REPORT

CENTRE FOR
INTERNATIONAL
ECONOMICS

Economic Impact Assessment

Of extending Commonwealth legislation to Norfolk Island

Prepared for

Department of Transport and Regional Services

Centre for International Economics
Canberra & Sydney

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Forward

THE CENTRE FOR INTERNATIONAL ECONOMICS was commissioned by the Commonwealth Department of Transport and Regional Services to undertake an assessment of the economic impacts arising from extension of Commonwealth legislation to Norfolk Island.

To gain an appreciation of the structure and operation of the Norfolk Island economy, Norfolk Island was visited in early August 2006 for the purpose of undertaking stakeholder consultations. Meetings were held with the Norfolk Island Government and bureaucracy, the Administrator, private sector businesses, government business enterprises, and individuals.

The CIE would like to thank all stakeholders who participated in the consultations, and who provided information/data in response to questions about the operation and performance of the Norfolk Island economy. The CIE is appreciative of the effort numerous people, particularly within the Norfolk Island Government, went to in tracking down and providing data.

Finally, the Norfolk Island Government is proposing, almost on a daily basis, to undertake some significant reforms, especially in the area of taxation. If these proposed reforms go ahead, then there is a chance that some elements of this report or the assumptions made will already be out of date.

Executive Summary

THE AUSTRALIAN GOVERNMENT is contemplating the extension of all Commonwealth legislation to Norfolk Island. Extending Commonwealth legislation to Norfolk Island can be expected to have substantial impacts on the local economy.

The magnitude of the economic impacts has been quantified through using a general equilibrium model of the Norfolk Island economy. The economic model identifies 18 sectors of economic activity, 5 areas of final demand, 2 factors of production, 15 types of indirect taxes and subsidies, and tracks dividend payments made by various government business enterprises and Norfolk Island Government (NIG) fee for service activities.

When quantifying the economic impacts of extending Commonwealth legislation to Norfolk Island, only those pieces of legislation that will have either significant economic or social impacts have been considered. Broadly speaking, the areas of legislative change can be confined to:

- direct and indirect taxation;
- superannuation (and the superannuation guarantee);
- customs duties, quarantine and immigration;
- markets, business operations (including government business enterprises) and corporate conduct;
- operation of the labour market (minimum wages, labour supply); and
- social welfare.

The model of the Norfolk Island economy is based on 2004-05 data. As it is assumed that Commonwealth legislation will be rolled out on 1 July 2007, there is a need to know what the Norfolk Island economy looks like in 2007 and beyond.

The baseline for the Norfolk Island economy embodies four substantial changes to the economy post 2004-05, these being:

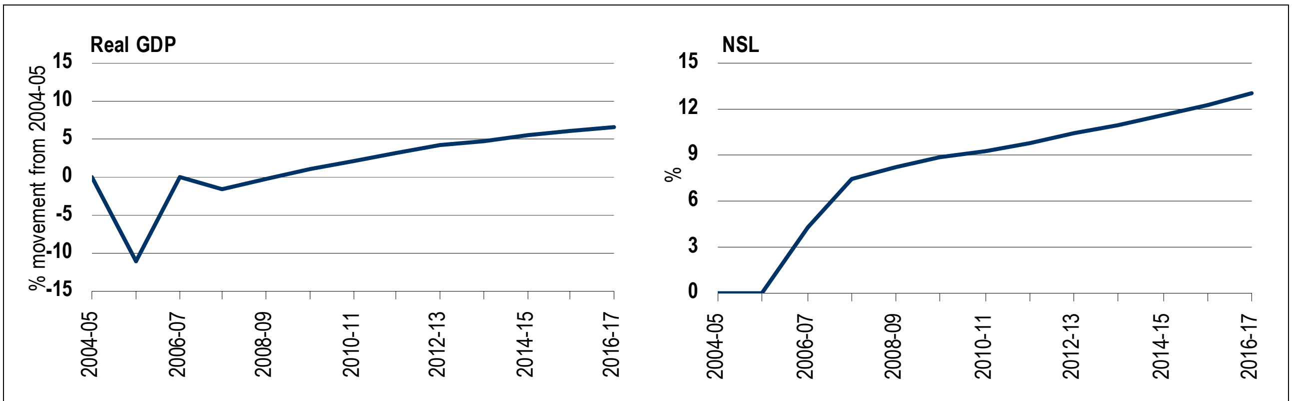
1. tourism numbers decline from 33 000 in 2004-05 to 30 000 in 2005-06 (an 11 per cent decline);
2. the Asset Management Plan is introduced in 2006-07, with expenditure on infrastructure (and depreciation) ranging between $9.9 million in the first year of the AMP to $17.4 million in the last year;
3. health and welfare expenditure by the NIG grows at 10 per cent per annum, reflecting an ageing population; and
4. the NSL is introduced in 2006-07 to balance government revenue and expenditures.

GDP in the baseline is reported in chart 1, as is the required rate of NSL to balance the NIG's revenue with expenditure. The NSL increases over time due to increasing costs associated with the Asset Management Plan (and funding depreciation) and rising health and welfare expenses due to an ageing population. As the NSL increases, GDP is constrained and post 2016-17 GDP (and other economic indicators such as employment, household consumption etc) start to slow/decline.

Unless something can be done to contain the expenditure required of the NIG or find alternative revenue sources, the economic modelling suggests that the Norfolk Island economy will struggle beyond 2017-18 or so. The economy is simply too small to fund/meet its expenditure requirements, even with the introduction of the NSL.

It is against this baseline that Commonwealth legislation is applied. Extension of Commonwealth legislation has substantial implications for Norfolk Island in the areas of direct and indirect taxes, corporate conduct, workplace conditions and subsidies directed to the social services (health care, welfare, and education). Taken together, and with the new gover-

1 **The NSL and real GDP in the baseline**



Data source: CIE model of the Norfolk Island economy.

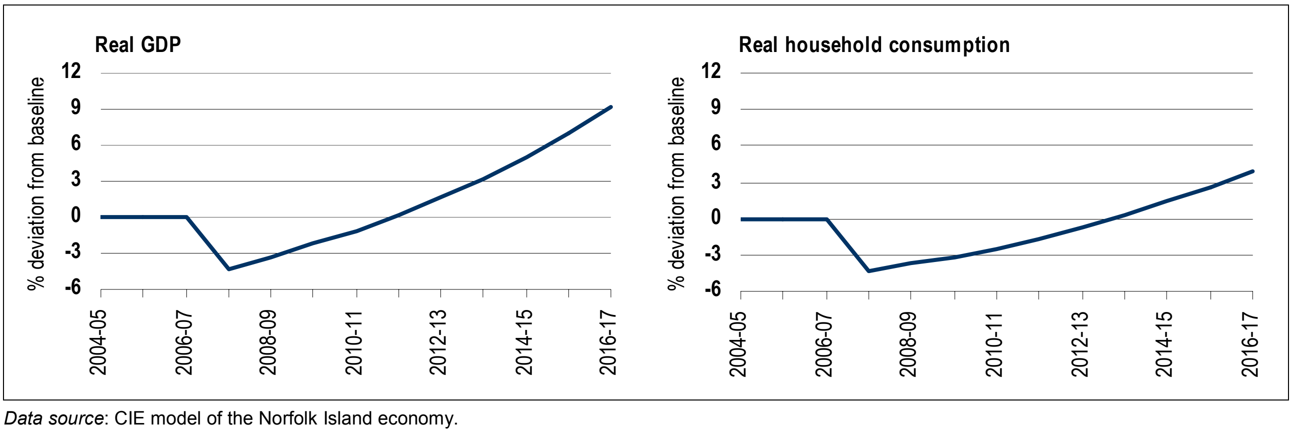
nance model under which the NIG assumes responsibility for providing all state and local government services, the overall impacts of Commonwealth legislation are initially negative, before becoming strongly positive. The impact of Commonwealth legislation on real GDP and household consumption, the preferred welfare indicator, are reported in chart 2.

By 2011-12 GDP is forecast to be higher than baseline. This reflects that under the baseline, the local economy is expected to slow/contract under an ever increasing NSL (needed to fund the AMP, depreciation, higher health and welfare expenses etc). compared with this baseline, Australian taxes and transfers to households impose less of a cost burden/impost on the Norfolk Island economy and hence economic activity is forecast to be higher than baseline.

Extending Commonwealth legislation to Norfolk Island is also forecast to see household consumption being higher than baseline (by 2013-14). The impact of Commonwealth legislation on real household consumption primarily reflects the combination of two factors — nominal household income (including transfers) and the CPI. Immediately after the extension of legislation, Norfolk Island nominal GDP, and hence household income, contracts (by 9 per cent). The CPI is also lower, but by only 5 per cent. Hence households are relatively worse off in real terms, with real household consumption being 4 per cent lower than baseline in 2007-08. As nominal GDP improves and the decline in CPI (relative to baseline) increases over time, real consumption increases and exceeds baseline levels in 2013-14 and beyond.

There are several options for ameliorating adverse impacts of extending Commonwealth legislation to Norfolk Island. Phasing in Australian tax legislation, removing indirect taxes and levying a payroll tax instead of a property tax each generate more favourable impacts (relative to the main simulation) for the Norfolk Island economy.

2 **Economic impact of Commonwealth legislation on the Norfolk Island economy**



Data source: CIE model of the Norfolk Island economy.

1 *Introduction*

THE AUSTRALIAN GOVERNMENT is contemplating the extension of all Commonwealth legislation to Norfolk Island. The extension of legislation is to be accompanied by a new governance model for non-Commonwealth responsibilities to be retained by Norfolk Island. The rationale for moving away from the arrangements of the last 27 years — self-determination — primarily stems from numerous reviews into the future of Norfolk Island. By and large, these parliamentary and independent reviews have arrived at the same conclusion — the status quo cannot be maintained. Concerns have been raised about the level of services delivered on the Island and that the underlying economy is too small and has too narrow a base to generate sufficient funding to finance infrastructure. Of late, concerns have been raised about the financial sustainability of the government.

It should be noted that the Norfolk Island Government (NIG) and private individuals have recently commissioned reports into the financial sustainability of Norfolk Island. These reports challenge the assumptions made in the 'Australian Government' reports, and suggest that the Norfolk Island economy is/could be made financially sustainable.[1]

The objective of this report

The issue of financial sustainability is clearly important and has been rigorously debated. However, it is not the objective of this report per se to establish whether, and under what conditions, Norfolk Island is sustainable. Rather, the primary objective of this report is to provide an economic assessment of the impacts arising from the extension of Commonwealth legislation to Norfolk Island. The impacts are assessed (quantified) through using a general equilibrium model of the Norfolk Island economy.

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[1] See, for example, CRA International 2006, *The Sustainability of the Norfolk Island Government: A Review of the Acumen Report*, CRA International, July 2006; Norfolk Island Action Group 2006, A Model for Sustainability, NAG; and Econtech 2006, *Modelling the Norfolk Island Government's Financial Position*, Econtech, September 2006.

While not a direct focus of this report, the issue of sustainability does however enter into considerations. When assessing the economic impacts, account needs to be taken of what the economy is going to look like in the future (known as the 'baseline'). If living standards on Norfolk Island are to be maintained (or improved) in 2007 and beyond, then the economy will clearly need to move to a sustainable footing. The issue of sustainability is addressed in a later chapter.

There are a vast number of pieces of Commonwealth legislation that could be rolled-out to Norfolk Island. Unfortunately, the resources are not available with which to quantify the economic impact of each piece of legislation — nor is it warranted. Numerous pieces of legislation will either have no major impact (such as the *International Air Services Commission Act 1992*), not be applicable to Norfolk Island (such as the *Antarctic Treaty Act 1960*), or already be applied in Norfolk Island (such as the *Sex Discrimination Act 1984*).

In ascertaining those pieces of legislation that will have either significant economic or social impacts, relevant Commonwealth departments have been relied upon to identify legislative changes that will likely have a major economic or social impact. Broadly speaking, the areas of change can be confined to:

- direct and indirect taxation;
- superannuation (and the superannuation guarantee);
- customs duties, quarantine and immigration;
- markets, business operations (including government business enterprises) and corporate conduct;
- operation of the labour market (minimum wages, labour supply); and
- social welfare.

Report structure

The report is structured as follows. Chapter 2 details the economic model used to quantify the impacts of extending Commonwealth legislation to Norfolk Island, the underlying database, and assumptions regarding the baseline.

The changes arising from the extension of Commonwealth legislation to Norfolk Island are detailed in chapters 3 (direct and indirect taxation) and 4 (welfare, other areas). These chapters take the format of identifying the current arrangements in Norfolk Island, how these arrangements would change if Commonwealth legislation were rolled out, and how these changes were entered into the economic model for the purpose of quantifying the impacts (that is, the modelling ‘shocks’).

The economic modelling results are reported in chapter 5. In chapter 6 the sensitivity of the modelling results to one area of critical importance to the Norfolk Island economy — tourist numbers — is investigated. Also investigated in the sensitivity analysis are different levels of expenditure on infrastructure carried out by the NIG. Options for reducing any adverse impacts associated with the extension of legislation to Norfolk Island are considered in chapter 7.

Finally, in chapter 8 some general observations are made on the Norfolk Island economy. In making these observations, including areas of potential reform, the ultimate objective is to provide an environment favourable to economic growth.

2 Economic model of the Norfolk Island economy

A GENERAL EQUILIBRIUM MODEL of the Norfolk Island economy has been built for the purpose of quantifying the economic impacts of Australia extending Commonwealth legislation to Norfolk Island. An overview of the model and its underlying database is provided below.

A model of the Norfolk Island economy

The model used in this study is the ORANI-G model combined with data describing the Norfolk Island economy. The ORANI-G model is a single-country generic computable general equilibrium model that has been applied to a wide range of countries. The range of applications is described on the website of the Centre of Policy Studies at Monash University (http://www.monash.edu.au/policy/oranig.htm).[2]

Extensions were made to the model to allow for the particular policies (in particular, changes in the regime of taxes and subsidies) that were required in this study. For example, income taxes were introduced and the labour supply made responsive to post-tax income. Also, income accounting equations tracking the movement of income (generated by taxes, subsidies and dividends from government business enterprises) between the Norfolk Island Government, residents of the Island, and the Australian Government were introduced. The comparative static ORANI-G model was run in a sequential mode to emulate the phased introduction of changes and generate time-paths. For example, a baseline time-path including NIG expenditure on infrastructure was generated, and then a policy time-path (introducing a switch from the Norfolk Island to the Australian tax regime) was generated and compared with the baseline time-path.

[2] The particular variant adapted for this study can be downloaded from http://www.monash.edu.au/policy/archivep.htm#tpmh0041.

Underlying database

General equilibrium models are data intensive. The basic data set is an input-output (IO) table of the underlying economy.[3] An IO table quantifies the relationship/economic linkages between the various productive sectors of an economy and areas of final demand (such as consumption, exports etc). It also specifies sectoral demand for the various factors of production (land, labour and capital). Essentially, an IO table tells us what is produced, how it is produced, and who buys it. Unfortunately, an IO table does not exist for Norfolk Island, meaning that the table had to be constructed from scratch using the available economic data, including:

- the recently completed (first) ABS survey of private sector activity in Norfolk Island;[4]
- financial statements from the Norfolk Island Administration;
- the Commonwealth Grants Commission study into the financial capacity of Norfolk Island;[5] and
- IO tables developed for other 'tourism based island economies'.[6]

Data was also obtained from stakeholders during the consultation phase of the project and over subsequent weeks.

The resulting IO table identified 18 sectors of economic activity, 5 areas of final demand, 2 factors of production, and 15 types of indirect taxes and subsidies (see table 2.1). The IO table also tracked dividend payments made by various government business enterprises (GBEs) and NIG fee for service activities.

[3] For an example of an input-output (and other associated tables), see ABS 2006, *Australian National Accounts: Input-Output Tables — Electronic Publication, 2001-02 Preliminary*, Table 2, Cat no. 5209.0.55.001, ABS, Canberra.

[4] See ABS 2006, *Norfolk Island Business Statistics 2004-05*, Cat. No. 8139.0, ABS, Canberra.

[5] See CGC 2006, *Review of the Financial Capacity of Norfolk Island 2006, Staff Paper — Supporting Information*, CGC, 2006, pp. 137–42.

[6] The source for these other broadly comparable IO tables was database 6 of the Global Trade Analysis Project (GTAP). GTAP database 6 has a 57 sector IO table for region 'Rest of Oceania', which includes the economies of the Cook Islands, Fiji, Nauru, New Caledonia, Norfolk Island, Papua New Guinea, (Western) Samoa, Solomon Islands, and Vanuatu, among others.

2.1 **Structure of the Norfolk Island economy model**

Sectors of economic activity	*Areas of final demand*	*Factors of production*	*Indirect taxes and subsidies*
Agriculture, forestry, fishing	Consumption	Labour[c]	Absentee Landowners Levy
Mining, construction, maintenance	Government	Capital	Accommodation Levy
Manufacturing	Investment		Company fees
Trade	Exports		Departure fees
Accommodation	Imports		Financial Institutions Levy
Cafes, restaurants			Fuel Levy
Clubs			Liquor Licence fees
Tour operators			Land Title fees
All other industries			Stamp duty on cheques
Dwellings			Tattersalls lotteries
Electricity			Vehicle registration, licences
Communications			Customs Duties
Liquor bond			Norfolk Sustainability Levy
Lighterage			NI Government subsidies
Healthcare			Aus Government subsidies
Other government[a]			
Norfolk Island Government[b]			
Australian Government (on Island)			

[a] Includes areas of economic activity such as Norfolk Island airport, Water Assurance Fund, KAVHA Fund, Museums, Workers Compensation Fund, Cascade Cliff Rock Enterprise, Offshore Finance Centre, Gaming Enterprises and the Tourism Bureau. [b] Includes core government responsibilities such as education, law and order, policy formulation etc. [c] Costs associated with labour have been disaggregated into the component parts of wages and salaries, other staff entitlements (half airfares and the like), superannuation contributions, and workers compensation contributions.

Source: CIE developed input-output table of the Norfolk Island economy.

The quality of the underlying data

The accuracy of the modelling results is highly dependent on the quality of the data in the underlying database. During construction of the IO table it became apparent that there were some data 'irregularities' and that some widely held 'perceptions' were not entirely supported by the available data. As is shown by the in depth example below, such irregularities may influence the economic impacts of extending Commonwealth legislation to Norfolk Island.

An example of a data irregularity — determining average wage rates

A minimum (adult) wage of $8.50 per hour is legislated on Norfolk Island. Rolling out Commonwealth legislation to Norfolk Island could therefore impact on the local labour market if wages of $8.50 were being paid and the Australian legislation stipulated a higher minimum wage. Hence there is a need to know what the average wage rate is.

The average wage has been determined using publicly available and 'official' data, such as the ABS survey of business activity on Norfolk Island and the Government's financial accounts. In 2004-05, workers' compensation premiums totalled $314 891 (the premium is based on $0.20 per hour worked). Of this amount, $80 826 was paid by the government sector (the

Administration, GBEs etc). At a premium of $0.20 per hour, the government's workers' compensation premium equates to just over 404 000 hours of labour. From the government's financial accounts, we know employee remuneration totalled $9.3 million, or around $8.7 million after superannuation is excluded.[7,8] Given these figures, the hourly wage rate for employees in the government sector is $21.44 (on average). Note that this average masks some quite substantial variation between wage rates across the various areas of government. For example, the hourly wage rate in Postal services is nearly $18, while in the Legislative Assembly it is nearly $56 per hour.

The private sector's workers' compensation contribution was $234 065 in 2004-05 (given by total contributions minus public sector contributions). This is equivalent to 1.17 million hours of work. The ABS identified total wages being $17.24 million, giving an average hourly wage of $14.73.[9]

It was suspected that private sector wage rates would vary across sectors, so an attempt was made to derive sectoral wage rates. Unfortunately, the ABS did not separately identify workers' compensation payments made by each industry. Instead, the ABS reported 'Other compensation of employees', which includes workers' compensation premiums and superannuation contributions. Hence there is a need to split out the workers' compensation contributions for each industry.

The ABS reported that, in aggregate, the private sector's contributions to workers' compensation and superannuation totalled $290 000.[10] From above we know that the private sector's workers' compensation premium totalled $234 065; superannuation contributions are therefore equal to $55 935. The workers' compensation premium therefore accounts for nearly 81 per cent of the ABS's 'Other compensation of employees' category. This share was used to split out the workers' compensation payment for each private sector activity identified in the IO table. Results of the analysis are presented in table 2.2.

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[7] In splitting total employee remuneration into its component parts of wages/ salaries and superannuation, it was assumed that the average superannuation contribution was equivalent to 6.5 per cent of wages.

[8] The wage bill figure comprises wages/salaries paid to NIG employees only. As such, it excludes around $1.8 million in wage payments made to teachers at the Norfolk Island School, who are, strictly speaking, employees of NSW Education.

[9] See ABS 2006, *Norfolk Island Business Statistics 2004-05*, Cat. No. 8139.0, ABS, Canberra, table 1.

[10] See ABS 2006, *Norfolk Island Business Statistics 2004-05*, Cat. No. 8139.0, ABS, Canberra, table 2.

2.2 **Calculating private sector wage rates**

Sector	*Wages*	*Workers' comp.*	*Hours of work*	*Wage rate*
	$	$	Hours	$/hour
Agriculture, forestry, fishing	304 000	7 264	36 320	8.37
Mining, construction, maintenance	1 574 000	19 371	96 854	16.25
Manufacturing	576 000	8 071	40 356	14.27
Trade	5 148 000	43 584	217 922	23.62
Accommodation	2 533 000	28 249	141 246	17.93
Cafes, restaurants	1 871 000	20 178	100 890	18.54
Clubs	808 000	8 071	40 356	20.02
Tour operators	1 348 000	22 599	112 997	11.93
All other industries	3 080 000	76 676	383 382	8.03
Total all private sector industries	17 242 000	234 065	1 170 324	14.73

Source: CIE calculations based on ABS data.

