REVIEW

3. In the 1999 Review, the Commission decided not to assess disabilities for expenditures associated with industry promotion and development or assistance provided to individual businesses. It considered these forms of assistance to be subject to strong policy influence¹ and assessed them by the equal per capita method.

MAJOR ISSUES

4. In Discussion Paper CGC 2002/6, the Commission made the following observations.

- (i) All operating expenses incurred by the State general government sector on economic development were in the equalisation budget, but many did not have differential needs associated with them.
- (ii) Since standard policy was to assist economic development, there was an in-principle case for examining whether differential needs existed.
- (iii) It was not clear that the equalisation budget should be adjusted to explicitly treat revenue foregone as an expense. Currently revenue forgone reduces the revenue standard.
- (iv) It was not clear whether expenses incurred in years prior to the assessment period should be included in an assessment. If they

¹ Report on General Revenue Grant Relativities 1999, Volume II, Methods, Assessments and Analysis, pages 148-149.

should, it was not clear how it would be best achieved. Past expenses could be relevant because current revenue capacities may reflect an accumulation of past State policies on economic development.

- (v) Given the many forms of economic development assistance, for practical reasons, assessments might have to be limited to direct assistance measures.
- (vi) It was not clear what cost disabilities existed for expenses on assistance or how they could be measured.
- (vii) If it was accepted that States' economic development policies reduced the policy neutrality of assessed/observed revenue bases, possible ways of removing the influence of policy differences included:
 - adjusting specific revenue bases; and/or
 - adjusting standardised revenues by applying a standard rate of return on State expenses.

5. At the October conference, States acknowledged that they pursued economic development policies in one way or another. However, there was little agreement on how economic development assistance should be defined. Most States were opposed to a narrow definition. Most also opposed a differential assessment of expenditure needs or adjustments to revenue bases on both conceptual and practical grounds. They argued that equalisation should not apply to development expenses because the assessment of differential (non-zero) needs could involve the Commission in judgements about the efficacy of economic development policies. On practical grounds, some States argued that expenditure disabilities were difficult if not impossible to define and measure, as were revenue adjustments.

6. Western Australia, the main proponent of change to the way the Commission treats economic development policies, suggested assessing differential expenditure needs for projects of national significance. Of the Commission's proposals, it preferred the approach which adjusted standardised revenue for a rate of return on expenses.

CURRENT VIEWS

7. The *Commonwealth* said the concept of a broad but separately identifiable category of economic development expenditures and/or tax expenditures presented a range of conceptual and empirical challenges. It noted there was no consensus on what classes of expenses and tax expenditures would constitute a broad economic development category. Also, there were a number of major practical issues including:

- the difficulty of assessing policy neutral disabilities; and

- the potential for unintended ‘double-counting’ between economic development disabilities and other disabilities.

8. It was sceptical that measurement and data issues associated with either a broad or narrow approach to assessing the need for economic development expenditures or tax expenditures could be adequately resolved in the current review.

9. It suggested it might be possible to address mining revenue as a special case. In particular, it suggested that it might be possible to make adjustments to the real costs of resource extraction in assessing States’ capacity to raise revenue from mining. It accepted, however, that the actual expenditure by a State could not be used to adjust its own revenue base. There would also need to be clear criteria for determining which State expenditure could be treated as part of the real costs of extraction and when it would be appropriate to do so.

10. *New South Wales* expressed some sympathy with Western Australia’s position but believed that the issue could be addressed by a global approach to the assessment of revenue capacity. It opposed all other proposed approaches because they were too difficult to implement and required too much judgement by the Commission. It argued:

- differential expenditure assessments would create a bias depending on States’ approaches to economic development. It said the data needed to undertake differential assessments are unavailable; and
- adjusting revenue assessments was too narrow an approach and it would be impossible to determine which economic development projects would have proceeded without the assistance.

11. New South Wales suggested that the Commission note the Productivity Commission’s view that economic development assistance often does not have economic benefits. It said that as some assistance inhibits growth, States with project-specific or firm-specific economic development policies should perhaps be penalised.

