SUBMISSION 41

TREASURY SUBMISSION TO NORFOLK ISLAND GOVERNANCE INQUIRY

INTRODUCTION

This submission has been prepared by the Commonwealth Treasury. The views expressed in this submission are those of the Treasury and do not necessarily reflect those of the Treasurer or of the Commonwealth Government.

In addressing issues of financial sustainability of self-government arrangements on Norfolk Island, the main focus of the submission is on the current degree of transparency in the economic and financial circumstances of Norfolk Island and on the principles that should inform the raising of government revenues on the Island.

ECONOMIC AND FISCAL CIRCUMSTANCES OF NORFOLK ISLAND

A significant challenge in any effort to assess the current economic and fiscal circumstances – including fiscal sustainability – of Norfolk Island is the paucity of available economic data as well the approach taken to reporting in the Norfolk Island government accounts. (For example, Norfolk Island's accounting framework comprises distinct Fund accounts that correspond to different classes of items than those found in corresponding accounts of mainland jurisdictions.) This was noted in the 1997 *Report on Norfolk Island* by the Commonwealth Grants Commission (CGC) and continues to prevail today.

The most recent comprehensive analysis of the economic circumstances of Norfolk Island that is publicly available is the CGC's 1997 report. In assessing the economic capacity of Norfolk Island the CGC noted that while there was reasonable data on public sector activities there was scant information on the level of private sector activity on Norfolk Island.

Notwithstanding these limitations on data availability the 1997 CGC report noted that in 1995-96:

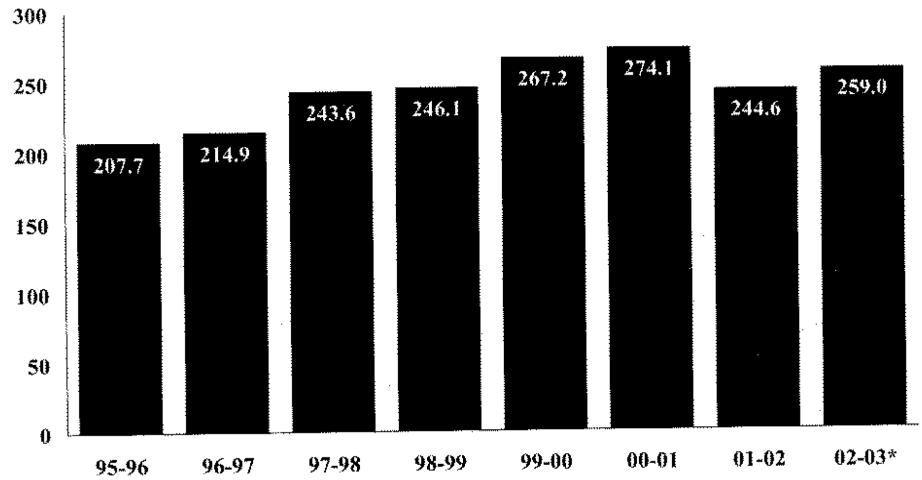
- The private sector was roughly estimated at around $57 million, contributing 75 per cent of the Norfolk Island economy – with tourism being the largest industry on the island; and
- The local (non-government, non-tourist) economy at around $30 to $35 million contributed at least 40 per cent.

In the period since the CGC report there appears to be little evidence of any significant change in the underlying *economic* circumstances of Norfolk Island. The pattern of growth in taxation revenues reported in the Norfolk Island government's financial statistics in recent years is consistent with data on tourist arrivals (see Figure 1 below). This suggests ongoing strength in the tourist industry on the Island, which remains the main contributor to the Norfolk Island economy.

As was the case for the tourism industry worldwide, 2001-02 was a relatively poor year for tourism (and hence for taxation revenues collected) on the Island – particularly by the standards of recent years – though there does appear to have been a rebound in tourism levels during 2002-03. Tourism levels have been higher than those that prevailed at the time the CGC was preparing its 1997 report (increasing by an average of 3.2 per cent per year from 1995-96 to 2002-03) although growth in tourist numbers has slowed since 1999-2000.

Figure 1

Tourism numbers, 1995-96 to 2002-03
(in thousands of visitor-days)



Source: Government of Norfolk Island
Note: * Treasury projection (assuming annual growth equal to growth during first ten months of year).