As can be seen, the calculated hourly wage rates range between just over $8 and nearly $24. There are two 'issues' with the hourly wages reported in table 2.2. Firstly, there are some wages below the legislated minimum of $8.50 per hour. This may be explained by a relatively high share of persons employed being under 18 years of age, and hence not subject to the $8.50 minimum wage.

Secondly, for some sectors, such as Trade, the hourly wage is unexpectedly high. During the stakeholder consultations retailers suggested that staff received around $15–17 per hour. If we assume that the ABS wage figure of $5.148 million is correct, then the high hourly wage rate can only result from too few hours of work being calculated, which in turn necessitates an underpayment of the workers' compensation premium in some sectors.[11] Indeed, financial details for one retailer provided to CIE suggest that only around 71 per cent of the liable workers' compensation premium is actually made. Such underpayment could be achieved through not revealing the true amount of time employees spend working. In the absence of income tax returns, it would be virtually impossible for the Government to verify that the correct workers' compensation payments are being made.

What does apparently too high wage rates in the private sector mean for the economic modelling? Firstly, and in terms of rolling out Australian minimum wages to Norfolk Island, the change in wages on island may potentially be understated. Secondly, underpayment of premiums may have some impact on the financial sustainability of the government, which will have a bearing on the rate at which the Norfolk Sustainability Levy

[11] Even if we assume all of the ABS's 'Other compensation of employees' was a contribution to workers' compensation, the average hourly wage in the Trade sector falls to just over $19.

(NSL) needs to be set so as to bridge any revenue shortfalls. (The same logic would extend to underpayment of other indirect taxes/charges.)

However, in the absence of better data, all we can use is the information that is currently available and officially endorsed.

The key observation to take from this example is that there are some apparent irregularities with the data. As the model of the Norfolk Island economy is driven by the underlying database, it is possible that these irregularities will have some impact of the modelling results. *However, in the CIE's view the data issues are not significant enough to change a result from being positive to negative, from being small to large or vice-versa.* Hence while more comprehensive data is always preferable, the data available is of sufficiently high quality to enable generation of accurate modelling results.

The baseline

The IO table, and hence model of the Norfolk Island economy, is based on 2004-05 data. It is assumed that Commonwealth legislation is rolled out to Norfolk Island on 1 July 2007 (or later in the event that any legislative changes are phased in overtime). Quantifying the economic impact of the legislative changes therefore requires knowing what the Norfolk Island economy looks like in 2007 and beyond.

The 'baseline' represents the business-as-usual scenario — that is, what can we expect to happen in the Norfolk Island economy in the absence of Australia extending Commonwealth legislation? The baseline needs to encompass views about the future structure of the economy and include other (relevant) policy decisions. For example, in July 2006, the Norfolk Island Government introduced the (compounding) Norfolk Sustainability Levy (NSL), which is a broad consumption based tax. Hence the baseline will need to include the NSL.

In constructing the baseline, various assumptions have had to be made about:

- tourism numbers and tourist spend;
- government (including GBEs) expenditure forecasts; and
- the rate at which the NSL is set and the future of other taxes.

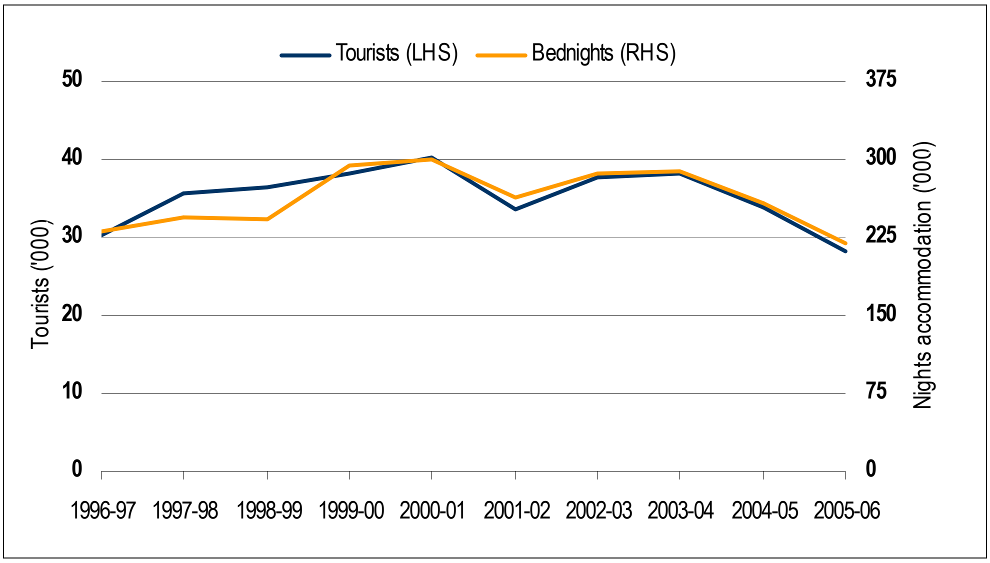
The assumptions made under each of these areas are discussed below.

Tourism numbers and spend

As can be seen in chart 2.3, tourism numbers have been steadily declining since 2000-01, when some 40 200 tourists visited the Island. The marked decline in tourist numbers in 2001-02 — a decline of 16.5 per cent on the previous year's figure — is probably attributable to a fall in tourist confidence following the September 2001 terrorist attacks in the United States. However, since 2003-04 when tourism numbers had recovered to 38 317, there has been a substantial decline in tourism numbers. In 2005-06, only 28 219 tourists visited the Island, which is 70 per cent of the peak figure obtained in 2000-01.

In the baseline it has been assumed that tourism numbers stabilise at 30 000 per year, with each tourist spending 7.6 days (on average) on Island. We note that some of the recent decline in tourism numbers could be attributed to the well documented airline difficulties, notably the collapse of Norfolk Jet in July 2005. With OzJet scheduling seven flights weekly between Australia and Norfolk Island, there is renewed optimism that tourism numbers will increase.[12]

2.3 **Tourism numbers**



Data source: Norfolk Island Tourism Bureau statistics.

[12] OzJet flies from Brisbane and Sydney to Norfolk Island on Wednesdays, Saturdays and Sundays. In August 2006 OzJet introduced an additional Sydney to Norfolk Island flight on Fridays. It is not known as this stage whether the Friday flight will be permanent. In addition to the flights to/from Australia, there are also 2 weekly services between Norfolk Island and New Zealand.

CIE agrees the more frequent flights to Norfolk Island can only help the tourism industry. However, we are not immediately convinced that greater carrying capacity will necessarily equate to greater tourism numbers in the absence of other reforms or additional marketing exercises. For example, stakeholders noted that:

- there were not enough resorts of high quality;
- resorts were typically too small to benefit from scale economies;
- there are policy impediments to successful accommodation businesses growing; and
- there are divergent views (amongst stakeholders) as to which tourist market Norfolk Island should be targeting (baby-boomers, retirees etc).

For these reasons, we hold tourism numbers constant at 30 000 per annum. In chapter 6 sensitivity analysis is conducted around tourist numbers to see how sensitive the modelling results are to assumptions about the number of tourists.

It is estimated that in 2004-05, tourists were directly responsible for around $55.1 million worth of expenditure (see table 2.4). This is equivalent to $1 638 per tourist, or $215 per tourist 'day' spent on Island.[13]

2.4 **Tourist spend** 2004-05

Area of expenditure	*Total expenditure*	*Share attributed to tourists*	*Tourist expenditure*	*Spend per tourist*
	$	%	$	$
Accommodation	13 177 000	100	13 177 000	391
Retail	39 675 000	70	27 772 500	823
Tour operators	4 619 000	100	4 619 000	137
Cafes etc	6 663 000	71	4 750 166	141
Clubs	2 931 000	50	1 465 500	43
Liquor Bond[a]	1 057 863	100	1 057 863	31
Fuel[b]	366 200	100	366 200	11
Airport[c]	1 739 670	100	1 739 670	52
Tourism Bureau[d]	86 452	100	86 452	3
Museums[e]	238 411	100	238 411	7
Total	70 553 596	78	55 272 762	1 638

[a] Sales to tourists obtained from Liquor Bond monthly sales accounts. [b] Tourists assumed to account for 10 per cent of fuel sales to the private sector (calculated to be 1.8 million litres of fuel, based on the fuel excise raising $366 200 at $0.20 per litre) and a pump price of $2 per litre. [c] Airport income from landing fees and security screening charges attributed to tourists based on the share of departure fees accounted for by tourists (93.6 per cent) [d] Sales by the Visitors Information Centre. [e] Includes museum entry tickets, souvenir shop sales and entry tickets to Trail of Fifteen Play.

Source: CIE calculations based on ABS 8139.0, the Administration of Norfolk Island Financial Statements 2004-05, and information provided during stakeholder consultations.

[13] During 2004-05 there were 33 742 tourist to Norfolk Island, who spent 257 032 days on island. On average, each tourist spent 7.62 days on island.

With inflation on Norfolk Island running at nearly five per cent per annum over the last five years, tourist spend would need to increase by five per cent each year just to hold real expenditure constant. While there is an absence of time series data, we are not sure that tourist spend has been increasing, even in nominal terms. If anything, it has been going in the opposite direct — numerous stakeholders provided anecdotal evidence that spend per tourist was falling.[14] It has been assumed in the baseline that tourism marketing etc is successful in reversing this occurrence, with tourist spend being held constant at $215 (real 2004-05 dollars) per tourist day spent on island.

Government expenditure

The public sector (and its GBEs) accounts for nearly 30 per cent of GDP. Given the importance of the public sector to the Norfolk Island economy, the baseline needs to take into account (expected) future outlays in wages, and recurrent and capital expenditure. The later area is especially important if claims of 'under investment in infrastructure/asset management' are to be addressed. Future expenditure also has implications for government (and GBE) revenue needed so as to enable that expenditure to be funded. Ultimately, any shortfall between expenditure and revenue from existing taxes/charges will need to be made up (see Norfolk Sustainability Levy below).

The NIG was asked to provide expenditure forecasts for both general government activities and those of its GBEs. Unfortunately, this data does not appear to be readily at hand.[15] Part of the difficulty in obtaining budget forecasts may lie in Norfolk Island only having recently commissioned an Asset Management Plan (AMP) to advise on required government capital outlays.[16] As the (draft) AMP was only delivered in early 2006, the NIG may not have had sufficient time to incorporate required capital outlays as identified in the AMP into the budget planing cycle.

On top of this, CIE understands that the NIG disputes some of the required capital outlays. Specifically, the AMP identified that $87 million would

[14] Some stakeholders attribute this to the marketing campaign targeting the wrong type of tourist, and '2 for 1' airline deals resulting in low spending tourists visiting the Island.

[15] The CIE was provided with some budget forecasts, only to be informed at a later date that those forecasts were several years out of date and were not to be relied upon for forecasts of government/GBE expenditure.

[16] See Asset Technologies Pacific 2006, *Administration of Norfolk Island: Summary Report Draft 1 — 15th February 2006*, ATP, February 2006.

need to be spent on roads over 15 years (comprising backlog costs of $32 million, capital costs of $41 million and maintenance costs of $13 million). The NIG (and others on Island) dispute these figures, which consider that required road expenditure is more likely in the vicinity of $26 million. It should be noted that CIE has not been provided with an official NIG position on/critique of the AMP figures.

The issue of the disputed AMP expenditure aside, it was surprising that the NIG and its GBEs did not have up-to-date forecasts of future expenditure (and revenue required to fund that expenditure). Given the absence of such data, it is not immediately clear that an effective strategy for managing infrastructure planning over the longer term is in place.

The absence of expenditure forecasts and an official NIG position on required infrastructure expenditure put forward in the AMP plan has made specifying the baseline in terms of NIG activity difficult. In generating the baseline, we have no option but to use the NIG budgetary forecasts provided to the CIE (which are apparently three years out-of-date) for future government wage and recurrent expenditure and expected dividend payments.

However, in cases where consultation with Administration staff have suggested more up to date future expenditure requirements, such as in the areas of health and welfare, then those estimates have been used.[17]

This may see, for example, increased expenditures in the areas of welfare and health (due to an aging population) being too conservative and understated.

The CIE is not in a position to be able to critique the required infrastructure expenditure as outlined in the AMP, hence the figures in the AMP are taken to be correct. As we do not know if the NIG will meet the time profile of expenditure requirements outlined in the AMP, for simplicity, it has been assumed that the infrastructure spend is spread evenly across the 15 years covered by the AMP. This sees the NIG and its GBEs spending nearly $9 million per year on backlog works, maintenance and new capital (see table 2.5). It is also assumed that the infrastructure costs are fully paid in the year in which the expense is incurred.[18]

[17] Administration staff suggested that due to the ageing population, future increases in health and welfare expenditures of 10 per cent per year are expected (or have recently been observed). Hence in the modelling, health and welfare expenditure is increased (annually) by 10 per cent.

[18] This likely over simplifies the situation, and may lead to too large a revenue raising requirement. For example, the NIG could (presumably) borrow to fund

Backlog works over the 15 year period of the AMP total $33 million. The vast majority of this expenditure (some $32.6 million) is capital refurbishment, which ultimately adds to the capital stock (in addition to new capital replacement/investment) and whose depreciation will need to be funded.

2.5 **Assumed annual infrastructure expenditure in the baseline**

Area of government	*Backlog*	*Maintenance*	*Capital*	*Total*
	$	$	$	$
Electricity	753	94 253	537 747	632 753
Communications[a]	1 936	100 014	122 733	224 683
Liquor bond	251	24 621	13 158	38 030
Lighterage	1 047	5 483	5 068	11 597
Health	5 467	48 547	102 737	156 750
Other GBEs	11 720	279 827	1 527 607	1 819 153
Norfolk Island Government	2 179 088	1 092 053	2 824 362	6 095 503
Total	2 200 261	1 644 798	5 133 411	8 978 471

[a] An additional $1 million has been added to the AMP's telecommunications expenditure estimates to reflect Norfolk Telecom's post AMP decision to roll out a mobile network.

Source: CIE calculations based on required infrastructure expenditure as specified in the AMP.

Norfolk Sustainability Levy

In July 2006 the NIG introduced the Norfolk Sustainability Levy, which is a broad-based (and compounding) consumption tax. The NSL was introduced for the purpose of broadening the tax base, and, depending on the success of the revenue raising exercise, remove/reduce some other indirect taxes.[19] These include Customs Duty (on goods intended for re-sale), the Accommodation Levy, Financial Institutions Levy and Departure Fees. The NSL has initially been set at a rate of 1 per cent (of gross revenue), with the future rate and a decision on removal of other taxes being subject to review (expected to be undertaken in late 2006).

The issue of the NSL, and whether it will be used to replace other indirect taxes, has been problematic. Despite numerous stakeholders indicating that they thought other taxes would be removed with the introduction of the NSL, and even though the NIG citied this prospect as a rationale for introducing the NSL, there has been little comment since August 2005 on the future of other taxes.

its infrastructure expenditure, and then repay the loan over an extended period. Through repaying the loan over say 30 years, (ideally) the economy will have grown over this time therefore giving a larger economy/tax base with which to fund future loan repayments.

19 See *Norfolk Sustainability Levy Bill 2005, Explanatory memorandum and impact of legislation*, August 2005.

Indeed, recent events (and a new Finance Minister) have indicated a change in thinking. Specifically, the NIG has recently announced its intention to raise import duties on all goods (excluding food, fuels, alcohol, tobacco and vehicles) from 10 per cent to 13 per cent — a 30 per cent increase in duty. The move to increase import duty contradicts some of the intentions underpinning the introduction of the NSL.

Given this, it is assumed that the current regime of indirect taxes remains in place and at current rates. This sees, for example, the import duty on goods being kept at 10 per cent. The economic model has been used to determine the rate at which the NSL needs to be set so as to balance government expenditure (see above) with government income. That is, revenue raised via the NSL meets any revenue shortfall.

The economic modelling suggests that the NSL needs to be set at 7 per cent in 2006-07, increasing to 12.3 per cent in 2016-17 in order to allow the NIG to meet its expenditure needs.[20]

[20] Note that after 2016-17, the NSL needs to increase significantly each year due to rapidly growing health and welfare costs increasing faster than GDP.

3 Legislative changes — taxation

DIRECT TAXATION is one of the fundamental differences between Norfolk Island and Australia. Currently, Norfolk Island has virtually no direct taxes. It raises revenue through a variety of indirect taxes, some of which would necessarily be replaced if Commonwealth legislation were extended to Norfolk Island.

It should be pointed out that while Norfolk Island does not currently have a system of direct taxation, its citizens (and those visiting the Island) do pay taxes. For example, in 2004-05 the NIG raised $7.9 million in taxes, or nearly $4 000 per capita (excludes fee for service type charges). If the abnormally large dividends that the NIG is obtaining from (some of) its government business enterprises (GBEs) and the levied 'management fee' are acknowledged as taxes, then taxes per capita exceeds $4600.[21]

Generally, the extension of Commonwealth legislation would include the introduction of:

- income tax for individuals;
- Medicare levy (and the Medicare levy surcharge);
- income tax for business (including company tax);
- goods and services tax (GST);
- fuel, alcohol and tobacco excises; and
- tariffs.

Excise duties apply to specified goods regardless of whether they are produced or manufactured in Australia or imported into Australia.

This chapter discusses the changes arising from extending Commonwealth tax legislation to Norfolk Island and describes how CIE have modelled the effects.

[21] This figure is based on the GBEs earning an appropriate, rather than abnormally high, rate of return to capital.

Income tax (including the Medicare levy) for individuals

Australia levies direct income tax on all individuals who earn income in Australia and who are deemed a resident for tax purposes. Australia's progressive income tax rates are shown in table 3.1.

3.1 **Tax rates for 2006-07**

Taxable income	*Tax on this income*
$0 to $6 000	Nil
$6 000 to $25 000	15 cents for $1 over $6 000
$25 001 to $75 000	$2 850 plus 30 cents for each $1 over $25 000
$75 001 to $150 000	$17 850 plus 40 cents for each $1 over $75 000
Over $150 000	$47 850 plus 45 cents for each $1 over $150 000

Source: ATO (2006), 'Individual income tax rates', http://www.ato.gov.au/individuals/content.asp?doc=/content/12333.htm&mnu=11485&mfp=001/002, Accessed September 2006.

Medicare levy and Medicare levy surcharge

Medicare is the scheme that gives Australian residents access to health care. It is partially funded by contributions from individual taxpayers via a Medicare levy. The Medicare levy is 1.5 per cent of an individual's taxable income.

The Medicare levy surcharge applies to high-income individuals who do not have private patient hospital insurance. If an individual earns over $50 000 and does not have approved private patient hospital insurance then they are liable for a surcharge of 1 per cent of their taxable income.

Changes to Norfolk Island legislation

Norfolk Island does not levy individuals with income tax.

Extending the Medicare Levy to Norfolk Island would replace the existing health care funding arrangements levied on Norfolk Islanders.

Currently, Norfolk Island partially funds its health care through a health insurance levy, which is levied upon every adult on the Island (except welfare recipients). The levy is a fixed fee of $125 paid quarterly. There is also an additional levy of $25 per quarter that covers medical evacuations. Hence over the course of a year, each adult would pay $600 in Norfolk Island health care premiums. Under the Medicare regime an individual would have to earn $40 000 per annum before incurring a health care levy of $600.

The levy goes to Norfolk Island's Health Care Fund. The Health Care Fund provides covers for many medical costs once a family spends in excess of $2500 on medical treatments in a year. In 2004-05 there were around 100 families that exceeded the $2500 threshold.

Design of modelling simulation

Australia has a progressive income tax regime. This means we need to know the income of each (working) person to determine the applicable income tax rate. Unfortunately, this data is not directly available.

The 2001 Census does, however, allow an income distribution profile to be established.[22] This distribution profile was 'fitted' around average weekly income in 2004-05 (calculated to be $467). To the derived income profile for 2004-05, Australian income tax rates for 2006-07 were applied and allowances made for tax offsets (low income, zone and dependents). From this, an implied average income tax rate of 9.8 per cent was calculated. In the economic modelling a tax rate of 9.8 per cent is levied on wages economy wide. The Medicare Levy is incorporated in the implied tax rate.

With the introduction of Medicare, the Norfolk Island Health Care Fund becomes redundant, and hence adults do not have to be levied with an annual levy of $600. This results in a cost savings to households of $749 321.

Income tax for business

Businesses in Australia are liable for income tax. Taxable income is the difference between assessable income and allowable deductions. It may differ from the method used by businesses to calculate their profit.

Assessable income includes most money received in carrying on a business. The main exceptions are:

- loans received;
- equity contributed by the owner(s); and
- GST collected or GST credits.

Allowable deductions include most expenses incurred through the normal operations of the business. Generally, businesses can claim:

[22] See Administration of Norfolk Island 2001, *Norfolk Island Census of Housing and Population 7 August 2001: Statistical report on characteristics of population and dwellings*, Administration of Norfolk Island, October 2001, table I5.

- an immediate deduction for expenses necessary for the regular operation of the business; and
- a deduction over a number of years for the decline in value (depreciation) of other expenses, for example, most capital assets.

There are some payments that business make that are not considered allowable deductions. These include:

- loans made by the business;
- money drawn or borrowed from the business by the owner;
- private or domestic expenses; and
- GST (if it is claimed as a credit on the business' activity statement).

Income tax rates for individuals (see table 3.1) are also applicable for some types of businesses including:

- sole traders;
- partners in partnerships;
- most beneficiaries of trusts; and
- an individual as an employee of their own trust or company.

The income tax rate for companies is 30 per cent. There are no thresholds or variations in the tax rate for companies.

All Australian companies must be registered through the Australian Securities and Investment Commission (ASIC). For tax purposes a company is defined as an incorporated or unincorporated body or association. The definition does not include partnerships or non-entity joint ventures. A company is a distinct legal entity and pays tax under the company's name.

Current arrangements on Norfolk Island

Norfolk Island does not tax business income.

Design of modelling simulation

Australia's income tax for companies is designed as a tax on capital equivalent to 30 per cent tax on a company's net operating surplus. Net operating surplus, which is essentially net profit, is defined as income less expenditure, interest and depreciation.