12. Subsequently at bilateral discussions with the Commission, New South Wales argued that economic development was about getting State fundamentals right without providing direct government assistance. New South Wales did not generally provide project/industry/company specific concessions because this would favour one part of the tax base over another.

13. *Victoria* said that the Commission would have to overcome too many practical problems to address the economic development issue. It opposed the proposed approaches saying they would all require too much judgement and would create a bias by encouraging States to manipulate their economic development policies to maximise their grant share.

14. Victoria said that the Commission should adopt the broadest possible definition of economic development assistance if it pursued the economic development issue. In its view, it was not possible to identify and measure disabilities in a policy neutral

way. It said that there were no specific disabilities that required States to provide different levels of economic development assistance. It said it was unclear what the Commission was trying to measure as the per capita costs of economic development activities and unclear whether they were already captured by the comprehensive assessments of disabilities such as administrative scale, service delivery scale, dispersion etc.

15. *Queensland* expressed some support for differential assessments. It said, however, that any assessments should not create a bias towards any sector of the economy or towards States depending on their economic development policies.

16. Queensland said that only direct economic development assistance should be included in a differential assessment and then only if a standard policy applied. It said that the process of equalisation should give States a similar capacity to pursue economic development projects, not to actually achieve similar levels of development.

17. Queensland opposed both the proposed approaches involving revenue assessment adjustments. It considered those approaches were biased towards States where economic development projects were high profile or more easily identifiable. Adjusting revenue bases would be too difficult, given the task of ascertaining which revenues were influenced by economic development assistance and by how much. Determining a standard rate of return also would be too complex and would require too much judgement.

18. Queensland noted that compiling accurate and complete data on economic development assistance would be very difficult. It opposed the inclusion of past economic development assistance. It also pointed out that for Queensland, revenue foregone due to tax concessions should already be included in the equalisation budget.

19. *Western Australia* said that the most practical approach was to adjust standardised revenues to provide States with a standard rate of return on their economic development expenditures. It suggested that the Commission base the standard rate of return on risk-adjusted bonds. It also suggested criteria for identifying which expenditures should be included. It said these should be limited to activities which:

- could demonstrate a strong national economic benefit; and
- have not been (or will not be) subject to disability factor assessment (that is, no double counting).

20. It defined national benefit to mean:

- (i) a project has international comparative advantage, setting aside the various forms of market failure (listed below);
- (ii) the project actually goes ahead and there is reasonable expectation that it would not have gone ahead without the assistance provided;
- (iii) government assistance is “World Trade Organisation-compliant”; and
- (iv) all or some of the following forms of market failure exist;

- subsidies by other nations,
- provision of public goods,
- externalities,
- economies of scale in development hubs, and
- imperfect information.

21. Western Australia said its approach minimised data problems and overcame the problem of defining and measuring disabilities. It would also take account of past economic development expenditures, providing the amortised costs fell in the current five year assessment period. It said economic development expenses should be amortised over the period of expected returns.

22. Western Australia also made the following points.

- (i) Government assistance that targets market failure can enhance economic development, a view supported by the then Industry Commission. Its report on Mining and Minerals Processing² noted that there was a case for government support of infrastructure provided by mining companies to the benefit of others.
- (ii) Well-targeted assistance to mining companies helps achieve the optimal development of a State's natural endowments.
- (iii) The lack of economic potential is not a disability that should be assessed. The Commission's role is not to attempt to equalise private income. The Commission should be assessing needs for State investments to produce optimal development outcomes, including overcoming market failures and assuming the risk in developing public owned resources.

23. **South Australia** submitted that the current equal per capita assessment of direct economic development assistance should continue. It opposed all of the proposed approaches. It said it was impossible to define economic development assistance in a way that did not discriminate against certain States. In particular, South Australia noted that identifying whether a project was in the national interest is a Commonwealth policy issue and not something in which the Commission should be involved.

24. South Australia submitted that identifying disabilities would require too much judgement. It said that differential assessments would create incentives for States to increase economic development assistance. Making adjustments to revenue assessments would be too difficult because the Commission would have to judge whether assistance was actually necessary for a project to proceed.

