GST Distribution Review

Interim Report

March 2012

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Manager
Communications
The Treasury
Langton Crescent Parkes ACT 2600
Email: medialiaison@treasury.gov.au

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Foreword from the Panel

It is impossible for a report on an inherently 'technical' topic such as this to avoid descending into detailed analysis of the issues. Although we have sought to present our analysis of ideas put forward by experts and interested parties in an accessible way, most of the Chapters that follow inevitably go into considerable detail.

Before you go on that journey, we want to start you off with a few key higher-level impressions that the Panel has formed.

The first thing that has struck the Panel is that, outside of a small core group of aficionados, very few people, politicians included, have a good understanding of the mechanism by which the goods and services tax (GST) is distributed between the States, known as Horizontal Fiscal Equalisation. If you read the submissions to the Panel, you will see that even the objectives and principles underlying the concept are furiously contested amongst the experts. We therefore do not expect our thoughts on any of the contentious topics to be met with instant agreement. Nevertheless, we see this lack of transparency, driven largely by the level of detail in the current process, as a key challenge to be overcome.

Secondly, because the Panel is reviewing the way a set pool of money is distributed, it is easy to be cynical about what is effectively a 'zero-sum' game. To the extent that the Panel recommends a change that increases any one State's share of GST, someone else's will decrease. For this reason, our interim report has focussed more on the ideas and principles behind them, and has not merely been driven 'by the numbers'. Clearly, towards the end of this process, when the principles have been settled, the numbers will provide an important reality check.

Finally, whatever the outcome, the importance of horizontal fiscal equalisation to the Federation should not be underestimated. We have only to look at the recent difficulties in Europe to see what can happen when a political union and a common currency is not adequately supported by internal arrangements to deal with the unequal and changing circumstances between the component political entities.

The Panel is conscious that a Review like this comes along infrequently. We are therefore keen for it to be comprehensive, thorough and forensic, but most of all we intend to pursue a vision for Commonwealth/State fiscal cooperation that will prove sustainable for many years to come. Cooperation to build consensus will be a vital part of achieving that goal.

The Hon. John Brumby   Mr Bruce Carter   The Hon. Nick Greiner AC

Introduction

What has the Review been asked to do?

The initial Terms of Reference[1]

On 30 March 2011, the Commonwealth Government announced a review of Australia's system of distributing the GST amongst the States and Territories (hereinafter collectively referred to as simply 'the States'). The Panel conducting the Review has been asked to consider whether the current arrangements for distributing the GST will ensure Australia is best placed to respond to the expected significant structural changes in the economy and will maintain public confidence in the financial relationships within the Federation.

This interim report outlines the Panel's thoughts on the matters set out in the initial Terms of Reference, taking into account the various positions and ideas put forward by States, academics and other interested parties in response to the initial Issues Paper.

Currently the Commonwealth distributes GST according to the principle of horizontal fiscal equalisation (HFE). This Review is not a debate about whether HFE should continue. The Terms of Reference make it clear that the long-standing principle of equalising States' capacity to provide services and infrastructure to their citizens has served Australia well.[2]

Nevertheless, there are substantial concerns about the current form of GST distribution, aspects of its outcomes and the inability of States to anticipate those outcomes with reasonable confidence. On closer examination some of these concerns might turn out to be apparent, rather than real. Others might relate to the practical limitations of the current system to meet its stated goal, while yet others might represent symptoms of the present economic times.

The Panel believes that the importance of HFE to the Australian Federation cannot be overstated and, in this context, considers that whatever changes are recommended by this Review, States that are fiscally weaker at any given time must continue to have the capacity to provide substantially similar levels of services and infrastructure to their citizens. But from our work to date, there is clearly room for improvement and refinement in the process, however sound the underlying principles.

With respect to institutional issues relevant to the equalisation process, the Panel notes that its Terms of Reference make it clear that the Commonwealth Grants Commission (CGC) will continue to make recommendations on the distribution of the GST.

1 The Terms of Reference are set out in Appendix A and are available on the Review's website: http://www.gstdistributionreview.gov.au.

2 GST Distribution Review Terms of Reference, issued on 30 March 2011, paragraph 6.

Finally, as stated in the Issues Paper, the Review has *not* been asked to consider if the GST rate should be increased, nor if the range of goods and services on which the GST is payable should be broadened.

Supplementary Terms of Reference

Supplementary Terms of Reference were issued by the Commonwealth Government on 17 November 2011, asking the Panel to examine and make recommendations on possible changes to the form of equalisation to achieve the following objectives:

- ensure that HFE does not provide a disincentive to State tax reform
- utilise HFE to provide incentives and disincentives to promote future State policy decisions which improve the efficiency of State taxes and mineral royalties
- examine the incentives for States to reduce Minerals Resource Rent Tax (MRRT) or Petroleum Resource Rent Tax (PRRT) revenue through increasing State mineral royalties.

Following consideration of submissions the supplementary Terms of Reference will be addressed in a second interim report that will be provided to the Commonwealth Treasurer in mid-2012.

Context of the Review

Before embarking on an examination of various ideas as to how Australia's equalisation system could be improved it is important to take stock of the context in which the Review is operating.

While the Australian economy is performing well, there is a degree of uncertainty in the outlook driven largely by the deterioration in global economic growth and financial conditions. Growth prospects for the Australian economy remain solid, underpinned by a record pipeline of resources investment and strong growth in commodity exports to the large emerging market economies in the fast-growing Asian region. Nevertheless, the growth outlook has implications for Commonwealth and State budget revenue. All Commonwealth and State Governments are expecting to deliver fiscal deficits, or at best, very modest fiscal surpluses, in the near-term.

Of particular relevance to the Review, the Panel notes:

- While growth in GST revenue — the current vehicle for equalisation — has averaged 6.6 per cent in the ten years since the introduction of the GST, for the next few years 5.4 per cent per year is expected.[3] Lower growth may have implications for the range of approaches and specific proposals the Panel might recommend.
- Recent significant and rapid changes in the relative financial position of Western Australia have led to greater divergence in State fiscal capacities and, therefore, substantial changes in the distribution of the GST amongst the States. These changes

3 Historical GST payments to 2010-11 sourced from Commonwealth Government *Final Budget Outcome,* various years. Forward estimates of GST entitlements sourced from *Mid-Year Economic and Fiscal Outlook 2011-12*, page 70.

have heightened scrutiny about the equalisation process and its outcomes in recent years.

- A number of other special factors (of varying degrees of importance) have contributed to the heightened scrutiny, including recent large data revisions, changes made in the CGC's 2010 Review, a large increase in the size of one-off infrastructure payments to the States as part of the Commonwealth Government's Economic Stimulus Package, and the 2010 proposal by the Commonwealth Government to take back a portion of the GST revenue to fund national health reform.

- Extra Commonwealth funding is not available to fund changes to Australia's equalisation system. Any proposed reforms must be achieved using the GST and other revenue currently made available to the States.

GST revenue

The current vehicle for fiscal equalisation is the GST revenue. GST grants replaced financial assistance grants (FAGs) and revenue from abolished State taxes in 2000-01. At its introduction the GST was cast as a tax that would grow automatically with the level of activity in the national economy.[4] The *Intergovernmental Agreement* that accompanied the introduction of the GST made it clear that all GST revenue would be shared among the States to be spent according to their own budget priorities. It was anticipated that the GST would provide the States with access to a more robust tax base that would grow over time thus ensuring that State budgets would be substantially better off over the medium term.[5]

When the GST was introduced the anticipated medium term growth assumption for GST revenue was for 6 per cent per year.[6] In fact, GST revenue grew from $24.4 billion in 2000-01 to $45.9 billion in 2010-11, an average annual growth rate of 6.6 per cent. However, growth in the latter half of the past decade has been lower, averaging 4.4 per cent per year between 2006-07 and 2010-11. This period includes the impact of the global financial crisis in 2008-09, when GST revenue fell by 2.7 per cent.

The outlook for GST revenue to 2014-15 is for modest growth of 5.4 per cent a year. A number of factors are contributing to the current weakness of GST revenue. Increased household savings associated with the 'cautious consumer' and the consolidation of household balance sheets have contributed to a decline in consumption as a share of GDP. In recent years there has also been a steady decline in the expenditure on items attracting GST as a share of total consumption. This effect is partly cyclical — during downturns, households tend to allocate a greater proportion of their income towards GST-free goods and services (such as health and education), and spend less on goods and services that attract GST.[7] More broadly, a slowdown in employment growth,

4 In the 2000-01 Budget Speech the Treasurer said that 'from 1 July [the States] have a revenue base that grows in line with the economy … It will provide a secure base to fund their services.'
5 Commonwealth Budget Paper No. 3, Federal Financial Relations, 2000-01, page 5.
6 The model adopted by the Commonwealth Treasury to calculate budget balancing assistance anticipated medium term growth for GST revenue of 6 per cent growth per year.
7 There are other factors at work. Prices of goods not subject to GST have risen more than goods subject to GST. The price increases were most significant in areas such as rental services, health and education. Furthermore, as these areas are largely non-tradeable, they are unlikely to have benefitted from factors such as a stronger Australian dollar.

uneven conditions across the economy and a strong Australia dollar will contribute to weakness in GST revenue in the short term.

The Panel believes the current weakness in GST revenue may have implications for achieving reform — simply put, reform would be easier in a strongly revenue positive environment. In this vein, the Panel notes recent Productivity Commission and Commonwealth Treasury estimates of annual GST revenue forgone due to the exemptions that apply to imports of intangibles and packages below a low value threshold of $1,000. Any effective policy or compliance action to capture some of this revenue would bolster the GST revenue outlook.

The 2011 Tax Expenditure Statement produced by Commonwealth Treasury estimated, albeit with low reliability, that revenue forgone in 2011-12 would be $630 million in relation to the low value threshold and $1.1 billion on imports of certain services and intangibles.[8]

If overseas online shopping continues to increase at current rates, revenue forgone could increase significantly. The Productivity Commission reported that total online sales are predicted to grow 10 to 15 per cent per year for the next three years, with market estimates suggesting that overseas internet sales currently represent 2 per cent of Australian retail spending, or $4.2 billion.[9]

The Productivity Commission found that there are grounds, in-principle, to reduce the low value threshold, but that it is currently not cost-effective to do so. For example, lowering the threshold to $100 could collect around $500 million in revenue, but at a cost of $1.2 billion in administration and compliance costs.[10]

There are a number of options that could be considered to address this situation (such as a self-assessment model, requiring major offshore suppliers to pay GST, or collecting GST through overseas jurisdictions or card issuers), but none are straightforward to implement. In response to the Productivity Commission's recommendations, the Commonwealth Government established the Low Value Parcel Processing Taskforce to consider the efficiency of processing arrangements at the border. The Panel supports the Commonwealth's efforts and, to this end, has commissioned work and provided information and views to the Taskforce for their consideration.[11]

A brief of history of equalisation in Australia

The aim of equalising the fiscal capacity of the States and the way it is done have often given rise to contentious debates between the Australian Government and the States, and amongst States themselves. These debates about the equalisation system and its outcomes have occurred over time with varying levels of intensity. Most recently, the current mining boom and the global financial crisis have contributed to substantial changes in the distribution of the GST amongst the States and led to greater scrutiny of

8 Commonwealth Treasury, *Tax Expenditure Statement 2011*, January 2012, pages 194 to 195.
9 Productivity Commission, *Report on the Economic Structure and Performance of the Australian Retail Industry*, December 2011, page 73.
10 Productivity Commission, *Report on the Economic Structure and Performance of the Australian Retail Industry*, December 2011, pages 199-200.
11 This work is available on the Review's website (http://www.gstdistributionreview.gov.au).

the equalisation process and its outcomes. Australia's demographic and other structural policy challenges are also having a differential impact on the States.

Since 1910, the Australian Government has provided some form of financial support for fiscally weaker States. The view was taken that, unless some type of intervention occurred, the Federation would be unsustainable. Less endowed States with weaker financial positions would have had to reduce services and/or raise additional revenue. To enable the poorer (and smaller) States to provide services to their residents at anything close to the same standard, it was recognised that a mechanism was required to adjust their fiscal capacities through special grants.

The current system continues to involve grants from the national government to the States, recognising and adjusting for their disparate capacities, with the aim of horizontal fiscal equalisation. Since the 1970s these grants have been made to all States.[12] While changes have been made to the specific arrangements for deciding the amount of support each State receives and the source of funds to facilitate these payments, the broad aim of equalisation has remained unchanged.

The introduction of the GST in 2000 led to a shift in the emphasis in Commonwealth-State relations from the amount of assistance made available by the Commonwealth to the interstate allocation of a fixed pool of funds in a 'zero sum game'.

Despite the level of disharmony at times, typically the equalisation process receives little attention except when State shares of Commonwealth financial support change substantially. In large part, this Review has occurred in the context of a strong improvement in the financial position of Western Australia and the resulting reduction in its GST share. In March 2012 the CGC recommended a 2012-13 per capita relativity for Western Australia of 0.55135.[13] If adopted, this will result in a decline in GST paid to Western Australia of $598 million compared to the previous year.

As explained in more detail in Chapter 1, Australia is not the only federation with a strong commitment to the principle of horizontal fiscal equalisation. Other countries have equalisation programs that are just as contentious and subject to periodic review. In 2006 Canada completed a comprehensive review of its equalisation program. The most contentious issue in the Canadian review was how mining revenues should be treated in the equalisation formula, given the potential for mining revenues to increase disparities among the Provinces.[14]

Outcomes over time

The Panel considers that the GST distribution outcomes in recent years should be viewed in the context of changes in the relative financial positions of the States throughout the history of the Federation. Traditionally, the two most populous States — New South Wales and Victoria — have been the States with the strongest fiscal capacity while South Australia, Tasmania and the Northern Territory have been the

12 The Northern Territory and the Australian Capital Territory were included in 1988-89 and 1993-94 respectively.

13 An explanation of average and annual relativities is given in Chapter 2.

14 See Chapter 1 for an explanation of Canada's equalisation program. See also the Canadian Department of Finance website http://www.fin.gc.ca/fedprov/eqp-eng.asp and the Report of the Expert Panel on Equalisation and Territorial Formula Financing, Canada, 2006.

States with the weakest fiscal capacity.[15] The fiscal capacities of Queensland and Western Australia have fluctuated, particularly in more recent times. Queensland and Western Australia, traditionally States with below average fiscal capacities, are now among the States with above average fiscal capacities. Western Australia has shown the greatest change in its relative fiscal strength. Currently Western Australia is the State with the strongest fiscal capacity, surpassing New South Wales and Victoria in 2008-09. Whereas in the past only New South Wales and Victoria helped meet the fiscal needs of the other States, that task is now shared between the four largest States.

Table 1 shows the relativities for each year since the introduction of the GST. They represent the per capita assessed fiscal capacities of the States calculated by the CGC and are used for determining the distribution of the GST.[16] The latest set of relativities recommended by the CGC will be used to distribute the GST in 2012-13.

Table 1: Relativities applied 2000-01 to 2012-13

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2000-01	0.90913	0.87049	1.01830	0.98365	1.18258	1.51091	1.11289	4.16385
2001-02	0.92032	0.87539	1.00269	0.97516	1.17941	1.50095	1.14633	4.02166
2002-03	0.90631	0.86824	1.01174	0.97592	1.19447	1.55419	1.15216	4.24484
2003-04	0.89117	0.87010	1.01902	0.96946	1.21215	1.59948	1.14979	4.38638
2004-05	0.86750	0.86534	1.05504	1.03054	1.20407	1.55939	1.12930	4.26538
2005-06	0.86846	0.87552	1.04390	1.02500	1.20325	1.55299	1.14300	4.26682
2006-07	0.87332	0.89559	1.02387	1.00480	1.18862	1.54931	1.14575	4.32755
2007-08	0.89079	0.90096	1.00607	0.94747	1.20791	1.54465	1.16293	4.36824
2008-09	0.91060	0.92540	0.96508	0.88288	1.20856	1.52994	1.17205	4.51835
2009-10	0.93186	0.91875	0.91556	0.78485	1.24724	1.62040	1.27051	5.25073
2010-11	0.95205	0.93995	0.91322	0.68298	1.28497	1.62091	1.15295	5.07383
2011-12	0.95776	0.90476	0.92861	0.71729	1.27070	1.59942	1.11647	5.35708
2012-13	0.95340	0.92135	0.98506	0.55135	1.28491	1.58105	1.18058	5.52844

Source: CGC, 2012 Update, page 123.

Note: In 2009-10, the pool to which the relativities were applied changed. Prior to this, they were applied to a pool comprising GST revenue and health care grants. Since 2009-10, relativities have been applied to GST revenue only.

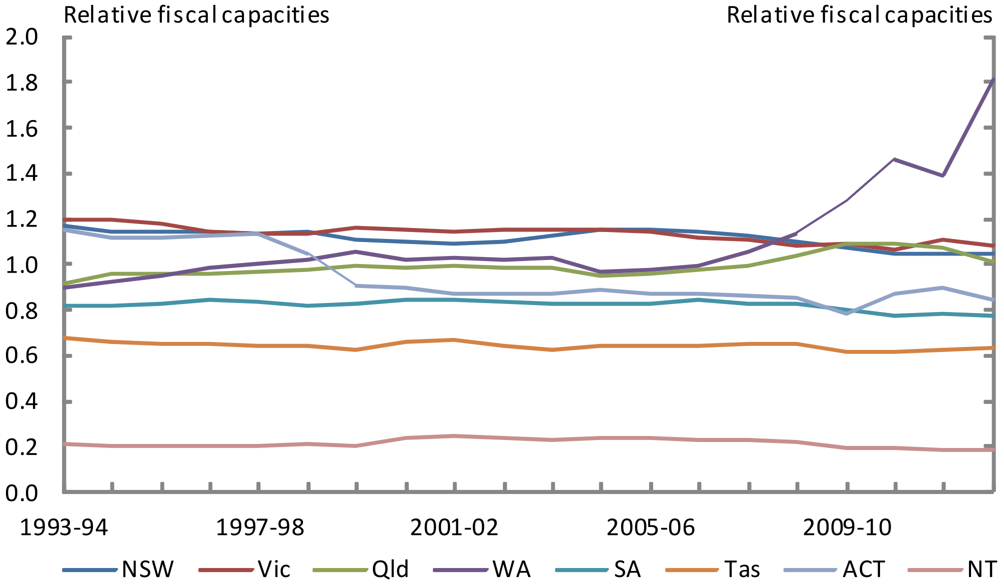
Figure 1 provides an alternative presentation of States' fiscal capacities. It shows the relative fiscal capacities of the States since 1993-94 — the first time equalisation was applied to all States and Territories.[17] In this presentation, the State with the strongest fiscal capacity (currently Western Australia) appears at the top of the chart and the State with the weakest fiscal capacity appears at the bottom of the chart (consistently the Northern Territory).

15 Until 1998-99 the ACT was a donor State, but since that time its fiscal capacity has been below average. The shift from donor to recipient status in that year was largely the result of changes in methods and data used in revenue and expenditure assessments.

16 Prior to 2009-10 the relativities were applied to a pool comprising GST revenue and Health Care Grants. Since 2009-10 they have been applied to a pool of GST revenue only.

17 For a more comprehensive discussion of how State fiscal capacities have changed over time and why see *The Commonwealth Grants Commission: The Last 25 Years*, 2008.

Figure 1: Relative Fiscal Capacities 1993-94 to 2012-13



Source: Commonwealth Grants Commission.

Note: Relative fiscal capacities are the inverse of per capita relativities. While the trends in the figure are mostly driven by changes in State circumstances, they are also affected by the introduction of the GST in 2000-01 and changes in assessment methods in 1993-94, 1999-2000, 2004-05 and 2010-11. The introduction of the GST resulted in a large increase in the funds distributed on an equalisation basis and this moved the relativities of all States closer to one.