The remaining businesses (self-employed, partnerships and trusts) pay income tax based on the individual tax rates. The CIE analysed average income for non-company businesses on the Island. It was determined that the average net operating surplus meant that the implied tax rate for sole traders etc would be 17.5 per cent.

As information was not available on incorporated companies by sector, a weighted average of the two tax rates was calculated an applied to all businesses operating on the Island. The weighted average rate of taxation of 20.2 per cent was applied to businesses (including GBEs) operating on Norfolk Island.[23]

Goods and Services Tax

The Goods and Services Tax (GST) is a broad-based tax of 10 per cent on most goods, services and other items sold or consumed in Australia. Most basic food for human consumption is GST-free. Medical services are also GST-free if a Medicare benefit is payable for the service or if a medical or approved pathology practitioner performs the service.

Businesses accumulate input tax credits for any GST paid/incurred by the business. Hence ultimately, it is only end users (such as households) that incur the GST.

In Australia GST revenue is collected by the Australian Tax Office but distributed to the states. Every Australian state (and territory) would need to acquiesce to the inclusion of Norfolk Island in the distribution of GST revenue for the Island to receive such revenue. Assuming this is the case, the revenue redistributed back to Norfolk Island is likely to be higher than the revenue raised on Norfolk Island.

Changes to Norfolk Island legislation

If the GST is extended to Norfolk Island it would replace some existing taxes. In particular, the Norfolk Sustainability Levy (NSL), which the Norfolk Island Government recently began trialing, would be abolished.

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[23] Note there might be some incentive for some businesses currently incorporated on Norfolk Island to change their structure to benefit from a lower average rate of income tax. If this were to occur it would reduce the weighted average tax rate used for this analysis.

Design of modelling simulation

GST was calculated as an ad valorem tax on sales to households and exports by various sectors of Norfolk Island's economy. The rates for each sector differ because the GST is not levied on food or most medical services. The GST rates for each sector are shown in table 3.2.

The share for retail trade was determined by calculating the share of GST-free food as a share of total retail trade turnover. Primary produce was based on import data provided by Norfolk Island Customs. Adjustments were made to the FOB value of GST-free food imports to account for freight and retail markup. The share of retail trade that was attributable to primary produce was 3.8 per cent. The weighting of non-GST goods as a proportion of goods sold in the retail sector makes the effective GST rate for retail trade 9.6 per cent.

For modelling purposes, the GST revenue raised on Norfolk Island goes to the Australian Government (that is to say, it is not directly returned to the Norfolk Island Government).

3.2 **Effective rates of GST, by sector**

Sector	*Effective rate of GST*
Agriculture, forestry and fishing	0.0
Mining, construction & maintenance	10.0
Manufacturing	10.0
Retail trade	9.6
Accommodation	10.0
Cafes, restaurants	10.0
Clubs	10.0
Tour operators	10.0
All other industries	10.0
Dwellings	0.0
Electricity	10.0
Communications	10.0
Liquor bond	10.0
Lighterage	10.0
Health	0.0
Other GBEs	10.0
Government	10.0

Source: CIE estimates.

Fuel excise

Australia levies a fuel excise (at differing rates) on all fuel and fuel related products used in non-stationary engines. The rates of duty vary depending on the nature of the fuel or the purpose for which it is to be used (see table 3.3).

3.3 **Fuel excise rates in Australia**

Fuel	*Rate of duty*
Fuel[a], for use as fuel in an aircraft	$0.02854 (per litre)
Fuels[b], for other use	$0.38143 (per litre)
Petroleum-based oils and their synthetic equivalents (including recycled oil)	$0.5449 (per litre)
Petroleum-based greases and recycled greases	$.05449 (per kg)

[a] Includes kerosene and gasoline. [b] Includes kerosene, heating oil, gasoline, diesel, biodiesel, denatured ethanol, fuel oil, crude petroleum oil, petroleum condensate and other refined or semi-refined petroleum products.

Source: ATO (2006), 'Excise duty rates', http://www.ato.gov.au/businesses/content.asp?doc=/content/4085.htm&page=5&H5, Accessed September 2006.

Changes to Norfolk Island legislation

The Australian excise duty on fuel would replace the Norfolk Island fuel levy. (Norfolk Island also levies fuel imports with an import duty of 10 per cent. This duty would be removed following application of the Australian tariff schedule to Norfolk Island.) Currently, the Norfolk Island's fuel levy is $0.20 per litre at the bowser, and is only paid by the private sector and households/tourists.

The electricity generator and other government vehicles are not liable for the levy (or the duty on fuel). Following extension of Commonwealth legislation, the general government sector and any government businesses on Norfolk Island would be liable to pay the fuel excise.

Design of modelling simulation

The amount of fuel used by each sector of the economy was determined based on estimates of fuel use. For the private sector and areas of final demand (households, tourists) total fuel use — 1.8 million litres — was known due to $366 200 in fuel excise being raised, at a rate of $0.20 per litre. Dividing the former by the latter gives us total fuel use by the non-government sectors (1.8 million litres). This fuel use was then spread across the private sector and households and sales to tourists.

From Norfolk Island Customs total fuel imports were obtained (1.5 million litres of petrol and 2.7 million litres of diesel). As the private sector and households/tourists used 1.8 million litres of fuel, 2.4 million litres of fuel must be used by the government sectors. This was then allocated across the various government sectors (and GBEs). The Norfolk Island Electricity Service accounted for the majority of this fuel use (some 2.3 million litres of diesel).

The simulation removes Norfolk Island's fuel excise of $0.20 per litre, and replaces it with Australia's fuel excise of $0.38341 per litre. Any sectors that rely on transport would be impacted through the change in the price of fuel, which either raises their input costs or raises the price for the sectors of final demand. Note that as the Norfolk Island Electricity Service's generators are stationary, diesel fuel used by the NIES remains excise free.

The revenue from the fuel excise goes to the Australian Government, with the Norfolk Island Government losing its fuel-related revenue ($366 200 in 2004-05).

Alcohol and tobacco excises

Alcohol and tobacco excises in Australia are generally set at fixed rates. For example, different strength beers are levied with excises ranging between $20.39 and $37.90 per litre of alcohol (note that the first 1.15 per cent of alcohol content in beer is duty free). Ultimately, the rate of excise is based on the quantity of alcohol or tobacco content within a product.

The exception to the fixed rate excise is wine. Wine has an ad valorem duty of 5 per cent plus a Wine Equalisation Tax (WET) of 29 per cent. These are both levied on the wholesale price of wine.

The tobacco excises is calculated on the tobacco content of the product or the number of cigarette sticks. The rate of the tobacco excise is $298.01 per kilogram of tobacco content. For cigarettes with 0.8 grams or less of tobacco content the tobacco excise is $0.2384 per stick.

Changes to Norfolk Island legislation

Norfolk Island does not impose alcohol or tobacco excises (instead, import duties are levied on these products). Extending Commonwealth alcohol and tobacco excises (and WET) would replace some of Norfolk Island's tariffs. Norfolk Island uses ad valorem tariffs on alcohol and tobacco imports. The rates for Norfolk Island's alcohol and tobacco tariffs are provided in table 3.4.

Norfolk Island has one domestic producer of wine, but no other significant manufacturers of alcohol or tobacco products.

3.4 **Tariffs for Norfolk Island alcohol and tobacco products**

Product	*Norfolk Island tariff (%)*
Beer	20
Wine	25
Spirits	30
Tobacco products	500

Source: Norfolk Island Customs.

Design of modelling simulation

As Norfolk Island does not currently have alcohol or tobacco excises, application of Commonwealth legislation sees the Australian excises being applied. (Note that extending Australia's tariff schedule to Norfolk Island would see the current import duties levied on beer, wine, spirits and tobacco being removed. The issue of import duties is addressed further below).

For modelling purposes, the excise has been converted to an ad valorem rate. The ad valorem equivalent of the alcohol excise was estimated based on the alcoholic content for a generic type of beer, wine and spirit using Australia's alcohol excise rates. It uses alcohol import volumes provided by Norfolk Island Customs to weight beer, wine and spirit consumption for a generalised alcohol excise equivalent tariff. The alcohol excise equivalent tariff is calculated to be 84 per cent. In the modelling, the cost of alcohol purchased by the Liquor Bond is increased by 84 per cent. (Note that as a result of moving to Australia's tariff schedule, any increase in the cost of alcohol imports will be partially offset when Norfolk Island's high alcohol tariffs are removed.)

The tobacco excise equivalent tariff rate is calculated based on the volume of tobacco product imported on Norfolk Island.[24] Australia's tobacco excise is calculated to increase the rate of duty for tobacco by 451 per cent compared with the baseline. In the modelling it is assumed that all tobacco products are purchased by the retail sector. The effect on the sector is calculated by multiplying tobacco's share of retail turnover by the percentage change in costs due to the effective tariff rate. In the model, Australia's tobacco excise translates to a 3.3 per cent increase in the cost of purchases by the retail trade sector from the manufacturing sector. (Note that, as with alcohol, moving to Australia's tariff schedule will partially offset the tobacco excise because Norfolk Island's tariff on tobacco is removed).

[24] Provided by Norfolk Island Customs.

Revenue previously raised by Norfolk Island tariffs on alcohol and tobacco is eliminated. Revenue from the alcohol and fuel excise is transferred to the Australian Government.

Import tariffs

Australia has undergone a process of removing or dramatically lowering many of its tariffs. The average Australian import duty in 2006 is 3.5 per cent (excludes excises). Additionally, Australia has trade and investment agreements with the following countries:

- New Zealand;
- United States of America;
- Thailand; and
- Singapore.

Merchandise imports from these countries are, or will be at some point in time, duty free. Australia is currently negotiating trade agreements, or considering entering into negotiations with Malaysia, other ASEAN members, China, Japan and Korea.

Changes to Norfolk Island legislation

In contrast to Australia, Norfolk Island imposes comparatively high tariffs. For example, in 2004-05 the average tariff was 10.4 per cent. Moreover, there is some indication that Norfolk is seeking to increase its tariff with the Norfolk Island Government approving a bill to increase the general tariff rate from 10 to 13 per cent.

Should Australia's Customs and Customs Tariff Acts be applied to Norfolk Island they would replace the existing tariff regime. The current Norfolk Island tariff schedule is reproduced in table 3.5. Furthermore, under the Australian tariff regime the vast majority — some 87 per cent — of imports into Norfolk Island will be duty free, as these products originate in either Australia or New Zealand, and hence will not attract import duty.

3.5 **Norfolk Island tariff schedule**

Good or product	*Norfolk Island*
	% (unless otherwise stated)
Goods – food or live animals	6
Seed potatoes	6
Butane gas	6
Fuel	10
Beer	20
Wine	25
Spirits	30
Tobacco products	500
Motorcycles	15
Passenger motor vehicles - new	15 (or $1000, whichever is greater)
- used	15 (or $1000, whichever is greater)
Other motor vehicles	5 (or $1000, whichever is greater)
All other goods (general tariff)	10

Source: Norfolk Island Customs.

Design of modelling simulations

All of Norfolk Island's existing tariffs are removed. They are replaced by the Australian tariff schedule, with effective rates of duty determined for different sectors of the Norfolk Island economy based on analysis of import data provided by Norfolk Island Customs. As only four 'merchandise sectors' have been identified in the economic model, only four aggregate tariff rates have been calculated (see table 3.6).

3.6 **Effective tariff rates on Norfolk Island**

Sector	*Norfolk tariff*	*Australian tariff*[a]
	%	%
Agriculture, forestry and fishing	7.8	0.39
Mining, Construction, Maintenance	0.0	0.42
Manufacturing	10.6	3.74
Liquor	25.4	0.0

[a] Note these rates exclude Australia's excise on fuel, alcohol and tobacco as these are contained in a separate modelling simulation.

Source: CIE estimates.

4 Other legislative changes

COMMONWEALTH LEGISLATION encompasses a broad range of areas beyond taxation. Some legislation will also have substantive economic impacts if it is applied to Norfolk Island. Notable areas where legislation will have major economic impacts include:

- customs, immigration and quarantine;
- superannuation;
- markets, business and corporate conduct;
- workplace relations
- communications; and
- social welfare.

This chapter describes how the application of non-tax Commonwealth legislation will also have economic impacts for the Norfolk Island economy. The responsibilities assumed the Australian Government under the new governance model, and what this means for the (state and local government type) responsibilities to be provided and funded by NIG, is also discussed.

Extending provision of Australian Government services

Applying Commonwealth legislation entails that some current NIG responsibilities will be undertaken (and funded) by the Australian Government. The Australian Government would likely be responsible for funding both the provision and administration of a range of areas, including:

- customs;
- immigration;
- quarantine;
- police;

- some health programs; and
- social security.

For example, the NIG spent $920 839 on social security benefits in 2004-05. If the Commonwealth's social security legislation were extended to Norfolk Island the Australian Government would fund social security payments to Norfolk Island residents. Under the Australian Government system social security payments would increase by $88 622, making the Australian Government's total provision of social welfare just over $1 million. In other words, the $920 839 social welfare responsibility of NIG is shifted to the Australian Government, who both 'picks up the tab' and increase payments.

Customs, immigration and quarantine

Customs, immigration and quarantine regulations will cause a variety of changes to the current operation of the Norfolk Island Government.

Customs

Extension of Australia's customs legislation would mean Australian Customs was responsible for:

- inspecting goods entering Norfolk Island;
- application of Australia's tariff schedule; and
- processing incoming international passengers.

Changes on Norfolk Island

Australian Customs would replace Norfolk Island Customs. It is unlikely that Australian Customs would have the same labour resource requirements as Norfolk Island Customs currently uses. However, some capital infrastructure investment would be necessary if Australian Customs operated on Norfolk Island.

Design of modelling shock

The NIG no longer needs to fund the Norfolk Island Customs service. The Norfolk Island Government expenditure on customs of $358 240 per year is withdrawn from NIG's expenditure requirements. In its place the Australian Government is expected to spend $1.1 million per year on operating costs for the Australian Custom Service (ACS) on Norfolk Island. In addition, ACS would have capital expenditure of $1.3 million in the first year of its operation Norfolk Island.

Migration

Australian law mandates free movement of individuals between Australia's states and territories. Additionally, New Zealand residents can live and work in Australia without restrictions. For non-Australian or non-New Zealand individuals entering Australia visa requirements vary depending upon the nature and duration of the visit and the origin of the visitor. Migration for employment reasons is permitted but subject to a number of conditions. Australia has 'Working Holiday' agreements with a number of countries allowing holders of the appropriate visa opportunities for temporary employment.

Changes to Norfolk Island

Australia's Migration Act would override migration legislation on Norfolk Island. This might mean that some Norfolk Island General or Temporary Entry Permit (GEP, TEP) holders would no longer be eligible to remain on the Island.

Impact on modelling

The Australian Government will perform immigration services on Norfolk Island. This will reduce the NIG's expenditure by $120 570 per year. The Australian Government does not anticipate requiring any permanent immigration officers be stationed on Norfolk Island.

Other impacts of extending the migration act are not explicitly modelled, for example the effect of Commonwealth legislation on current TEP holders. Nevertheless, the model of the Norfolk Island economy does implicitly capture the effects of migration. Internal migration (from Australia and New Zealand residents) is dependent on, among other things, wage rates and the demand for labour on Norfolk Island. The model captures changes in the demand for labour and changes in employment. From this, we can infer changes in migration.

Quarantine

It is unclear how Norfolk Island will be treated under various parts of agricultural and export-related legislation until the Australian Quarantine

Inspection Service (AQIS) undertakes a comprehensive pest and disease survey of the Island. It is expected that the survey might take up to a year to complete.

In the absence of any substantive agricultural or food processing export industries this is unlikely to have an economic impact on the Island. However, Norfolk Island's disease status will affect the designation of Norfolk Island's airport. If the Island is deemed to have a quarantine status equivalent to Australia then flights between Australia and Norfolk Island can depart from domestic terminals in Australia. Departures from domestic terminals generally have a lower cost than departures from international terminals. This could potentially lower the cost of airfares to Norfolk Island.

Changes to Norfolk Island legislation

Australia's quarantine legislation would override equivalent legislation currently in place on Norfolk Island.

Impact on modelling

The Australian Quarantine Services (AQIS) will provide quarantine services on the Island. This will reduce NIG's expenditure by $150 700 per year. AQIS expenditure on Norfolk Island is captured in spending by Australian Customs.

Other effects of extending Australia's quarantine legislation are not explicitly modelled. However, the extension of Australia's quarantine regime may have a profound, albeit indirect, impact on the Norfolk Island economy. If the cost of flights to Norfolk Island is lowered (and the cost reduction is passed on through lower airfares) then it might increase tourist numbers to Norfolk Island. Changes to Norfolk Island tourist numbers are modelled as part of the sensitivity analysis (see chapter 6).

Superannuation

The superannuation guarantee requires that employers contribute 9 per cent of each employee's earnings base to a superannuation fund or retirement savings account. Contributions need to be made at least every quarter.

Changes to Norfolk Island legislation

The Norfolk Island Government Administration is currently the only sector required to make superannuation contributions (to a Provident Fund). The rate of the superannuation contribution is variable depending on the years of service (see table 4.1). Administration employees must also make a mandatory contribution of 5 per cent of their base public sector earnings to the superannuation scheme. The scheme does not permit voluntary contributions from the employee.

A range of private sector businesses on Norfolk Island currently provides superannuation-type payments to employees. The scope and scale of these contributions varies between businesses. It is estimated that across the entire private sector, superannuation payments only totalled $55 000 in 2004-05.

Introduction of the superannuation guarantee will replace Norfolk Island's existing superannuation arrangements.

4.1 **Superannuation contributions for Norfolk Island public service**

Years of public service	***Employer contribution***	***Employee contribution***
	%	%
Up to 12 years	6.0	5.0
12 to 18 years	6.5	5.0
Over 18 years	8.5	5.0

Source: Consultation with Norfolk Island Government Administration.

Design of modelling simulation

Using data provided by the Norfolk Island Administration and the ABS the rate of superannuation was determined for both the private and public sectors of the Norfolk Island economy.

As was discussed in chapter 2, through using the level of private sector contributions to the workers' compensation levy, the CIE was able to determine the level of superannuation contributions. This was compared with the total wages payed by the private sector, indicating that the effective rate of superannuation contribution by the private sector was equivalent to only 0.32 per cent of the wage bill.

The CIE were informed by the NIG that in the public sector superannuation contributions averaged 6.5 per cent.

The impact of Australia's superannuation guarantee was modelled by determining the additional contribution that employers would be required to make. The increase in employer contributions is equivalent to a rise in the wage bill for the:

- private sector of 8.68 per cent; and
- public sector of 2.50 per cent.

Markets, businesses and corporate conduct

Australian legislation would bring a number of changes to the way that both private sector businesses and government business enterprises operate on Norfolk Island. Australia's taxation arrangements and business regulations would generally increase compliance costs for businesses on Norfolk Island. The increase in compliance costs is likely to be more significant in earlier years and diminish in later years. Australia's business regulations are likely to increase corporate accountability on Norfolk Island. Other changes will occur through the introduction of the *Trade Practices Act 1974* (TPA) and the National Competition Policy (NCP).

Trade Practices Act

The TPA aims to promote competition, fair trading and provide consumer protection. The Australian Competition and Consumer Commission (ACCC) supervises the TPA. Australia's TPA covers a wide range of corporate areas, with an aim to improve corporate behaviour. Some aspects corporate governance covered by the TPA include:

- anti-competitive practices;
- unconscionable conduct;
- industry codes;
- unfair practices;
- product safety and information;
- country of origin claims;
- condition and warranties; and
- product liability.

Changes to the corporate conduct of businesses on Norfolk Island

There is no equivalent legislation on Norfolk Island although the TPA might replace some aspects of legislation from a variety of Norfolk Island Acts. The primary impact on business would be an increase in compliance costs, although in most cases this is unlikely to be significant. For example, the current practice by some Norfolk Island businesses of using the phrase 'duty free' when the products are not duty free would no longer be permissible.

Businesses that have a monopoly are likely to be more severely affected by the TPA. In some cases the ACCC might need to regulate prices for some essential services. Government business enterprises are most likely to be affected in this manner.

Additionally, under the NCP, government business enterprises must operate under competitive neutrality principles and have operational separation from the general government sector. This is likely to erode the commercial advantage that currently extends to the Liquor Bond and the current regime of exempting GBEs from Norfolk Island indirect taxes (such as the fuel excise, Financial Institutions Levy etc).

Design of modelling simulation

The primary affect of extending the TPA to Norfolk Island would be to reduce opportunities for monopoly rents by businesses with substantive market power. Presently, some businesses generate a return on capital of more than 65 per cent. The TPA effectively means such a return on capital is unsustainable. The simulation lowers the return on capital in selected sectors of the economy as illustrated in table 4.2. The effect of a lower return on capital is to lower prices of these goods services produced by the sectors (as would be the case if the sector were opened to competition or regulated).

A lower rate of return to capital will have the flow on effect of reducing dividend payments from the GBEs to the NIG. This will see the NIG being required to make up subsequent revenue shortfall elsewhere.

4.2 **Return on capital for selected sectors**

Sector	*Return on capital in modelling simulation*
	%
Electricity	20
Communications	20
Liquor Bond	14

Source: CIE estimates.

Compliance requirements

Businesses are required to register or report for a number of items to comply with Australian legislation. For example, businesses with a turnover greater than $50 000 per year are required to report to be registered for an Australian Business Number (ABN).

Australian legislation entails a number compliance requirements including:

- company registration and reporting requirements with ASIC;
- provision of Business Activity Statements (BAS) to the Australian Tax Office (ATO);
- registering for Pay-As-You-Go (PAYG) withholding; and
- obtaining a tax file numbers (TFN) for some businesses.

Changes to Norfolk Island business reporting requirement

Australian legislation would impose additional compliance and reporting requirements on Norfolk Island businesses. Company registration would no longer be completed by the NIG but by ASIC. The NIG would no longer be able to raise revenue through company fees. Some aspects of Norfolk Island's legislation would still be relevant, for example businesses would still register their names with the Norfolk Island Government.