² Industry Commission, *Mining and Minerals Processing In Australia*, Volume 1, Report, Report No 7, 1991, page 91.

25. South Australia argued that the standard budget should not include revenue foregone because it was purely a policy choice of the State to provide assistance via tax concessions or exemptions. Neither should past economic development expenditures be included. To do so would set a precedent that would have a large impact on equalisation.

26. *Tasmania* said that the definition of economic development assistance should be broad enough to include all identifiable assistance. That would include assistance that did not necessarily lead to a revenue benefit. It argued that a narrow definition would intensify the bidding war between States for projects that would satisfy the Commission's definition. There is also the possibility that it would encourage the manipulation of economic development projects to meet the definition.

27. Tasmania said disabilities associated with economic development arose due to a State's size, demography and geographical factors. It suggested that its Competition Index, based on market size and distance to markets, could be used as the basis for assessing disabilities.

28. It said that to include past economic development expenditures in any assessment would be too difficult. It did not support either of the proposed approaches based on adjusting revenue assessments.

29. The *ACT* said there was no need for the Commission to change its current approach to economic development assistance. An assessment which supports expenditure on economic development would encourage States to pursue further expenditure of this type, potentially to the detriment of the overall economy. It also noted that deciding whether projects provided a national benefit would require too much judgement by the Commission.

30. The *Northern Territory* supported an assessment of disabilities. It said guidelines may be required to ensure that the assessment does not encourage States to change their policies or to inefficiently direct resources toward economic development activities. If a project fulfils the guidelines, the manner of assistance should not matter. It would not include assistance that shifted activity to a particular State. The inclusion of revenue foregone and direct assistance by trading enterprises might require some offsetting adjustments which could increase the complexity of the assessment. It opposed the inclusion of past expenditures because to do so would be too complex.

31. It said that small States experienced disabilities in the provision of economic development assistance due to the absolute size of their budgets. It noted some specific disabilities relevant to the Northern Territory including:

- (i) underdeveloped economic and social infrastructure;
- (ii) high construction costs;
- (iii) high borrowing costs and limited borrowing capacity; and
- (iv) comparatively low own-source revenue.

32. The Northern Territory opposed the two proposed approaches involving adjustments to revenue assessments. It said adjusting revenue bases to exclude revenue attributable to economic development expenditure seems contrary to equalisation principles if the revenue benefit significantly outweighed the expenditure. It would disadvantage States that lacked economic development potential. It argued that it would be too difficult to implement the proposal involving a standard rate of return.

33. The Northern Territory said that the broader the definition of economic development assistance, the more difficult it would be for the Commission to collect data. Any data pertinent to whether the economic development assistance was crucial to a project proceeding would reflect the judgement of each State.

AN ASSESSMENT OF ECONOMIC DEVELOPMENT EXPENSES

Commission view

34. In considering the specific proposal from Western Australia, the Commission has addressed two questions in particular:

- (i) is there a case, on either conceptual or practical grounds, for assessing disabilities in relation to expenditure on some types of economic development activities, but not others? and
- (ii) is there a case, on either conceptual or practical grounds, for assessing disabilities in relation to 'successful' projects (that is, projects which generate distinct and positive revenues), but not others?

35. States spend on economic development for a variety of reasons, and in a variety of ways. There are a broad range of drivers that fuel State economic development policies and there are no consistent indicators which the Commission could use to explain the pattern of this expenditure. Even if it is possible, on practical grounds, to formulate an assessment approach for some particular types of expenditure (as Western Australia has done for mining/resource development), it is not evident conceptually that equalisation will be improved overall by assessing disabilities in relation to some types of activities and in relation to some specific areas of economic development expenditure, but not others.

36. In short, while Western Australia has pointed to one type of asymmetry which it sees in the Commission's present approach, its proposal would introduce asymmetry of another kind. The Commission does not believe that an approach that would constitute partial or selective equalisation would be consistent with an enhanced equalisation outcome overall. It is not possible to conclude what the impact of selective equalisation would be on the overall outcome.