Outlook for GST distribution

The CGC recommended relativities for distributing the GST revenue in 2012-13 are shown in Table 1 (above).

As Western Australia's fiscal position has improved, its relativity has declined, resulting in a reduction in its GST share. It is unclear how much lower Western Australia's relativity will go. The Western Australian Government said it expects its per capita relativity to reach 0.36 by 2014-15.[18] Depending on the strength of the mining boom, it is conceivable that their relativity could reach zero in the medium to long-term.

A relativity of zero, while technically possible, would mean that Western Australia's own source revenue was so strong that it needs no GST to have the average fiscal capacity and that the other States require all the GST revenue to reach the average capacity. The fairness of such an outcome would entirely depend on one's perspective, and the Panel explores these various perspectives in the Chapters that follow.

The Panel's approach

The consultation process

To date the Panel has met with and consulted States (including Premiers, Treasurers and Shadows, as well as officials), the CGC, academics with known interest in federal-state financial arrangements, and other interested parties. The consultation process began in May 2011 with the Panel visiting each jurisdiction to obtain initial views on particular

18 Western Australia Department of Treasury and Finance, Government Mid-Year Financial Projections Statement 2011-12, December 2011, page 13.

issues of concern. This was followed by the release of an Issues Paper in July 2011 that provided some basic background about the history of HFE in Australia and the key features of the current system.[19] The initial Issues Paper posed a number of questions intended to guide, but not limit, the content of submissions and the Panel received 25 detailed submissions in response.[20] In October 2011 the Panel convened a symposium in Sydney with the aim of providing an additional opportunity for academics to meet with the Panel and present their views.

Consultations related to the additional Terms of Reference commenced in late 2011 and submissions closed on 9 March 2012. The Panel will produce a second interim report addressing the additional Terms of Reference in mid-2012.

Following this, and after considering the consequent further submissions and consultation, the Panel will draw together its recommendations in a final report to be presented later this year.

In the Panels' view, reform in this area will not be achieved solely by the Commonwealth imposing a view on the States — high quality reforms will come about through the States and Commonwealth working cooperatively and with goodwill on all sides.

The structure of this report

This first interim report outlines the Panel's current thinking on the different positions and proposals put forward by the States and other interested parties in response to the initial Terms of Reference. Where there is sufficient information and either power of argument or consensus of view, it has indicated which of those proposals appears to have merit and may be worth pursuing further. In other areas, where some of the ideas have not been tested as rigorously, the Panel has called for further information to be provided by proponents of those views. The report makes a point of drawing out a range of views, especially from the States, as, in the end, an appreciation of all views is required to reach a meaningful consensus. While nothing is ruled out at this stage, the Panel has indicated some positions and directions that it is not inclined to pursue further in the absence of additional compelling evidence or argument.

The Panel's views are presented in boxes throughout the report. Together, or in some combination, these views represent opportunities for improvement.

The report itself is divided into nine Chapters, the first eight of which examine key features or aspects of HFE and the GST distribution mechanism from a particular perspective, such as whether a proposal improves simplicity, predictability or stability of GST payments, or affects efficiency. The final Chapter begins the process of considering how certain proposals might interact and affect the system as a whole.

How to respond to the interim report

The Panel will commence a second round of face-to-face consultations following the release of both interim reports. In the meantime, interested parties are invited to provide further submissions on the approaches and proposals outlined in this report.

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19 The Issues Paper is available on the Review's website http://www.gstdistributionreview.gov.au.
20 Submissions are available on the Review's website http://www.gstdistributionreview.gov.au.

Provide your comments and ideas

By email: gstdistributionreview@treasury.gov.au

By post: The Secretary
GST Distribution Review
The Treasury
Langton Crescent
PARKES ACT 2600

All submissions will be available for reading and downloading from the Review website at http://www.gstdistributionreview.gov.au unless confidentiality is specifically requested.

1 The role and purpose of *Horizontal Fiscal Equalisation*

This Chapter explains the background and goals of the current system of fiscal equalisation, and introduces some key concepts that will be developed in later Chapters.

The Terms of Reference make it clear that this is not a review of whether the concept of Horizontal Fiscal Equalisation (HFE) should continue to apply, but rather, what form it should take. However, the wide range of meanings attributed to the term HFE makes it important to consider what HFE is, to examine how it is currently approached in Australia, and review how it has been thought about in Australia in the past.

In particular, this Chapter will:

- describe what HFE is, and discuss the range of ideas the term can cover
- briefly examine how other federations approach HFE
- describe how the HFE system operates and has operated in Australia
- explore the form of HFE needed in Australia today and in the future.

1.1 What is Horizontal Fiscal Equalisation and what is it intended to achieve?

If all sub-national governments in a country faced the same circumstances — that is, if they all had the same ability to raise revenue and faced the same service costs — then HFE would not be necessary. However, different sub-national governments typically have different costs and capacities to raise revenue for reasons that are beyond their control. The process to address these differences is known as Horizontal Fiscal Equalisation (or HFE).

In Australia, HFE is not referred to in the Constitution, defined in legislation or described in any agreement between governments. Rather, the definition has evolved over time, largely through the body that administers HFE in Australia — the Commonwealth Grants Commission (CGC). The current CGC definition of HFE is:

> *State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.*[1]

1 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities*, 2010 Review, Vol 1, page 34.

At a simpler level, the CGC describes horizontal fiscal equalisation as follows:

> ... *equalisation aims to put all States on a level fiscal playing field.*[2]

The range of concepts covered by the term *Horizontal Fiscal Equalisation*

In Australia, HFE is performed only by payments from the Commonwealth to the States (that is, no payments are made by one State to another), a situation largely driven by the high degree of Vertical Fiscal Imbalance (VFI) in Australia.[3] The current source of funds to address HFE is the revenue from the goods and services tax (GST). With HFE being sought through GST payments to the States, the challenge for the designers of the system (and now the Panel) has been how to make these payments 'fairly'.

Fairness is an inherently subjective concept and there is a range of views on what is, or is not, 'fair'. Because the various perceptions of fairness are critical to an evaluation of the current system of GST distribution, this concept is dealt with in more detail later in this Chapter.

For present purposes, it is sufficient to point out that some jurisdictions and commentators argue that the Commonwealth should simply give the States the same amount of revenue per citizen, referred to as an equal per capita (EPC) distribution.[4] Both New South Wales and Victoria suggest that an EPC distribution of GST would be the most appropriate form, although both States acknowledge that additional payments would then need to be made by the Commonwealth to some States, or in relation to some issues.[5]

New South Wales says:

> *An alternative distribution model incorporating an equal per capita distribution of the GST pool to all states, with an additional, separately funded equalizing distribution to the recipient states would provide a simpler, more transparent, more stable system of HFE.*[6]

Victoria considers that:

> *There is a strong case for transitioning to an EPC distribution of the GST pool over the longer-term ... EPC shares would be simple to calculate, thus negating the*

2 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities*, 2010 Review, Vol 1, page 22.

3 VFI refers to the imbalance of taxing powers and spending obligations between the central and the sub-national governments in a Federation. Where the sub-national governments raise less from taxes than they spend and the central government funds the difference, VFI is said to exist. For further discussion of VFI, see page 6.

4 The Northern Territory says that there are misinterpretations regarding the meaning of 'equal per capita' in that an equal per capita distribution is not the same as an equal payment per recipient distribution. For example, the amount of age pension payments to individuals is fixed across Australia, but this does not constitute an equal per capita distribution of pension payments in each state: see Northern Territory submission to the GST Distribution Review, October 2011, Appendix B, page 73.

5 It could be argued that an EPC distribution does not constitute HFE, as no assessment is made of the relative fiscal capacities of the recipients. On the other hand, it could also be argued that, as an EPC distribution does not consider the source of the revenue, it is an implicit form of HFE. However, as both States suggesting EPC in their submissions make reference to additional payments being required, the question of whether EPC alone constitutes HFE or not does not directly arise.

6 New South Wales submission to the GST Distribution Review, November 2011, page 47.

> *need for a complex CGC architecture to calculate relativities. The system would also be devoid of the type of perverse incentives for inefficiency that exist under the current system.*[7]

At the other end of the spectrum of opinion, some argue that States should receive an amount based on a precise and comprehensive measurement of their revenue raising capacity and their service delivery costs. This requires a form of equalisation that is broad and deep — broad in the scope of matters it encompasses and deep in terms of the level of detail considered on each.

The current system in Australia is closer to this 'broad and deep' notion of HFE than equalisation systems in other countries.[8] However, it is not at the extreme end of the spectrum, due to practical data limitations and prior deliberate moves towards simplicity.[9]

Some State submissions can be seen as proposing a move further towards the 'broad and deep' end of the spectrum. For example, the Australian Capital Territory proposes subsidies paid by the Commonwealth to specific industries be included, thus broadening the scope of HFE.[10]

Similarly, Western Australia suggests that, if the existing equalisation framework is retained, a range of 'gaps' should be addressed, including, for example, servicing national parks.[11] Inclusion of such costs would increase the depth of relevant individual assessments.[12]

In short, the concept of HFE has been and can be used to cover the entire spectrum of variations between an EPC distribution and a 'broad and deep' form of full equalisation.

Does HFE describe the mechanism or the objective?

As well as encompassing a range of concepts, the term HFE can be used to refer to both an objective and the mechanism used to achieve it. Henry Ergas and Jonathan Pincus make this point in their submission to the Review:

> *Horizontal fiscal equalisation refers both to a mechanism and to an objective. The mechanism is the process through which revenues collected by the Commonwealth from the Goods and Services Tax ... are distributed to the States and Territories ...*

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7 Victorian submission to the GST Distribution Review, October 2011, page 6.

8 See Western Australian submission to the GST Distribution Review, October 2011, page i; New South Wales submission to the GST Distribution Review, November 2011, page 6; Warren, N, *Benchmarking Australia's intergovernmental fiscal arrangements*, 2006, page 103; Boadway, R and Shah, A, *Intergovernmental fiscal transfers: principles and practice*, 2007, pages 36, 70 and 93.

9 See Northern Territory submission to the GST Distribution Review, October 2011, pages 38-39.

10 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 8.

11 Western Australian submission to the GST Distribution Review, October 2011, pages 22, 54.

12 See also Queensland's point regarding costs of regional growth related to mining in Chapter 4 (section 4.2), the discussion of mining-related infrastructure costs in Chapter 6 (section 6.2), South Australia's statement that the lack of contemporaneity in the system should be addressed (South Australian submission to the GST Distribution Review, September 2011, page 3) and Victoria's point regarding cost pressures due to high migrant populations and urban congestion (Victorian submission to the GST Distribution Review, October 2011, page 18).

> *The objective is that of securing particular outcomes captured by the term 'equalisation'.*[13]

In Australia, these two meanings of the term are often used interchangeably because there has been no practical reason to differentiate between them. However, the distinction between the use of the term to describe the mechanism and the objective may become important if additional goals are sought through the GST distribution mechanism in the future.

Equalising States' capacity, not individual outcomes

While HFE encompasses a range of meanings, a feature common to many is the notion of equalising States' *capacities*, rather than actual outcomes.

In pursuing HFE, national governments seek to compensate for things outside States' control. The goal is therefore often said to be to give States the *capacity* to provide equal outcomes without reversing or overriding the States' own policy choices. The use of the word *capacity* in this way emphasises the freedom of States to choose how to spend their money, even if their choices ultimately produce unequal outcomes for various classes of citizens.

Practical constraints on HFE models

There are practical constraints on all HFE models.

Advocates of the EPC model often suggest that extra funding should be provided by the Commonwealth to the States.[14] However, as explained in the Introduction, extra Commonwealth funding is not available and existing payments from the Commonwealth to the States (specific purpose payments and national partnership payments) are already fully committed. In any case, an approach that distributed GST on an EPC basis, but required 'equalisation' of other Commonwealth payments would merely shift the current criticisms of HFE to the form of equalisation used to determine States' shares of the other funding.

Concepts of HFE at the other end of the spectrum, seeking a more comprehensive form of equalisation, also face problems. A complete and comprehensive form of equalisation would ideally seek to be contemporaneous, but the unavailability of timely data creates a constraint.[15] A separate constraint, contained in both the Panel's Terms of Reference and the latest Intergovernmental Agreement, is that GST payments cannot be tied. This would constrain those models of HFE that seek to equalise outcomes for individuals.

1.2 HFE around the world

Many federations and some unitary nations perform some form of HFE.

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13 Submission from Henry Ergas and Jonathan Pincus to the GST Distribution Review, September 2011, page 2.

14 New South Wales submission to the GST Distribution Review, November 2011, page 48; Victorian submission to the GST Distribution Review, October 2011, page 6.

15 See Chapter 2.

While comparing the range of HFE approaches around the world can be useful, care is required before concluding that one country's approach is suitable for another, as a wide range of factors influences the chosen form of HFE. The political structures, the degree of VFI, and the historical and social circumstances of a nation all have a significant bearing on the form of HFE that is most appropriate for a particular country.

Nevertheless, to demonstrate the different approaches currently in use, brief summaries of HFE as applying in Canada and Germany are set out below.

Canada[16]

Canada's equalisation program aims to ensure that Provinces have sufficient revenue to provide reasonably comparable levels of public services at reasonably comparable levels of taxation (subsection 36(2) of the *Constitution Act, 1982*).

To this end, Canada equalises Provinces' revenue-raising capacity, but not their expenditure needs. Further, one of the main sources of revenue for some Provinces — mining revenue — is subject to a discount of fifty per cent. Provinces receive the greater of the amount they would receive by fully excluding natural resource revenue, or by excluding 50 per cent of natural resource revenue.

As in Australia, equalisation payments are untied funds (so Provinces are free to spend the funds as they choose) and there are no transfers between Provinces, with all HFE transfers coming from the national government to Provincial governments. However, unlike Australia, only Provinces with below average capacities receive equalisation payments, so that each Province is not 'equalised' to exactly the same capacity. Provinces with below average capacity are equalised 'up' to the average, but those with above average capacity neither receive payments nor are required to contribute.

Canada's external territories, however, have a separate program, with both their revenue raising capacities and expenditure needs recognised.

Germany

Germany mainly equalises for revenue, with only some small adjustments for expense needs (namely population dispersion and cross-border issues).

There are multiple sources of funds for equalisation in Germany.

First, the Federal Government provides poor Lander[17] with an above average share of Value-Added Tax (VAT). VAT revenue is shared among all levels of government. The Landers' share has recently been around 45 per cent, although it has varied over time. This share is allocated among them on an equalising basis, with 75 per cent distributed EPC and the remaining 25 per cent paid to Lander with below average fiscal capacity.

Secondly, unlike Canada or Australia, there are direct transfers *between* sub-national Governments. Poor Lander receive adjustment payments funded by the wealthy Lander.

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16 Information sourced from Department of Finance Canada, Equalization program; and Expert Panel on Equalization and Territorial Formula Financing, 2006.

17 Lander is the term for Germany's sub-national Governments, and can be roughly translated into 'States'. Germany comprises 16 Lander (or States).

Thirdly, Lander whose financial capacities after the distribution of VAT and transfers between the sub-national governments are still marginally below the average receive supplementary grants from the federal government.[18]

Vertical Fiscal Imbalance (VFI)

A range of factors influences the form of HFE used in any particular country. One important factor is the level or degree of VFI — a high level of VFI can make it easier for a national government to pursue a more complete form of HFE, because it is less likely to require direct transfers between sub-national governments.[19]

By international standards, Australia exhibits a high degree of VFI. VFI can be measured in several ways, but is often measured as State Government own-source taxes or revenues as a proportion of State Government expenditure. By this measure, Australian States experience considerably higher levels of VFI than sub-national Governments in Canada and Germany. State Government own-source revenues are around 54 per cent of State Government expenditure in Australia compared to over 70 per cent in both Canada and Germany.[20] However, such figures can hide differences in the way taxes are structured and collected. German Lander, for example, have limited discretion in setting the tax rates and defining the tax bases for some of their 'own source' taxes.[21] Canadian Provinces and Australian States, by contrast, have power to set bases and rates for all their own taxes.

1.3 How does HFE apply in Australia?

How HFE has applied in Australia in the past

Before World War II, the system was less 'full' than now in several ways.

First, not all States were included in the equalisation system. 'Claiming' States were raised to a minimum standard, rather than all States being equalised to an average. Secondly, not all expenditure categories were assessed. Instead, the assessment was limited to health, education and law and order.

Part of the reason for this was practical. Less money was distributed from the Commonwealth to the States (the degree of VFI was considerably less before World War II) and data sets were harder to obtain.[22]

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18 Stehn, S J, and Fedelino, A, *Fiscal Incentives in the German Equalization System,* 2009, page 6; Boadway, R, and Shah, A, *Intergovernmental Transfers: Principles and Practice*, 2007, page 147.

19 Walsh, Cliff., *The Equity Case for Equalising Fiscal Capacities: Rationales, Value-Judgements, Compromises and their implications*, A Discussion Paper prepared for the Department of Treasury and Finance, Government of Victoria, September 2011, page 25 – 28.

20 Warren, Neil, *Benchmarking Australia's intergovernmental fiscal arrangements*, final report to the New South Wales Government, 2006, page 56.

21 Stehn, S J, and Fedelino, A, *Fiscal Incentives in the German Equalization System*, 2009, pages 6-7; Boadway, R, and Shah, A, *Intergovernmental Transfers: Principles and Practice*, 2007, page 147; Commonwealth Grants Commission, *The Commonwealth Grants Commission: The Last 25 Years*, 2008, page 96 and Bundesministerium der Finanzen, *The Federal Financial Equalisation System in Germany*, page 4.

22 Walsh, Cliff, *Fiscal Capacity Equalisation: An exploration and critique of the equity rationale*, A Discussion Paper prepared for the Department of Treasury and Finance, Government of Victoria, December 2011, page 74 (see also attachment B and section 7 (starting at page 85)).

Reforms in the late 1970s led to the inclusion of all States (but not Territories) in the equalisation process. The Northern Territory and Australian Capital Territory were included in 1988-89 and 1993-94 respectively.

The idea that States should be equalised to the 'same' capacity was not formally introduced into the CGC's definition of HFE until the 1990s. Prior to that, the phrase 'not appreciably different from' had been adopted.