The Norfolk Island Government raised more than $75 000 revenue via company fees in 2004-05. This would be lost.

Design of modelling simulation

Compliance requirements are more acutely felt by businesses as they adjust to new systems. The extension of so many new reporting requirements for businesses will increase costs for business as they adjust to the Australian regime.

The simulation uses estimates of compliance costs submitted by the National Association of Retail Grocers of Australia (NARGA) to, and subsequently cited by, the Regulation Taskforce.[25] NARGA suggest that compliance costs for small businesses due to GST are 28.25 per cent of the

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[25] NARGA 2005, *Submission to the Regulation Taskforce: Reducing the Regulatory Burden on Business*, November.

Regulation Taskforce 2006, *Rethinking regulation: Report of the Taskforce on reducing regulatory burdens on business*, Report to the Prime Minister and Treasurer, Canberra, January.

revenue raised by the GST from that business. The simulation uses this number to estimate the generalised compliance costs for businesses across the entire Norfolk Island economy. Compliance costs are believed to be most severe in the first year and are phased out over five years.

The NIG will no longer have to finance company registration. This will reduce NIG expenditure by $30 449 per year. ASIC will provide these services and it is unlikely that they would need a presence on Norfolk Island.

Workplace relations

Australia's workplace relations legislation will bring a number of changes to workplace practices on Norfolk Island. The introduction of the minimum wage and increased leave entitlements are two areas that are likely to have substantial economic impacts.

Minimum wage

Australian legislation provides that a minimum wage must be paid to employees. The Fair Pay Commission determines the level of the minimum wage. Currently, the minimum wage in Australia is equivalent to $12.75 per hour.

Changes to Norfolk Island legislation

Australia's minimum wage would replace Norfolk Island legislation on the minimum wage. The minimum wage on Norfolk Island is $8.50 per hour, however, as is was discussed in chapter 2, the minimum wage does not appear to be binding in some sectors of the Norfolk Island economy. In sectors such as retail trade the realised wage for employees is actually substantively higher than the minimum wage.

Design of modelling simulation

The impact of introducing Australia's minimum wage is to increase the wage in sectors of the Norfolk Island economy where the wage is currently lower than the minimum wage. Data in the model indicates that there are two sectors where the wage is currently below Australia's minimum wage. The two sectors are 'Agriculture, forestry and fisheries', and 'All other industries'. The nominal wage in these sectors is increased to $12.75 per hour. This sees a 150 per cent increase in the nominal wage rate in these sectors.

Leave entitlements

Under Australia's WorkChoices legislation employees can accrue up to four weeks of annual leave per year.

Changes to Norfolk Island legislation

Conditions of employment under WorkChoices would supersede some parts of Norfolk Island's Employment Act including leave entitlements. Norfolk Island's Act specifies that employees can accrue three weeks of annual leave per year. WorkChoices will mean that employees are entitled to five additional days of leave per year. Note that under WorkChoices employees might request to cash out up to two weeks of their credited annual leave entitlement under their annual leave entitlement every 12 months.

Design of modelling simulation

Increasing leave entitlements on Norfolk to Australia's four weeks of annual leave is equivalent to a 2 per cent loss in worker productivity. The loss of productivity was calculated according to the additional time employees spend absent from work. The loss of productivity was applied across all input sectors of the economy except the Australian Government sector.

Communications

The introduction of Australian legislation would mean calls to the Australian mainland would be deemed subscriber trunk dialling (STD) rather than international calls. Postal services would also be priced according to Australia Post's rates (although Norfolk Island currently uses these rates anyway for all non-local mail).

There are two further components of Australia's communications-related legislation that would have substantively affect operations of the communications sector on Norfolk Island:

- service obligations; and
- Part XIC of the TPA.

The Universal Service Obligation (USO) in the case of telecommunications, or the Community Service Obligation (CSO) in the case of postal services, specify the minimum level of service on the island. Typically, Telstra or Australia Post carries out the respective obligations in Australia. The Minister for Communications may designate a different service provider for the USO. Australia Post sometimes tenders postal service in remote communities, with CSOs one of the criteria of the service delivery contract.

Changes on Norfolk Island arising from Australia's communications-related legislation

The introduction of Australian legislation would at the very least reduce the profitability of Norfolk Telecom and Norfolk Post and cause the closure of the Philatelic Bureau. Special dispensation might be given, as is the case with the Christmas and Cocos (Keeling) Islands so that Norfolk Island might continue to produce local stamp issues. However, this would be in substantially reduced quantities to Norfolk Island's current philatelic production. Australian legislation might lead to the closure of Norfolk Telecom and Norfolk Post with the services to be provided by Telstra and Australia Post. Under either scenario dividends to the Norfolk Island Government would fall significantly or be eliminated.

If Norfolk Telecom continued to operate, Part XIC of the TPA would lead to a reduction in its return on capital. The ACCC is likely to regulate prices to be more cost reflective, consequently eliminating (or greatly reducing) cross-subsidisation between international and local calls. This would dramatically lower the cost of international calls and increase the cost of local calls.

Design of modelling simulation

The model does not distinguish between who provides communications services on the Island. As mentioned previously in relation to the TPA, whoever provides communications services on Norfolk Island will not be able to generate the same level of monopoly rents as is currently generated on the Island.

Social welfare

Australia has a variety of legislation addressing social welfare objectives. Generally, these take the form of providing specific purpose payments to certain individuals or subsidising socially desirable services such as health and education.

Social security

Australia's legislation provides a range of social security benefits including:

- aged pensions;
- disability pensions;
- Family Tax Benefits;
- Newstart allowance (for job-seekers); and
- Youth allowance (for young people who are study or seeking work);

Eligibility for payments is based on a range of criteria, which generally includes income and/or asset tests. Recipients of these benefits might also be eligible for additional add-on benefits including:

- Remote Area Allowance — for individuals deemed to live in a remote area);
- Rent Assistance — assistance for individuals who rent privately; and
- Utilities Allowance — assists with the payment of regular bills such as water and electricity.

The level of any social security payment is typically affected by whether an individual is:

- single;
- has a partner; or
- has children.

Changes to Norfolk Island legislation

Australia's legislation would replace social security legislation on Norfolk Island. Norfolk Island currently has legislation pertaining to the provision of aged and disability pensions.

Norfolk Island does not provide an unemployment allowance. However, there is currently no reported unemployment on the Island although provisional assessment of the Norfolk Island economy suggests that the level of underemployment might be quite high.

There are currently eighty-six recipients of aged pensions, six recipients of special pensions and eight recipients of invalid benefits on Norfolk Island. Pension recipients on Norfolk Island would be eligible for the Remote Area Allowance. The fortnightly rate for the Commonwealth's aged pension exceeds the aged pension currently provided on Norfolk Island. A comparison of the maximum pensions for Norfolk Island and Australia are shown in table 4.3.

Recipients of Norfolk Island pensions are subject to an income test but are not subject to an assets test. It is unclear how pension recipients would be affected on Norfolk Island were they subject to an assets test as information on pensioner assets was not available. Additionally, Australian disability pensions have different eligibility criteria to what currently exists on Norfolk Island. It is unclear whether Norfolk Island's current disability recipients would qualify under the Australian system.

In addition, about thirty pensioners on Norfolk Island receive pensions via the Department of Veteran Affairs. These pensions would be unaffected by the implementation of Commonwealth legislation although the pensioners would become eligible for add-on allowances, notably the Remote Area Allowance.

4.3 **Maximum fortnightly pensions in Norfolk Island and Australia**

Marital status	*Norfolk Island*	*Australia*[a]
	$ per fortnight	$ per fortnight
Single	481.60	517.90
Couple	401.80 (each)	432.80 (each)

[a] Includes Remote Area Allowance.

Source: Norfolk Island Administration and Centrelink (2006).

Design of modelling simulation

A profile of the recipients of pensions on Norfolk Island, provided by the Norfolk Island Administration, was used to determine the change in pension income for recipients on the Island. It was assumed that all current recipients of Norfolk Island pensions would still be eligible under the Australian system.

The aggregate increase in the pensions received on Norfolk Island is estimated at $88 622 per year. The figure is used to increase household income following the introduction of Australia's social security system.

The NIG will no long have to fund social welfare on the Island. This would reduce NIG expenditure by $920 830 per year in direct social service payment. Additionally, the NIG would reduce expenditure on other welfare services by $1.3 million per year (medical expenses of social welfare recipients). The Australian Government would provide social security payments of $1 million per year. For modelling purposes this is simulated as a payment from the Australian Government to households on Norfolk

Island. Health-related social welfare services provided by the NIG are discussed below.

Unemployed residents of Norfolk Island will be entitled to the Newstart allowance once Commonwealth legislation is extended. The model of the Norfolk Island economy can determine changes in employment resulting from a policy change. This enables the impact of Commonwealth legislation on employment in Norfolk Island to be determined, with (any) employee losing their job being entitled to the Newstart allowance of $430 per fortnight (includes zone allowance). The economic modelling incorporates Newstart payments to all persons who become unemployed.

Depending on income, households in Norfolk Island may be entitled to Family Tax Benefit (Part A), which is an annual tax benefit designed to help families with the cost of raising children. The income distribution profile used to determine average income tax rates for individuals (see chapter 2) was used to calculate the proportion of households falling within the various income thresholds relevant to the income test for Family Tax Benefits Part A. The number of households with an assumed two dependent children in each income band was then determined.

As Part A benefits vary according to child age, data from the 2001 Norfolk Island Census was used to determine the proportion of children in each of the age bands attracting a different payment. From this, a weighted average payment per child was developed for each household income band. This saw, for example, households with an annual income of less than $40 000 receiving $3747 (on average) for each of two children. Taken across all households entitled to the Part A payment, it is estimated that Norfolk Island households are entitled to $1.5 million in Part A payments. In the economic modelling, the Australian Government transfers $1.5 million to households in Norfolk Island.

Funding for health services

The Australian Government funds a variety of programs, which would be extended to Norfolk Island if Commonwealth legislation were applied. Programs where funding is likely to be provided for Norfolk Island health services includes:

- multi-purpose services (aged care);
- Aged care assessment program;
- Home and community care program;
- Medicare benefits schedule (MBS);

- Australian Health Care Agreements (AHCA);
- national childhood immunisation register;
- national blood arrangements;
- private health insurance;
- Public Health Outcome Funding Agreements (PHOFA); and
- rural health (including Medical Specialist Outreach Assistance Program and the Royal Flying Doctors' Service).

The major programs or agreements that would be implemented on Norfolk Island legislation following extension of Commonwealth legislation are discussed in further detail below.

Australian Health Care Agreements

The AHCAs are a series of agreements between the Commonwealth and the various State and Territory governments. Under the agreements the Commonwealth provides a grant to help fund public hospitals in each of the states and territories. To be eligible for the funding the respective state or territory governments must increase their own public hospital funding such that cumulative rate of growth at least matches the cumulative rate of growth of the Commonwealth under the respective AHCA.

Medicare Benefits Schedule

The Australian Medicare Program provides access to medical and hospital services in Australia. Services listed in the MBS are either free or heavily subsidised by the Australian Government. Subsidies to the patient are generally around 75 per cent of the scheduled fee for hospital treatment and 85 per cent of the scheduled fee for other clinical services.

Pharmaceutical Benefits Scheme

The PBS provides a subsidy to Australian residents for most prescription medicines. Prescription medicines are listed on the PBS following assessment by an independent expert body. The PBS covers around 80 per cent of prescriptions dispensed in Australia. Under the scheme the most a general patient pays for medicines listed on the PBS is $29.50. Concession cardholders pay at most $4.70.

Changes to Norfolk Island health care funding

The major impact of extending health-related programs and legislation will be to reduce the burden on the Norfolk Island Government to fund the hospital. In 2004-05, the Norfolk Island Government provided a subsidy to the hospital of $843 500. It is expected that some Norfolk Island health-related legislation would need to be repealed or amended.

In addition, the extension of Commonwealth health programs will subsidise the cost of health care for residents on the Island.

Design of modelling simulation

Health funding represents an injection of recurrent spending into the Norfolk Island economy. Some of this spending will offset expenditure by the Norfolk Island Government, the remaining amount will subsidise the cost of health services on Norfolk Island — effectively lowering the cost of these services to households.

The estimated subsidy to the health sector is $3.0 million per year, which comprises funding per year for:

- Aged care — $0.9 million;
- AHCA — $0.9 million; and
- Other health funding — $1.2 million.

The estimated subsidy to the households for health services is $1.5 million per year, which comprises:

- MBS — $1.0 million; and
- PBS — $0.5 million.

Household demand for health services is capped at $1.8 million, a 50 per cent increase in Norfolk Island households' current level of health consumption (excluding household spending on the health care levy). The cap places an upper bound on the level of increased demand arising from the subsidies to the health sector. Implicitly, any further subsidies would increase the quality of services or increase the return on capital for the health sector.

The cap is calculated based on the sum of the expected expenditure for the MBS and the PBS,[26] plus the estimated household contribution to the purchase of health services under both schemes. The additional

[26] Provided by the Department of Health and Ageing (DoHA).

contribution of households for medical services is $151 000, while for purchases of pharmaceutical goods it is $146 000. The figures are calculated based on the average number of services purchased through the MBS and PBS, and multiplied by the average co-payment made by households.[27] The DoHA expenditure estimates for the MBS and PBS were used to calibrate data to suit circumstances on Norfolk Island.

Maternity payment

The Maternity payment, or 'baby bonus' as it is more commonly known, provides a one-off cash payment to mothers if they have a baby born during the financial year. The amount of the bonus is $4000.

Design of modelling simulation

Based on the number of births on Norfolk Island in 2004-05, the 'baby bonus' provides a subsidy to households of $100 000 per year.

Schools assistance

The Australian Government's General Recurrent Grants Programme for Schools provides supplementary funding to assist schools achieve specific objectives agreed by the Australian Government and the states and territories. Funding is determined through block grants calculated on a per student bases according to movements in average government school recurrent costs.

In the Government school system the rate per primary school student in 2006 is $605 and the rate per secondary school student is $900.

Design of modelling simulation

The Recurrent Grants Program subsidises education on Norfolk Island by $224 500. For modelling purposes the education sector is contained within the general government sector of the economy.

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[27] A weighted average was used for the PBS to reflect differences in the total value of purchases by concession card holders and general households. Typically, concession card holders account for 83 per cent of purchases under the PBS and pay $4.70 per item.

Information provided by DoHA and Health Insurance Commission 2005, 'Statistical tables', *Annual Report 2004-05*, http://www.medicareaustralia.gov.au/about/about_us/annual_report/04_05/statistics.htm, accessed 19 September 2006.

Additional Australian Government financial assistance

The Commonwealth Grants Commission (CGC) calculated the level of financial assistance that the Norfolk Island would need from the Australian Government to enable it to deliver Australian average levels of service. This is in addition to Australian Government funding for:

- customs;
- health;
- education; and
- welfare.

The CGC believe that NIG will require $12.3 million to fund state equivalent services and $4.9 million to fund local government services.[28] (Note that these figures include depreciation and loan repayments.) Under the CGC modelling, and once NIG's revenue raising capacity is taken into account, the Australian Government would be required to provide $9.7 million in financial assistance to Norfolk Island for provision of services. Note that the funding of $9.7 million is in addition to funding that the Australian Government would provide under specific Commonwealth legislation and programs.

The CGC estimate the revenue raising capacity of the NIG to fund state and local services is $8.4 million.[29] With the NIG already raising $3.9 million (in 2004-05) in state and local government type taxes/charges, the additional tax raising capacity at the state and local government level is $4.4 million.[30] In the economic modelling the revenue raising capacity at the state and local government level is allowed to move in line with economic activity.

Through specifying the revenue required to be raised by the NIG (set equal to the CGC's estimate of the NIG's revenue raising capacity minus what is already raised), the CIE's model of the Norfolk Island economy can deter-

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[28] CGC (Commonwealth Grants Commission) 2006, *Review of the financial capacity of Norfolk Island*, Staff paper — supporting information, July, tables 5-18, 6-12 and 8-1.

[29] Ibid, p. 110.

[30] Taxation revenue raised in 2004-05 by the NIG at the state and local government level comprises the Accommodation Levy ($560 435), Liquor Licences ($82 539), Vehicle registration etc ($470 939), Departure fees ($1 080 930), Absentee Land-owner charges ($112 997), Tattersalls Lotteries commission ($150 049), Land Title fees ($329 578), Financial Institutions Levy ($1 131 012) and Stamp Duty on cheques ($12 780).

mine the required financial assistance from the Australian Government.[31] Hence in the modelling the NIG is assumed to levy households with a generic type tax to raise $4.4 million. The Australian Government then meets any revenue shortfall. Note that there may be a need for subjective judgement as to what funding Australian should contribute. For example, Norfolk Island may be able to raise the additional $4.4 million, but the economic implications of doing so might be considered too ‘adverse’ (in terms of GPD, household welfare etc). Hence a decision might be made that Australia should contribute more funding so as to lower the revenue raising burden on the NIG.

Design of modelling simulation

The modelling simulation is set up to allow calculation (within the model) of the required financial assistance from the Australian Government. Essentially, the Australian Government meets the revenue shortfall (if any) between the NIG’s revenue raising capability and its expenditure on state and local government type services/responsibilities.

[31] Alternatively, we could inform the model as to the size of the financial assistance from Australia, and let the model determine how much revenue the NIG needs to raise so as to fund its state and local government responsibilities.

5 Economic impacts of extending legislation to Norfolk Island

EXTENDING COMMONWEALTH LEGISLATION to Norfolk Island will impart a fundamental change on the underlying economy. The proposed changes are therefore expected to have a likewise substantial impact on most economic indicators.

The economic impact arising from extension of Commonwealth legislation to the Island is quantified through use of the general equilibrium model of the Norfolk Island economy (see chapter 2 for model details). Before turning to the modelling results, the modelling simulation undertaken is outlined.

The modelling simulation

The economic model of Norfolk Island is 'rolled forward' according to the baseline assumptions identified in chapter 2. This allows us to generate a picture of the economy in forthcoming years. The importance of the baseline should not be underplayed — it has a central role in quantifying the economic impacts. For example, in 2004-05, the NIG has a positive cash flow of around $1 million. If Australia's tax regime — 10 per cent GST, company tax, individual tax etc — were now applied to the economy in a comparative static sense, then the impacts on the local economy would likely be substantially negative, with GDP all but collapsing.

However, the position of the NIG in 2004-05 is somewhat misleading. Once depreciation is taken into account, the NIG (and its GBEs) actually ran at a deficit of nearly $1 million. And if the required infrastructure expenditure of nearly $9 million per year identified in the AMP is included, then the NIG ran a deficit of around $10 million. Clearly, this is not sustainable. Hence looking forward, the NIG will need to raise another $10 million or so in additional taxes. It is from this higher tax base (and the associated economic ramifications) that the impacts of the Australian legislation must be assessed against.

The modelling simulation sees the following.

- An assumed starting date for Commonwealth legislation of 1 July 2007.
- The baseline is as specified in chapter 2 (which requires the rate of NSL to be set at between 7–12 per cent to balance NIG revenue and expenditure after taking into account future dividend payments — see below).
- The modelling shocks identified in chapters 3 and 4 are then applied to the underlying baseline.
- Extension of Commonwealth legislation sees the NIG being left with state and local government like responsibilities. The NIG is therefore required to fund health, education, law and order, roads, and water and waste management type services; it is estimated that these services cost $14.9 million per year to provide at an Australian standard.[32]
- To provide state and local government services at an Australian standard, funding by the NIG needs to increase by $3.5 million over and above what it already spends in these areas ($11.4 million). Any revenue shortfall between existing revenue and required expenditure at the state and local government level is met via a generic tax levied on households.
- Finally, the Australian Government meets any shortfall between the revenue raising capacity of the NIG and required expenditure on state and local government services on Norfolk Island.

The baseline, AMP and NSL

Before examining the economic impacts of extending Commonwealth legislation to Norfolk Island, it is pertinent to make clear the economic consequences of the baseline assumptions. The baseline embodies four substantial changes to the economy post 2004-05, these being:

1. tourism numbers decline 11 per cent in 2005-06;
2. the AMP is introduced in 2006-07, with expenditure on infrastructure (and depreciation) ranging between $9.9 million in the first year of the AMP to $17.4 million in the last year;
3. health and welfare expenditure by the NIG grows at 10 per cent per annum, reflecting an ageing population; and

[32] Estimates of responsibilities (and cost thereof) left with NIG are taken from Commonwealth Grants Commission 2006, *Review of the Financial Capacity of Norfolk Island 2006*, Staff paper — Supporting Information, CGC, July 2006, Canberra, tables 5-8, 6-12 and 8-1.

4. the NSL is introduced in 2006-07 to balance government revenue and expenditures.

Each of these, by itself, would represent a substantial change to the Norfolk Island economy. Taken together, the financial imposts on the NIG and the impacts on underlying economic activity bring into question the ability of the Norfolk Island economy to support/fund the expenditure requirements (see below).

Due to the importance of the AMP expenditure in 'driving' the baseline results, the AMP is focused on below.

Over 2005-06 to 2019-20, the AMP suggests that Norfolk Island needs to spend $134 million on infrastructure works. Of this amount, $76 million is new capital works and $32.6 million is backlog capital works that will add to the Island's capital stock. Some of this infrastructure expenditure is to be undertaken by the GBEs. If the GBEs are allowed to operate as commercial ventures, then those GBEs will be responsible for funding their own capital expenditure requirements.

Hence if we just focus on the infrastructure expenditure required by the NIG, then the NIG needs to carry out $121 million worth of expenditure, of which $99 million is capital works. Under the current situation, the AMP expenditure is to be met by a population of 2000. To fund this expenditure, the NIG will need to raise additional taxes of nearly $61 000 per capita (spread over the course of the next 15 years). This looks to be a tall order.

However, this is not the end of the story. As the NIG's capital stock increases over time (by around $6.6 million per year) due to capital works, so to does the annual depreciation bill. If the capital stock is to be maintained, then depreciated will need to be funded. The requirement to fund depreciation (and the AMP expenditure itself) has an impact on the level of NSL needed to balance the NIG's expenditure with its revenue.