37. This is not to say that the Commission has accepted that the Western Australian proposal would overcome the practical difficulties inherent in an assessment identified earlier. It still leaves unresolved a number of critical questions such as:

- (i) What constitutes a disability?
- (ii) What types of expenditure would be included in any such assessment?

The Commission notes that the majority of States share these concerns.

38. The Commission has not, therefore, accepted that a clear conceptual case has been made by Western Australia that would enhance the equalisation outcome, and does not propose to develop an assessment reflecting disabilities in the way proposed.

Analysis and comments

39. For the Commission to assess disabilities for economic development expenses, it would need to address two questions:

- (i) what constitutes economic development assistance? and
- (ii) what disabilities are associated with economic development assistance?

40. There is no agreement among States on either question.

What constitutes economic development?

41. Economic development can cover many aspects of State activities, including:

- (i) general economic policies;
- (ii) infrastructure (physical and social);
- (iii) industry programs; and
- (iv) project-specific assistance.

42. In their submissions, States discussed economic development in both a narrow and a broad sense. In its narrow sense, economic development is about State policies relating to the provision of infrastructure, industry promotion and development, and the provision of assistance to individual businesses (including tax concessions). These policies impact on the expenditure and revenue standards in a direct way. It is generally possible to separately identify these expenses. In this paper, we refer to them as direct (economic development) expenses.

43. In its broad sense, economic development is about States' general economic policies, the States' economic fundamentals. The Commonwealth talked about implementing sound framework policies — sound fiscal and economic policies, including appropriate investments in human and general-use physical infrastructures. These policies also impact on expenditure standards but in a different way. It is rarely possible to separately identify expenses relating to them. To do so would require apportioning expenses among the many policy objectives they are intended to meet. For example, it is

not possible to separately identify the proportion of education costs attributable to a State's policy to improve its economic capacity and comparative advantage from other education policies. In this paper, we refer to these expenses as indirect (economic development) expenses.

44. While we may not be able to separately identify them, these indirect expenses are included in the standards of many categories, including:

- Education categories;
- Law and Order categories;
- Roads; and
- General Public Services.

45. The direct expenses will be included in the Economic Activities categories (formerly the Services to Industries and Concessions and Other Payments categories). Commission staff will distinguish two forms of direct expenses:

- Industry Regulation — this component comprises expenses on industry regulation; and
- Economic Development — other direct expenses on industry.

46. In the following sections on disabilities, the focus is on the latter. The question of which disabilities are associated with Industry Regulation will be discussed in the relevant Economic Activities draft assessment papers.

What constitutes a disability in relation to economic development expenses?

47. Just as there is no agreement on what constitutes economic development, there is no agreement on what constitutes an economic development disability. In Information Paper CGC 2002/01³, Commission staff said that for a disability to be assessed:

- There must be a conceptual basis for the existence of a disability — implementing the standard policy results in different per capita levels of expenditure for each State.
- Either:
 - There is empirical evidence that the differences being examined affect the costs of provision of State services (through different levels of use of the service or different unit costs in providing services); or

³ CGC 2002/1 *Guidelines to Implementing Horizontal Equalisation*, pages 34 and 35.

- There is incomplete evidence that the additional use and/or costs are incurred but:
 - ❖ the case is strong in logic;
 - ❖ the Commission judges that sufficient evidence exists; and
 - ❖ the Commission judges that including the factor will increase the likelihood that HFE will be achieved.
- The disability factor is material, either because it is large or has a large impact on HFE based funding.
- The margin of error associated with the disability's application is acceptably small.

What constitutes a disability in relation to indirect economic development expenses?

48. Indirect economic development policies are about putting in place the social and economic infrastructure that would make a State attractive for investment, including investments in human and general-use physical infrastructure (health, education, transport and essential services).

49. It is not possible to associate particular expenses with these broader policies, but the related expenses are included in our category standards. The issue is whether, in addition to the disabilities it already applies, the Commission ought to apply economic development disabilities in these categories.