A more detailed history of HFE in Australia can be found in the CGC's publications: *The Last 25 Years* and *Equality in Diversity*.[23]

How HFE applies in Australia today

Australia currently adopts an approach that is closer to 'full' equalisation than any other country. Australia's approach to equalisation can be considered 'full' in two ways. First, it seeks to equalise States to materially the 'same' capacity — it does not merely seek to act, for example, as a safety net bringing weak States up to a minimum standard. Secondly, it is broad in scope (including revenues, expenses, and capital) and deep in detail (in each of its assessments).[24]

How the CGC calculates HFE payments

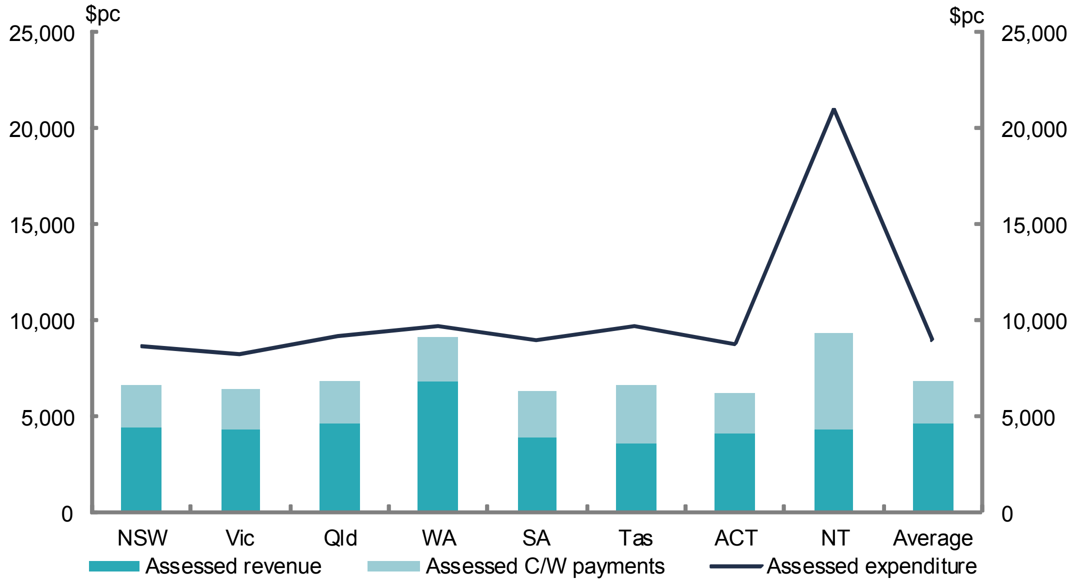
The CGC uses a total of States' actual revenue and expenses to construct an 'average' State budget, which includes the costs to provide the average level of services and the average revenue raised by State taxes. It then considers to what extent States may be able to raise more (or less) than the average level of revenue (for example due to property market activity), and what factors beyond a State's control (such as demographic and geographic features) may require it to spend more (or less) than the average to provide services. States with below average capacity to raise revenue, or facing above average costs to provide services, receive relatively more GST revenue, while States with above average capacity to raise revenue, or facing below average costs to provide services, receive relatively less GST revenue.

Figure 1.1 below shows each State's assessed revenue (that is, the revenue they would raise from their own sources if they applied the average policies), their assessed expenditure (that is, the funding they would need to provide the average level of services and infrastructure, given their demographic characteristics and population growth) and their Commonwealth payments (actual non-GST payments received from the Commonwealth). There is a 'gap' between the assessed expenditure and the total of the assessed own source revenue plus Commonwealth payments.

23 Commonwealth Grants Commission, 1995, *Equality in Diversity: History of the Commonwealth Grants Commission*, Second Edition, Australian Government Publishing Service; Commonwealth Grants Commission, *The Commonwealth Grants Commission: The Last 25 Years*, 2008.

24 References suggesting that Australia's current form of HFE is 'full' (or seeks to be 'full') include: Commonwealth Treasury submission to GST Distribution Review, October 2011, page 9; Northern Territory submission to the GST Distribution Review, October 2011, page 14; Queensland submission to the GST Distribution Review, October 2011, page 3; Tasmanian submission to the GST Distribution Review, October 2011, page 15; New South Wales submission to the GST Distribution Review, November 2011, page 10; Victorian submission to the GST Distribution Review, October 2011, page 2, 23; Australian Capital Territory submission to the GST Distribution Review, October 2011, page 9.

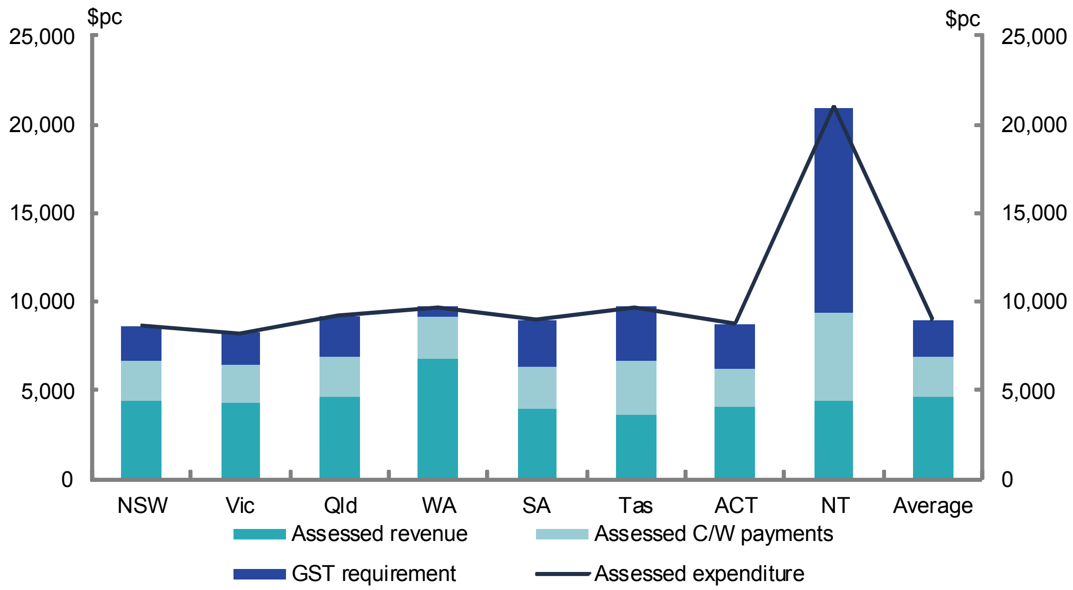
Figure 1.1 Revenue available to meet expenditure requirements, 2010-11



Source: CGC, 2012 update
Note: Assessed expenditure is the sum of assessed expenses, assessed investment and assessed net lending.

As shown in figure 1.2, the GST payment fills the gap between the revenue available (from the Commonwealth and States' own sources) and expenditure requirements, thus producing the result that States have (materially) the same capacity to fund their separate needs.

Figure 1.2 GST requirement, 2010-11



Source: CGC, 2012 update

Once the CGC has calculated how much GST a State requires to fill the 'gap', it then divides the requirement by the average GST per capita to produce a 'relativity'.

Figures 1.1 and 1.2 show that some States have higher assessed revenue or expenditure per capita than others. Some States have higher assessed revenue per capita because there are factors beyond these States' control that mean they have a greater capacity to raise revenue from their own sources. For example, if a State has particularly high land values, its capacity to raise revenue from land tax may be greater than the average.

Similarly, higher assessed expenditure arises because the CGC considers that there are factors beyond these States' control that lead to higher costs in providing the average level of services to their residents. One example of a factor is the proportion of older people in a State's population. As older people utilise hospital services more than the average, States with a higher than average proportion of older people may have above average hospital costs, contributing to a higher than average assessed expenditure.

Following from the fact that the CGC seeks to achieve materially the 'same' level of capacity for all States, the CGC assesses *revenue capacity* and *expense needs* wherever it observes that a difference between the States is material.

The CGC's assessment of revenue currently comprises 13 revenue assessments in eight categories:

- mining, conveyances, payroll, insurance, motor vehicle, land, other and Commonwealth payments.

The assessed expenditure includes 93 expenditure assessments across 14 categories:

- schools, post-secondary, admitted patients, community health, welfare and housing, communities, justice, road, transport, services to industry, other, depreciation, investment and net lending.

When making judgements about assessments, the CGC has reference to four key principles. These principles were developed by the CGC in their 2010 Methodology Review, having evolved from principles used in the past.

The principles (sometimes called 'pillars') indicate that equalisation should be implemented through methods that:

- reflect what States collectively do
- are policy neutral
- are practical
- are most appropriate to the application year.[25]

The principle that equalisation should reflect 'what States collectively do' means that, as far as practical, the CGC seeks to avoid making judgments about what States *could* or *should* do. The average budget is therefore based on the average range of services actually provided by States and the average range of taxes actually imposed by States.

25 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities*, 2010 Review, Vol 1, pages 35-37 and for further information on *materiality*, see also page 39.

The principle of policy neutrality means that the CGC seeks to ensure that policy differences between States do not affect the GST distribution, and that the GST distribution process does not provide the States with incentives to vary their policies.

The principle of practicality refers to the need to base assessments on sound and reliable data and methods. It includes the idea that materiality and reliability of assessments need to be considered.

Finally, the CGC seeks to recommend GST payments that are most appropriate to the application year — that is, the distribution should be contemporaneous (or 'up to date') and should reflect State circumstances in the year the funds are used.

Some States are strong supporters of these principles,[26] while others argue that the CGC does not implement the principles effectively in practice.[27] States' detailed concerns with the implementation of these principles, particularly in relation to policy neutrality, are discussed in later Chapters.

The goal of the current HFE process

As explained above, while the ultimate goal of the current system is a fair distribution of the GST amongst the States, there is considerable dispute about whether the outcomes of the current process achieve that.

While State submissions show broad agreement with the notion that HFE currently has equity as its main objective, various States have different views on whether this objective is being met.

The Northern Territory, Australian Capital Territory, Tasmania and South Australia all argue strongly for the maintenance of a robust system of (full) equalisation, on the grounds that this is essential if the system is to be 'equitable'.[28]

The Northern Territory says:

> *The promotion of equity and fairness has been a central objective of Australian governments, and are long standing tenets of Australian society ... The distribution of GST revenue based on the principle of fiscal equalisation is only one policy measure underpinning all governments' objective of achieving equity for all Australians, but it is an integral component. Equalisation is intended to provide horizontal equity between states, which complements other government policies aimed at vertical equity.*[29]

The Australian Capital Territory considers that:

> *HFE's key purpose is equity [and, i]n a federal system equity requires the equal treatment of equals or equal treatment for persons different in no relevant*

26 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 2.
27 New South Wales submission to the GST Distribution Review, November 2011, page 13.
28 Some States also argue for HFE by way of analogy with the situation in a unitary government or the actions of the current Federal Government (see Appendix B, and Attachment A to the South Australia submission to the GST Distribution Review, September 2011, pages 6, 18-19; Australian Capital Territory submission to the GST Distribution Review, October 2011, pages 0, 4).
29 Northern Territory submission to the GST Distribution Review, October 2011, pages 36, 37.

respect. This underlying principle of equitable treatment is an important value to all Australians.

Australia's equalisation system is world-leading. Its objective, to allow each State to provide comparable services and infrastructure to every Australian citizen no matter where they reside is an egalitarian and equity driven approach ...

States should have the same fiscal capacity for services to their citizens irrespective of the varying policies. Such fiscal equity is fundamental to a civilised federation and is described as 'essential as a guide to the operations of a liberal democratic state, stemming from the same base as the principle of equality of individuals before the law'.[30]

The Tasmanian submission argues along similar lines:

Equity is at the heart of HFE. Principles relating to efficiency, simplicity and predictability/stability are important aspects of a sound equalisation process. However, any dilution (or lower weighting) of these principles does not result in HFE ceasing to function adequately. By contrast, if the principle of equity is down-graded, the equalisation process will fail to achieve its major aim.

HFE reflects the principle that Australians should have access to a similar standard of service, regardless of the jurisdiction in which they live. This is [sic] strong egalitarian principle has been widely held by the Australian community and been reflected in the CGC's approach, in one form or another, since its inception in the 1930s.[31]

South Australia says that:

HFE ensures that otherwise similar households and firms in an integrated national economy, within the Australian federation, are not treated as different class citizens and entities merely on account of the accidents of natural resource location and circumstances of fellow residents within state borders.[32]

While the four remaining States broadly agree that the main goal of the current system is equity, they generally would not consider that an equitable system necessarily requires absolute equality of treatment — in their views, fairness (equity) could be achieved through a less rigorous pursuit of equal outcomes.

For example, Victoria argues that:

Over time, Australia's system of HFE has moved from one based on broad equity to one based on specific equality. These concepts are distinct. The goal of equity can be met without the provision of equal standards of service ... equity is an important element of a strong and stable federation. However, it is arguable that

30 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 4.
31 Tasmanian submission to the GST Distribution Review, October 2011, page 17.
32 South Australian submission to the GST Distribution Review, September 2011, page 5.

the current system of HFE over-reaches in its quest for equality and thus, it is questionable if the system is successful in achieving its goals.[33]

New South Wales summarises the current system as one that:

... seeks to achieve full equalisation of state government fiscal capacities ... This contrasts with the income tax/welfare system in Australia which aims only to moderate the income distribution of individuals.[34]

Western Australia says:

The current form of fiscal equalisation in Australia is too extreme. It is equivalent to a 100 per cent tax on any excess of one State's fiscal capacity over the average for all States. This would not be considered equitable or efficient in any other part of the national tax and transfer system. Nor is it seen in any other federation globally.[35]

Queensland considers that the aim of the GST distribution process is unclear, and argues that the Panel should seek to clarify it. Queensland quotes summaries of the aim of HFE mentioned in the CGC 2010 Review, the Commonwealth Budget papers and the issues paper of this Review, and argues that:

The intent of the three statements ... is for all States to have the capacity to provide services to their residents. However, the statements differ in the suggested standard for these services. The Review's Terms of Reference do not refer to standards, the Commonwealth Grants Commission refers to 'the same standard', and the Australian Government refers to 'a comparable standard'. While the difference between the approaches of the Commonwealth Grants Commission and the Australian Government may appear to be a matter of semantics, in practice they seek quite different outcomes…

Additionally, in no area of Australian public policy does a desire for absolute equality of outcomes override all other considerations. Governments do not provide identical levels of services to every resident. The tax and transfer system does not equalise net incomes for all Australians. This is because other objectives — efficiency, fairness, simplicity — need to be taken into consideration to produce an optimal outcome.[36]

To resolve the differences identified, Queensland proposes that:

… this Review should seek to clarify the aim of the GST distribution process, and recommends the aim that is adopted be consistent with that specified by the Australian Government in 2011, and articulated in the Review's Terms of Reference (GST Distribution Review 2011, clause 3) and the Review Panel's Issues Paper (GST Distribution Review 2011a, p. 1). That is, the aim of the GST

33 Victorian submission to the GST Distribution Review, October 2011, pages 13, 14.
34 New South Wales submission to the GST Distribution Review, November 2011, page 10.
35 Western Australian submission to the GST Distribution Review, October 2011, page i.
36 Queensland submission to the GST Distribution Review, October 2011, page 2-3.

> *distribution process should be to provide the necessary budget support so that all States have the capacity to provide services at a comparable standard.*[37]

1.4 Other criticisms of the current form of HFE

While the current HFE process exists primarily to balance out States' disparate capacities, some commentators consider that the current process creates other problems. Criticisms include that the current process:

- is too unpredictable
- is too complex
- creates problems for the provision of nationally significant infrastructure
- creates disincentives for reform or incentives for inefficient provision of services.

These criticisms, among others, are discussed in detail in later Chapters.[38]

However, even regarding the goal of horizontal equity, the current form of HFE has been criticised.

In their Review of Commonwealth-State Funding in 2002, Professor Ross Garnaut and Dr Vince FitzGerald concluded that:

> *The current system ... fails to ensure equal treatment of people in similar fiscal positions (horizontal equity) ... because it focuses on States rather than households or individuals, and because untied funds are not required to be spent on areas for which they are allocated ...*[39]

Likewise, Victoria argues that:

> *HFE should be designed to ensure that individuals have access to comparable government services, regardless of the state in which they reside.*[40]
>
> *HFE, in this view, is a compromise which recognises the tension between horizontal equity and state autonomy. It can only ever secure a relatively narrow form of equity, in which differences in public sector treatment of residents should arise only from democratically supported decisions, not from fiscal capacity differences (Walsh 2011, p7). Further, studies have shown that HFE redistribution subsidies do little to reduce the inequity of income between rich and poor*

37 Queensland submission to the GST Distribution Review, October 2011, page 3.

38 See Chapter 2 for a discussion of criticisms relating to HFE's unpredictability, Chapter 3 for criticisms relating to the complexity of the system, Chapter 4 for criticisms relating to disincentives for reform and incentives for inefficient provision of services and Chapter 5 for criticisms relating to infrastructure payments.

39 Garnaut, R, and FitzGerald, V, *Review of Commonwealth-State Funding, Final Report*, August 2002, page 123.

40 Victorian submission to the GST Distribution Review, October 2011, page 13.

> *individuals and families; in other words, the HFE model has a negligible, or in some instances an adverse, effect on income equity.*[41]

Victoria goes on to argue that Australia's circumstances have changed, that HFE has outlived its original intent, and that, nowadays:

> *HFE's role in securing interpersonal equity has largely disappeared ... the income tax system, combined with social security and welfare transfers, is far more effective in moderating the income distribution of individuals and households than the HFE system.*[42]

On the other hand, some argue that the focus on States' capacities (rather than individuals' or households') is a key element of the current system, providing residents of individual States with the ability to elect governments that provide a mixture of taxes and services preferred by residents of that State. For example, Tasmania says:

> *HFE is not about achieving equity between individuals. Any variations in actual service standards across jurisdictions reflect different preferences between jurisdictions rather than a failure of HFE to deliver equity.*[43]

Western Australia also argues that the current form of HFE is failing to meet its objective of equity, but for different reasons to Garnaut and FitzGerald. Western Australia considers that its low relativity is 'manifestly unfair', arguing that:

> *Western Australia currently receives only 72 per cent of its population share of the GST pool, where population shares are broadly representative of the contribution each State's people make to the GST pool through their consumption. Having regard for the lags in the equalisation process and recent growth in mining revenues, it is projected that the 'return' to Western Australia will decline to about 33 per cent in 2014-15 ... Notwithstanding the equalisation objective, such a low return to Western Australia is considered manifestly unfair, particularly after taking into account the large subsidy already provided by the State through the Commonwealth budget more generally, the effort that Western Australia has made to develop its natural resource endowment (and thereby to raise revenue from its own sources) and substantial shortcomings in the equalisation methodology.*[44]

In addition, Western Australia argues that HFE fails to produce intergenerational equity:

> *HFE equalises mining endowments across States.*
>
> *As a result, the resource State cannot retain its endowment (after conversion from minerals to cash in the form of royalties) for investment to secure its future (unlike other endowments). From a national perspective, the resource endowment, after redistribution across the nation, ends up largely supporting consumption rather than investment for future generations.*

41 Victorian submission to the GST Distribution Review, October 2011, page 14.

42 Victorian submission to the GST Distribution Review, October 2011, page 21.

43 Tasmanian submission to the GST Distribution Review, October 2011, page 17, 18; see also Australia Capital Territory submission to the GST Distribution Review, October 2011, page 2.

44 Western Australian submission to the GST Distribution Review, October 2011, pages 10, 11.

In this context, only the State with the resource has an incentive to use it to secure its future. The only equity justification for equalising any mining royalties is that State Governments are likely to use some of the royalties for consumption rather than development for the future, even if fully retained by the State.

If equalisation of royalties is reduced, non-resource States may receive smaller GST grants 'now', but more in the future than would have otherwise been the case — to the extent that the resource State has been able to invest royalties to help build a stronger economic base, including for when the minerals have been exhausted (with the fiscal returns from a stronger economic base being shared by all States).[45]

Is a low relativity inherently 'unfair'?

Even aside from concerns with intergenerational equity or the current methodology, Western Australia appears to argue that a low relativity is inherently unfair, using the analogy of personal income tax:

Australia's comprehensive equalisation is currently equivalent to a 100 per cent marginal tax rate on any above-average fiscal capacity ... No one would ever consider a 100 per cent marginal tax rate on above-average personal or corporate income to be fair, particularly as above-average income has often been achieved through hard work and good choices.[46]

Further, Western Australia considers that its low relativity risks undermining confidence in the Federation, arguing that:

... fiscal equalisation is no longer the unifying force in the Australian federation that it was intended to be when the Commonwealth Grants Commission (CGC) was established in the 1930s — at which time States such as Western Australia demanded compensation for the costs they incurred from high external tariffs and other protectionist Commonwealth policies.