For example, in the final year of the AMP, the NIG is required to fund:

- (new and backlog) capital works of $6.6 million;
- maintenance works of $1.5 million; and
- depreciation of $9.3 million.

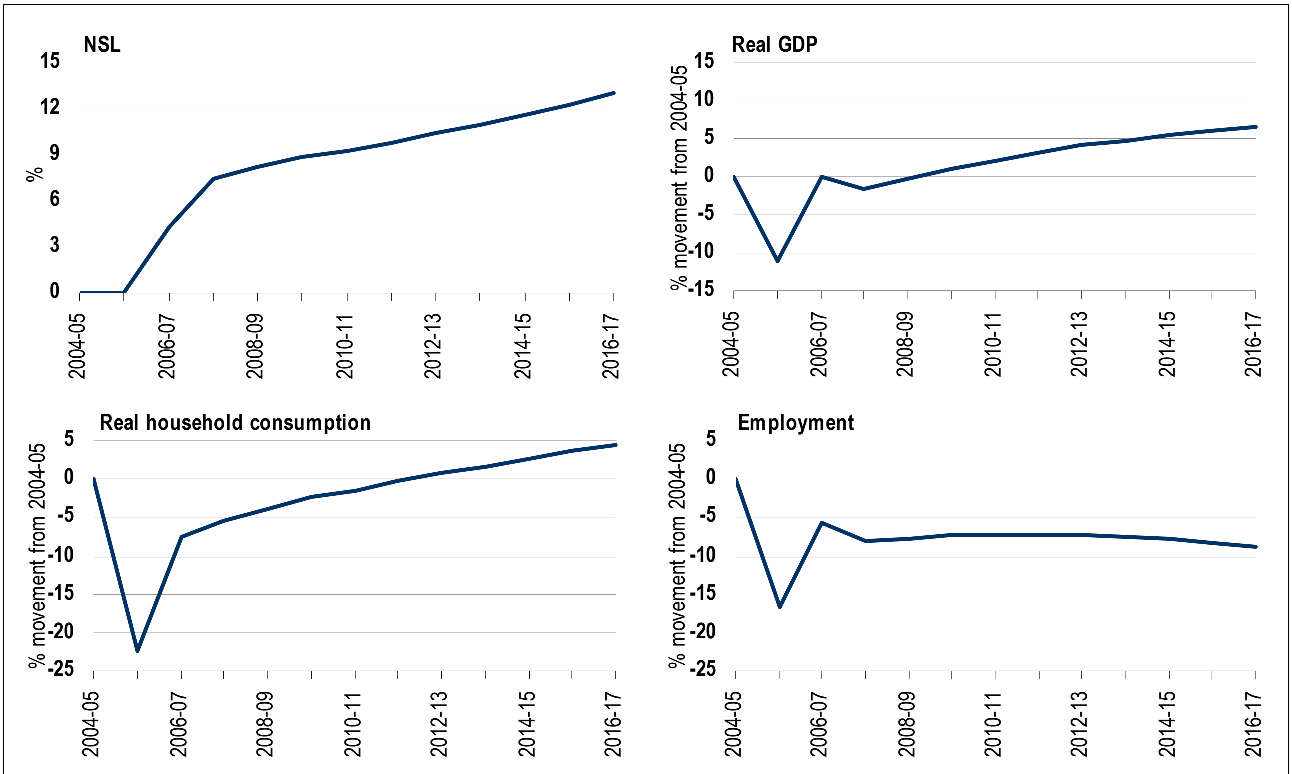
The depreciation figure is calculated as 8 per cent of the capital stock at the start of the year. In year 15 of the AMP, the NIG's capital stock is $123 million, comprising the original capital stock prior to the commencement of the AMP (some $24 million) plus $67 million in new capital works and $32 million in backlog capital works carried out under the AMP.

As the costs associated with the AMP plan (and health and welfare expenditure) increase year on year, so too does the rate of NSL required to balance the NIG's budget. Chart 5.1 shows the required rate of NSL under the baseline and some other basic economic indicators. In 2016-17 (year 11 of the AMP) the required rate of NSL to balance the NIG's budget is 13.1 per cent, up from 4.3 per cent in 2006-07.

As already noted, the NSL is a compounding tax. For a non-compounding GST type tax (levied only on private consumption final demand) to raise the same revenue as Norfolk Island's NSL, then the GST type tax would need to be set at a rate ranging between 9 per cent (2006-07) and 31 per cent (2016-17).

It is important to appreciate that the additional infrastructure spending embodied in the AMP will improve productivity in the economy. Hence even though (the cost of) depreciation is increasing year on year, so too is productivity, which acts to give a larger economic base to which the NSL is applied. Hence over the period 2008-09 to 2011-12, the NSL is quite stable at around 8–10 per cent. However, due to increasing health care and welfare costs, the required NSL starts to rise quite quickly as the increasing health and welfare costs start to bite. This sees the NSL increasing, and other

5.1 **The Norfolk Island economy under the baseline**



Data source: CIE model of the Norfolk Island economy.

economic indicators starting to slow/decline around 2016-17. For example, in 2020-21 GDP is estimated to be only 4.8 per cent above 2004-05 levels, down form a high of 6.6 per cent in 2017-18 (not graphed). Unless something can be done to contain the expenditure required of the NIG or find alternative revenue sources, the economic modelling suggests that the Norfolk Island economy will struggle beyond 2017-18 or so. The economy is simply too small to fund/meet its expenditure requirements.

Real GDP falls initially due to a contraction in tourism numbers between those observed in 2004-05 (33 000) and what was assumed going forward (30 000 post 2005-06). GDP picks up in 2006-07 with the introduction of the AMP and the fiscal stimulus that this brings. However, accompanying the AMP is the NSL, which acts to contract economic activity without the additional infrastructure funded by the NSL having come on line. As productivity improves due to the additional infrastructure, GDP starts to increase. In terms of what is driving GDP (from the expenditure side), it is primarily the AMP and the investment activity that this stimulates. Other areas of final demand, such as exports and consumption, do not contribute significantly to the GDP gains (tourism exports are actually negative due to the assumption that tourist numbers fall to 30 000 per annum).

Household consumption — the preferred welfare indicator — contracts markedly in 2005-06 due to fall in tourist numbers. With the AMP related expenditure commencing in 2006-07, there is a fiscal stimulus to the economy that goes some way to offsetting the decline in activity from lower tourism numbers. As such, household consumption picks up. Over time consumption continues to pick up as the AMP investment comes on line and improves productivity. Increased transfers from the NIG to households due to higher welfare payments also acts to increase household income. However, due to the ever increasing NSL acting to push up prices and dampen economic activity, household consumption only gets above 2004-05 levels in 2012-13.

Even though the increase in investment activity necessitates greater employment (in investment related activities), overall the fall in tourism numbers plus the NSL see economic activity and employment contracting from 2004-05 levels. Furthermore, the AMP sees capital accumulation and productivity gains. The productivity gains mean less inputs, including labour, are needed to produce a given level of output. Hence there is a 'second round' of reduced demand for labour. The downturn in employment post 2012-13 (primarily) reflects the adverse effect of the increasing NSL on activity, and especially tourism.

The decline in employment could be expected to primarily manifest in a reduction in TEP numbers.

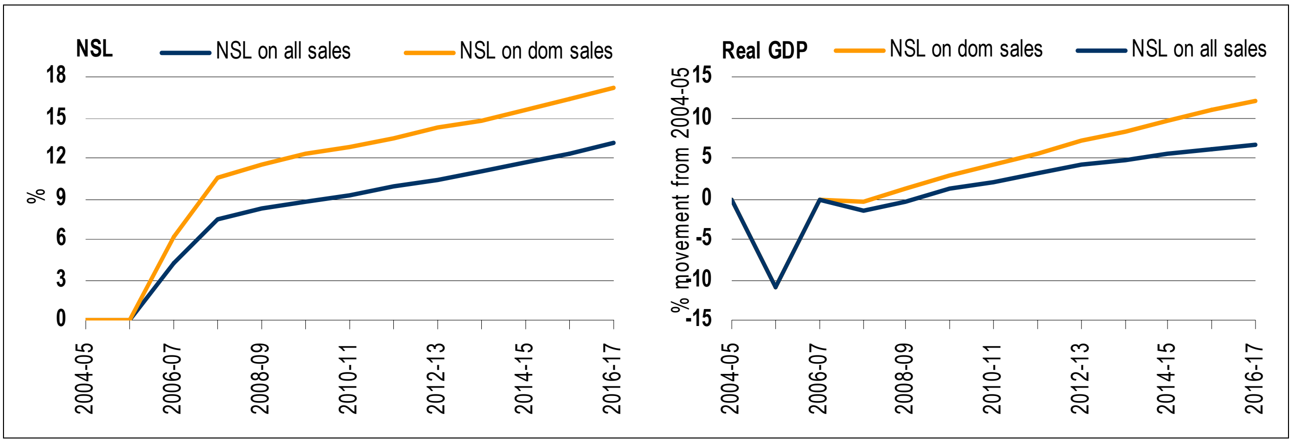
Taxing tourists — should the NSL be applied to all sales?

As an aside, the economic model of Norfolk Island developed for this project allows investigation of whether the NIG's approach of raising a disproportionately large share of taxation revenue from tourists is economically justifiable.

To investigate this issue, the baseline has been established under two scenarios. Under the first, the NSL is applied to all sales, whether they are to permanent residents of Norfolk Island or tourists (this is the 'standard' baseline, see results presented in chart 5.1). Under the second scenario, the NSL was only applied to sales to permanent residents of Norfolk Island. That is, sales to tourists (and the export market) are NSL free. The required rate of the NSL, and the impact on GDP, under the restricted NSL scenario are shown in chart 5.2 (also shown for comparison are the standard NSL and baseline GDP results).

As can be seen, only levying domestic sales with the NSL sees the required rate of NSL being higher (as the tax is being applied to a smaller economic base). The required rate of NSL is around 3–4 percentage points higher if only sales to permanent residents attract the NSL. However, as the price sensitive tourism market is NSL free, GDP is nearly 1 percentage point higher than under the standard baseline in 2006-07, and up to 5 percentage points higher in 2016-17. This result is observed as under the standard baseline, levying all sales with the NSL pushes up the prices experienced by tourists, and being price sensitive, they respond by holidaying

5.2 **Should tourists be taxed?**



Data source: CIE model of the Norfolk Island economy.

elsewhere. The fall in tourism (exports) adversely impacts on GDP.

As this investigation has shown, it is not in Norfolk Island's interest to raise a disproportionately large share of tax revenues from its price sensitive tourists. While 'taxing tourists' might be the correct political strategy, it is not in the best economic interest of Norfolk Island to overly tax visitors.

Note that when quantifying the impacts of extending Commonwealth legislation to Norfolk Island (see below), the standard baseline is used (that is, the NSL, GDP etc forecasts as reported in chart set 5.1).

Economic impacts

Extension of Commonwealth legislation has substantial implications for Norfolk Island in the areas of direct and indirect taxes, corporate conduct, workplace conditions and subsidies directed to the social services (health care, welfare, and education). Taken together, and with the new governance model under which the NIG assumes responsibility for providing all state and local government services, the overall impacts of Commonwealth legislation are initially negative, before becoming strongly positive.

The move from having a negative to positive impact stems from the deterioration in the Norfolk Island economy's baseline. From chart 5.1 it can be seen that by around 2014-15 the NSL increases to quite a high level, with other economic indicators (GDP, employment etc) beginning to slow in response. compared with this scenario, the economic impacts arising from extending Commonwealth legislation to Norfolk Island are eventually beneficial to the economy.

With Norfolk Island raising $8.4 million to fund state and local government type services, it is estimated that required financial assistance from the Australian Government will total $286 million over the 2007-08 to 2016-17 period. This assistance is in addition to any transfers, such as Family Tax Offsets or PBS etc subsidies, made to Norfolk Island as a result of extending Commonwealth legislation to the Island.

The financial assistance required from the Australian Government is so large due to:

- NIG loses it revenue from the NSL, import duties, fuel excise and company fees and abnormally large dividend payments from (some of) its GBEs;
- the NIG raises only $8.4 million in taxation revenue; and

- there is still a need to fund the AMP and state and local government responsibilities (including loan repayments, funding depreciation etc).

Putting these factors into context sees the $8.4 million in taxation revenue raised by the NIG only just covering the annual AMP expenditure of $8 million (excludes depreciation). With the cost of depreciation approaching $7.2 million in 2016-17, plus escalating health care costs and the costs associated with the NIG undertaking its core government responsibilities, the NIG will clearly need large financial assistance from the Australian Government.

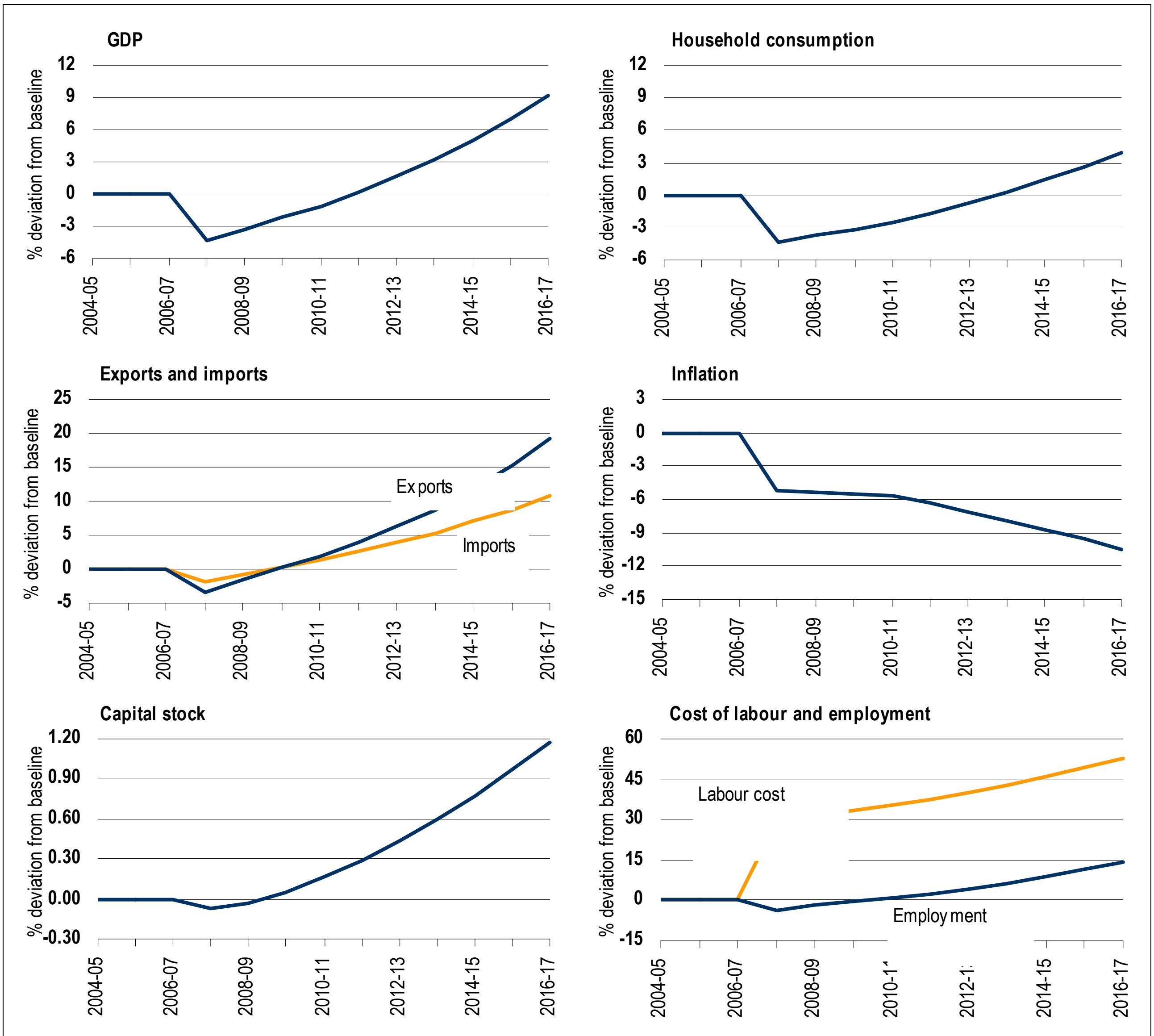
The economic impacts of Commonwealth legislation on the main (macro-economic) indicators for Norfolk Island is reported in chart 5.3. Modelling results are reported as a percentage deviation from baseline figures (some of which were reported in chart 5.1). That is, the (percentage) difference between the new GDP etc figures and what they otherwise would have been.

The headline result of an initial decline in GDP is primarily driven by the Australian legislation driving up the cost of labour. In the first period of the extension of Commonwealth legislation (2007-08) labour costs rise by 29 per cent (see results for 'Labour costs' in chart 5.3). This is a cost-push result, reflecting the impacts of income taxation, superannuation payments, minimum wages and Australian leave conditions combining to drive up the cost of labour to businesses. As labour costs rise (relative to baseline) there is a slight contraction in employment. However, as GDP picks up over time, there is increased demand for labour and rising employment, with the price of labour being 'bid up' by competing users (hence labour costs rise due to demand-pull).

By 2011-12 GDP is forecast to be higher than baseline. This reflects that under the baseline, the local economy is expected to slow/contract under an ever increasing NSL (needed to fund the AMP, depreciation, higher health and welfare expenses etc). compared with this baseline, Australian taxes and transfers to households impose less of a cost burden/impost on the Norfolk Island economy and hence economic activity is forecast to be higher than baseline.

Even though extending Commonwealth legislation is eventually beneficial for the Norfolk Island economy, the capital stock is only slightly higher than baseline. The fact that the increase in capital stock is smaller than the increase in GDP primarily reflects there being 'surplus' capital on Norfolk Island under the baseline. For example, the baseline incorporates an 11 per cent fall in tourism numbers in 2005-06 and the introduction of the NSL in 2006-07. The resultant initial decline in economic activity (see chart 5.1) is

5.3 **Real economic impacts of extending Commonwealth legislation to Norfolk Island**



Data source: CIE model of the Norfolk Island economy.

accompanied by a reduced demand/need for capital. However, the capital stock cannot change instantaneously, so for a period of time there will be surplus capital. Under the Commonwealth legislation GDP is forecast to be higher than baseline (by 2011-12). As GDP expands the formerly 'surplus' capital is once again utilised, meaning that the net change in the capital stock does not have to be overly large in order to allow GDP to expand.

Tourism is a labour intensive activity. Increasing labour costs will therefore have an impact on tourism exports. This is especially the case before other effects take hold. The impact on tourism exports will mainly be a function of two opposing effects — labour costs (which act to raise prices and contract exports) and replacing the NSL with the GST (which acts to lower prices and increase exports). Up until 2009-10 the former dominates, while in 2009-10 and beyond the later dominates and exports are higher than baseline.

For example, in 2007-08 the cost of labour is estimated to be 29 per cent higher than baseline, and replacing the NSL with the GST will see prices fall by 7 per cent. However, by 2016-17 labour costs are forecast to be 53 per cent higher, but replacing the NSL with the GST will lower prices by 21 per cent. These opposing effects see the price of 'tourism exports' being 1.3 per cent higher in 2007-08, but over 6 per cent lower than baseline in 2016-17. As such, tourism exports go from being 4 per cent below baseline in 2007-08 to being 20.6 per cent above baseline in 2016-17. Increased tourism exports contributes to the observed higher GDP.

The decline and then increase in imports broadly reflects the time profile of GDP (but lagged), and the dependence of the Norfolk Island economy on imports. Hence when GDP is lower than baseline, so too are imports. As GDP picks up there is increased economic activity, and hence an increase in imports.

The price index faced by Norfolk Island residents (the CPI) is forecast to decline by around 6–11 per cent. This is primarily due to replacing a compounding NSL of 7–13 per cent with a lower and non-compounding GST of 10 per cent. The time profile of the CPI reflects what is expected to happen to the NSL, and hence prices on Norfolk Island, under the baseline. After a period of modest increases in the NSL rate (up until 2011-12), the rate of NSL needs to increase so as to enable the NIG to meet its expenditure requirements. As the NSL goes up, so too do prices on Norfolk Island (by more than the rate of NSL due to it being a compounding tax). This sees, for example, an NSL of 13.1 per cent in 2016-17 (equivalent to a GST of 31 per cent) being replaced with a 10 per cent GST. Hence the CPI is lower than baseline under Commonwealth legislation.

Large subsidies by the Australian Government of health care and related services also have an impact on the CPI. For example, the Australian Government essentially meets the cost of the local hospital, and households no longer have to pay the Norfolk Island Health Care levy (they do however pay a Medicare levy through income tax). This sees the formerly considerable cost of health care to households falling substantially, which acts to lower the CPI.

Finally, household consumption is forecast to be higher than baseline by 2013-14. The impact of Commonwealth legislation on real household consumption primarily reflects the combination of two factors — nominal household income (including transfers) and the CPI. Immediately after Commonwealth legislation is extended to Norfolk Island nominal GDP, and hence household income, contracts (by 9 per cent). The CPI is also lower, but by only 5 per cent. Hence households are relatively worse off in real terms, with real household consumption being 4 per cent lower than baseline in 2007-08. As nominal GDP improves and the decline in CPI (relative to baseline) increases over time, real consumption increases and exceeds baseline levels in 2013-14 and beyond.