50. Since it is not possible to associate particular expenses with these broader policies, it is not possible to say whether there are differential costs associated with them. This is because economic development is only one of many reasons for providing these services. It is far from clear that there are disabilities, other than those already assessed, which drive costs in these areas. For example, the education disabilities would account for any differences in the demand for or cost of providing education services (including a desire to improve employment outcomes which may lead to increases in own source revenue).

51. Staff have not identified, and States have not provided, evidence to show that States face additional per capita expenditure on education, health, law and order or general services because they are used to implement broader economic development policies. Nor has there been any argument about what any such disabilities might be and how they might be measured.

52. Commission staff propose to recommend to the Commission that additional disabilities for the impact of broader economic development policies not be assessed.

What constitutes a disability in relation to direct economic development expenses?

53. In their submissions most States opposed the assessment of disabilities for direct assistance. They were concerned that it would be too difficult to measure disabilities in a policy neutral and objective way.

54. Western Australia said that spending was related to the existence of market failure.

55. Tasmania suggested disabilities arose from:

- the size of each State's budget — smaller States were disadvantaged in attracting and establishing new economic activity;
- a State's demography and geography — business was attracted to areas with large populations and States with small markets that were distant from larger ones were further disadvantaged.

56. The Northern Territory said it experienced disabilities because of:

- the size of its budget — smaller States were disadvantaged in the level of assistance they could offer to industry and in their capacity to meet tied or matching funding requirements associated with Commonwealth initiatives; and
- its underdeveloped economic and social infrastructure — it needed to incur higher expenses to provide support and infrastructure comparable to that readily available in other States. It also has disabilities relating to high construction costs, high borrowing costs and limited borrowing capacity and its comparatively low own source revenues (including the lack of taxation powers over offshore petroleum areas).

57. ***Market failure.*** Western Australia said economic development spending was closely related to the existence of market failures that stand in the way of optimal private sector development. It provided examples of market failure including economies of scale in developing infrastructure in greenfield development hubs and distortionary international subsidies.

58. Conceptually, market failure could lead to greater demands for assistance and higher economic development expenses. These additional expenses could reflect needs other States did not have. There are practical difficulties which prevent the Commission from assessing a disability for those needs. First, it would require a definition of what constitutes market failure. Second, it would require a method of identifying which expenses were caused by market failure. For example, if a State had to provide infrastructure in greenfield development hubs, what portion of the total expenses should the Commission accept as being related to the market failure? For market failure to be assessed as a disability, the Commission requires a method of identifying and measuring it. It is not clear what that method would be.

59. Given that it is not clear how the Commission could identify or measure disabilities, Commission staff propose to recommend to the Commission that it not assess disabilities in relation to market failure.

60. ***Size of budget.*** Both Tasmania and the Northern Territory said a disability should be assessed for budget size. This disability would be similar in concept to the fixed cost component of the 1999 Review administrative scale factors. That is, each State having the capacity to spend a specified amount on targeted assistance⁴.

61. The conceptual case for assessing a size of budget disability has not been established. It is not clear what needs would be addressed by a size of budget disability. If it is about providing States with the capacity to attract more business, it is arguable that all States have needs in this area. If it is about providing smaller States with the capacity to bid for business on an equal footing with larger States, other States have questioned whether this constitutes need. Western Australia said that needs should not be assessed for assistance whose primary purpose is to shift activity between States.

62. Even if the conceptual case were accepted, no evidence has been provided on what would be an appropriate level of targeted assistance for each potential project and what might be the appropriate number of projects in each State. It is not clear how the Commission would determine such numbers.

63. Given that the conceptual case has not been established and it is not clear how the Commission would identify or measure disabilities, Commission staff propose to recommend to the Commission that it not assess a size of budget disability.

64. ***A State's demography and geography.*** Tasmania said businesses are attracted to areas with large populations. States with small populations that are distant from larger markets are disadvantaged.

65. Equalisation is about equalising States' financial capacity to provide services. It is not about equalising outcomes, standards of living or economic activity. Commission staff do not accept that a conceptual case has been established for assessing a disability to account for business location decisions.