In its 1997 report the CGC noted that the Norfolk Island had the financial capacity to meet the obligations associated with its existing government functions, in terms of both service provision and infrastructure requirements. At that time the Norfolk Island Government had been in surplus for a number of years. That said the CGC judged that some services (vocational education and training, health and social security) were being provided at levels below that provided in Australia. Sustaining the Island's infrastructure was also pointed to by the CGC as a future pressure for the Island. In particular, the CGC pointed to difficulties Norfolk Island is likely to face in sustaining its economy and associated revenue capacity if it did not improve its administrative capacity and infrastructure. The CGC concluded that Norfolk Island's administrative and revenue capacity should be improved to meet likely future demands in these areas.

The Norfolk Island Government has acknowledged that it is coming under increasing fiscal pressure as a result of the growing need to replace or upgrade several elements of Norfolk Island's infrastructure and growing demands for expenditures on health, education and welfare.[1] In response to these pressures, the Norfolk Island Government adopted a "maintenance" budget for the 2002-03 fiscal year in which a balanced budget was achieved only by making temporary cuts to recurrent and capital spending.

In May 2002, the Norfolk Island launched *Focus 2002*, a comprehensive review of the Island's fiscal and economic sustainability. In the report of the review, tabled in the Norfolk Island Assembly meeting on 19 March 2003, it was noted that expenditure is rising at a rate far greater than income and this situation is not sustainable. In response the review identified some measures to address this including limited expenditure savings, possible management reforms, possible changes to the provision of social and health expenditures (including tightening eligibility

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1 For example, cf. the May 2002 discussion paper released by the Norfolk Island government in launching its *Focus 2002* review of the economic sustainability of the Island; the 5 June 2002 statement by the Norfolk Island Minister for Finance and subsequent debate in the Assembly in consideration of the *Appropriation Bill 2002* (as reported in the Norfolk Island Hansard); and section 3.4 and Attachment 19 of the Focus 2002 Report tabled 19 March 2003. According to the Island's published financial information welfare expenditures (including pensions and medial expenditures) grew at an average annual growth rate of 14.7 per cent between 1995-96 and 2001-02 – significantly faster than the rate of growth of taxes and charges.

requirements) and the need for improved information technology systems. The report reinforced the earlier findings of the CGC report that there is insufficient funding available for future infrastructure needs and that there are considerable risks for Norfolk Island if capital works continue to be funded from recurrent funds derived from Government Business Enterprise (GBE) payments. The report noted that, even in the short term, revenues need to increase significantly to maintain the current level of service delivery, meet increased cost predictions and maintenance of infrastructure needs. Recognising that there were limited opportunities for further savings the report recommended that approval be given for intensive investigation into new revenue options as soon as possible.

In terms of Norfolk Island's revenue raising capacity the CGC's 1997 report found that:

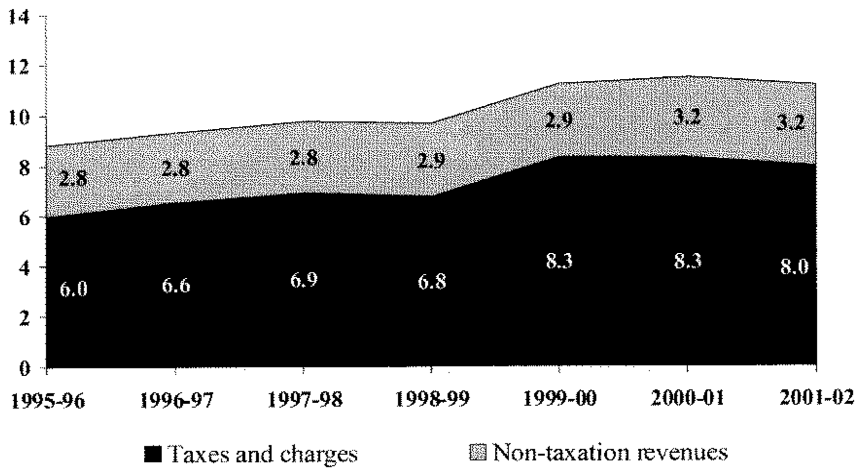
- Norfolk Island imposed a more limited range of taxes and charges than governments on the mainland;
- In areas that Norfolk Island did tax, its tax rates were high;
- The taxation system on the Island was regressive, generally did not tax wealth or income, and fell disproportionately on tourists;
- Norfolk Island has considerable untapped revenue sources, with little use made of taxes on income and wealth, including land, and possibilities for broadening the range of taxes imposed.