Instead fiscal equalisation is becoming a divisive influence, undermining public understanding and support for the Federal system. The wheel has turned full circle.[47]

[T]he subsidy now provided by Western Australia is becoming so extreme that equalisation (at least in its current form) is no longer supported by all participants.[48]

Western Australia concludes that:

... current and prospective equalisation outcomes are so extreme as to destroy any consensus on their acceptability ...[49]

45 Western Australian submission to the GST Distribution Review, October 2011, pages 14-15.
46 Western Australian submission to the GST Distribution Review, October 2011, page 12.
47 Western Australian submission to the GST Distribution Review, October 2011, page i.
48 Western Australian submission to the GST Distribution Review, October 2011, page 11.
49 Western Australian submission to the GST Distribution Review, October 2011, page 23.

Others argue that Western Australia's low relativity is entirely appropriate given its strong revenue raising capacity. For example, Tasmania:

> *…strongly believes that variability in state relativities should not necessarily be of concern or warrant any particular attention. Rather, it is the direct correlation of state relativities to changes in state circumstances which matters. State relativities will fluctuate over time, and significantly so where relative state economic or demographic circumstances change. This should come as no surprise to states or HFE commentators ... Structural change in the economy has contributed to increased trend divergence in state relativities as state fiscal capacities diverge. For example, the rise of China has created stronger global demand for Australia's mineral resources.*
>
> *The value of mining production and associated investment has increased significantly, with investment in the mining sector projected to equal the combined total of investment of all other sectors by 2012. High mineral and other commodity prices have driven Australia's terms of trade to historic record high levels. As a result of this mining boom, iron ore exports from Western Australia and black coal exports from Queensland have grown dramatically in recent years. As revenues increase from state mining royalties, GST revenue to those states has, appropriately, decreased reflecting the fact that they have become more self-sufficient.*[50]

The Australian Capital Territory and the Northern Territory make similar points.[51] South Australia argues that the strong demand for Australia's mineral resources means that other industries and regions (such as South Australia) are facing increasing competitive pressure from an appreciating exchange rate. South Australia says that:

> *Any move away from full equalisation transfers would result in the South Australian economy being exposed to the adverse consequences of currency appreciation without receiving an appropriate sharing of the benefits of the terms of trade boom.*[52]

For some, the relativity calculation is simply a function of statistics. The Australian Capital Territory makes this point by saying:

> *Western Australia's relativity of 0.68298 has no direct dollar value as it is merely a weighting which relates back to the Australian average (equal per capita) distribution of 1.00000.*[53]

The Commonwealth Treasury submission suggests that, if all Commonwealth payments were considered in the calculation, Western Australia's relativity would be higher. Under this scenario, Western Australia's 2011-12 relativity would be 0.95, instead of the figure of 0.72 used by the CGC.[54]

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50 Tasmanian submission to the GST Distribution Review, October 2011, page 5-6.

51 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 0; Northern Territory submission to the GST Distribution Review, October 2011, page 16-18.

52 South Australian submission to the GST Distribution Review, September 2011, page 7.

53 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 8.

54 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 13.

Finally, the assertion that Western Australia's low relativity means that GST levied on consumption in Western Australia is effectively transferred to other States is disputed.

Australia Capital Territory makes this point in its submission:

> *It is not possible to calculate the actual GST contributed in each jurisdiction because the location of lodging tax returns is frequently different to the location at which the GST is collected. The mining industry is largely exempt from GST due to it exporting much of its product. On the other hand it is able to claim credit for GST paid on its significant capital investment. Therefore, the overall GST contributed by the Western Australian economy is likely to be lower than average.*[55]

While it is not possible to trace GST collections to their source, just under a third of Western Australia's economy is comprised of an export industry (mining)[56] which does *not* pay GST, but for which GST on inputs will be refunded. New South Wales and Victoria on the other hand, which have economies based more on domestic industries and host the head offices of many retailers, probably 'collect' more GST per capita than Western Australia.

Ultimately, the lowest Western Australia's relativity could go is to zero. A relativity of zero would mean that Western Australia's own source revenue was so strong it would not require a share of GST to achieve the average fiscal capacity — the other States would require all the GST to achieve the average. In this situation, despite receiving no GST, Western Australia would still have the capacity to provide at least the same standard of services to its citizens as the other States.

If measures were put in place to ensure that Western Australia continued to receive a share of the GST despite having a zero relativity, Western Australia would have a *stronger* fiscal capacity than the other States and would be able to provide a higher level of services to its citizens and/or levy lower taxes on businesses and households than the other States. Practically, this would mean that the Western Australian government could provide smaller class sizes in schools, more elective surgery procedures, more social housing, larger concessions to electricity consumers and better transport infrastructure than other States.

Adopting a longer term view provides a different perspective on a low or zero relativity. For example, comparing Western Australia's long-term (i.e. about 20-year) average relativity with that of Victoria, the State which has traditionally had the strongest fiscal capacity, Western Australia's average relativity would still be slightly above Victoria's (namely, 0.887 compared to 0.885).[57]

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55 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 8.

56 'Mining activity accounted for 27.5% of GSP in 2009-10', from p1 of *Western Australia Economic Profile – August 2011*, produced by the Department of State Development, Western Australia State Government.

57 The long-term average covers 22 years from 1993-94 to 2014-15. It does not cover the period up to 1993-94 when Western Australia was consistently a 'claimant' or 'recipient' State.

1.5 What form of GST distribution is right for Australia's future?

The ideal model for GST distribution

The key challenge for the Panel when considering the form of GST distribution is to ensure that the payments are distributed 'fairly'. However, the 'ideal' model would not only be 'fair', it would:

- be seen to be fair
- be easily understood (be simple and transparent)
- allow States to plan their Budgets reasonably (be predictable)

and would not:

- encourage bad policy
- discourage good policy
- cost more than it needs to
- detract from public confidence in the Federation.

Currently, the distribution of the GST revenue is governed by the CGC definition of HFE as meaning equalising to materially the same capacities.[58] All other aims (such as the pursuit of simplicity, predictability and policy neutrality) are subsidiary to achieving the paramount objective of equality.

The Panel has been asked to consider whether other goals should be pursued through the distribution of GST revenue. Such other goals include providing incentives for economic reform, incentives for the efficient provision of services and maintaining confidence in the Federation. While the recently added Terms of Reference[59] will be discussed in detail in a second interim report, the Panel notes that it has been asked to consider whether and how State tax reform could be pursued alongside HFE.

The pursuit of other goals may allow more scope for the GST distribution process to emphasise the subsidiary aims of simplicity, efficiency and predictability. That is, by seeking to pursue tax reform or greater confidence in the Federation, it may also be easier to develop a form of distribution that is simple, predictable and creates no incentives for inefficiency.

Should 'full' HFE be the goal?

The Panel's consideration of the issues above has led it to examine whether 'full' HFE is still the most appropriate model, especially given the need to consider other goals.

58 See sections 1.1 and 1.3 for a discussion of how the GST is distributed in Australia today.

59 See the Supplementary Issues Paper which sets out some background information relating to the additional Terms of Reference, http://www.gstdistributionreview.gov.au/content/Content.aspx?doc=issuespaper.htm

As outlined earlier, the current form of HFE in Australia is widely considered to be a reasonably 'full' form of HFE. A less absolute (or 'partial') form of equalisation would allow for goals other than equity to be pursued, and might also allow for greater emphasis to be placed on the aims of simplicity, predictability and efficiency.

There are, of course, a wide variety of ways that partial equalisation could be pursued. The HFE system could be made more partial by not seeking to provide States with the 'same' capacity, but rather by seeking to equalise them to some other standard. Alternatively, a more partial form of equalisation could be pursued by narrowing the scope of the current assessments or pursuing individual assessments in less detail.

States' positions

States indicate a range of views on 'full' or 'partial' HFE.

As a general rule, the four States that currently receive less than their population share of GST (often referred to as 'donor' States) favour a more partial form of equalisation.

Victoria says:

> *Just as governments pursue only partial equalisation of budget capacities of private persons within jurisdictions, HFE's equity goals can be fulfilled by a system that acts as a 'safety net' to enable jurisdictions to provide an adequate (or minimum) level of services, as was the original rationale of the CGC's processes.*
>
> *Partial equalisation of service standards is justified because of the inevitable trade-offs between the degree of equality pursued and the adverse incentive effects which can follow, reducing the level of efficiency achievable. A system which enables states to achieve identical service standards (rather than comparable standards or a minimum standard) can create efficiency costs without commensurate equity benefits.*[60]

New South Wales favours a HFE definition that involves equalising to a 'comparable' standard, rather than the 'same' standard, arguing that:

> *An alternative definition of HFE is provided in the Commonwealth's Budget Paper No. 3:*
>
> > *Horizontal fiscal equalisation provides the necessary budget support so that all States have the capacity to provide services at a comparable standard, while ensuring that the interstate transfers are not so large that they would significantly distort economic behaviour and reduce productivity growth. (Budget Paper 3, p106)*
>
> *New South Wales considers that this definition is much more suitable than the CGC's definition because it allows for the importance of efficiency effects and productivity growth. There is little in the current HFE system to ensure that the pursuit of equity is not at too great a cost to overall economic efficiency.*[61]

60 Victorian submission to the GST Distribution Review, October 2011, page 13.
61 New South Wales submission to the GST Distribution Review, November 2011, page 12.

While Western Australia does not explicitly seek a more partial form of equalisation (and argues that in some areas the CGC currently performs partial equalisation by failing to recognise some of its costs), the combination of some of its recommendations (such as a relativity floor and a limit to annual falls in GST relativities) places it on the 'partial' end of the spectrum.

Queensland specifically supports consideration of partial forms of equalisation:

> *... the aim of the GST distribution process should be to provide the necessary budget support so that all States have the capacity to provide services at a comparable standard.*
>
> *Queensland believes consistent adoption of this aim would allow a wider consideration of approaches to GST distribution that provide the best outcome in terms of efficiency, equity, simplicity, predictability, and stability.*
>
> *Queensland also believes that in recent years the application of the GST distribution process has been overly focused on the equalisation of total fiscal capacity, that is on full equalisation across the States. Queensland believes this is an overly narrow interpretation of the aim of the process and that it is possible to provide all States with the capacity to provide services without needing to equalise all revenues. Accordingly, Queensland supports exploration of 'partial' equalisation approaches in this Review as a means of achieving a better balance of the efficiency, equity, simplicity, predictability, and stability criteria.*
>
> *In addition, Queensland believes there is an opportunity to consider whether 'a comparable standard' should be defined in terms of the average activity of States, as occurs currently, or whether an alternative definition may be appropriate.*[62]

By contrast, States that currently receive more than their population share of GST (often referred to as 'recipient' States) favour the maintenance of a full form of equalisation.

Northern Territory says that:

> *Australia's form of equalisation is often described as 'full' or 'comprehensive'... [C]omprehensive equalisation is the only form of equalisation appropriate to Australia's needs due to the relative heterogeneity of states, in terms of population characteristics, geographic location, size and structure of economies and natural resource endowments, and the level of VFI between the Commonwealth and the states. These circumstances lead to significant disparity of expenditure needs and revenue capacities between Australian states.*[63]
>
> *Full equalisation is based on the principle that persons living in comparable locations should expect similar access to government services. The concept of social citizenship at the national level should continue to be the primary objective of equalisation in Australia. A move away from full equalisation would imply that*

62 Queensland submission to the GST Distribution Review, October 2011, page 3.
63 Northern Territory submission to the GST Distribution Review, October 2011, page 37.

> *Australians living in similar regions of different states do not deserve the same access to government services.*[64]

Tasmania believes the Review's Terms of Reference require full equalisation:

> *The Review Terms of Reference require full equalisation — that is, GST is to be distributed 'consistent with the principle that jurisdictions should have equal capacity to provide infrastructure and services to their citizens'. Tasmania asserts that this cannot be achieved with anything less than full equalisation.*
>
> *Tasmania is strongly of the view that full equalisation is essential to achieving the current principle of HFE. Any form of partial equalisation (revenue or expenditure only or parts thereof) or proximate equalisation (less than 100 per cent of an agreed standard) would not result in states being provided with the same capacity to provide services and would result in greater regional disparities.*[65]

South Australia argues along similar lines:

> *The current, comprehensive, system of fiscal equalisation in Australia is a fundamental strength of the Australian federation.*
>
> *The terms of reference requires the Review to be guided by the principle that 'jurisdictions should have equal capacity to provide infrastructure and services to their citizens'.*
>
> *The Government of South Australia would strongly oppose any Review recommendations which were at odds with this principle. Proposals such as placing a 'floor' under relativities on some 'numerological' basis, or engaging in 'partial' equalisation (even if under the banner of 'simplification') would not be consistent with the terms of reference — they would clearly not deliver equal capacity ...*[66]
>
> *Similarly, partial equalisation would represent an arbitrary approach, requiring some form of national compact as to the acceptability or desirability of jurisdictions not having equal capacity to provide the same standard of all services (and which services should reflect an equal capacity principle and which should not). Even if such an agreement could be reached in relation to the equity shortfall involved, the outcome would be inefficient.*[67]

The Australia Capital Territory strongly supports the current system of HFE[68], saying:

> *Full equalisation is the only appropriate goal of HFE ... Some States would argue that certain revenues or expenditures should be either left out of the scope of equalisation or included only in part ... The selective exclusion of specific revenue*

64 Northern Territory submission to the GST Distribution Review, October 2011, page 39.
65 Tasmanian submission to the GST Distribution Review, October 2011, page 15, 16.
66 South Australian submission to the GST Distribution Review, September 2011, page 2.
67 South Australian submission to the GST Distribution Review, September 2011, page 7.
68 Australia Capital Territory submission to the GST Distribution Review, October 2011, page 1.

> *or expenditures would not achieve equalisation. Such arguments effectively trade-off equity against other objectives.*[69]

A new challenge

Recent additions to the Panel's Terms of Reference expand the Review's remit. The supplementary terms of reference are:

> *The Review should examine and make recommendations on possible changes to the form of equalisation to achieve the following objectives:*
>
> *a. ensure that HFE does not provide a disincentive to State tax reform,*
> *b. utilise HFE to provide incentives and disincentives to promote future State policy decisions which improve the efficiency of State taxes and mineral royalties, and*
> *c. examine the incentives for States to reduce Minerals Resource Rent Tax or Petroleum Resource Rent Tax revenue through increasing State mineral royalties.*
>
> *In considering this issue, the Review will be guided by the following:*
>
> *a. the findings of the Australia's Future Tax System Review relating to existing State taxes and mineral royalties,*
> *b. the Minerals Resource Rent Tax and Petroleum Resource Rent Tax provide a more efficient approach to charging for Australia's non-renewable resources than mineral royalties, and*
> *c. State tax reform will not be financed by the Australian Government.*

These new terms will be dealt with in a second interim report, following receipt of further submissions in response to the supplementary issues paper released on 22 December 2011.

1.6 Summary of the Panel's view on the role and purpose of HFE

The Terms of Reference contain guidance that the long standing practice of HFE has served Australia well, and submissions from the recipient States show strongly held views in support of the full equalisation goal of the current system. The Panel will therefore not recommend change lightly.

Nevertheless, judging by the disparity of views contained in submissions from experienced jurisdictions and commentators, the present arrangements are complex, opaque and therefore either not agreed, or not well understood. These circumstances result in criticisms that are linked to the issue of whether 'full' HFE should be the goal.

Furthermore, both international experience and Australia's own past practice show that something considerably less than pursuit of absolute equality between jurisdictions can result in a fair outcome and produce confidence in Federal financing arrangements.

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69 Australia Capital Territory submission to the GST Distribution Review, October 2011, page 9.

The Panel's view on the proper role and purpose of the GST distribution

*The Panel intends to investigate whether providing **comparable** capacities for States would be an approach more suitable to current challenges than providing materially the **same** capacities.*

The Panel therefore invites submissions on how this concept might be accurately described and effectively implemented.

2 Predictability and stability of HFE outcomes

The Terms of Reference require the Review to consider the predictability and stability of HFE outcomes, so as to better support long term decision making and reform by governments.

A number of submissions to the Review address predictability and stability. In considering the issues raised by them, the Panel has given particular thought to the following questions:

- Why do GST shares move?
- How do changes to GST shares (predictable or otherwise) affect State budget planning?

2.1 Why do GST shares move?

Any discussion of predictability of GST shares needs to commence with an examination of why GST shares move. The first point to note is that States' GST shares are merely an inverse reflection of their underlying fiscal capacities — the weaker a State's capacity, the higher its GST share, and vice versa.

States' fiscal capacities are therefore determined by the combined interaction of:

- their own source revenue raising capacity
- relevant payments received from the Commonwealth[1]
- a State's expenditure needs.

As these various components differ across jurisdictions, each State's fiscal capacity will differ. In relation to own source revenue, for example, States have varying capacities to raise payroll tax, stamp duty on conveyances and revenue from mining royalties, according to their individual employment and wages rates, property values and mineral wealth. Similarly, States may receive varying amounts of Commonwealth payments to support State activities. On the expenditure side, States' shares of population groups such as Indigenous people, people living in low socio-economic status regions, older people and younger people all differ, leading to different requirements for services and the settings in which those services are provided.

GST payments as a 'balancing' item

As explained in Chapter 1, GST payments act as the 'balancing item' to fill the gap between States' expenditure requirements and the revenue raised and received by them (see Figures 1.1 and 1.2 and related commentary). It follows that, the more volatile the movements in other State finances from housing or mining booms (or

1 For details of which Commonwealth payments affect GST shares see Chapter 5.

slumps), changes to population composition, or changes to the distribution of Commonwealth payments for specific purposes, the less stable GST shares will be.

Timing effects

To achieve a truly 'full' equalisation, GST payments would have to be made precisely as State circumstances change. This would mean, for example, that the distribution of GST revenue in any year would be based upon the assessed revenue, expenditure and Commonwealth payments for specific purposes in that year. This theoretical outcome is known as equalisation being 'fully contemporary'.

A fully contemporary system would actually produce the *largest* volatility in the GST distributions, but would result in the *least* volatility in total State revenues, because any shortfall (or increase) in State revenues would automatically and instantaneously be offset by an adjustment to their GST payment.

A fully contemporary model is probably unattainable due to problems with available data. For example, for the CGC's work to be fully contemporary in determining GST shares for States to apply in 2012-13, it would have to know how much revenue States would raise in that year and what their level of expenditure would be, along with the distribution of this expenditure amongst key population groups. However, when the CGC made its recommendations for 2012-13 in February 2012, these data were either not yet available or were considered to be unreliable (that is, subject to change). There would also be an element of circularity in this situation, as States usually want to know what their expected GST allocation will be for a particular year, prior to finalising their own budgets.

As a result, GST distributions for a given year are based on historical results from past years.

What are *relativities* and what do they mean?

The CGC expresses its recommendations for the distribution of GST revenue as per capita 'relativities' to enable its historical calculations to be applied to the current GST pool. The relativity for a State for a particular assessment year is the ratio of its per capita GST requirement to the all-State average per capita GST requirement.

Although limited by the use of historical data, an aim of the current approach is to reflect conditions in the States in the year the GST is distributed, as closely as the data allow. Relativities assist this approach, as they are applied to the current (application) year GST pool — effectively indexing the historical results by the growth in the GST pool between the assessment and application years — and use application year rather than assessment year, populations.[2]

2 Alternatives to presenting the HFE outcomes as relativities are discussed further in Chapter 8.

What else drives changes to GST payments?

The relativities recommended by the CGC to apply in a particular year are only one driver of the actual GST payments to the States.

The GST payments represent the combined effects of:

- the relativity calculated for the State (including corrections to previous relativity calculations)
- the State's population size
- the amount of GST revenue available to be distributed.

Changes in any of these components will lead to changes in GST payments.