66. Given that the conceptual case has not been established, Commission staff propose to recommend to the Commission that it not assess a demography and geography disability.

67. ***Underdeveloped economic and social infrastructure.*** The Northern Territory says it has to provide greater per capita levels of support to its business sector because of:

- its underdeveloped economic and social infrastructure;
- higher construction costs;

⁴ The same absolute amount would imply higher per capita figures for smaller States.

- higher borrowing costs and limited borrowing capacity; and
- low own source revenue.

68. In so far as this argument applies to public sector infrastructure, it is not clear whether the Territory is claiming disabilities over and above those assessed in the Depreciation and Debt Charges assessments. It has not provided evidence of the additional costs and the extent to which they are not addressed by other assessments. Similarly, it is not clear whether the Territory is claiming additional revenue disabilities for its low capacity above those assessed in revenue categories.

69. It is possible that businesses also face additional infrastructure costs, but their decision to locate in the Territory suggests that there are other commercial advantages which outweigh these costs. A conceptual case for assessing disabilities because of private sector infrastructure costs has not been advanced or established.

70. Given that the conceptual case has not been established, Commission staff propose to recommend to the Commission that it not assess an underdeveloped infrastructure disability for the Northern Territory.

71. While some States have claimed they experience disabilities, they have not provided evidence that disabilities exist nor have they established how the Commission could identify and measure any disabilities. For these reasons, Commission staff propose to recommend to the Commission that it continue to assess economic development expenses equal per capita.

72. **Past expenses.** Under the proposed approach, direct expenses would be included in the standard budget. Consistent with usual Commission practice, past expenses would not be included if the assistance was provided in years prior to the years of assessment. The only exception would be categories that have an assessment method which uses a longer time series such as depreciation, debt charges and mining.

Conclusion

73. There is no agreement among States on:

- (i) the concept of economic development;
- (ii) the scope of economic development; or
- (iii) what constitutes an economic development disability.

74. Commission staff propose to recommend to the Commission that:

- (i) all States provide economic development assistance and, on the basis of what States do, all operating economic development expenses incurred by the State general government sector should be included in the equalisation budget. This would be so regardless of whether the assistance related to successful or failed projects; and

- (ii) it continue to assess economic development expenses by the equal per capita method. Staff have been unable to identify economic development disabilities and States have not provided the conceptual case and the empirical evidence on which an assessment could be made. Some of the State positions on economic development appear to be driven by the perceived merits of individual State policies. The standards used in equalisation assessments are based on what States do on average. The Commission's role does not extend to making judgments on the merits of those actions.

TREATMENT OF REVENUE FOREGONE

75. It is the standard policy of States to provide tax concessions as a means of assisting industry. The issues for the Commission are:

- should revenue standards be based on gross revenues (that is, adding back revenue foregone through tax concessions) or net revenues (that is, ignoring revenue foregone through tax concessions)? and
- should a policy adjustment be introduced to account for States' tax concession policies?

Gross or net revenues?

76. Currently, revenue standards are based on net revenues. A reason for continuing this practice is that it reflects what States do — they report the revenues they actually collect.⁵ In Information Paper CGC 2002/1⁶, Commission staff said the use of internal standards was one of the pillars of equalisation. An advantage of this approach is that the Commission does not try to guess what level of service might be appropriate. It is guided solely by what States on average do.

77. The Commission does gross up expenses by separately assessing user charges. It does this because it accepts that the disabilities that apply to the user charges are different from those that apply to the related expenses. On the same basis, the Commission could gross up revenues (by adding back revenue foregone) and treat the revenue foregone as Economic Development Assistance. There are a number of practical difficulties with this proposal:

- the Commission's standards would be conceptually different from those reported by the ABS or the States in their budget documents;

⁵ In cases where States record total collections and provide the tax relief through tax refunds, the Commission subtracts the refunds from collections in deriving the standard.

⁶ *CGC 2002/1 Guidelines to Implementing Horizontal Fiscal Equalisation*, pages 6 and 7.