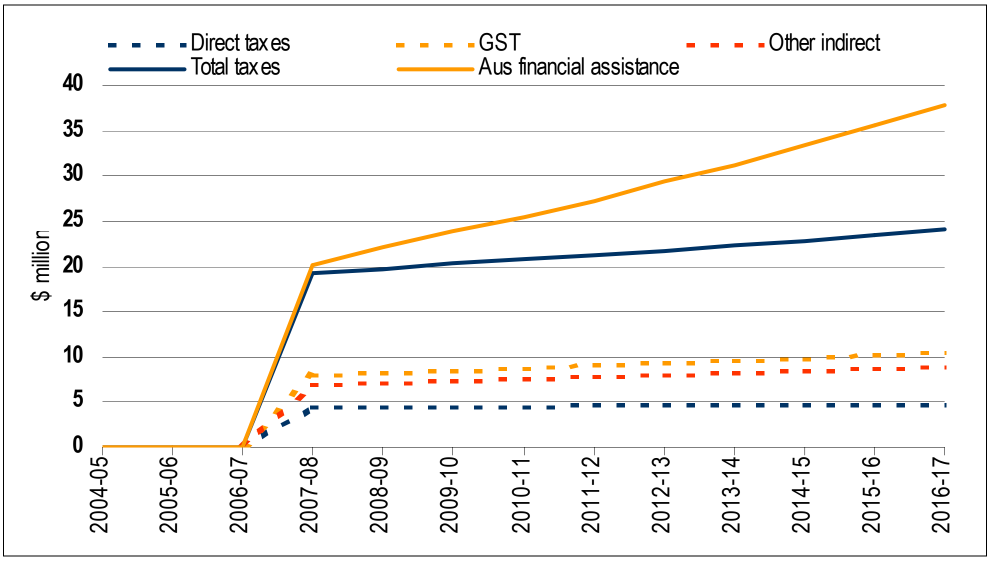
In chapter 6 the sensitivity of these modelling results to assumptions about tourist numbers and expenditure under the AMP is investigated, while in chapter 7 differing tax bundle options are investigated.

Taxes paid to the ATO

Extending Commonwealth legislation to Norfolk Island will see a different tax regime being implemented on the Island. Not only will different taxes apply, but taxation revenue will now flow to the Australian Taxation Office (ATO) instead of the NIG. Chart 5.4 reports the taxation revenue estimated to flow to the ATO as a result of extending Commonwealth direct and indirect taxes to Norfolk Island.

Taxes collected on Norfolk Island, when expressed as a share of nominal GDP, are quite high in comparison to the situation in Australia. Over the period 2007-08 to 2016-17, the GST take is 12.7 per cent (on average) of

5.4 **Annual taxes paid to the ATO and financial assistance to the NIG[a]**



[a] Direct taxes comprise company and individual income taxes. Other indirect taxes comprise import tariffs, alcohol excise, tobacco excise and fuel excise.

Data source: CIE model of the Norfolk Island economy.

GDP, while total taxes paid are 41.8 per cent of GDP. Note that total taxes paid include not only taxes paid to the ATO, but also tax revenue raised by the NIG at the state and local government level. In comparison, GST revenue is around 4–5 per cent of Australian GDP, while total taxes (across all levels of government) are around 32 per cent of nominal GDP. Hence the tax burden of Norfolk Island is relatively higher.

This observation reflects the fact that the Norfolk Island economy is more dependent on tourism exports than is the case in Australia. The GST is a tax on final private consumption and sales to tourists visiting Australia (that is, tourism exports via consumption abroad). In the case of Norfolk Island, where essentially all exports are tourism exports, there will be a much larger base to which the GST is applied and hence revenue raised than is the case in Australia, where a substantial portion of exports will be GST free as these products/services are sent to foreign markets. The higher GST take will also see total taxes (expressed as a share of GDP) being higher in Norfolk Island than is the case in Australia.

Also reported is the estimated required financial assistance from the Australian Government. This assistance is in addition to legislative driven subsidies of/transfers to Norfolk Island. As can be seen, the required financial assistance is forecast to increase over time in line with increasing expenditure required of the NIG.

6 Sensitivity analysis

THE NORFOLK ISLAND ECONOMY is very sensitive to the number of tourists. Underlying the modelling results in the previous chapter was the assumption that the number of tourists visiting Norfolk Island would level out at 30 000 per year.

In this chapter the sensitivity of the modelling results to assumptions made about tourist numbers is investigated. Two alternative assumptions are considered, these being:

- optimistic — 35 000 tourists visit Norfolk Island each year; and
- pessimistic — 28 000 tourists visit Norfolk Island each year.[33]

All other baseline and modelling assumptions are left unchanged. Hence we overlook, for example, any relationship between the number of tourists on Island and required infrastructure expenditure.

On the matter of infrastructure, and as evidenced by the discussion in chapters 2 and 5, assumptions regarding expenditure carried out under the AMP play an important part when establishing the baseline for the Norfolk Island economy. To gauge how important is the AMP, sensitivity analysis is conducted around differing levels of infrastructure expenditure carried out by the NIG, namely:

- 75 per cent of recommended AMP expenditure is undertaken;
- 50 per cent of recommended AMP expenditure is undertaken; and
- 25 per cent of recommended AMP expenditure is undertaken.

[33] It was initially intended to do sensitivity analysis around 35 000 and 25 000 tourist visiting Norfolk Island each year (2005-06 and beyond). However, in doing the economic modelling it became apparent that tourist numbers below 28 000 or so would pose significant difficulties for the Norfolk Island economy in terms of being able to fund the NIG's expenditure requirements. Given the question mark over the long term sustainability of the local economy under the 25 000 tourist assumption, the sensitivity analysis had to be conducted around a larger number of tourists (28 000).

Changing tourist numbers and AMP expenditure will act to change the baseline for the Norfolk Island economy. The modelling shocks reported in chapters 3 and 4 are then applied to this new baseline.

Basic modelling results for the two alternative tourism scenarios and differing levels of AMP expenditure are provided below.

Tourism numbers

An increase in tourist numbers to 35 000, assumed to occur in 2005-06, will deliver a notable gain to Norfolk Island's GDP. With a larger tax base, the NSL only needs to be set at between 3–6 per cent in order for the NIG to meet its expenditure requirements. Due to the compounding nature of the NSL, an NSL of 3–6 per cent is equivalent to a GST type tax of 6–13 per cent (respectively). compared with the 'Standard' baseline reported in chapter 5, the increase in tourist numbers improves the economic situation on Norfolk Island with GDP being considerably higher.

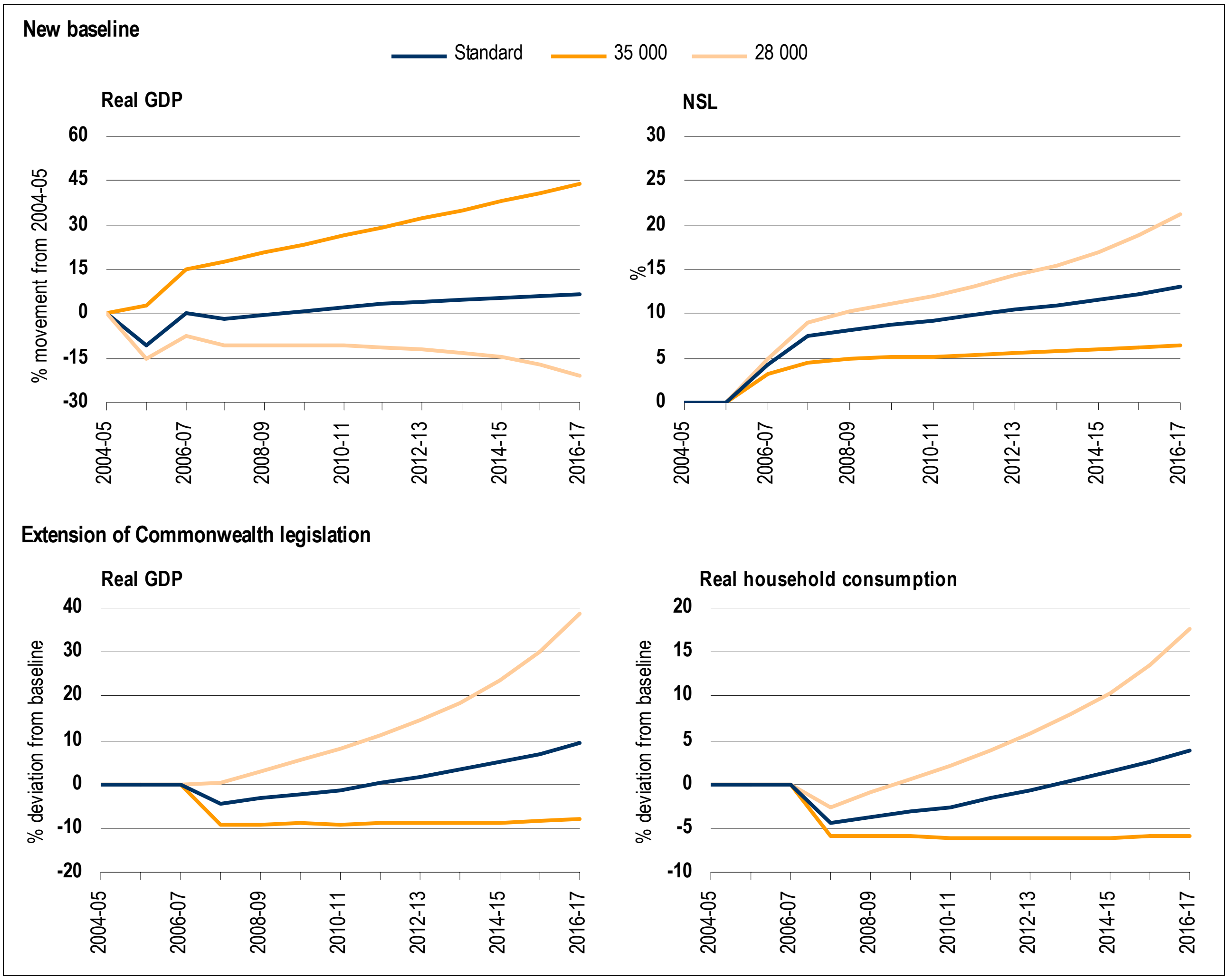
The 35 000 tourists baseline demonstrates the adverse impact the compounding NSL has on the local economy. With the increase in tourist numbers in 2005-06, real GDP is higher. However, the fiscal stimulus associated with the AMP commencing in 2006-07 sees a substantial rise in GDP. From then on, as this infrastructure comes on line and improves productivity, and in the absence of a high rate of NSL which acts to slow the economy, there is explosive GDP growth.

Baseline results for real GDP and the required rate of NSL under the differing assumptions about tourist numbers are reported in chart 6.1. Also reported is the Standard baseline from chapter 5.

A further contraction in tourist numbers from what was assumed in the Standard baseline (30 000) to 28 000 visitors per year worsens the economic situation on Norfolk Island. Real GDP is significantly lower due to the fall in tourist numbers. Hence there is a smaller economic base with which to raise required revenue, and subsequently a higher rate of NSL is needed. In turn, the higher rate of NSL further dampens economic activity. The local economy is expected to be in severe difficulty by around 2013-14 if only 28 000 tourists (consistently) visit the Island.

As noted in chapter 5, the economic impacts of extending Commonwealth legislation to Norfolk Island depends on the underlying baseline. Hence, and as can be seen in the bottom panels of chart 6.1, Commonwealth legislation is more beneficial for the Norfolk Island economy if there are

6.1 **Sensitivity analysis — tourist numbers**



Data source: CIE model of the Norfolk Island economy.

28 000 tourists, and less beneficial if tourist numbers increase to 35 000. This primarily reflects the differing rate of NSL under the various baselines and the net tax change/impost associated with moving to the Australian tax regime.

The modelling results are therefore sensitive to tourist numbers, and the implications thereof on the underlying baseline.

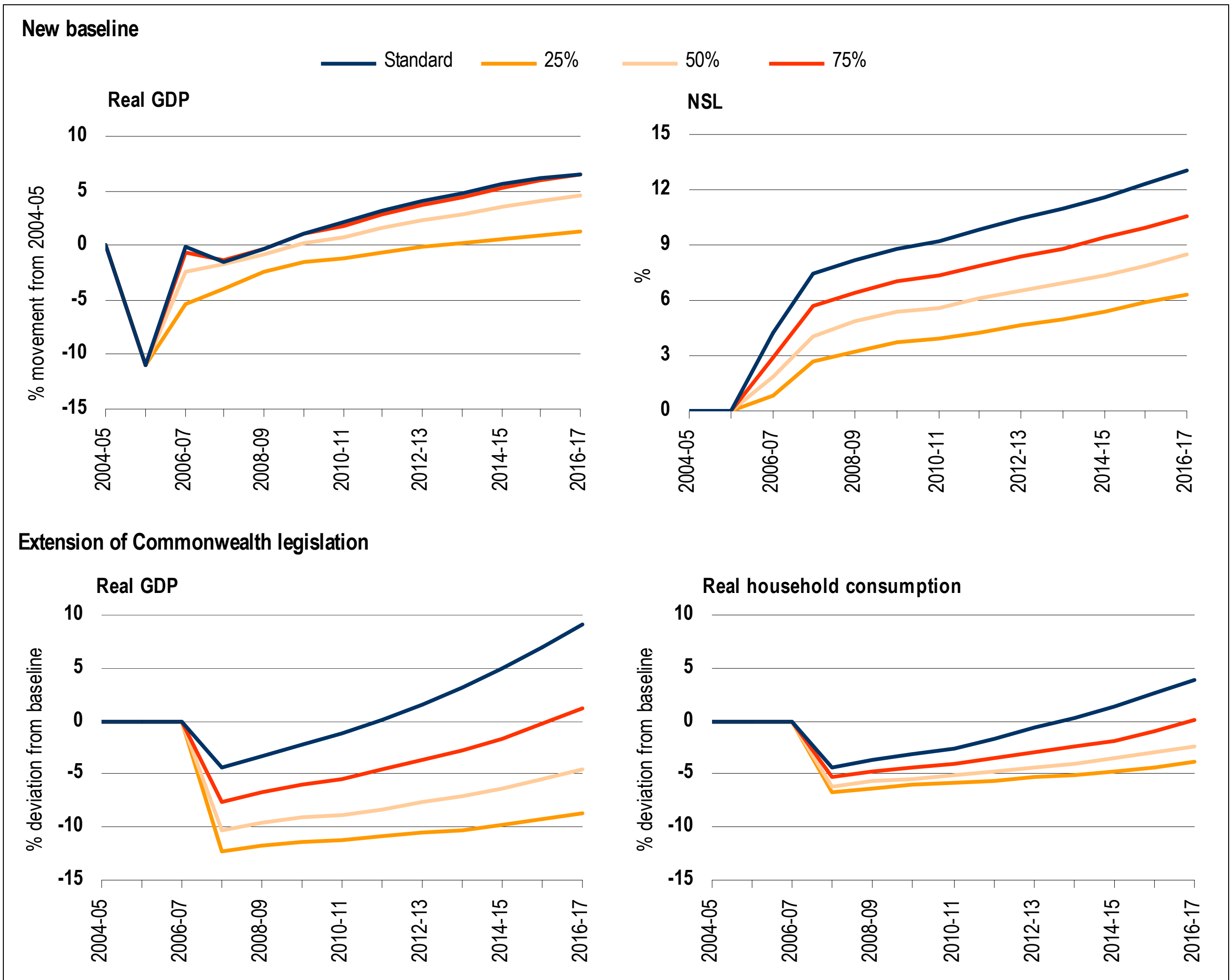
AMP expenditure

Reducing expenditure on the Asset Management Plan will lower the revenue raising requirements of the NIG and the tax (NSL) impost on the local economy. However, as infrastructure expenditure is undertaken for a reason — to improve productivity/living standards — spending less on infrastructure will ultimately materialise in the form of reduced GDP in the future. Chart 6.2 reports the new baseline GDP figures under different assumptions about AMP expenditure, and the required rate of NSL to fund (now reduced) NIG expenditure.

As is to be expected, spending less on infrastructure sees GDP being lower than under the Standard baseline. Reduced spending on infrastructure sees smaller productivity gains, as there is less capital. And smaller productivity gains impacts on the competitiveness of the local economy, and hence GDP.

However, spending less on the AMP also means that the NIG will have to raise less revenue to fund that infrastructure expenditure. This means that the rate of NSL is lower than that needed in the Standard baseline, and hence the negative impacts of the NSL on economic activity are likewise lower.

6.2 **Sensitivity analysis — AMP expenditure**



Data source: CIE model of the Norfolk Island economy.

Comparing the impact on GDP under the Standard baseline and that under the 75 per cent AMP baseline, the productivity and NSL effects almost balance out, resulting in very little difference (in terms of GDP) between the these two baselines. From this observation it could be inferred that there is an optimal amount of AMP expenditure, and that this optimal amount may be lower than 100 per cent of the expenditure suggested in the AMP.

The effect of extending Commonwealth legislation on the Norfolk Island economy is shown in the bottom panel of chart 6.2. As can be seen, real GDP and real household consumption are markedly worse if different levels of AMP expenditure are undertaken. This reflects the fact that under the alternative levels of AMP expenditure, the required rate of NSL is lower, and hence the gains from replacing the Norfolk Island tax regime with Australian taxes (and transfers etc) is not as great. Hence GDP is lower as the Australian taxes (net of transfers, subsidies etc) impose a net cost on the local economy.

As was the case for tourist numbers, the modelling results are sensitive to assumptions made about the level of expenditure on infrastructure carried out under the AMP.

7 Options for mitigating negative impacts

ADVERSE ECONOMIC IMPACTS from the extension Commonwealth legislation to Norfolk Island can be ameliorated to some extent. Strategies largely revolve around how Australian taxes might be implemented on the Island and which taxes to extend. Options for the Australian Government to reduce any adverse impacts, or make gains larger, include:

- phasing in tax legislation; and
- not extending indirect taxes (GST, import duties and excises).

In addition, there are a several alternative scenarios that might affect the economic impact of extending Commonwealth legislation to Norfolk Island. Changes in the methods used to raise taxes or the level of compliance on the Island are likely to have some bearing on the results of the main modelling simulation (see chapter 5). Two scenarios have been prepared to illustrate how the Norfolk Island economy would be affected if:

- a payroll tax is used by the NIG to raise the additional $4.4 million from the local economy (to meet the CGC's suggested revenue raising capacity) instead of a generic tax on households; and
- there were a greater level of non-compliance with Australian taxation legislation.

These options and scenarios affect the Norfolk Island economy in different ways. The economic burden of taxation falls differently on the various sectors of the economy depending on the nature of the tax. Similarly, the nature and scope of taxes is likely to affect the economy in different ways. This chapter investigates how these options/scenarios influence the implications of extending Commonwealth legislation to Norfolk Island.

Option 1: Phasing in tax changes

The major (and only real) advantage for phasing in legislative changes is to reduce compliance costs for businesses and individuals on the Island. In terms of economic effects, phasing in legislation that has adverse economic impact is not a consequence avoided but a consequence delayed. That being said, compliance would represent a significant cost for businesses on the Island, most notably in the initial years of extension of Commonwealth legislation.

During consultation on Norfolk Island one stakeholder put forward a plan to help alleviate compliance costs. The plan is for a two-year dry run of tax compliance requirements, whereby Norfolk Island residents and businesses must still complete income tax forms, business activity statements, indeed, the whole gamut of tax reporting requirements. However, the residents and businesses would not be liable to pay tax for the first two years. The dry-run would be used so Norfolk Islanders could become familiar with Australian tax reporting requirements. Furthermore, the plan would allow the ATO to target assistance to any areas where they believe tax legislation was not being correctly interpreted. The CIE believe there is considerable merit in this plan.

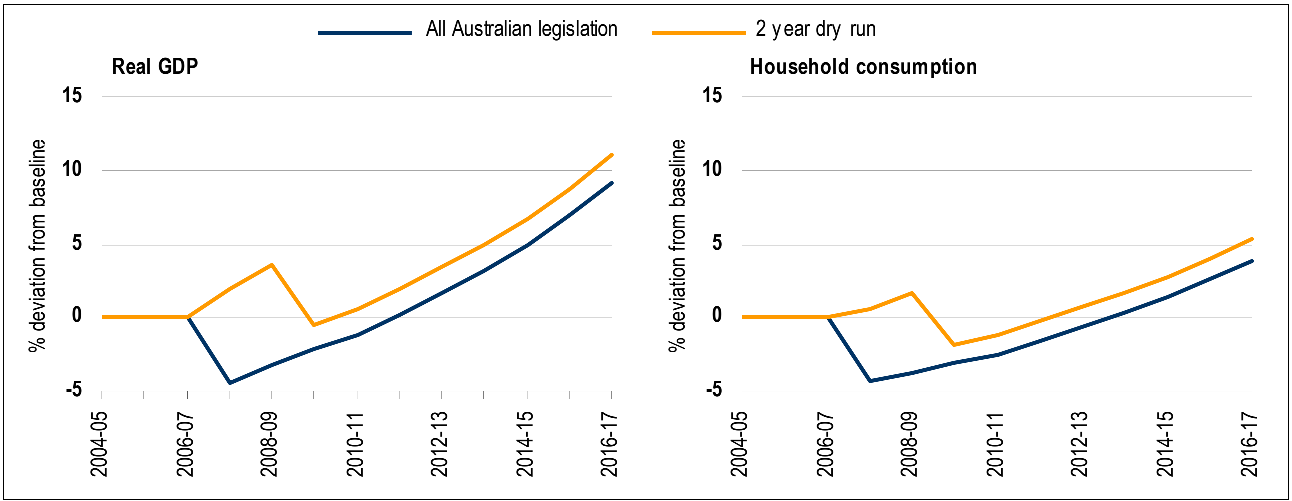
As previously mentioned (see chapter 4), the CIE have drawn on Australian estimates of compliance to model compliance costs on Norfolk Island. Compliance costs begin at 28.3 per cent of the GST revenue raised in the first year and are phased out over five years. By phasing in tax legislation, and with increased assistance from the ATO, these costs could be avoided/reduced.

Economic impacts on Norfolk Island economy

The impact on the Norfolk Island economy from reducing compliance costs sees real GDP being slightly higher in the years over which compliance costs were assumed to exist (see chart 7.1).