As a general rule, States are not concerned about changes to GST shares occasioned by changes in population size, as these are reasonably predictable and stable (in the sense that they change in multi-year cycles). Further, while in some years the growth in the GST (or, on one occasion, the lack of it) comes as a surprise, there is general acceptance that this is not an issue to be dealt with by this Review.

While relativities vary due to changes in States' circumstances, they can also move because of revisions to earlier data. Although changed circumstances *generally* have a larger effect than data revisions, the 2011 Update was a case where revisions had around the same effect on the relativities as changes in circumstances. The reason for this was the 'back casting' of the interstate wages adjustment. An understanding of revisions requires a discussion of averaging, as it is applied in HFE calculations.

The stabilising effect of averaging relativities

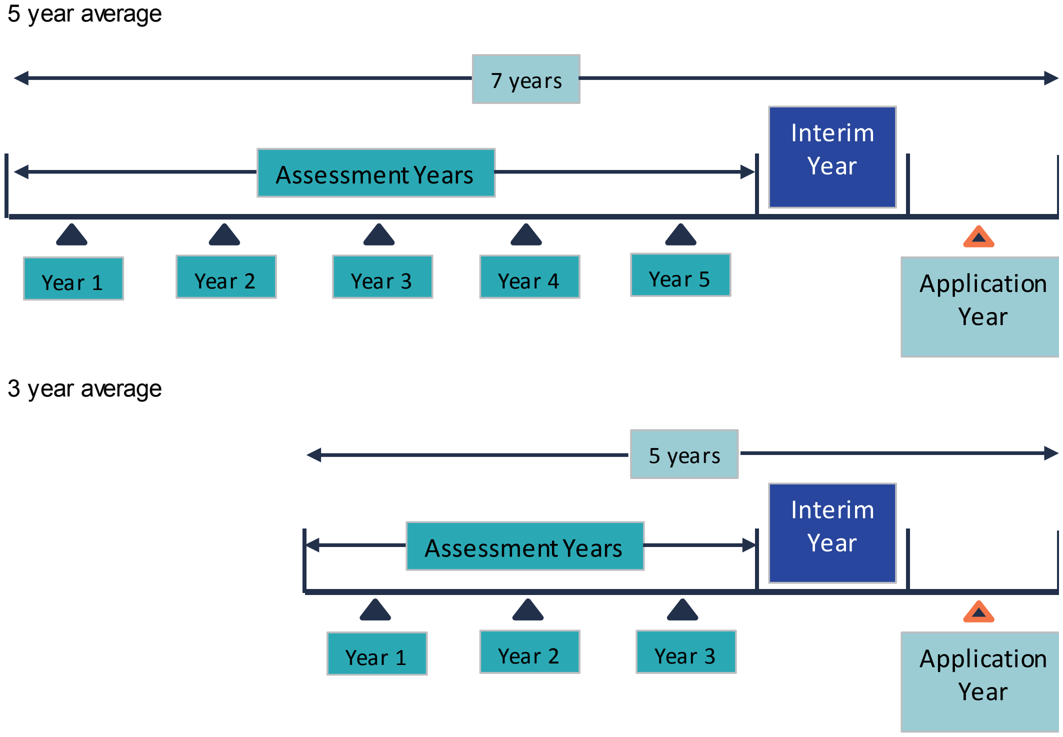
As explained above, the current form of HFE uses historical results to calculate a relativity to apply to the current year. The current year's (application year) relativity is, in fact, an average derived from the annual relativities calculated for each of the three assessment years included in the current Update of relativities.

A five year average was applied from 1991 to 2009. A three year average was adopted by the CGC following the 2010 Review with the aim of making the relativities more contemporary. The new approach meant that the relativities for the 2012-13 application year represented the average of relativities calculated for the three years from 2008-09 to 2010-11 (the assessment years).

Revision effects come about when data for earlier years that remain in the span of assessment years are amended or updated. In the 2012 Update, 2010-11 was included in the average for the first time, while 2007-08 dropped out of the calculation. At the same time, data revisions were applied to the 2008-09 and 2009-10 years.

The make-up of a five year average as compared with a three year average is shown diagrammatically in Figure 2.1 below.

Figure 2.1: Average relativities



Note: The CGC calculates relativities in the interim year, which are provided to the Treasurer. Once confirmed, the GST payments resulting from the relativities are included by States in application year budgets.

Figure 2.1 shows that, with a five year averaging process, States' circumstances from seven years previously still affect GST shares in the application year. Even with a three year average, circumstances up to five years before affect current GST shares.

As can be seen from Figure 2.1, the result of using historical data and averaging is a 'lag' in achieving equalisation outcomes — the longer the averaging period, and therefore the lag, the less contemporary the HFE outcome. This is because an incoming year incorporated into the five year average has a 20 per cent impact on the final relativity, whereas an incoming year incorporated into the three year average has a 33⅓ per cent impact on the final relativity. In general, the longer the averaging period, the more stable and predictable the GST share. On the other hand, revisions to data are more likely to have a greater effect within a three year average than a five year average.

Three year averaging therefore arguably reflects the fiscal circumstances of the application year more closely than five year averaging. However, the relativities produced by five year averaging are likely to be more stable (or less volatile) in most circumstances than those produced by three year averaging.

What are the consequences of the lag for GST allocations?

As explained above, a consequence of the averaging approach is that there can be a gap between the actual GST distribution received by a State (its application year result) and the CGC calculation of the State's required GST for that year, once it becomes an assessment year. Since, in most cases the gap is subsequently reversed by a rebalancing of relativities, the gap is referred to as a lag (to give a sense of impermanency).

A further aspect of the gap or lag is that there will be three variations on its size, one for each time that a year is an assessment year (with three year averaging). While there would usually be relatively minor changes in the second and third time a year is assessed, more substantial differences can arise when there have been substantive data revisions, for example, through the inclusion of the most recent Census data.

From 2004-05 to the present, New South Wales has had a negative lag effect, meaning that it has been assessed to have required more GST in the subsequent assessments than was originally estimated in the application year. This result reflects New South Wales' declining fiscal capacity over this period. In contrast, over the same period, Western Australia has had a positive lag effect, reflecting its increasing fiscal capacity. Some States suggest that Western Australia's positive lag effect provides an ongoing and substantial benefit.

As the GST distribution is the result of relative differences in States' fiscal capacities, every time an assessed fiscal capacity changes between the application and assessment years for any State, all other States' assessed fiscal capacities will also change. Changes to assessed fiscal capacity between application and assessment years can be the result of movements in any of the 13 revenue assessments in the eight revenue categories, or any of the 93 expenditure assessments in the 14 expenditure categories.

For 2009-10, Western Australia's positive lag effect was largely due to its mining royalties, although increasing payroll taxes also contributed to the positive result. These increases were partially offset by a negative lag effect from stamp duties and the expense assessments. For New South Wales, the opposite was true. Its mining royalty and payroll tax assessments produced a negative lag effect, partially offset by positive lag effects from stamp duties and the expense assessments.

Past influences creating lag effects, such as property booms, have tended to flow across a number of States in turn, and have reversed reasonably quickly. Some States argue that the mining boom in Western Australia is changing this situation, leading to ongoing distortions to the GST distribution. Since the lag effects brought about by any temporary change in fiscal capacity are fully reversed when that fiscal capacity returns to its starting position, a key question is whether Western Australia's increased fiscal capacity due to mining will continue indefinitely at a new higher level.

While iron ore export volumes are projected to double over the next ten years, recent economic forecasts by the World Bank[3] and the IMF[4] have revised downward global growth expectations and raised the possibility of a renewed financial crisis. Such a scenario may lead to reduced demand for Western Australia's resources. Alternatively, because the system works on relative fiscal capacities rather than absolutes, a rebound in coal exports in Queensland, following the reduction in activity caused by flooding, would act to partially offset Western Australia's relative fiscal capacity.

In its 2010 Review the CGC considered a number of ways to make the relativities more contemporary and thereby reduce the impact of the lag. One approach considered was a two-part process in which an initial GST allocation is made and subsequently adjusted when accurate data become available. This approach, referred to as an 'advances and

3 World Bank, *Global Economic Prospects: Uncertainties and Vulnerabilities*, January 2012.

4 International Monetary Fund, *World Economic Outlook Update*, January 2012.

completions' approach, would offset any lag effects, although with negative impacts on predictability and simplicity for the reasons given above. Rather than adopt this approach in its 2010 Review, the CGC decided that reducing the averaging period to three years was the simplest method of making the relativities better reflect State GST requirements in the application year.

The Panel's view on the consequences of the lag

The Panel notes the various calculations of the value of the lag effect, but also notes that, when a State's relative fiscal capacity returns to its starting point, the lag effects will be completely reversed. While, on balance, lag effects provide a benefit to States with increasing fiscal capacities, this is difficult to assess far into the future with any certainty. This may change if the present strength of mining continues without being balanced by other factors.

The Panel notes that the most direct way to address lag effects — an advances and completions approach — was considered by the CGC at the 2010 Review, but not adopted. The Panel agrees with the CGC's decision, but is open to any views on how an advances and completions approach could be implemented without a negative effect on either predictability or simplicity.

Is there a difference between stability and predictability?

HFE outcomes can be unstable, but still be predictable. For example, Western Australia's declining relativity due to its large growth in mining royalty revenue is quite predictable to all States in the short term. The direction of change is clear and States can use published budget forecasts to derive a reasonably accurate estimate of the size of the effect on the distribution of GST revenue.

Alternatively, situations may arise, particularly for expense assessments, where HFE outcomes can be both unstable and unpredictable. In these cases, while the direction of effect may be predictable, a practical problem for States is that the size of the effect may not be able to be determined sufficiently accurately. This presents difficulties to jurisdictions that highly value knowing the precise effects on GST shares. Some States cite the inclusion of revised estimates for relative interstate wages in the 2011 Update as an example of this unpredictability.

The CGC attempts to mitigate the unpredictability of HFE outcomes through its annual *New Issues* paper, which presents States with CGC staff views on the treatment of new payments and data and seeks States' views prior to the CGC making final decisions. While the *New Issues* paper generally provides sufficient information for States to be able to predict the direction of HFE effects, it often does not provide information on the quantum of GST payments.

2.2 How changes to GST shares affect budget planning

New South Wales, Victoria and the Australian Capital Territory believe that it is crucial that States can accurately predict their GST payments.

New South Wales says:

> *The current method of implementing HFE in Australia often produces significant and unexpected movements in states' annual GST payments ... as a result of changes in the relativities. The changes in relativities are difficult to forecast, which potentially gives the changes a high surprise factor when they are released.*[5]

and:

> *The current CGC practice of releasing the updated relativities in February introduces an additional element of uncertainty into a state's decision making process.*[6]

Victoria says:

> *States' ability to develop their short to medium-term fiscal strategies requires stability and predictability to be a clear priority.*[7]

and:

> *Given the limited fiscal levers available to states, it is crucial that states are able to accurately predict their share of GST.*[8]

Both New South Wales and Victoria also comment on the fact that, as GST payments comprise a large proportion of State budgets, even small changes in relativities can have large budgetary impacts. New South Wales says:

> *... in the 2010-11 Budget NSW GST was estimated at $14.762 billion, including an increase due to the relativity of $277 million, which was less than 2 per cent of GST. However, this incremental change to GST was a significant proportion (36 per cent) of the estimated surplus in that year.*[9]

Similarly, Victoria says:

> *GST revenue is now the largest revenue line for all jurisdictions, save for Western Australia (23 per cent in Victoria's case in 2010-11, compared with just 16 per cent when Financial Assistance Grants were last used in 1999-00). Consequently even small changes in per capita relativities can have significant impacts on states' budgetary capacities.*[10]

The Australian Capital Territory follows this theme, saying:

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5 New South Wales submission to the GST Distribution Review, November 2011, page 37.
6 New South Wales submission to the GST Distribution Review, November 2011, page 39.
7 Victorian submission to the GST Distribution Review, October 2011, page 14.
8 Victorian submission to the GST Distribution Review, October 2011, page 2.
9 New South Wales submission to the GST Distribution Review, November 2011, page 39.
10 Victorian submission to the GST Distribution Review, October 2011, page 14.

> *Predictability in GST payments is very important for governments in fiscal management.*[11]

Queensland says that it:

> *…welcomes the consideration of approaches that seek to increase the predictability and stability of outcomes, with the aim of better supporting long-term decision-making and reform by governments.*[12]

Western Australia's view is that stability can best be enhanced either through the operation of a relativity floor, below which a State's relativity cannot fall, or other options for limiting the extent to which relativities can fall in a year.[13]

The remaining States were generally of the view that changes in States' circumstances inevitably led to some volatility in GST shares, but that this in turn resulted in lower volatility for overall revenues.

South Australia says:

> *Changes in GST relativities are the mirror of changes in State circumstances (for example, Western Australia's GST grant falls when its royalties are growing, with offsetting impacts). Because of HFE, each state effectively gets its population share of the total of all states revenues plus or minus variations in local revenue raising effort. This can be more stable than one state's own revenue streams so long as the HFE assessment is not too lagged. Furthermore State Treasuries may be able to anticipate some of the components of the relativity update changes ...*[14]

Tasmania says:

> *While all states value predictability and stability, changes in state circumstances will invariably lead to some degree of variability associated with GST revenue distribution, regardless of the form of HFE.*[15]

The Northern Territory says:

> *... volatility in relativities is a positive feature of equalisation. It demonstrates that equalisation is working and that it is adapting to changes in the structure of the Australian economy.*[16]

and:

> *When GST shares are considered in the context of total revenue available to each state, the GST volatility largely offsets changes in other revenues and contributes to comparatively stable total revenues.*[17]

11 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 19.
12 Queensland submission to the GST Distribution Review, October 2011, page 5.
13 Western Australian submission to the GST Distribution Review, October 2011, pages 50 and 53.
14 South Australian submission to the GST Distribution Review, September 2011, page 15.
15 Tasmanian submission to the GST Distribution Review, October 2011, page 31.
16 Northern Territory submission to the GST Distribution review, October 2011, page 58.
17 Northern Territory submission to the GST Distribution review, October 2011, page 57.

While noting the importance of predictability, the Australian Capital Territory observes:

> *Overall, a degree of volatility, particularly on the revenue side, reflects that the relative strengths of States' economies are changing and that HFE is working.*[18]

The Commonwealth Treasury concludes that:

> *Analysis of GST payments to the States suggests that as a source of revenue, GST payments exhibit similar variability to State own-source tax revenues; including when changes in GST relativities are taken into account.*[19]

The CGC says that the current system of HFE is responsive to changes in States' circumstances and that States are aware of the Commission's procedures. Thus they:

> *…have scope to adopt fiscal strategies which manage the outcomes and the timing effect on their budgets.*[20]

The Association of Mining and Exploration Companies (AMEC) says that the form of HFE should be simplified to increase predictability and stability of State budgets. In AMEC's submission, the current process is extremely complex and this complexity:

> *…creates an unpredictable budget environment for State and Territory governments. This has an indirect 'flow on' effect for … business investment … due to the … uncertainty caused by … revenue shortfalls and the subsequent need to raise taxes.*[21]

The Business Council of Australia (BCA) says that achieving maximum revenue predictability and stability will be critical for States in meeting future fiscal challenges. The BCA identified the treatment of certain infrastructure payments and mining as areas impacting on the predictability of State revenues.[22]

2.3 Options for improving the predictability and stability of GST shares

Options to improve predictability and stability directly are canvassed in this Chapter. Broader reforms to the GST distribution system might have ramifications for predictability and stability and these are considered in later Chapters.

Possible variations to improve predictability and stability in the context of the current approach to HFE include:

- changing the averaging period over which States' relativities are assessed
- 'fixing' annual relativities by allowing only changed circumstances, but not revisions to data previously included in relativity calculations, to affect updated relativities

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18 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 19.
19 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 7.
20 Commonwealth Grants Commission submission to the GST Distribution Review, August 2011, page 10.
21 Association of Mining and Exploration Companies (Inc) submission to the GST Distribution Review, October 2011, page 5.
22 Business Council of Australia submission to the GST Distribution Review, December 2011, pages 22-23.

- limiting relativity changes by introducing floors to relativities, or otherwise restricting movements in States' GST shares.

Before considering these options for change to the current system, the Panel notes the strong views of the larger States that timing arrangements during updates to relativities can have an unpredictable influence on States' budgets (see discussion at page 31 above). The Panel therefore considers that if the CGC were to include in its *New Issues* paper as accurate an estimate as possible of the effect on States' GST payments of possible Commission decisions, it may help reduce uncertainty and increase predictability of outcomes, irrespective of any changes canvassed below.[23]

Changing the averaging period

As explained above, currently three annual relativities of past years are averaged to produce the recommended relativity for the upcoming application year.

In the 2010 Review, the CGC moved to a three year averaging period to better balance the competing needs of capturing current State circumstances and providing stability. Some commentators have suggested changing the averaging period back to five years, to improve predictability and stability (at the expense of being more contemporary).

No State has specifically sought a return to a five year average in the interests of greater stability of GST shares, with some submissions (for example, South Australia, AMEC) suggesting or implying that even greater contemporaneity is required.

The Northern Territory explicitly supports the retention of a three year average[24], as does Tasmania, which notes that an even more contemporaneous approach might have a downside:

> *The extent of the trade-off between contemporaneity and stability can have a significant impact on state GST revenue shares. This has been a focus of past HFE reviews. Arguably, HFE is given its full effect when assessments are made annually, with revenue adjusting to meet current circumstances. However, this would create significant volatility, which would make the management of state budgets very difficult. Delays in data availability also limit the ability of HFE to quickly and accurately reflect changes in state circumstances. Tasmania supports the current three year data averaging approach, adopted in the 2010 Review, as reflecting an appropriate balance between contemporaneity and stability.*[25]

Western Australia cautions that:

> *Changing the approach to 'contemporaneity' creates the risk of equalisation not being achieved over time, for example, where the averaging period is changed ... this risk crystallised when the CGC decided to move from five to three year averaging ... such changes could have significant costs that are never recovered.*[26]

23 This observation is formally recorded as a *Panel view* in Chapter 8, dealing with governance and communication issues.

24 Northern Territory submission to the GST Distribution Review, October 2011, page 54.

25 Tasmanian submission to the GST Distribution Review, October 2011, page 31.

26 Western Australian submission to the GST Distribution Review, October 2011, page 15 and pages 47-48.

This quote refers to the outcome that, whenever there is a change in the averaging period, all years will not have the same weight in HFE outcomes without some transitional arrangements. To be fully equalised, a year should be included in the HFE outcome for as many years as the averaging period. That is, in a five year averaging period, each year has an effective weight of 20 per cent and should be included in the HFE process for five years.

The effect of the CGC moving to a three year average period in 2010 from a five year average period (without any transitional arrangements) was to leave some years 'under-equalised', by up to 40 per cent.

The under-equalised years generally reflected a time when New South Wales had a stronger fiscal capacity than currently and Western Australia had a weaker fiscal capacity than currently. This led to the change in the averaging period disadvantaging Western Australia by around $500 million in GST payments, with a similar advantage to New South Wales.

In the absence of transitional arrangements, a return to a five year average period would risk a number of years being over equalised, by up to 40 per cent.[27]

The Panel's view on changing the averaging period

The Panel notes States' views that the three year average provides a practical and appropriate balance between the benefits of stability and contemporaneity. The Panel is not convinced that a further change to the averaging period would be advantageous at this time, particularly since this could have further unintended consequences in the transitional years for some States.

Fixing annual relativities

In the current practice of averaging three annual relativities to produce the application year's relativity, the earlier two annual relativities may change from the previous Update's calculation, due to data revisions. Data revisions caused significant unexpected changes to GST shares following the 2011 Update.