- there may be no point in grossing up actual revenues. The justification for grossing up actual revenues is based on the assumption that the disabilities to apply to the revenue foregone are different from those which apply to the expenditure category. It is not obvious that this would be the case. If they are the same, the relativities will be the same regardless of whether revenues are grossed up or not. For example, it is standard policy to provide a payroll tax concession to small businesses (through a tax free threshold). The Commission could add the revenue foregone back onto the Payroll Taxation standard and, for consistency, treat the same amount on the expenditure side as Economic Development Assistance. If it were to apply Payroll disabilities to that Economic Development Assistance, as is likely, it would have gone to significant effort to produce unchanged per capita relativities. The improvement in transparency would be offset by the absence of correspondence with reported revenues;
- the data might not be available. While States provide payroll tax concessions to particular big businesses, the standard practice is to tax big business. If the Commission were to include the revenue foregone, it would want data on both the revenue foregone (to be included in the Payroll Taxation standard) and the businesses' wages (to be used in the revenue base and value distribution calculations). In the past, the States have not been willing to provide this type of commercial in confidence information to the Commission.

78. For these reasons, Commission staff propose to recommend to the Commission that it continue the practice of using net revenue in calculating its revenue standards.

Should the Commission introduce a policy adjustment?

79. Where revenue bases are measured using the observed value of taxable activity (including that which receives the concession), tax concessions are reflected in the assessments as reduced effective tax rates. A decision to provide a concession is no different in concept from a decision to impose a lower rate of tax. Tax concessions could, therefore, be considered as an elasticity issue. While there may be a conceptual case for elasticity adjustments, there is little practical evidence to support such assessments. The Commission generally does not introduce adjustments to its observed revenue bases for the longer term effects that may arise from the responses businesses make to tax policies (of which elasticity is but one). Nor is it clear that making an adjustment for one of the many competing influences on the level of some economic activities would produce a better overall picture of State relative revenue raising capacities. Tax concessions are not a strong enough justification to warrant a change in the Commission's practice.

80. Commission staff propose to recommend to the Commission that it continue its practice of using net revenue to calculate revenue standards and effective rates of tax and not adjusting its revenue assessment methods for individual States' tax concession policies.

ASYMMETRY

Background

81. Western Australia raised the issue of asymmetry in the context of an apparent difference between the treatment of the benefits and costs of economic development policies in the Commission's assessments. It said the existing assessments created a disincentive to invest in projects that increase economic activity. It illustrated its case using mining revenue.

82. It said that under the equalisation process, revenues arising from an increase in the revenue base are in effect shared among all States according to their shares of the Australian population. Equalisation interprets an increase in a State's relative capacity to raise revenue from own sources as implying it requires a reduced share of GST revenue to finance its average level of services. In practice this meant that 90 per cent of the \$450 million revenue (in net present value terms) it expected to receive from development on the Burrup Peninsula would be redistributed across States. However, when it came to the cost of the investment required to facilitate the development, Western Australia said that existing methods implied that total cost would be borne by it. That was because an equal per capita assessment would be applied to the \$130 million State investment.

83. Western Australia argued this approach penalised States that engaged in successful economic development activity. The State had to bear the full cost of its economic development expenditure, whereas the 'fruits' of that expenditure were shared around other States.

84. While a case can be made for assessing disabilities for a particular area (as Western Australia has done for mining), it is not clear that equalisation is improved by assessing disabilities in one area but not considering them in other areas. Commission staff are not convinced that the Commission would be improving the equalisation overall by assessing disabilities to address specific areas or anomalies (such as asymmetry).

85. In principle, if disabilities are to be assessed for successful projects, they should be assessed for failed projects. If disabilities are to be assessed for mining, they should be assessed for other sectors. Commission staff accept that a narrowly targeted assessment of disabilities might improve equalisation in a particular sector, but we do not accept that it will necessarily produce a better equalisation outcome overall or that it will produce a better equalisation outcome than making no assessment of disabilities.

Should the Commission align economic development expenses and revenues?