Under this Option there is a temporary reprieve from direct and (some) indirect Australian taxation. The reprieve, combined with transfers from the Australian Government to local households plus health and education subsidies etc and removal of Norfolk Island's NSL, causes the Norfolk Island economy to boom, increasing by nearly 10 percentage points relative to the main simulation in 2007-08 and 2008-09. However, the economy's expansion is short-lived and once businesses and residents on the Island start to pay the full suite of Australian taxes the economy contracts relative to the main simulation.

7.1 **Removal of compliance costs**



Data source: CIE model of the Norfolk Island economy.

A 'gap' exists between the All Australian legislation and 2 year dry run simulation due to the compliance costs (in the former) having imposed a cost on businesses in the first 5 years following extension of legislation from which the economy is yet to recover (relative to the dry run scenario).

Household consumption, an economic measure of household well-being, follows a similar pattern to real GDP as chart 7.1 indicates.

Option 2: Do not extend indirect tax

Currently, some of Australia's external territories, such as Christmas Island and Cocos (Keeling) Island, do not incur indirect taxes despite being governed by Australian legislation. Using the precedent set in some of the other external territories, a similar proposition for Norfolk Island is considered.

Under this Option indirect taxes would not be extended to the Island. The taxes that would not be extended to Norfolk Island are:

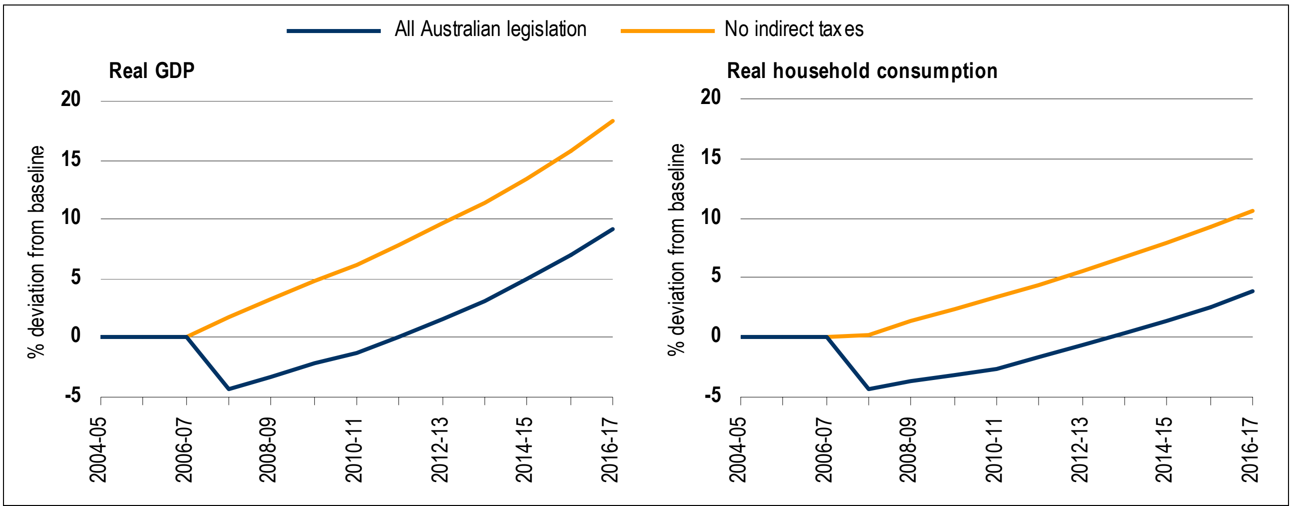
- GST;
- fuel, alcohol and tobacco excises; and
- Australia's tariff regime.

Economic impacts on Norfolk Island economy

The Norfolk Island economy, as represented by real GDP, is substantially better off relative to the main simulation if indirect taxes are not extended to the Island. Real GDP is between 6–9 percentage points higher (see chart 7.2). Since the Norfolk Island economy is highly dependent on price-sensitive tourists, lowering costs on Norfolk Island represents a boost to the economy, relative to the main simulation.

The findings for household consumption present a slightly different picture if indirect taxes are not extended to Norfolk Island. Households benefit from lower priced goods, which causes a significant expansion in consumption. Households would be better off relative to the main simulation if indirect taxes were not extended to Norfolk Island.

7.2 **Removal of indirect taxes**



Data source: CIE model of the Norfolk Island economy.

Scenario 1: NIG levies a payroll tax instead of taxing households

The main simulation assumes that the NIG levies a generic tax on households to fund any shortfall in revenue generation from existing state and local government sources and the CGC's suggested revenue raising capacity for the NIG ($8.4 million). Based on the CGC's report, the NIG would need to raise $4.4 million via the tax on households to fund the shortfall.

Typically, a state government would raise its taxes through a number of taxes including land tax, payroll tax and transfer duties. The exact mixture of the taxes is at the discretion of the respective state governments. To illustrate the difference between the different approaches the NIG Government might take to its own taxation requirements, this scenario considers the impact on the Norfolk Island economy from using a payroll tax rather than a generic tax on households (such as a property type tax).

The rate of payroll tax is set such that it raises $4.4 million by taxing the wages of all sectors of the economy (including government). The Norfolk Island economy-wide model calculates the appropriate level of payroll tax (that is, the rate of payroll tax is set as an endogenous variable within the model). There was no threshold set for the payroll tax, implying the payroll tax will be levied on businesses on Norfolk Island.

Economic impacts on Norfolk Island economy

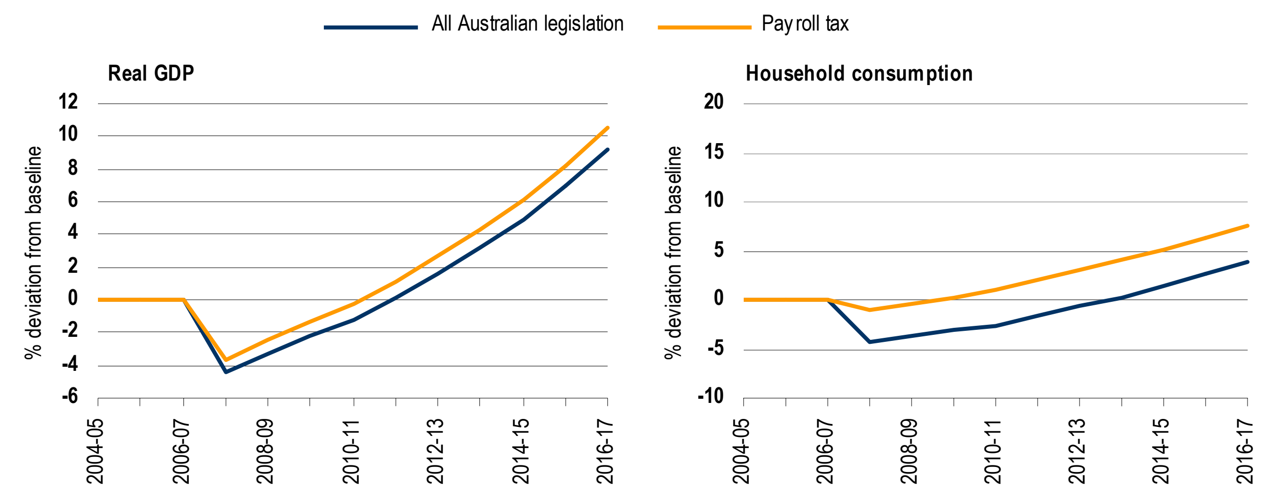
As can be seen from chart 7.3, raising the same amount of taxation revenue via a payroll or generic household tax has only slight implications for real GDP, but larger implications for household consumption.

A move from a tax on households to a tax on labour increases disposable income for household, but this will be offset to some extent by an increase in the cost of labour for businesses (labour costs are 45 per cent higher than baseline in 2007-08 versus 29 per cent higher in the main simulation).

The payroll tax needs to be set at a rate of 12 per cent in order to raise the required revenue. As can be seen from chart 7.3, the payroll tax is slightly beneficial to the economy, as evidenced by higher GDP and consumption, relative to the generic household tax. With higher GDP, there is increased demand for labour and hence higher wages (wages are bid up by competing demands). compared with the main simulation, the cost of labour to businesses is 16 percentage points higher. Of this, 12 percentage points can be attributed to the payroll tax, while the remaining 4 percentage points reflect demand pull on wages. In line with the increase in demand for labour, disposable wages are also marginally higher (1 percentage point).

With higher disposable wages and removal of the tax on households, real household disposable income and hence consumption is notably higher under the payroll tax option. Increased real consumption has second round flow on effects to investment and GDP (due to increased demand for consumables etc).

7.3 **NIG levies a payroll tax instead of a property tax**



Data source: CIE model of the Norfolk Island economy.

Scenario 2: Lower tax compliance

Compliance with Australia's tax legislation may represent a significant issue for the Australian Government if it does not invest an appropriate level of resources in compliance measures. The CIE has identified several data anomalies that it believes warrant further investigation to assess whether Norfolk Island residents and businesses are properly complying with their current tax legislation (see chapter 2). If tax avoidance is currently occurring then the extension of Australian legislation is unlikely to change Norfolk Island attitudes toward compliance.

Interestingly, less than perfect compliance has a range of economic effects. Clearly, non-compliant businesses or individuals benefit from increased disposable income or profitability. However, if it is assumed that a government requires a fixed amount of revenue then it must generate additional revenue to make up for the shortfall from non-compliant entities. The extra revenue is generated by increasing the average rate of taxation in the economy. Under this scenario, while some individuals are better off, the entire economy might be worse off, especially if the taxes used to raise the additional revenue are highly distorting.

Since Norfolk Island is relatively small in the context of Australia's tax base. A small level of tax avoidance is unlikely to cause a significant alteration to Australia's required level of taxation. Hence the level of services provided by the Australian Government is unlikely to be affected if there is some level of tax avoidance. However, if there were tax avoidance of NIG taxes then this is likely to have a more substantive impact on the economy.

Note tax avoidance is not endorsed by the CIE, nor should it be viewed as a measure for improving economic outcomes. Tax avoidance reduces the equity of the tax system and increases its inefficiency. It carries significant costs for any economy and governments have strong incentives to improve compliance measures.

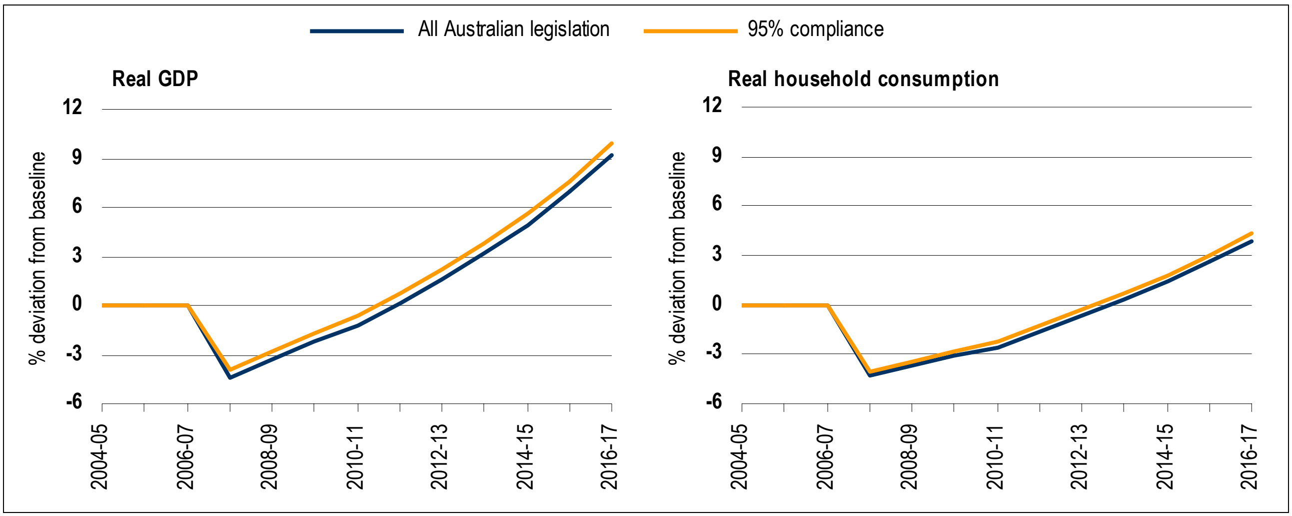
The CIE recognises that in reality tax avoidance does occur within an economy. Advice from the Australian Treasury suggests that avoidance of some taxes might be around 5 per cent. Using this benchmark, the CIE reduced the effective rate of taxation to 95 per cent of their simulation values (see chapter 3) for:

- GST;
- income tax for individuals; and
- income tax for businesses.

Economic impacts on Norfolk Island economy

As the Norfolk Island economy, and its tourism market in particular, is highly price sensitive, tax avoidance of Australian taxes is broadly beneficial for the economy. The NIG does not need to generate additional revenue to fund services so the reduced tax burden for households and businesses represents a gain to the respective entities. However, as can be seen from chart 7.4, the additional gain to real GDP and household consumption is not particularly large, but beneficial nonetheless.

7.4 **Lower compliance with Australian tax legislation on Norfolk Island**



Data source: CIE model of the Norfolk Island economy.

8 Some observations on the Norfolk Island economy

NORFOLK ISLAND has a beautiful landscape, a fascinating history, and due to its small population of around 2000 persons, residents experience a closely-knit social fabric. Ordinarily, there would be much to like about the lifestyle offered by Norfolk Island.

The Norfolk Island economy is also unique in many ways. Either directly or indirectly, tourism is responsible for the majority of economic activity; with there being very little economic diversification. With little local production, nearly everything used or consumed on the island is imported.

Unfortunately, these unique economic features — an almost total reliance on external markets for tourists and consumables — means that changes in global markets will be acutely felt in Norfolk Island. For example, the increasingly competitive South Pacific tourism market, plus the general downturn in tourism following the events of 9/11 and SARS, saw a marked downturn in tourism numbers, economic activity and government revenues on Norfolk Island. Resilience necessitates having an efficient, flexible and competitive economy that can respond to changes in external markets.

Norfolk Island is not only competing for tourists (and spend) in a global marketplace, it is also competing for labour and capital. With a slowing local economy (see below), and in the absence of fundamental reform, it is probable that labour and capital will leave the island in search of better returns elsewhere. As is discussed below, in terms of labour, this is happening already.

That is, even if Commonwealth legislation is not rolled out, maintaining the status quo does not appear to be a viable option.

With these comments in mind, some 'observations ' on the Norfolk Island economy are made below. In making these observations, the ultimate end point is to provide an environment in which businesses and economic activity can flourish, whilst meeting the community's needs. Only through a vibrant economy can opportunities be provided, population growth be encouraged, living standards improve and the costs associated with an aging population be funded.

Performance of the economy over time

There is very little economic data available on the Norfolk Island economy. In June 2006 the ABS released the first statistics on private sector activity in Norfolk Island.[34] As this was the first set of statistics (on business activity) released, there is no time series of data available with which to track economic growth.

Other indicators have therefore had to be used for the purpose of observing the performance of the economy over time. The indicators used comprise:

- tourism numbers — tourists are the lifeblood of the Norfolk Island economy, so a downturn in tourist numbers coincides with a downturn in economic activity;
- imports and import duties — as most things used/consumed on Norfolk Island are imported, the level of imports is a good proxy for economic activity; and
- population numbers — the number of permanent residents, especially those with Temporary Entry Permit (TEP) status, provides a good reflection for the demand for labour, and hence economic activity.

Results since 1996-97 for each of these indicators is provided in charts 8.1 to 8.3 below. Tourist numbers, imports and import duty, and the number of residents with TEP status were all highest in 2000-01. Following the events of 9/11 and SARS, there was a (global) downturn in tourism. The impacts of which were experienced in Norfolk Island, where the number of tourists fell by 16.5 per cent in 2001-02. As the number of tourists declined, so too did the value of imports, reflecting a general downturn in demand brought about by fewer people visiting the Island. Importantly, as imports declined so did the import duty collected by the government. Import duties were 9.2 per cent lower in 2001-02.

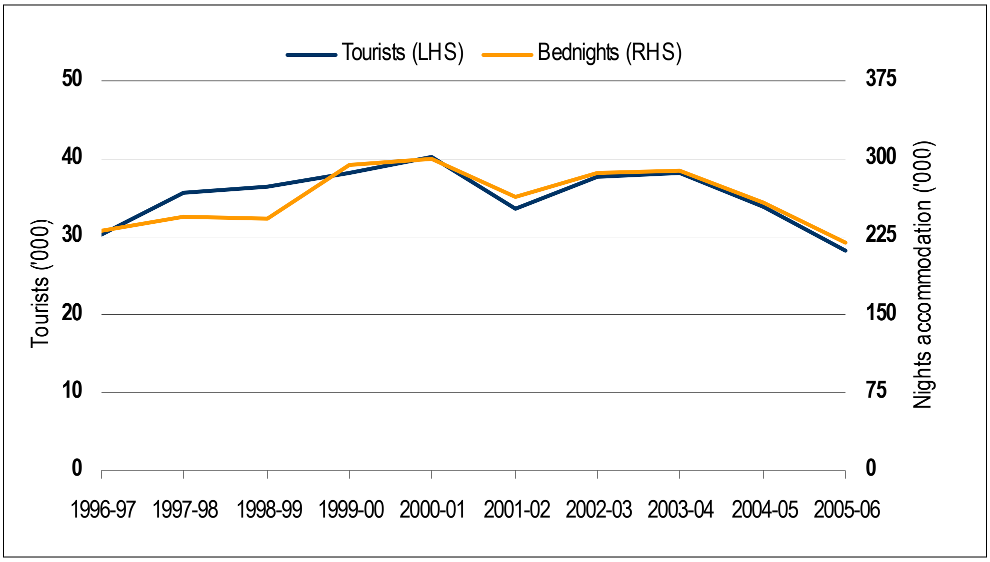
The number of residents with TEP status is a good proxy for the level of economic activity. TEPs are issued to foreign workers, and is conditional on those persons having paid employment. Hence a downturn in the number of TEPs in an indicator of fewer employment opportunities, which reflects

[34] See ABS (Australian Bureau of Statistics) 2006, *Norfolk Island Business Statistics 2004-05*, Cat. no. 8139.0, ABS, Canberra.

a downturn in economic activity. As can be seen from chart 8.3, the number of TEPs has been decreasing since 2000-01, but with a pronounced decline since 2003-04 (as is the case for all indicators). In 2005-06 there were 308 TEPs on Norfolk Island, only 8 more than was the case in 1996-97.

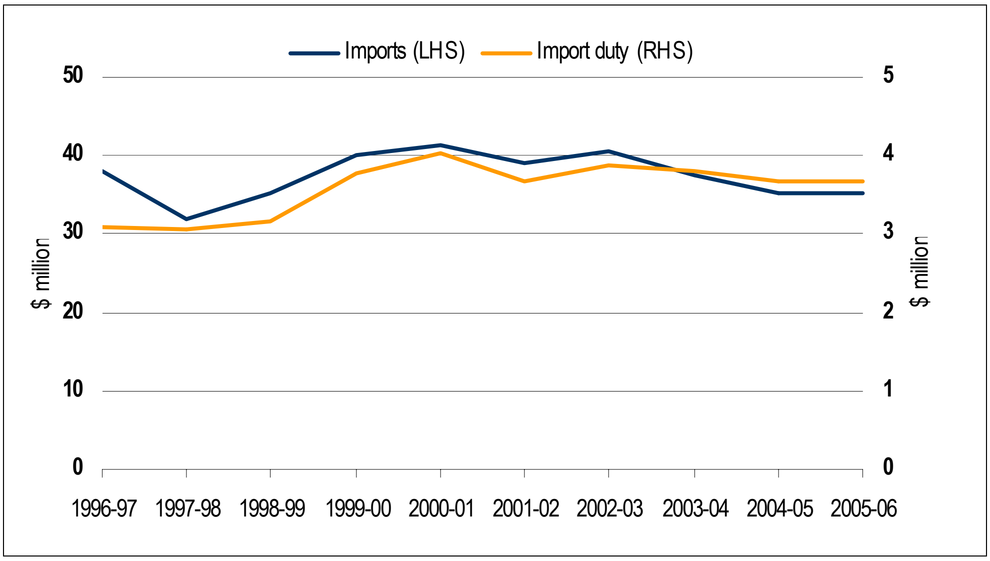
The observation to take from charts 8.1, 8.2, and 8.3 is that the economy appears to have been slowing since 2000-01. The slow down is even more pronounced since 2003-04. This would suggest that maintaining the status quo may not be a viable option for Norfolk Island.

8.1 **Tourist numbers**



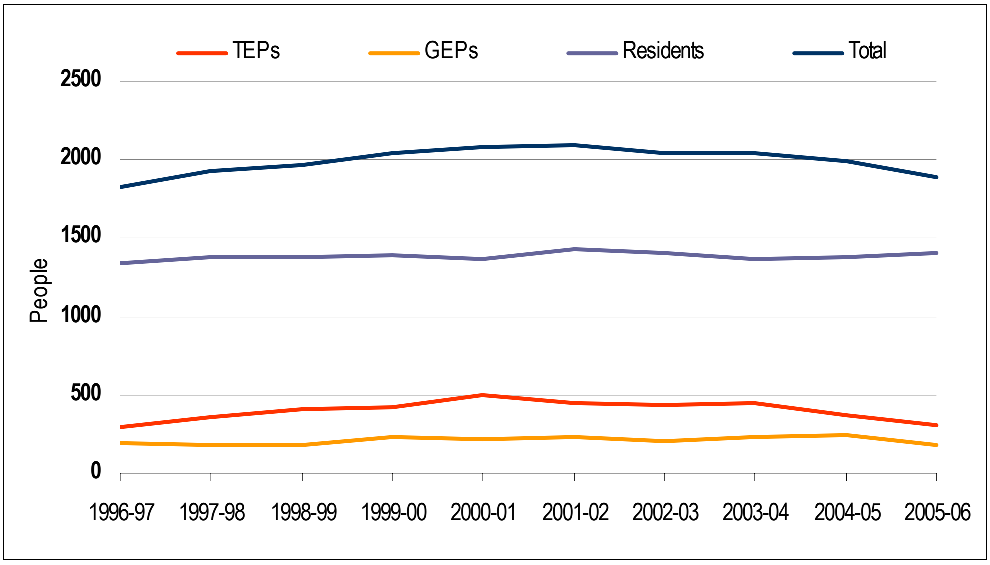
Data source: Norfolk Island Tourism Bureau statistics.