An approach suggested to improve stability is for data revisions not to be made to earlier assessment years, so that once an annual relativity is determined, it remains unchanged for the period of its contribution to the average relativity calculation.

Under this approach — referred to as not 'back casting' — changes in States' fiscal circumstances would still be recognised, but data inaccuracies subsequently identified would be allowed to remain in the relativity calculation. Predictability and stability would be improved as the average relativity would only change due to the influence of one year in three.

27 Transition arrangements could involve continuing to calculate relativities on both the old and new averaging basis, then weighting these results over a transition period until the new averaging basis had a 100 per cent weight. In its submission to the CGC on Contemporaneity in September 2009, page 3, Western Australia suggested a phase-in approach, proposing a minimum three year phase-in period from five year averaging to three year averaging. However, this three year phase-in period would still have not resulted in all years being fully equalised.

The downside of not 'back casting' — namely, entrenching errors in the calculations — could be mitigated by allowing some revisions, for example to some data sets such as the Government Financial Statistics (GFS), but not others, such as non-annual data sets such as the Survey of Education and Training (SET) and Census data. As SET data and Census data are only updated every four and five years respectively, the most recent data may reflect much larger differences between the States than annually updated data sets. As the time between the latest and previous SET and Census data sets is longer than the three years included in the relativity calculations, each assessment year will reflect the new data, which may lead to large and less predictable changes to GST payments. This was the case for the SET data applied in the 2011 Update.

A variation of this approach could be that, while 'no revisions' is the default position, particular revisions could be made, provided there is agreement from another body, such as Heads of Treasuries or the Standing Council on Federal Financial Relations.

An extension of this approach would be to fix relativities absolutely between reviews, although this would have the major drawback of not recognising any relative changes in States' fiscal capacities between reviews.

Victoria strongly supports not correcting for past data errors referring to the approach as 'setting previous relativities in stone, once published'.[28] Victoria also argues that correcting errors in previous years' calculations means that jurisdictions cannot rely on published annual relativities to remain constant.

Conversely, the Northern Territory directly opposes any 'locking in' of relativities. It says:

> *Locking-in relativities between major reviews or introducing a floor on relativities would lead to inequitable financial outcomes between states unless there was no change in relative state circumstances over that period.*[29]

No other State has advocated or specifically raised this approach.

The Panel's view on fixing annual relativities

The Panel sees merit in approaches that lead to increased predictability and stability in the GST distribution, especially where this can be delivered without substantial effects on overall outcomes. A default approach where data changes are not back cast may deliver this, although flexibility should be retained to allow revisions on a case-by-case basis.

28 Victorian submission to the GST Distribution Review, October 2011, page 4.
29 Northern Territory submission to the GST Distribution Review, October 2011, page 54.

Limiting relativity changes

Grouped under this heading are approaches that restrict downward changes to GST shares and payments, including adopting relativity floors.

While these approaches would typically increase predictability and stability for States with rapidly strengthening fiscal capacities, as the distribution of the GST revenue is a 'zero sum game', the 'cost' of maintaining GST payments for States would have to be shared across the remaining States.

If that cost was allocated on a relativity basis, all States would have differing fiscal capacities, with the cost being borne disproportionately by the recipient States. Alternatively, if the cost was shared on an EPC basis, the States bearing the cost would be equalised to the same fiscal capacity, albeit a below average capacity, and the benefitting States would have an above average fiscal capacity.

Western Australia, and associated State organisations and parliamentarians favour the introduction of a relativity floor, below which a State's relativity cannot fall. The most commonly mentioned floor in submissions was 0.75.[30]

Western Australia considers that the introduction of a relativity floor is a vital reform to the system. It says:

> *A floor on GST shares would be consistent with other elements of the Commonwealth's tax and transfer system, which limit the redistribution of income to preserve fairness and incentives.*[31]

Alternatively, Western Australia proposes that a State's GST relativity, incorporating the CGC's three year rolling average, not be allowed to fall by more than (say) one percentage point in any year. This would allow:

> *... States to retain significant benefits in the medium term from improvements to fiscal capacity, while still allowing an equity-based adjustment in the longer term.*[32]

In support of a 0.75 relativity floor Tony Crook MP, of Western Australia, says:

> *A 75 per cent floor in GST relativities would provide predictability and stability in the determination of strongly performing States' GST shares, and would support the ability of those states to make long term investment decisions.*[33]

30 There has been no evidentiary basis or logically probative argument put forward to support that particular number. The new Opposition Leader in Western Australia, Mark McGowan, has called for a 0.80 relativity floor: http://www.theaustralian.com.au/national-affairs/state-politics/mcgowan-digs-in-on-gst/story-e6frgczx-1226250784013, viewed 22 February 2012.

31 Western Australian submission to the GST Distribution Review, October 2011, page 50.

32 Western Australian submission to the GST Distribution Review, October 2011, page 53.

33 Tony Crook MP submission to the GST Distribution Review, October 2011, page 2.

In a letter to the Prime Minister on 11 November 2011, the Western Australian Legislative Assembly agreed to a resolution that, *inter alia*, calls on the Federal Government to:

> *... amend the Act [Federal Financial Relations Act 2009] to stipulate a minimum GST revenue-sharing relativity of 75 per cent, which would allow continuing respect for the principles of horizontal fiscal equalisation, but with proper recognition for population and without Western Australia being unfairly penalised for its disproportionate contribution to our national economic prosperity.*

However, the Western Australia Chamber of Commerce and Industry (WACCI) says that the process of establishing a floor would require careful consideration as to the longer-term impact on the way the GST is distributed.[34]

The Australian Capital Territory says that:

> *The Review should give consideration to some form of limit or transition where States are significantly negatively impacted by a change in GST shares or slow growth in the GST pool.*[35]

The Australian Capital Territory proposes that limits could take the form of no State receiving a lower nominal amount than in the previous year or a limit to the negative per capita impact of changes to relativities and pool sizes. It makes the observation that volatility is more difficult to manage when it is negative, rather than positive.

South Australia, Tasmania and the Northern Territory all say that any floors (or other restrictions on relativity movements) would result in inequitable fiscal outcomes between States.

South Australia and Tasmania go further, saying that any outcome that does not equalise States' fiscal capacities would be inconsistent with the Review's Terms of Reference.

New South Wales and Victoria did not raise the possibility of applying a relativity floor.

In order to form a view on the merits of floors it is necessary to have a proper understanding of the effect they could have on States' fiscal capacity. As pointed out in Chapter 1, a relativity of 'zero' would simply mean that one State's own source revenue was so strong that the other States required the entire amount of GST in order to reach the average fiscal capacity. Indeed, it is possible for one State's situation to be so strong that, despite receiving no GST, it has an assessed capacity well *above* the others. This was the case with New South Wales and Victoria in the early days of the federation.

Comparison of State revenue

Figure 2.2 below shows the components of total revenues for Western Australia and the balance of States in per capita terms from 2000-01 to the present, with estimates across the budget forward years to 2014-15.[36] Total revenues reflect State own source taxes,

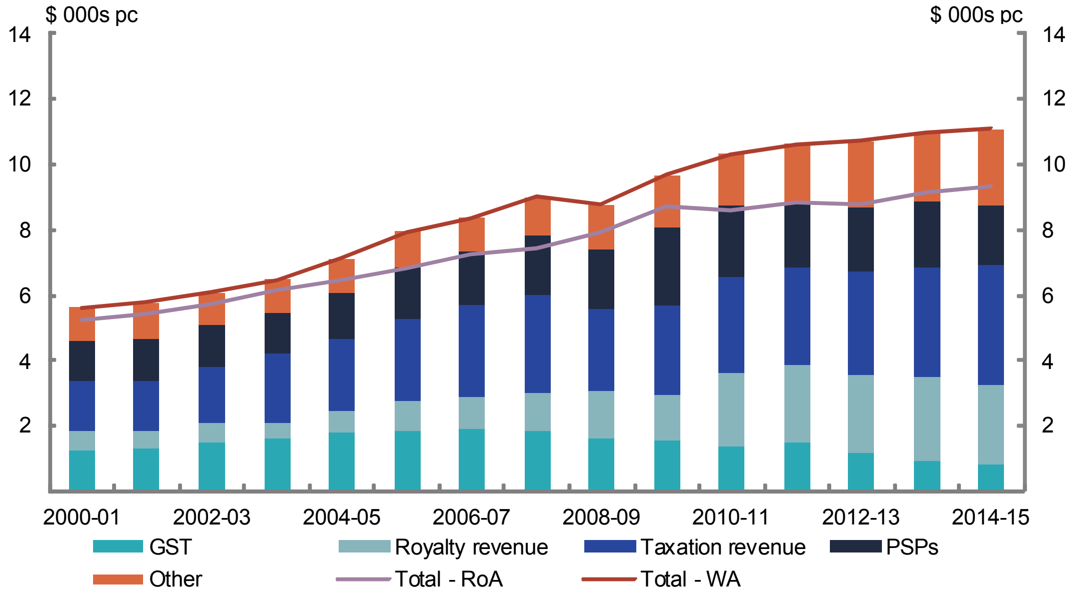
34 Western Australian Chamber of Commerce and Industry submission to the GST Distribution Review, October 2011, page 12.

35 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 23.

36 Similar charts have been prepared for all other States, and can be found at Appendix C.

mining royalties, GST payments, Commonwealth payments for specific purposes and other revenues (such as user charges).

Figure 2.2: Components of total revenue, Western Australia and total revenue, balance of States, 2000-01 to 2014-15



Source: ABS, GFS; Commonwealth and State budget papers; Secretariat calculations.

Figure 2.2 shows that, from the introduction of the GST as the pool for HFE in 2000-01, Western Australia has had greater total revenue per capita than the balance of States and that the current gap will likely be maintained across the forward estimates period.

A State may have a greater than average total revenue per capita as a result of one or more of the following conditions:

- It has a greater revenue raising 'effort'[37] than average.
- It is assessed to have higher than average expenditure needs and so received a larger share of GST revenue in order to have higher than average total revenue.
- Lag effects, resulting from its revenue capacity growing at a faster rate than the growth in the GST pool.

For Western Australia, the earlier years in Figure 2.3 primarily represent the effects of the first two conditions. However, the later years (apart from 2008-09, in which the global financial crisis affected Western Australia more than the other States) reflect the growing influence of lag effects.

Figure 2.2 also shows that over the forward estimates period, if the growth in mining royalties stabilises, reductions in GST compensate for them, and the gap between Western Australia and the remaining States will therefore also stabilise.

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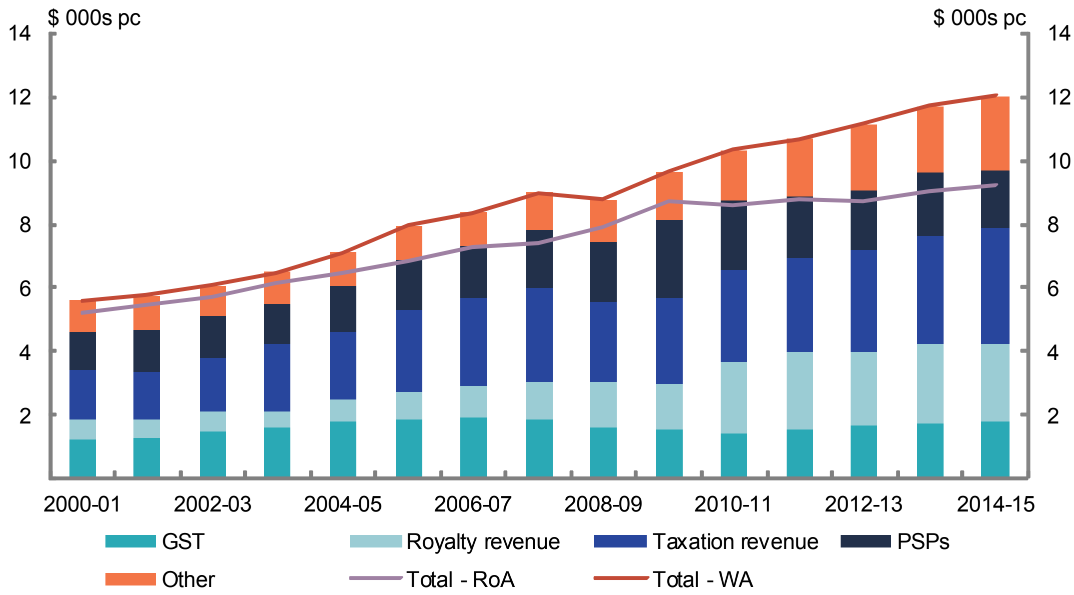
37 'Effort' here refers to the difference between a State's actual revenue raised and the revenue it would have raised had it followed average policies. A State that raises more revenue than assessed by following average policies is said to have an above average revenue raising effort.

If a relativity floor or some other limit to relativity changes was applied, there would be no offsetting reduction in Western Australia's GST revenue. Figure 2.3 shows the total revenues per capita for Western Australia and the balance of States if a relativity floor of 0.75 was applied. In this scenario, the gap between total revenues per capita for Western Australia and the balance of States widens across the forward estimates period, rather than stabilising.

Figure 2.3: Components of total revenue, Western Australia and total revenue, balance of States, 2000-01 to 2014-15, 0.75 relativity floor



Source: ABS, GFS; Commonwealth and State budget papers; Secretariat calculations.

The cost of the floor modelled in Figure 2.3 is of the order of $50 million per relativity basis point, assuming the 2012-13 GST pool size. If Western Australia's relativity dropped to 0.35 (or 40 basis points below the floor), the cost to the other States would be more than $2 billion.

In considering a relativity floor, there is no particular fiscal rationale as to why a 0.75 floor would be inherently fair or preferred to any other. Softer variants of limiting relativity changes could be a payment floor, so that, in a situation of increasing GST revenue, States would receive no less GST revenue in nominal terms than they did in the preceding year. The effect of this is to limit relativity reductions to those that can be absorbed by the growth in GST revenue. Costs to other States of the operation of a floor could be 'clawed back' if and when a State that had benefitted from a floor had its relativity increase back above the floor level. However the 'claw back' liability could be large and would likely lead to future uncertainty in the predictability and stability of GST allocations.

The Panel's view on limiting relativity changes

While the Panel sees merit in exploring approaches that lead to increased predictability and stability in the distribution of GST revenue, it considers that there is no compelling case for adopting a floor at present. Moreover, a relativity floor of 0.75 would cause a major disparity in the fiscal positions of the States in the very near future.

On the other hand, an approach that manages reductions in GST payments received by States, perhaps by ensuring that a State does not receive a lower nominal amount of GST revenue than in the previous year (in years when the GST revenue pool grows), could increase stability without such extreme consequences.

Furthermore, the Panel notes that other approaches (dealt with in Chapter 6) might address some of Western Australia's concerns.

3 Simplicity: Can the GST distribution process be made simpler?

The Terms of Reference for the Review require the Panel, in considering any possible changes to the form of equalisation, to have regard to simplicity and examine how alternative approaches would increase transparency.

The fiscal equalisation process has often been criticised for being complex. While the CGC simplified the process in its 2010 Methodology Review, many submissions to the current Review raise the need for further action.

3.1 What is the problem?

Some themes raised in submissions are that:

- the methodology is overly complex
- the current process leads to 'false precision'
- complexity arises from the interpretation of 'what States collectively do'.

However, there are contrary views, and some submissions caution that simplicity should not be pursued at the expense of 'full' equalisation (as described in Chapter 1). There are also some who argue for making certain assessments even more comprehensive, which may arguably lead to increased complexity (see section 3.4 below).

These themes are examined in the paragraphs below.

The methodology is overly complex

Some States and several other submissions raise concerns with the level of complexity inherent in the current process. States also generally note that complexity leads to poor understanding of the process, ultimately undermining support for HFE.

Victoria says:

> *... a similar outcome could be achieved through a simpler process that is less resource intensive.*[1]

Western Australia says simplification is essential and that complexity hinders understanding and hides mistakes. More broadly, Western Australia attributes the level of complexity to the process for developing the methodology:

> *The States were at least partly culpable for the failure of the 2010 Review to achieve genuine simplification. An inevitable consequence of each State's vested*

1 Victorian submission to the GST Distribution Review, October 2011, page 17.

> *financial interests is advocacy for the retention of any detailed method that increases their grant share.*[2]

New South Wales says:

> *The calculations themselves are numerous, often complex and difficult to understand. It also is difficult to envisage how all the detailed calculations fit together to produce the CGC's overall relativity recommendations. Beyond the CGC, a few staff in the Commonwealth and state Treasuries and perhaps a handful of academic economists, it is extremely unlikely that others would understand the Commission's processes, particularly in the absence of regular publication of the working papers.*
>
> *This lack of understanding can lead to a lack of support for the CGC's recommendations, which can lead to lack of public confidence in HFE and the CGC and its analysis. A simpler, more transparent system could improve public understanding and support for HFE.*[3]

Similarly, the New South Wales Business Chamber says:

> *The formula used by the CGC ... is generally seen as being overly complex and convoluted. The framework applied is very technical and is well understood by few people.*[4]

The Institute of Public Affairs says:

> *The HFE methodology used to determine the distribution of GST revenue grants is extremely complex, and is rife with data limitations leading to the excessive use of subjective judgment by the CGC.*[5]

However, there is not complete agreement that the current arrangements are too complex. For example, Tasmania says:

> *Given the magnitude and importance of HFE, Tasmania does not believe the CGC methodology to be unnecessarily complex. In fact, the core concepts are straight-forward.*[6]

Similarly, South Australia says:

> *South Australia does not consider that the CGC methodologies and processes are unnecessarily complex given the magnitude and the importance of the equalisation task. … It is not clear that the degree of complexity in the current system has any specific adverse consequences for stakeholders.*[7]

2 Western Australian submission to the GST Distribution Review, October 2011, page 44.
3 New South Wales submission to the GST Distribution Review, November 2011, page 37.
4 New South Wales Business Chamber submission to the GST Distribution Review, October 2011, page 2.
5 Institute of Public Affairs submission to the GST Distribution Review, September 2011, page 12.
6 Tasmanian submission to the GST Distribution Review, October 2011, page 4.
7 South Australian submission to the GST Distribution Review, September 2011, page 14.

The current process leads to 'false precision'

Several submissions raise concerns that the current process creates a sense of 'false precision'. For example, Victoria says:

> *... Australia can be characterised as having a 'Rolls Royce' HFE methodology. It attempts to accurately capture 'what states do' at a remarkable level of detail, and then equalise for identical outcomes across all major spheres of state government expenditure and revenue. However, in many cases Australia only has access to a 'horse and cart' level of data (which can be both inadequate and inaccurate) with which to perform HFE calculations. But, by trying to do too much with limited data, there is a risk that Australia's complex HFE system produces results that are 'precisely wrong' rather than 'roughly right'.*[8]

In the same vein, Western Australia says:

> *The complexity of the CGC's methods and still vast detail generated imply a level of precision that does not stand up to scrutiny ...*[9]

Likewise, Queensland says:

> *Although complexity creates the impression of rigour, it may be that the outcomes are actually less reliable than they seem.*[10]

However, other States raise concerns about the simplicity gains in the CGC's 2010 Methodology Review and emphasise that simplicity should not be pursued at the expense of equity or accuracy. (In this context, both descriptions refer to the current approach of 'full' equalisation).

For example, Tasmania says:

> *Most importantly, simplification should not be pursued to the detriment of the achievement of equity. That is, the CGC's assessments should not be over-simplified to the extent that they are no longer credible because they fail to capture the main drivers of material interstate variations in expenditure needs or revenue raising capacity.*[11]

Similarly, South Australia says:

> *Less complexity should not be an end in itself.*[12]
>
> *….The primary objective should be to achieve equalisation, and efforts to simplify the assessments should not undermine that principle.*[13]

8 Victorian submission to the GST Distribution Review, October 2011, page 16.
9 Western Australian submission to the GST Distribution Review, October 2011, page 41.
10 Queensland submission to the GST Distribution Review, October 2011, page 4.
11 Tasmanian submission to the GST Distribution Review, October 2011, page 29.
12 South Australian submission to the GST Distribution Review, September 2011, page 14.
13 South Australian submission to the GST Distribution Review, September 2011, page 3.