86. The example provided by Western Australia highlights a potential problem with the Commission's approach to assessments. The current practice is to consider separately the disabilities relating to categories of revenues and expenditures. If the Commission were to accept the Western Australia proposition, it could redress the perceived imbalance by aligning economic development expenses with the revenues they generate. This would signal a change in approach from a categories of expenditure and

revenue focus to a project focus. It is possible that the disabilities relating to individual projects would be different from those assessed for categories of expenditures and revenues.

87. To adopt this approach, the Commission would have to address the issue of which project related assistance should be aligned with the revenues they generate. Western Australia proposed guidelines⁷ for determining how this distinction could be made. Most States opposed the use of guidelines because they were subjective and they discriminated between the different ways States provide assistance. Commission staff agree. It would be difficult to justify including assistance because it was associated with a successful project or because it was in the national benefit and excluding other assistance because it was not. It is difficult to accept that using criteria, including the Western Australia guidelines, would improve equalisation. If criteria are not used to decide which project related expenses should be aligned and which not, the options for the Commission are to align all project related expenses or none.

88. By aligning economic development expenses with the revenues they generate, the Commission could apply the same disabilities to both the expenses and the revenues. While this change might appeal as a more neutral approach to individual projects, it creates its own problems. In practice, different disabilities would apply to different projects. Assistance provided for a mining project would probably be assessed differently from assistance provided for a tourism project.

89. The view of Commission staff is that there are several reasons for continuing to assess disabilities by category of expenditure rather than by project:

- (i) it is likely that differences in per capita economic development assistance are driven more by expenditure considerations than revenue considerations;
- (ii) there is no guarantee that providing assistance will generate future revenue, or when;
- (iii) there is no guarantee that the Commission could determine which revenues (or losses) related to which assistance;
- (iv) States make economic development decisions on the basis of many criteria, most of which are unrelated to equalisation consequences (for example employment outcomes);
- (v) other economic agents are also involved in decisions about the level of investment in a particular development. Their decisions and choices are as relevant as the State's decisions;
- (vi) applying revenue disabilities would draw the Commission into making decisions about which revenue disabilities to apply to which projects. These could lead to discussions about the worth of projects, which are

⁷ Refer to paragraphs 19 to 22.

good projects and which are bad projects. These issues have limited relevance for equalisation.

90. For these reasons, Commission staff propose to recommend to the Commission that it continue its category of expenditure approach and not align project related expenses with the revenues they generate.

Are revenue assessments policy contaminated?

91. New South Wales said the Western Australian example highlighted a deficiency in the revenue approach to assessments. Where the revenue approach used the observed level of activity as the capacity measure, it presumed extra activity was part of a State's natural endowment, rather than the result of its policies. Western Australia agreed saying the Commission's revenue approach did not remove the impact of individual States' policies on economic development. It said that, in some cases, there was a direct link between the economic development assistance they provide and the size of their tax bases.

92. While a link might be more obvious for some assistance (the Burrup example), it can be tenuous for others (Victoria's investment in education translating into increased payroll taxes, stamp duties and land tax revenues). For most forms of assistance it will be difficult to establish a link because:

- there can be a lengthy delay between the provision of the assistance and the change in the level of activity;
- it is not possible to say a project exists because of State assistance, it is possible the project could have proceeded without it; and
- it is not possible to ascribe an increase in activity to only one influence. For example, increased conveyances duty arising from the current property boom in New South Wales and Victoria are the result of many influences.

93. It is not clear that a link exists in many cases, nor that the link is in the direction suggested by States. The Productivity Commission said certain forms of economic development policies — particularly direct and tax-based subsidies to businesses — are often difficult to justify on economic grounds⁸. That comment suggests that the conceptual case for making an assessment is not clear cut.

94. Commission staff do not propose to recommend to the Commission that it introduce policy adjustments to its revenue assessments to account for the potential link between revenues and State assistance.

⁸ Commonwealth Treasury rejoinder submission.

Conclusion

95. This paper does not include a presentation of the draft assessment calculation, because no change to the method has been proposed and the calculation method remains the same as in the 2003 Update.