8.2 **Imports**



Data source: Norfolk Island Customs and Immigration statistics.

8.3 **Population**



Data source: Norfolk Island Customs and Immigration statistics.

Observations on the Norfolk Island economy

During this project, and especially after consulting with stakeholders on Island, it became evident that there were a number of areas where policy reform should be investigated irrespective of whether Commonwealth legislation is extended to Norfolk Island. In the CIE's view, the areas (or 'observations') identified below are not symptomatic of an efficient, competitive or flexible economy.

Observation 1: Freight costs

Nearly all products used or consumed on Norfolk Island are imported. The cost of getting products to Norfolk Island will therefore be important to the overall competitiveness of the economy, as (nearly) all products sold will have a transport/freight cost component in the price.

Numerous private sector stakeholders provided evidence of the high cost associated with getting products to Norfolk Island. For example, cases were cited where it cost $4 000 to get a container from Hamburg to Auckland, and then $16 000 to move if from Auckland to Norfolk Island. Typically, stakeholders suggested that freight costs to Norfolk Island were equivalent to 25 per cent of the free-on-board (FOB) value of the import.

The claim that freight costs are around 25 per cent of the FOB value appears to be supported by available statistics. For example, consider the Liquor Bond. From the government's financial statistics, we know that in

2004-05 the Liquor Bond purchased $2 020 520 worth of liquor. This figure includes the cost of freighting the alcohol to Norfolk Island. From import statistics, we know that the FOB value of these alcohol imports was $1 588 476. Freight costs are given by the difference between the two figures, and hence it cost $432 044 to transport $1 588 476 worth of alcohol to Norfolk Island. In this example, freight costs are equal to 27 per cent of the FOB value of the import.

In 2004-05 imports to Norfolk Island totalled $35.1 million. These products attracted import duties of $3.7 million. If we assume freight costs are equal to 25 per cent of the FOB price, then freight costs were $8.8 million (given by 0.25 * 35.1 million). Hence products that were valued at $35.1 million in say Australia, now cost $47.6 million in Norfolk Island, a cost increase of over 35 per cent. This cost 'increase' needs to be reduced if Norfolk Island is to be competitive.

There are likely to be numerous reasons why freight costs to Norfolk Island are so high. Small freight volumes reduce the potential for scale economies, and there is probably little chance of back loading supply vessels. Another issue, and cost impediment, concerns the inability to unload ships in all weather conditions. That is, if seas are rough, the current jetties do not permit ships to be unloaded. The Norfolk Island Harbour Corporation reports that between 1990-91 and November 2005, supply vessels spent 373 days waiting offshore for weather conditions to improve and allow unloading. The cost of these 'lost' days is built into freight rates. The Harbour Corporation believes that each day a ship spends waiting to unload results in the cost of freighting those goods being $70 000 higher.[35]

There would seem to be a strong case for undertaking a detailed feasibility study of a permanent jetty that enabled roll-on roll-off type operations, and more importantly, to allow supply vessels to unload in all weather conditions. Numerous other reports have arrived at a similar conclusion.[36] Ultimately, making an informed decision as to a permanent jetty's feasibility necessitates knowing the economic costs and benefits associated with that jetty.

[35] Uncertainty concerning whether ships will be able to unload etc also likely sees businesses holding larger stocks as a form of 'insurance' against weather induced delays in re-supplying. Carrying greater stocks would be associated with a cost impost (warehousing etc).

[36] For example, see Joint Standing Committee on the National Capital and External Territories 2005, *Norfolk Island Financial Sustainability: The Challenge – Sink or Swim*, The Parliament of the Commonwealth of Australia, Canberra, p. 41.

A permanent jetty also has the potential to open Norfolk Island to the 'cruise ship' market. The Harbour Corporation, amongst others, report that shipping tourism companies have expressed an interest in coming to Norfolk Island if they could (and not have to wait offshore for weather conditions to improve). Diversifying the source of tourists would also go some way to alleviating the 100 per cent reliance on airlines for tourists. Every time there are airline 'difficulties', the Norfolk Island economy suffers. Hence there is a need to be able to source tourists from alternative modes of transport.

Finally, CIE was bemused by the frequency with which jetties are built, and then pulled down, at Ball Bay. Every time there is a major construction on the Island, such as an airport runway reseal or the Cascade Cliff Safety Project etc, there is a need to build a temporary jetty at Ball Bay to enable the landing of heavy construction equipment. At project end, the jetty is dismantled. Since 1982, the Harbour Corporation reports that 9 temporary jetties have been built and later dismantled. The cost associated with this building and then dismantling may have gone some way to covering the cost of a permanent jetty.

The CIE is not immediately aware of the rationale for requiring jetties at Ball Bay to be later removed. There may be legitimate reasons for the current course of action. However, one thing is clear, the cost associated with building and then removing a jetty each time there is a major construction project will be passed onto the Norfolk Island Government and community. For this reason alone, CIE would suggest that the rationale underlying the requirement to dismantle jetties at Ball Bay be closely examined.

Observation 2: Import duties

Compared to its major trading partners, import duties (tariffs) are high in Norfolk Island. Over the last 3 years the average import duty has ranged between 10.1–10.4 per cent. While import duties are an important source of revenue for the NIG, import duties inflate business costs, and in so doing impact on competitiveness and dampen economic activity.

In an increasingly competitive and challenging tourism market, something needs to be done about decreasing costs on Norfolk Island, and this extends to looking at import duties. CIE believes that in an attempt to stimulate economic activity and competitiveness, Norfolk Island should be looking at lowering import duties. It was particularly alarming to hear that the NIG is actually contemplating increasing, rather than reducing, import duties.

For small economies like Norfolk Island, and where border taxes account for a large share of government revenue, removal of import duties will be associated with a large loss of government revenue. While cheaper imports will ultimately improve economic efficiency and expand economic activity, this will not happen immediately. Hence there will be a time delay between cutting import tariffs (and losing duty) and when the economy expands (to give larger tax base). CIE appreciates that the NIG would be put in a difficult position if this were to occur.

One option is to phase down tariffs over time. For example, the general tariff rate is 10 per cent. If tariffs were to be eliminated over 5 years, then the general tariff could be reduced to 8 per cent next year, 6 per cent in the year after that and so on. Under this regime the impact on government revenue will not be as dramatic, but likewise, economic activity will be slower to expand.

Observation 3: Government Business Enterprises

Typically, while remaining public sector bodies, GBEs are expected to behave in a commercial fashion. Implicitly, GBEs should have some degree of operational separation from the general government administration. By establishing a separate entity (the GBE), government can allocate dedicated resources to achieving specific functions. The independence of the GBE ought to ensure that sufficient resources are being provided to their respective areas of service delivery.

In Norfolk Island the GBEs act as little more than an extension of the general government. This does not in itself represent poor governance. However, the operation of GBEs on Norfolk Island features several fundamentally unsound practices, notably:

- pricing of GBE services often resembles taxation rather than cost-reflective pricing, where the ‘dividend required’ by the NIG influences the price of services;
- the NIG strips money (dividends and management fees) out of GBEs to cover general government revenue shortfalls;
- often there is no provision in GBE accounts for depreciation of assets; and
- GBEs’ capital expenditure is based on the financial position of the NIG rather than any asset management strategy.

GBEs on Norfolk Island are not genuinely allowed to operate in a commercial manner. Prices for most GBEs are determined by the Minister for Finance who has discretion to change prices at a whim. For example, when a revenue shortfall was discovered in the general government administration, the Minister for Finance increased line rental fees charged by Norfolk Telecom so that a larger dividend could be extracted from the GBE. Prices of some GBE services, notably Norfolk Telecom and the Liquor Bond, do not reflect any underlying cost structure. This means that the NIG is able to generate exorbitant rates of return on their capital investment. For example, Norfolk Telecom has a return on capital of nearly 70 per cent.

Current GBEs' prices are in fact a particularly inefficient form of taxation. The current pricing practices highly distort economic behaviour and create an inequitable distribution of the price burden. For example, while Norfolk Telecom's pricing schedule ostensibly targets tourist, it is also highly disadvantageous to local businesses that need to make international phone calls to suppliers. Further distortions are created because the Norfolk Island Government, including its GBEs, typically does not pay for GBE services. This leads to inefficient use of the Island's resources as users do not face the true cost of obtaining that service.

The CIE believes that Norfolk Island would benefit if an independent expert body set prices for essential services (for example, the Independent Price and Regulatory Tribunal of NSW or the Queensland Competition Authority).

Currently, some GBEs are not even accounting for depreciation, and this failure will see the gradual whittling away of the Island's capital stock. If depreciation is not accounted for then eventually Norfolk Island will be left without adequate infrastructure and no means of funding new capital purchases. The CIE strongly recommends that depreciation be included and funded in all GBE (and general government) accounts.

Similarly, Norfolk Island GBEs should be allowed to operate as true commercial enterprises. Improved operational separation and a defined dividend structure would allow the GBEs to improve budgeting and planning. GBEs would know their capital expenditure requirements and could operate budget and pricing structures to fund required capital expenditure. Moreover, it would remove the current problem where any funds in GBE accounts can be suddenly transferred to assist the NIG financial position. Such practices prevent GBEs from making any sort of forward planning. The CIE recommends improving operational boundaries between the GBEs and the general government so that the GBEs can properly achieve their commercially specified functions.

Observation 4: Competition

The government is the sole supplier of utilities on Norfolk Island. This sees the NIG (or its business enterprises) supplying electricity, communications, water and sewerage etc. The NIG is also the only supplier of alcohol on the Island. Hence the NIG has moved from areas where governments may have some justification for being involved in service provision (areas where there are natural monopolies and potential market failures) to controlling (and monopolising) typically private sector activities. There appears to be a genuine lack of competition in any area that the NIG has a commercial interest, and ultimately, this will hamper efforts to improve efficiency.

In relation to the Liquor Bond, there would seem to be little justification for government involvement. There are no obvious 'market failures' associated with retailing alcohol to justify government (only) provision. If there were concerns regarding adverse health impacts associated with consumption of alcohol, then the optimal strategy would be to tax alcohol, but then open the market up to competition. (The CIE is aware that numerous parties are interested in being able to sell alcohol on Norfolk Island). Under this arrangement competition would be used to ensure that alcohol retailers are not earning excessive (or monopolistic) returns.

In terms of the utilities, and wherever possible, competition should be encouraged. One area where this is possible is in electricity generation by the private sector. It was therefore particularly alarming to hear reports of households being 'threatened' with disconnection from the electricity grid if the household was to generate its own power. In this particular instance, the household was to install solar power. As households need electricity at night, when solar power is not feasible, the household had no choice but to abandon its plans.

CIE believes that the threat to disconnect the household is an interpretation of Section 6(3) of the *Electricity Supply Regulations 1986*.

> Where land is supplied with one or more electricity supply services provided by the Administration and with electricity provided from a private generating plant, the supply from the private generating plant shall be segregated from that part of the electricity provided by the Administration. (Section 6(3) of the *Electricity Supply Regulations 1986*)

Threatening to disconnect households/businesses etc from the grid if they generate their own power is a shortsighted position. Power is extremely expensive on Norfolk Island, at around \$0.60 per kWh (versus say \$0.12 per kWh in Sydney). If households or businesses can generate electricity cheaper than \$0.60 per kWh, and in so doing improve their position, then this needs to be encouraged. Furthermore, allowing others to produce electricity may delay necessary upgrades in the generating capacity of the Norfolk Island Electricity Service (NIES).

Hence instead of disconnection from the grid, provisions should be established to enable private electricity generators to sell excess power back into the grid.[37] With regulated prices (or more specifically, a regulated return to capital), it is to be expected that if NIES purchased power at less than $0.60 a kWh, then the average price of electricity would fall. This would be of benefit to all electricity users and the wider economy.

Observation 5: *Bed levy and unit/bed quota*

The NIG currently imposes an Accommodation Levy. The levy is set at the rate of $1/per bed/per night, and is paid irrespective of whether the bed is being used (that is, it is a 'cold bed' levy). In 2004-05 the Accommodation Levy raised $560 435, equivalent to 1 535 beds being levied during the year.

As of 1 July 2006, there were 65 places offering accommodation in Norfolk Island. In aggregate, these premises had 1 425 beds. (Note that the number of chargeable accommodation units in hotels/lodges etc on Norfolk Island is controlled via a legislated quota.) On average, each accommodation residency has 22 beds and will face an Accommodation Levy of $8 000 even though a booking might not be taken. With the downturn in tourism numbers, the Accommodation Levy impost will be increasingly borne by the hotel owners (assuming that it could be passed on to tourists if they were there).

A problem with the Accommodation Levy is that it is an inefficient tax. Hoteliers are required to pay the tax before bookings are taken, so they do not know if they will be able to recoup the paid Accommodation Levy from subsequent bookings. This will impart another area of risk onto hoteliers. It may also unduly influence hoteliers' business decisions, and see investments in different activities being treated differently. The ideal tax system would treat investments in different businesses neutrally.

To the extent that the Accommodation Levy can be/is passed onto tourists, and given the common view that most tourists to Norfolk Island are price sensitive, then it would appear that the optimal approach would be to lower taxation on tourists in an attempt to rekindle tourist numbers.

[37] Assuming that this is technically compatible with the existing grid/electricity infrastructure.

Given the identified problems/issues with the Accommodation Levy, the CIE suggests that it be removed as soon as possible (and assuming that it is not replaced with an equally distorting tax/charge).

As noted above, the number of chargeable accommodation units in hotels etc is controlled via a quota. As at 31 July 2006, there were 590 accommodation units spread over 65 hotels/lodges.[38] These 590 units contained 1 425 beds.

Under the *Tourist Accommodation Act 1984*, and for all intents and purposes, accommodation units are not transferable other than to bona fide purchasers of the property.[39]

In the CIE's view, the non-transferability of unit quotas is a significant oversight. It prevents the following from occurring:

- successful accommodation businesses cannot expand operations due to not be able to acquire additional quotas; and
- persons wishing to exit the industry cannot 'trade-in' a valuable asset in their possession — the quota — and use resulting funds to assist in structural adjustment;

Furthermore, as quota positions lapse if a business closes (that is, the quota is a declining cap), there may come a time when there are not sufficient quota positions available with which to satisfy tourism demand for beds. If this situation arose, then the NIG would (we assume) make more quotas available so that tourist demand could be met. But this begs the question — why have a declining cap in the first place?

The CIE strongly recommends that the issue of unit quotas be closely examined, with a view to removing them. However, it is also appreciated that the thing that destroys tourism, and especially eco-tourism, is tourism itself. If the planning approval process on Norfolk Island is not capable of stopping unabated tourism development, then the CIE accepts that quotas may be needed (at least until the planning approval process is brought up to speed).

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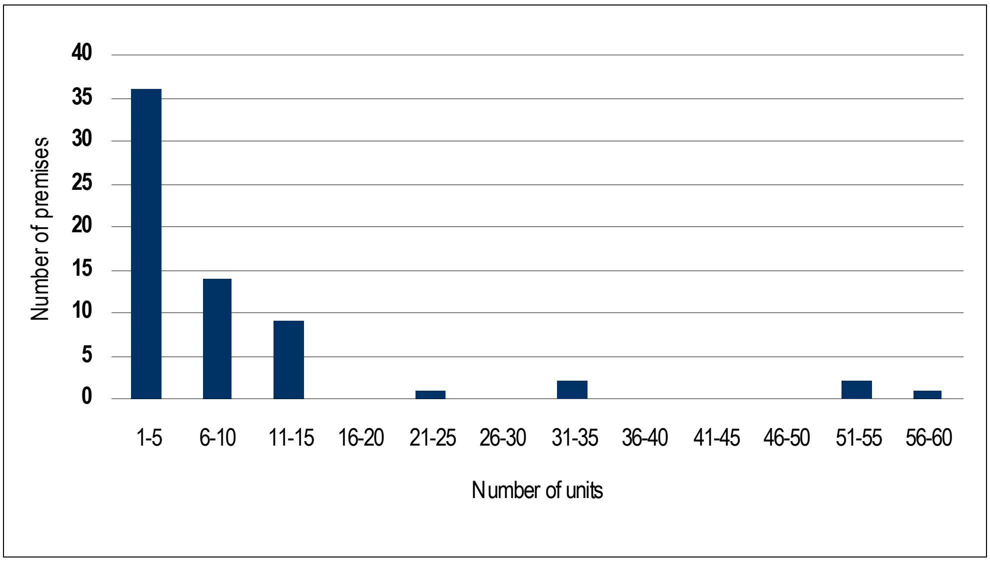
[38] An accommodation unit is defined as '…part of the accommodation house in respect of which a separate charge is usually made…' (definition taken from section 4(1) of the *Tourist Accommodation Act 1984*.

[39] Note that under sections 15A(2) and (3) of the *Tourist Accommodation Act 1984*, the Legislative Assembly may pass a resolution allowing the registration (and presumably quota) of a tourist accommodation house to be transferred to another place. CIE understands from stakeholders that this provision has not been exercised.

In the interim, and at a minimum, the CIE recommends making accommodation unit quotas transferable.

Chart 8.4 shows the distribution of accommodation unit numbers by premises. As can be seen, there are only a few large hotels/lodges, with the largest 10 premises accounting for 53 per cent of units (and 48 per cent of paid Accommodation Levy). We would anticipate that some of the more successful and larger premises would welcome the opportunity to enter into negotiations with less successful businesses for the purpose of obtaining the latter's quotas. We would expect this to be a win-win situation for all parties, as it would allow the successful businesses to expand, which is what should be encouraged, and would provide an exit strategy for less successful businesses.

8.4 **Distribution of beds**



Data source: Norfolk Island Tourism Bureau.

Observation 6: Political appeasement versus good policies

With around 2000 people, and even fewer in the voting population, Norfolk Island's politicians are very close to the personal impacts of any of their decisions. Norfolk Island politicians interact with their constituents on a daily basis. Politicians might face community resentment and hostility for decisions that provide overall benefits to the Norfolk Island economy but which also carry some adverse impacts for a small proportion of the community. In such circumstances political appeasement becomes much easier than making sound, but unpopular, policy decisions.

Norfolk Island's current tax system provides a good example of successive Norfolk Island Government's preference for appeasement over good policy. The Government levies few direct taxes on its population or businesses. Instead, it uses a variety of indirect taxes, with the burden of many taxes (and GBE pricing structures) designed to fall more heavily on tourists or non-residents. Ultimately, the failure of successive NIG's to address the underlying structural deficiencies of their tax system has led to the precariousness of their current financial situation. Yet, the inability of the NIG to address these issues is hampered because implementation of, for example, direct taxes, is likely to meet with hostility from some elements of the Norfolk Island community.

Regardless of whether the model of Norfolk Island Government remains unchanged, or moves to a modified self-government or local government model, the small size of the community, coupled with the NIG's relatively large responsibilities, will continue to hamper effective governance on the Island. Given this rather unique situation, a strong case could be made that the government 'needs to have its hands tied' when it comes to making some decisions. If some decision-making powers are not removed from the NIG's list of responsibilities, then there is every chance that politically popular decisions will prevail over economically correct decisions. Over the longer term, this will impose a cost on both the local economy and the community's living standards.

Observation 7: Exclusive distribution agreements

A number of retailers on Norfolk Island expressed concern that they might lose their exclusive distribution rights if Australian legislation is implemented. Currently, some Norfolk Island retailers enter commercial agreements that allow them exclusive distribution on Norfolk Island. The agreements allow the retailers to purchase goods directly from the producer.

Australian wholesalers also enter into commercial agreements for exclusive distribution rights across Australia. Australian wholesalers then distribute the product to retailers across Australia. While Norfolk Island is technically part of Australia, its ambiguous relationship to Australia has enabled some Norfolk Island retailers to maintain exclusive distribution agreements despite pressure from some Australian wholesalers that their exclusive distribution agreement encompasses Norfolk Island (see box 8.5). As most Norfolk Island importers both wholesale and retail the products they sell, they effectively remove one layer of 'margins' and price mark ups from the supply chain.

8.5 Retailer testimony on distribution rights

Our retail distribution rights allow us to purchase directly from companies, in particular Europe, USA and Asia. This means we do not have to go through the Australian distributor. This allows us purchase items at a similar price and retail them substantially cheaper as we are also the retailers. We believe that there is a fine line with the distribution set up as the Australian distributors have regularly tried to claim their rights over Norfolk, claiming we are part of Australia.

Our largest and most successful European supplier is [name withheld]. We have had a long association with this company. The Australian distributor has constantly tried to claim these rights which would force us to purchase directly from his [the Australian] company. This would mean that our purchasing price would be the same as all the retail outlets in Australia and we would have the added freight costs on top of this which would make the product not competitive with Australia.

Source: Norfolk Island retailer.

Such arrangements provide considerable advantage to Norfolk Island retailers. For example, one store claims to have the world's cheapest Lego. It is able to maintain low prices despite the high freight costs to ship goods to Norfolk Island.

Commonwealth legislation does not directly impact on these commercial arrangements. There is no specific legislation that would prevent Norfolk Island businesses from entering into such commercial arrangements. However, the extension of Commonwealth legislation would remove the present ambiguity regarding Norfolk Island's relationship to Australia. Wholesalers located in mainland Australia might consider that their commercial agreements now extend unambiguously to Norfolk Island. This could make some of the 'exclusive' commercial arrangements of Norfolk Island retailers redundant.

The number of businesses on Norfolk Island and the extent of their exclusive distribution agreements are unknown. Nevertheless, the CIE believe that, in the absence of a Commonwealth declaration to the effect that Norfolk Island is an external territory, the extension of Commonwealth legislation could lead to the loss of the exclusive distribution agreements for some Norfolk Island retailers. If this occurs it would contribute to a decline in the retail sector as prices rise due to the need to included whole-sale margins. This would have consequential impacts throughout the Norfolk Island economy, in addition to the results presented in this report.