The Northern Territory says:

> *Consideration needs to be given to achieving greater simplification where possible, but also whether simplification has produced results that are not consistent with equity objectives or not reliable. The mining assessment is one where the pursuit of simplicity has not led to an improved outcome.*[14]

The Australian Capital Territory notes that the CGC took significant steps to simplify assessments in the 2010 Review, but says:

> *While gains were made in simplicity, it came at the cost of reducing the 'accuracy' of HFE, as a consequence of using broader but less subtle measures of differences and applying arbitrary materiality thresholds.*[15]

Complexity arises from the interpretation of 'what States do'

Some States consider that the complexity arises from the CGC's principle of 'what States collectively do'. For example, Queensland says:

> *For any attempt at simplification to be successful, Queensland believes the current interpretation of the principle of reflecting 'what States collectively do'... needs to be considered.*[16]

Victoria says that the current assessments attempt to capture 'what States do' at a remarkable level of detail and that, despite attempts to simplify assessments in the 2010 Methodology Review, they remain extremely complex.[17]

However, South Australia favours adhering to the CGC's principle of 'what States do' as strongly as practicably possible:

> *... there is really no stopping point to the potential arbitrariness of the GST distribution if the principle of 'what states do' is not adhered to as strongly as practicably possible.*[18]

3.2 Elements of the current approach

As explained in Chapter 1, the current approach to equalisation in Australia seeks 'full' equalisation in a relatively comprehensive manner. The CGC identifies and measures (or assesses) the differences between the States in:

- what it costs to provide the average standard of services
- the revenue they could raise from each tax or charge if they made the average effort
- payments received from the Commonwealth Government (excluding the GST)

14 Northern Territory submission to the GST Distribution Review, October 2011, page 43.
15 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 2.
16 Queensland submission to the GST Distribution Review, October 2011, page 4.
17 Victorian submission to the GST Distribution Review, October 2011, page 17.
18 South Australian submission to the GST Distribution Review, October 2011, page 21.

- the net lending (fiscal surplus) or borrowing (fiscal deficit) States would need to finish the year with the same per capita value of net financial worth.

In the 2010 Methodology Review, the CGC sought to achieve equalisation in a simpler way. That review focussed on achieving simplicity through reducing the number of separate assessments that were required in the CGC's calculations. While only a small reduction was achieved in the revenue assessments, significant rationalisation of the expense assessments was achieved. Table 3.1 summarises the reduction in assessments following the CGC's 2010 Methodology Review.

Table 3.1: Simplification achieved in the 2010 Methodology Review

	2004 Review	2010 Review
Revenue assessments	13 categories of taxes and other revenues and 8 categories of user charges, some of which were sub-divided and each sub-division had a revenue base measure.	7 categories of taxes and other revenues, some of which are sub-divided and each sub-division has a revenue base measure, plus Commonwealth payments (8 categories in total).
	In total, there were 29 sub categories.	In total, there are 13 sub categories (a).
Expenditure assessments	39 expense categories, most of which were divided into components and multiple disabilities were assessed for each component.	12 expense categories, which are divided into components and multiple disabilities, are assessed for each component, plus an Investment category and a Net lending category (14 categories in total).
	In total, there were 171 components and 344 disabilities.	In total, there are 43 components and 93 disabilities.

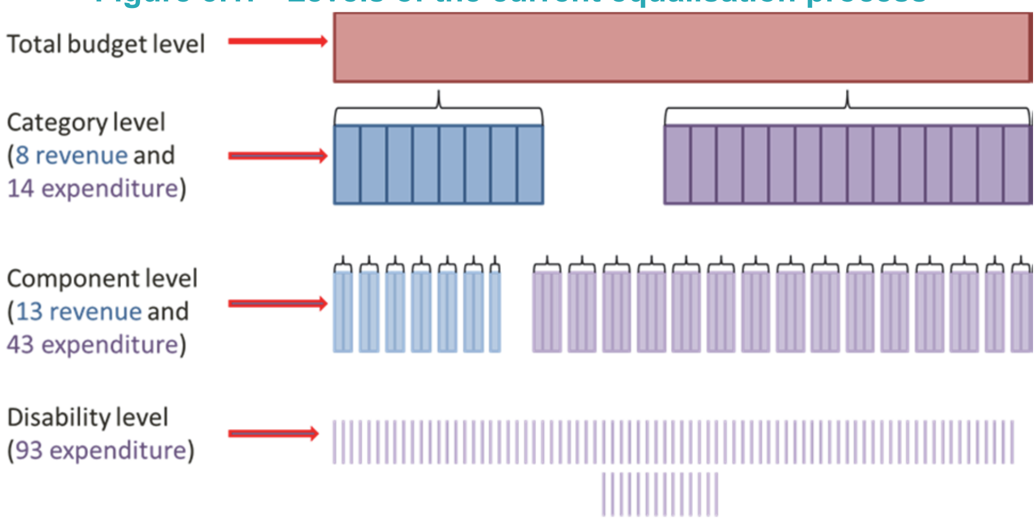
Note: (a) There are no categories of user charges because they are mostly included in the 'Other' revenue category.

Source: CGC 2010 Methodology Review, Main Report, volume 1, page 85.

Notwithstanding the gains from the CGC's 2010 Methodology Review, the Panel is examining whether further simplification could be achieved, either without altering current outcomes significantly, or with only modest or justifiable changes to them.

Figure 3.1 illustrates the level of detail in the current equalisation process by breaking it down into constituent levels.

Figure 3.1: Levels of the current equalisation process



3.3 Possible avenues to simplification

The following paragraphs examine how further simplification might be achieved in one or more of the levels of the process described above. The Panel has set out a broad suite of alternatives ranging from relatively discrete and minor changes at the 'disability' level, through to changes at the total budget level. Not all of these possibilities have been fully considered or addressed in submissions and consultations to date. The Panel has therefore set out its views on which avenues might prove productive, in order to generate further feedback following the release of the Panel's Interim Report.

Simplifying at the disability level

Freezing expenditure disabilities between reviews

Under this approach, the CGC would continue to update its assessments of revenue and Commonwealth payments each year. However, expenditure disabilities would be calculated in a methodology review year (approximately every five years) only and would not be updated in the years between methodology reviews.

The Northern Territory suggests:

> *Locking in expenditure factors would reduce the considerable effort required in each major review associated with the re-examination of expenditure methodologies, allowing the Commission to focus on the revenue assessments which drive volatility in the GST distribution.*[19]

> #### *The Panel's view on freezing expenditure disabilities*
>
> *The Panel sees the merit in freezing expenditure disabilities, but notes that it would represent only a minor improvement by simplifying the CGC's annual update process and would not address the major causes of underlying complexity.*

Simplifying certain complex disability assessments

Some States have concerns about the complexity of certain disability assessments, for example, the Australian Capital Territory says that the welfare and housing and education assessments could be simpler, but notes that these matters would be raised as part of a normal methodology review.[20]

> #### *The Panel's view on simplifying complex disability assessments*
>
> *The Panel considers that the CGC would be the appropriate body to consider disability assessments, such as the one raised above.*

19 Northern Territory submission to the GST Distribution Review, October 2011, page 6.
20 Australian Capital Territory submission to the GST Distribution Review, October 2011, pages 15 and 20.

Adopting higher materiality thresholds and/or stricter reliability guidelines[21]

To reduce the number of assessments in the 2010 Methodology Review the CGC introduced reliability and materiality guidelines. These guidelines were aimed at ensuring that assessments allowed only for disabilities that had a material effect on the GST distribution and were measured using conceptually rigorous methods and quality data that were fit for purpose.[22] The guidelines included a number of materiality thresholds. At the disability level, the CGC decided a disability would only be included if it changed the GST distribution for at least one State by $10 per capita across all relevant categories.[23] In its submission, the CGC says further simplification could be achieved by strengthening the guidelines and increasing the materiality thresholds.[24]

No State suggests increasing materiality thresholds and Western Australia rejects the mechanical use of thresholds, saying that, in the context of the existing framework:

> *… simplicity [should] be vigorously pursued on the basis of improving the reliability of assessments, rather than by adopting mechanical 'thresholds' to reduce the detail in the assessments ...*[25]

The Panel's view on higher materiality thresholds at the disability level

The Panel accepts the principle of increasing materiality thresholds to achieve further simplification, but notes that a large increase in the threshold for disabilities would be required in order to reduce the number of assessments significantly. Furthermore, the CGC would still need to collect data and do the analysis to determine whether the disability met a materiality threshold.

Simplifying components

Removing adjustments for tax implementation differences

Under this approach, the 'average of what States collectively do' benchmark would be set at one tax rate only and without tax-free thresholds or exemptions. For example, the assessment for payroll tax would not take into account that States have tax-free thresholds for small businesses and the assessment for stamp duties on conveyances would not be done for all 16 duty rates applying to different values of transactions.

The Panel's view on removing adjustments for tax differences

The Panel recognises that removing adjustments for tax differences would represent a move away from 'what States collectively do'. However, the approach would offer simplification benefits and could address concerns about policy neutrality. The approach will be considered further in the Panel's second Interim Report.

21 Higher materiality thresholds at the *category* level are discussed below.
22 The assessment guidelines used for the 2010 Review are included in Attachment A of the CGC 2010 Review Report, volume 1.
23 CGC, *Report on GST Revenue Sharing Relativities — 2010 Review*, Volume 1, page 87.
24 Commonwealth Grants Commission to the GST Distribution Review, August 2011, page 7.
25 Western Australian submission to the GST Distribution Review, October 2011, page 55.

Simplifying certain categories

Simplifying the capital assessments

In its 2010 Methodology Review the CGC changed the assessment of State capital needs. In part, the changes were intended to address the complexity in the previous debt charges assessment. Some States say the capital assessments remain complex, for example, the Australian Capital Territory says:

> *... [the capital assessments are] unduly complex to the point of being incomprehensible.*[26]

A simpler approach could be to recognise a State's infrastructure needs through an assessment of State depreciation expenses while also recognising the impact of population growth on a State's accumulated saving (or net worth). Such an approach could also include an imputed holding cost expense.

> ### *The Panel's view on simplifying the capital assessments*
>
> *The Panel agrees that the capital assessments could be simplified. However, these issues are of a methodological nature and the CGC would be the appropriate body to consider how to further simplify these assessments.*

Using broader indicators

Many States suggest broader or 'global' indicators be used for revenue assessments. Some also suggest broader indicators be used for expenditure assessments.

There are no common definitions of the terms 'broader indicators' or 'global indicators' and the two are sometimes used interchangeably. For present purposes, *global* indicators will be used to refer to the few very high level indicators of State capacity, such as Gross State Product (GSP), or Household Disposable Income (HDI). *Broader* indicators will be used to refer to indicators that are more closely linked to States' current revenue bases and expenditure responsibilities.

Compared to the current approach, broader indicators would involve using indirect methods that would be less sensitive to change in State policies. For example, rather than seeking data from the State Revenue Offices on the values of properties transferred, the CGC could base its assessment of stamp duties on conveyances on ABS housing finance data.[27]

Broader indicators for revenue assessments

Victoria gives an example:

> *[T]he lengthy assessment of payroll tax could be reduced by basing the assessment only on the ABS reported compensation of employees for each jurisdiction, and avoiding issues of thresholds or progressive rates. It may well be the case that less*

26 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 21.

27 As well as being simpler, this approach could assist policy neutrality – see Chapter 4.

> *complex and easier to follow methods would yield similar results to the status quo.*[28]

The Commonwealth Treasury suggests:

> *... [aggregating] state revenue sources according to their ultimate incidence and measuring these new categories against a broad base. This would mean that States could make revenue neutral adjustments within one tax base without affecting their GST relativity, reducing the likelihood that HFE effects would distort State tax mix choices.*
>
> *To determine a simpler way to aggregate the existing tax revenue assessments together, a distinction between the legal and economic incidence needs to be made, that is, those who pay the tax and those who bear the burden of the tax.*
>
> - *For example, insurance taxes are levied on insurance companies, but they are expected to largely pass the impost on to consumers of insurance through higher insurance premiums (prices). In this case, the legal incidence is on insurance companies but the economic incidence is on insurance policy holders.*[29]

An assessment based on this approach would include three revenue assessment categories of taxes on individuals, taxes on land and mining revenue. The ability of States to raise revenue from payroll, motor vehicle and insurance taxes would be assessed in the taxes on individuals category. The ability of States to raise revenue from stamp duties on conveyances and land tax would be assessed in the land tax category and the ability to raise revenue from mining royalties in the mining revenue category.

Queensland also provides a possible approach for the revenue assessments:

> *A combination of different proxies could be used to link the assessment of revenue capacities to the parts of the economy taxed by States and the extent to which different segments are taxed. This could be approached in a variety of ways, for example:*
>
> - *in relation to economic bases, State taxation may be grouped into taxes on labour, capital and land/resources; or*
>
> - *from a capacity to pay perspective, groupings could potentially be condensed to taxes on households and taxes on corporations.*
>
> *Revenue capacity from taxes on corporations could be measured using a proxy based on corporate profitability, total factor income or a similar measure.*
>
> *An assessment of revenue raised from households could use a broad measure of household capacity to pay tax, such as household disposable income.*
>
> *Total assessed revenue for the States could be derived in a similar way to the calculation of individual revenue assessments in the current process. States' relative per capita shares of the proxy indicator and the total revenue raised could be used to determine each State's revenue capacity compared to the standard.*[30]

28 Victorian submission to the GST Distribution Review, October 2011, page 3.
29 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 65.
30 Queensland submission to the GST Distribution Review, October 2011, page 15.

The Australian Capital Territory recommends changing the mining assessment and the assessment of stamp duties on conveyances by:

- *using more indirect measures for revenue bases that would be less sensitive to the policy choices made by States; and*

- *capturing tax elasticity effects within the measures of relative [revenue raising capacity]. (This approach was previously practised by the CGC, however was discontinued in the name of simplicity.)*[31]

New South Wales and Western Australia also propose that revenue be assessed based on less detailed and broader bases.

Broader indicators for expenditure assessments

Victoria, Queensland, Western Australia and Chamber of Commerce and Industry Western Australia suggest that broader indicators could be used for expenditure assessments.

Victoria says:

> *Many current revenue and expense categories use multiple indicators in the assessment calculation. These categories could be streamlined, or have single indicators introduced, to reduce the number of calculations used across the HFE system.*[32]

Queensland suggests:

> *Instead of categorising expenses by purpose and assessing individual disabilities in each category, the assessment could focus on factors that affect the cost of service delivery globally, across a broad range of State government functions. Some global factors are already included in the current process, such as difference in wage levels, remoteness and administrative scale.*
>
> *Many other disabilities in the current process, such as those relating to socioeconomic and other demographic influences, are applied in a range of categories using similar methodology, and could be combined into a single measure.*[33]

The Chamber of Commerce and Industry Western Australia suggests that, if expenditure needs continue to be assessed, that they be done:

> *... in a much more high-level way capturing the main drivers of cost differences as opposed to the current complex approach.*[34]

31 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 18.

32 Victorian submission to the GST Distribution Review, October 2011, page 3.

33 Queensland submission to the GST Distribution Review, October 2011, page 15.

34 Chamber of Commerce and Industry Western Australia submission to the GST Distribution Review, October 2011, page 3.

The Panel's view on the use of broader indicators

The Panel is highly attracted to the use of broader indicators, as they could offer significant simplification and may equalise to a similar extent as at present. Broader indicators would also reduce the scope for State policy changes to affect the GST distribution (see Chapter 4). However, the Panel recognises that using broader indicators could be seen by some States as a less precise measure of 'what States collectively do'.

The Panel therefore seeks further information, evidence and views from States about:

- *what broader indicators could apply, especially on the expenditure side, where the proposals are less well developed, and*
- *on the revenue side, why broader indicators, such as those described above, would not produce appropriate outcomes.*

Equalising for major revenue and expense items only

Under this approach, the number of expense and revenue categories assessed by the CGC would be reduced, effectively imposing a higher threshold for materiality at the category level.

Victoria and the Chamber of Commerce and Industry Western Australia suggest that all expenditure needs cease to be assessed. Victoria says:

> *The expense assessments conducted by the CGC are particularly complex and arguably create incentives for states not to reduce their sources of disadvantage.*
>
> *Revenue assessments, on the other hand, tend to be less complex and easier to understand, although there is still the need for the CGC to apply judgement. Assessing revenue only would improve efficiency, simplicity and transparency, while partially meeting the equity criterion by addressing differences in states' revenue raising capacities.*
>
> *Internationally, federal countries including Canada and Germany tend to concentrate on the equalisation of revenue capacities only, virtually ignoring cost disabilities in the provision of public services. These nations make achieving minimum standards rather than full equalisation their primary objective.*[35]

The Chamber of Commerce and Industry Western Australia says:

> *Move to revenue-only equalisation. This is the simplest and most objective method of equalisation, and is in line with international standards. Revenue equalisation would need to include all own-source revenue, including that which the Grants Commission has been reluctant to assess such as gambling taxes.*[36]

35 Victorian submission to the GST Distribution Review, October 2011, page 5.

36 Chamber of Commerce and Industry Western Australia submission to the GST Distribution Review, October 2011, page 3.

New South Wales proposes limiting expenditure assessments to core categories, saying:

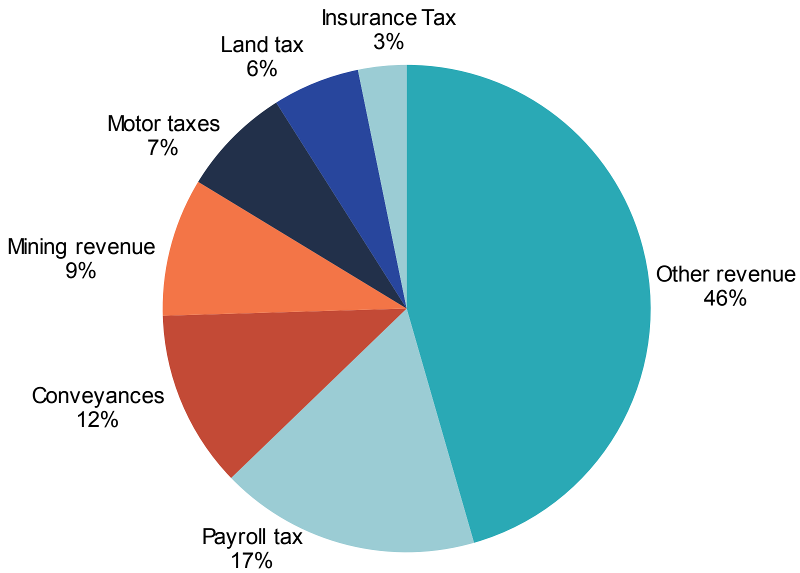
> *Should the Review favour only incremental change at this time, ... expenditure [should be] assessed based on a limited number of core services.*[37]

There could be several ways of limiting expenditure assessments to core categories, including increasing the materiality thresholds that apply to the size of a category or to the amount of the GST redistribution.

Figures 3.2.1 and 3.2.2 show the categories of State budgets that are currently assessed by the CGC. If categories that make up 5 per cent or less of State budgets were no longer assessed, then the CGC would no longer make differential assessments for insurance tax, services to industry, roads, depreciation, transport services, or post-secondary education.