Average annual growth of taxes and charges (see Figure 2 below) totalled 4.9 per cent from 1995-96 to 2001-02. Figure 2 also shows that after rising to around $8.3 million in 1999-2000 growth in taxes and charges in nominal terms has been relatively static, mirroring the flat growth in tourist numbers over the same period (see Figure 1).

Figure 2

Evolution of Norfolk Island Revenues, 1995-96 to 2001-02

(Revenue Fund, in $ millions)



Sources: Government of Norfolk Island Web site (www.norfolk.gov.nf), Table P1, and 2001-02 Financial Statements

The low level of taxation on the Island translated into a much higher reliance of the Norfolk Island government on non-taxation revenues – particularly dividends from GBEs and interest earnings, which accounted for about a quarter of its revenues (compared to only 7 per cent on the mainland).[2]

Consideration of options for improved fiscal sustainability of Norfolk Island would need to encompass examination of alternative revenue sources. Any such examination needs to be informed by a good understanding of the structure of the economy and the tax base as well as Norfolk Island's overall fiscal strategy. Some of the practical constraints identified earlier in terms of the ability to capture reliable economic data would need to be addressed in order to support examination of the policy options available. This would also assist the Norfolk Island Government in making longer term policy judgements about the level of service provision and possible approaches to improving its financial capacity.

Reference could also be made to a range of fiscal principles and practices that typically inform government decision-making with regard to the raising of revenues.[3]

In Australia and the vast majority of other countries, taxation is the main source of government revenues. Tax systems are commonly assessed against their ability to generate adequate revenues to pay for the public services demanded by their constituents (ie. without undue reliance on borrowing that can impose tax burdens on future generations with inadequate offsetting future benefits) as well as against a number of broad principles:

- that taxes should be efficient (ie. that they should cause minimum economic distortions);
- that the overall tax system should be equitable (or fair); and
- that taxes should be simple.

In practice, these principles often conflict with each other to some extent. For example, equity objectives may require more complex legislation, which may conflict with simplicity and possibly also efficiency objectives. Administrative capacity may be a factor in considering the relative complexity of any additional taxes.

No particular ranking is attached to any of the general policy principles of efficiency, equity and simplicity. However, it would be the responsibility of the Norfolk Island Government to determine how to balance these principles in any particular case.

There are also other issues relevant in evaluating a tax or a tax system. These include the extent to which the design of the system contributes to voluntary compliance, achieves an appropriate level of tax expenditures, aligns the tax and income support systems, and is consistent with the current fiscal strategy.

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2 1997 *Report on Norfolk Island*: Table 7-1, (p.144). Expressed in dollars per capita, non-taxation revenues on Norfolk Island in 1995-96 were over twice the average level on the mainland ($1,329 per capita, versus $583).

3 In section 6.3 and attachment 19 of its Focus 2002 report, the Norfolk Island government has already begun to sketch out a range of tax design criteria.

SUMMARY AND CONCLUSIONS

The lack of up-to-date economic and financial information that is comparable to that published for other Australian jurisdictions makes it difficult to precisely ascertain and compare the current economic and fiscal circumstances of Norfolk Island. Accordingly, within a broader review of fiscal sustainability and of governance and accountability arrangements on Norfolk Island, it would be worth considering ways of enhancing the availability of economic, financial and other data on Norfolk Island. This would provide a more robust basis on which to support strategic policy formulation and review as well as allowing greater transparency and more timely benchmarking of the Island's economic and fiscal performance relative to other Australian jurisdictions.

For example:

- The absence of comparable economic data on Norfolk Island's GDP and its components – e.g. on personal and corporate income, consumption, investment, imports and exports – makes it difficult to ascertain and compare the Island's revenue-raising capacity and need for public services.

- The lack of a standardised accounting framework also makes it difficult to assess the relative financial needs of the Norfolk Island government.

That said available evidence suggests that the underlying economic circumstances of Norfolk Island, including its untapped capacity to raise revenues noted in the CGC's 1997 *Report on Norfolk Island*, have not materially changed since that report. However, infrastructure and other expenditure pressures anticipated at the time of the report have exerted increasing fiscal pressure on the Norfolk Island government and led it to review its expenditures and explore options for expanding its revenues.

In exploring options for expanding its revenues, Norfolk Island should be guided by the need to raise adequate tax revenues (ie. without having recourse to undue levels of borrowing) in a way that is transparent as possible to taxpayers and the community and strikes an appropriate balance between the objectives of achieving a tax system that is as efficient, as equitable and as simple as possible.