Figure 3.2.1: Assessment categories as a share of States' Budgets[38]

Revenue



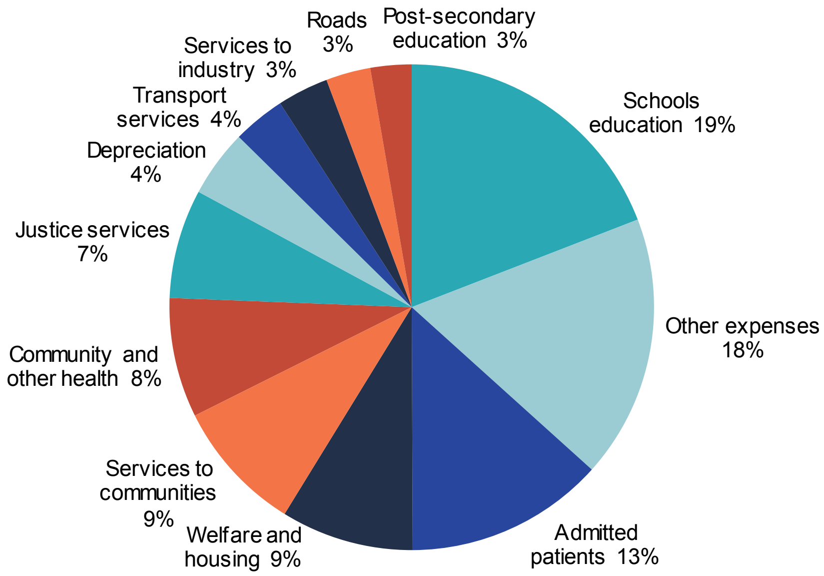
Source: CGC, 2012 Update.

37 New South Wales submission to the GST Distribution Review, November 2011, page 4.

38 Revenue categories are measured as a share of total revenue. Expenditure categories are measured as a share of total expenditure.

Figure 3.2.2: Assessment categories as a share of States' Budgets

Expenditure



Source: CGC, 2012 Update.

An alternative approach could be to limit the categories based on the amount of GST distribution, that is, where States have greater differences in their fiscal capacities. As Table 3.2 shows, if categories that redistribute $500 million per year or less are no longer assessed, land tax, motor tax, insurance tax, other expenses, depreciation, transport services, net lending, conveyance duty, services to industry and post-secondary education would drop out.

Table 3.2: GST redistribution by assessment category

Revenue categories	GST Redistribution $m	Expenditure categories	GST Redistribution $m
Mining revenue	4,711	Schools education	1,108
Payroll tax	924	Other expenses	404
Conveyances	434	Admitted patients	592
Land tax	407	Welfare and housing	725
Motor taxes	349	Services to communities	670
Insurance Tax	141	Community and other health	997
Other revenue	0	Justice services	846
Commonwealth payments	1027	Depreciation	460
		Transport services	291
		Services to industry	181
		Roads	520
		Post-secondary education	129
		Investment	696
		Net lending	231

Source: CGC, 2012 Update.

The Panel's view on equalising only for major items

The Panel sees potential difficulties with equalising for major revenue and expense items only. For example, in both scenarios above, roads and transport would not be assessed, but if roads and transport were grouped together, they would be. Therefore, if this approach is to be used, the CGC's current categorisation might have to be regarded as a guide only.

The Panel would like proponents of this approach to provide further suggestions and information on the implementation of the approach.

Simplifying at the total budget level

Using global indicators

Some States suggest that the Review should explore the potential for global indicators to be used in the assessment of fiscal capacity.

Victoria says:

> *The use of broad 'global' level assessments could be explored, as an alternative to attempting the measurement of all state activities through a large number of individual 'sector' level assessment categories. Provided appropriate and reliable proxy measures could be found, it could be possible to assess revenue and/or expenditure with just a few global indicators. One approach might be to base GST distribution on a simple global economic indicator of relative wealth, such as gross state product (GSP) per capita. This would be a proxy for the overall fiscal capacity differences of jurisdictions, adjusted for the net impact of revenue base and expenditure requirement differences.*
>
> *Serious consideration of such an approach would be beneficial. It could significantly streamline HFE calculations, and reduce the role of judgement in GST distribution. Large gains in transparency would be made, and GST revenues would be much easier to forecast.*
>
> *However, it needs to be acknowledged that GSP itself can be a volatile series and is subject to extensive revision over time. Nevertheless, the Panel is encouraged to consider what global indicators might be appropriate.*[39]

Western Australia says:

> *In relation to parts (d) and (e) of Recommendation 5, we consider that the GST Distribution Review should recommend that appropriate terms of reference be issued to the CGC to develop a genuinely simpler and more reliable alternative to the current detailed category-by-category assessment of States' revenue and expenditure 'needs', by rigorously considering a minimal number of aggregated categories, with 'needs' for each category based on measures of the broader underlying revenue capacity or cost drivers.*

39 Victorian submission to the GST Distribution Review, October 2011, page 4.

> *For example, the CGC could adopt a 'global' measure (or measures) of differences in States' underlying revenue raising capacities. Rather than assessing differences in actual legislated tax bases, the CGC could have regard for the fact that the ultimate incidence of most taxes is on income or consumption.*
>
> *Similarly, a 'global' assessment of differences in States' underlying costs of providing services may be possible. This might still require separate measures for broad cost pressures such as those arising from indigeneity and population location, and for capital and economic development expenditures.*[40]

Queensland also suggests that global indicators be explored.

However, Tasmania says that this approach would depart from an equalisation outcome:

> *An example of extreme simplification on the revenue side is to have one global revenue assessment which is an indicator of the aggregate revenue base for each state. This could be based on state GSP or state household income. However, as states do not actually tax GSP or household income, the result of such an approach would depart from an equalisation outcome.*[41]

Similarly, the Australian Capital Territory does not support the use of global measures as a means of simplifying the revenue assessments.[42]

The Panel's view on simplifying at the 'total budget' level

While the Panel is keen to explore the use of global indicators, it acknowledges potential difficulties with the approach. For example, if GSP per capita was used as a proxy for States' fiscal capacity, would States with lower GSP per capita receive additional GST payments? Alternatively, if growth in GSP was the proxy, would States with high rates of GSP growth, and possibly greater infrastructure demands, need additional GST payments?

The Panel would like proponents of the use of global indicators to provide further ideas and information on the implementation of the approach, and how it could achieve appropriate outcomes.

Partial equalisation of donor States

This approach is sometimes referred to as a 'donor and recipients' model. The donor States would continue to provide support to recipient States, however, the donor States would not be fully equalised. Victoria, Queensland and Western Australia suggest this.

For example, Queensland suggests:

> *... focusing on redistributing a proportion of the GST pool from 'donor' to 'recipient' States.*[43]

40 Western Australian submission to the GST Distribution Review, October 2011, page 55.
41 Tasmanian submission to the GST Distribution Review, October 2011, page 30.
42 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 18.
43 Queensland submission to the GST Distribution Review, October 2011, page 18.

Western Australia says:

> *The fiscal equalisation system should allow a group of States, if they wish, to agree among themselves on matters that affect the allocation of GST grants among them, including the redistributive outcome (while not affecting outcomes for non-participant States). A fixed split of the GST pool between CGC-assessed States and self assessed States is also recommended under this option.*
>
> *A free agreement to depart from the CGC process will reflect a view that all parties believe they can do better, helping to ensure a welfare–enhancing outcome. As this submission has sought to highlight, there are many issues to be addressed and balanced in determining a HFE outcome. State negotiations can take into account a wider or narrower range of factors than the CGC.*[44]

Victoria suggests that the Australian Capital Territory (ACT) receive an EPC share:

> *Under this proposal, the four (or five) larger states would support the three (or two) smaller states, with the exception of the ... ACT which would receive an equal per capita share of the GST pool. The ACT would be excluded as it has the highest per capita income in Australia in a small compact area without issues of remoteness, diseconomies of scale or significant disadvantaged population groups. The GST pool would effectively be split, with a small amount equal to the needs of the smaller states being provided to them through an HFE system, and the remainder being distributed EPC among the donor states.*[45]

The Panel's view on moving to a donor and recipient approach

The Panel is receptive to a donor and recipient approach as it appears it could offer significant simplification gains, particularly to donor States, while still providing support to the recipient States. However, depending on how this approach was implemented, it could result in recipient States having a stronger fiscal capacity than some donor States. Ideally, the donor States would develop a proposal to be put to the recipient States for their consideration and approval, as a donor and recipient approach will only prove workable if there is genuine consensus amongst States.

The Panel seeks further details from States on the design of a donor and recipient approach, including how to determine the size of the GST pool allocated to the recipient States, how best to measure the fiscal capacity of recipient States and when a recipient State could become a donor State (and vice versa).

No assessment of State fiscal capacities

'Equal per capita' distribution

New South Wales and Victoria suggest the GST be distributed on an equal per capita (EPC) basis, with separate Commonwealth payments to recipient States.

New South Wales says:

44 Western Australian submission to the GST Distribution Review, October 2011, page 53.

45 Victorian submission to the GST Distribution Review, October 2011, page 5.

... New South Wales considers that the new equalisation framework should consist of the GST pool being distributed on an equal per capita basis across all states. The Commonwealth should separately fund any additional equalisation redistribution to the smaller states.[46]

Victoria says:

Ultimately, in a modern Australia, the GST should be distributed on an equal per capita (EPC) basis, with particular policy challenges dealt with separately through targeted and accountable means. This change could take time and would need to be implemented carefully through a staged transition.[47]

The Business Council of Australia, NSW Business Chamber and Ergas and Pincus, also support a distribution of the GST on an EPC basis. Business Council of Australia says:

… [t]he simplest approach to distributing the GST without compromising efficiency could be to do so on an equal per capita basis. Such an option would seek to reduce the complexity and adverse impacts of the current approach. However, the costs of moving to such an approach in the short term while retaining equity and budget stability for recipient jurisdictions would be significant. In effect, additional funding outside of the current fixed GST pool would be required so that current recipient jurisdictions would not be made worse off.[48]

While an EPC distribution would simplify the GST distribution significantly, in the absence of any additional payments, it would have a serious impact on the budget of the smaller States. Tasmania examines the impact of a move to EPC distribution, and concludes that:

…if GST revenue were distributed on an EPC basis in 2011-12, instead of under HFE, an extremely negative impact on smaller states' General Government revenue would occur. At the same time, there would be correspondingly smaller positive impacts for the larger states. [Tasmania's analysis]… shows that an EPC distribution would reduce Tasmania's General Government revenues by 14.4 per cent and the Northern Territory's revenues by 46.8 per cent. In contrast, the percentage increase for Western Australia is much less significant at 5.6 per cent and for Victoria, Queensland and New South Wales only 2.4 per cent, or less.[49]

The Northern Territory makes a similar point:

While the amount of GST redistributed between states is relatively small in the national context, it is significant to state budgets. Partial equalisation or an equal per capita distribution of GST would pose a critical risk to small states' capacities to deliver the national average level of services and would have a crippling effect on economic growth and employment in these states.

For example, the amount of GST redistributed to the Territory compared with an equal per capita share represents about 40 per cent of the Territory's total revenue ($1.9 billion in 2010-11). This revenue is essential for ensuring that

46 New South Wales submission to the GST Distribution Review, November 2011, page 4.
47 Victorian submission to the GST Distribution Review, October 2011, page III.
48 Business Council of Australia submission to the GST Distribution Review, December 2011, page 6.
49 Tasmanian submission to the GST Distribution Review, October 2011, page 10.

> *services are provided to the entire Territory population. Without this critical budget support, the Territory would be unable to provide many services, particularly to its remote population.*[50]

As well as having a severe impact on smaller States' budgets, the Northern Territory goes on to argue that an EPC distribution would not achieve equalisation outcomes, saying:

> *An equal per capita distribution would provide greater stability and predictability in state GST revenue. Changes in GST revenue would only be caused by changes in national GST collections and/or changes in states' shares of the national population. However, equal per capita distribution would not achieve equalisation outcomes and would result in significant disparities between states in fiscal capacity to deliver an average level of services.*[51]

In practice, those supporting EPC envisage that additional Commonwealth payments be made to recipient States and, in the medium term at least, there are no additional funds. Even if there were, this approach would raise implementation questions, including how best to determine which States received the additional payments, how much each should receive and how to cope with changing circumstances of States.

For these reasons, there is a risk that some of the complexity of the current system would be transferred to other Commonwealth payments. While existing Commonwealth payment structures could assist, they do not generally seek to equalise States' capacities.

The Panel's view on moving the GST distribution to an EPC basis

While the Panel acknowledges that moving the GST distribution to an EPC basis would simplify the distribution of the GST significantly, it is practically not achievable in the absence of a further funding source.

If further funds were available and similar processes and institutions were required to determine how to distribute those other payments, the simplification benefits of the proposal may be limited.

3.4 Is there a need to *extend* the current assessments?

As foreshadowed at the opening of this Chapter, some States suggest changes that could be argued to lead to added complexity in the equalisation process. For example, the Australian Capital Territory says:

> *There is an argument for extending the HFE system. There are many unmeasured yet significant factors that affect States' prosperity that are not currently included in the equalisation process. For example, Commonwealth recurrent and capital payments paid as subsidies to specific industries such as to the agriculture, defence, automotive, and textile, clothing and footwear manufacturing industries. These payments are not evenly distributed among the States and, as they are*

50 Northern Territory submission to the GST Distribution Review, October 2011, page 25-26.

51 Northern Territory submission to the GST Distribution Review, October 2011, page 63.

> *often direct to industry, do not appear on State government budgets, but nonetheless provide valuable economic stimulus to some States.*[52]

South Australia considers that:

> *The main deficiency in current arrangements is a lack of contemporaneity. The lags in the system mean that mining revenues in their current growth phase are not being fully equalised. This needs to be addressed.*[53]

The Panel's concluding comment on simplification

The Panel believes that the GST distribution process should be able to produce fair and reasonable outcomes more simply. Any simplification that would facilitate broader understanding of the distribution process and, in turn, foster greater confidence in the distribution outcomes, would be a significant achievement.

While some of the approaches above seek simplification with the same outcomes as present, the Panel considers that equalising States to 'comparable' rather than the 'same' level of services (as discussed in Chapter 1) would facilitate moves towards even simpler, more transparent and more easily understandable arrangements.

Recognising that many States have not had the opportunity to comment on the majority of ideas in this Chapter, the Panel seeks comments and feedback on which, if any, of the simplification proposals are worth pursuing.

52 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 9.
53 South Australian submission to the GST Distribution Review, September 2011, page 3.

4 HFE and efficiency

The Terms of Reference require the Review to consider efficiency, including the effect of alternative approaches on the allocation of resources in the national economy and on States' reform, service delivery and investment decisions to best meet the requirements for growth.

A range of potential efficiency effects flow from the current GST distribution system. In its July 2011 issues paper, the Panel sought views on two aspects of efficiency:

> *Firstly, whether the outcomes of fiscal equalisation create inefficiencies in the national economy over time. That is, what are the efficiency implications of the outcomes of equalisation whereby the distribution of the GST to State Governments is less than or more than an equal per capita share? This could give rise to issues relating to the efficient location of resources and grant dependency.*
>
> *Secondly, whether the process of implementing equalisation has efficiency implications. For example, there may be implications if the equalisation process created distortions in government policy and funding decisions.*[1]

While submissions and consultations largely focus on the effect of HFE on State policy, several submissions discuss the relationship between HFE and the efficient location of people and capital and some raise concerns about the administration costs.

For ease of navigation through this wide range of possible efficiency effects, this Chapter divides them into categories, each discussed in a separate section. The final section examines the relationship between efficiency and some alternative forms of HFE.

The categories used to frame the discussion are:

- Policy effects, consisting of
  - Process effects
    - Capacity effects
    - Average policy effects
  - Outcome effects
    - The flypaper effect
    - The grant dependency effect
- Location effects, comprising cost equalisation and structural adjustment effects
- Administration costs.

1 GST Distribution Review Issue Paper, July 2011, page 26.

Discussion of the relationship between HFE and State policy inevitably touches on issues raised in the Panel's supplementary Terms of Reference regarding the relationship between HFE and tax reform. The Panel has initiated a parallel process to explore HFE and tax reform, and this will be covered in the Panel's second Interim Report.

4.1 Policy effects

Many submissions, including all State submissions, discuss whether the current HFE arrangements distort State policy.

Most of the debate focuses on whether States are encouraged to alter their own policy decisions to account for the effect that their policies may have on future GST shares. The Panel has decided to call these *process effects*, as they relate to whether policy decisions feedback into the process for calculating GST shares.

Process effects

The key debate raised by submissions appears to be whether changes in GST shares are likely to affect State decisions in any significant way.

In considering whether changes in GST shares are likely to affect State decisions, it is worthwhile noting that any change in GST will lag changes in State policy or circumstances by two years and then phase in over three years (see Chapter 2 for discussion of the lag effect of averaging relativities). Thus any effects may be muted or deferred. However, even if HFE does *not* appreciably distort State decisions, the perception that it can appears to be undermining support for the HFE system.

Capacity effects

The main concern of many submissions appears to be that States do not suffer the full fiscal costs or gain the full benefits if changes in their circumstances result in reductions or improvements in their underlying fiscal capacity. Under HFE, States essentially receive their population share of changes in their fiscal capacity, regardless of whether they are a donor or a recipient (see Table 4.1). Furthermore, they benefit to the same degree from increases in the fiscal capacity of other States.

Table 4.1 Share of changes in State fiscal capacity

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Population share	32	25	20	10	7	2	2	1
Share of fiscal capacity	32	25	20	10	7	2	2	1

Source: CGC 2012 update

The effect on State budgets is somewhat more complicated than the effect on State fiscal capacity as assessed by the CGC. When the CGC adjusts GST shares in response to a change in fiscal capacity, it seeks to provide each State with the revenue it requires to deliver average services. Therefore, if a State has above or below average tax rates or spending levels, the impact on its budget will be higher or lower than the impact on its assessed fiscal capacity.

On the revenue side, if a State's revenue base increases, the CGC will reduce its GST share to offset the increase in its revenue raising capacity so that it only receives its population share of the fiscal benefits. The State will keep any revenue to the extent that it levies an above-average tax rate and lose to the extent that it levies a below-average tax rate.

A similar result occurs on the expenditure side. If a State's expenditure needs fall, the CGC will reduce its GST share in line with the decrease in the State's costs of services. The State's budgetary position will also increase or decrease in proportion to any above or below average spending.

These changes in assessed State fiscal capacity and the position of State budgets may or may not influence State decisions. However, in theory they reflect a State's policy choices, rather than net benefit or loss for its population.

If a State's budgetary position improves by more than its assessed fiscal capacity it is because it chooses to levy higher than average taxes on its population or has a lower than average level of spending on services. If a State's budgetary position deteriorates relative to its assessed fiscal capacity it is because it raises lower than average taxes or has higher than average spending.

How do capacity effects arise?

A State can influence its fiscal capacity if it can change its revenue base or expenditure needs.

A State's revenue base is largely shaped by factors in the broader economy that are beyond its control. For example, States could have done little about the contraction in revenue because of the Global Financial Crisis in 2008-09. State policy may have some influence at the margin, particularly in the long-term, through business tax and regulatory policy and investments in infrastructure.

Western Australia notes that a State can increase its CGC assessed fiscal capacity by increasing its tax compliance efforts in situations where the CGC relies on State data to measure the size of the tax base:

> *... the CGC uses State-provided data on the value of taxed land, property transfers and motor vehicle transfers to measure States' revenue bases for land tax, conveyance duty and stamp duty on motor vehicle transfers respectively. If a State increases its compliance effort, the CGC will measure it as having an expanded revenue base.*[2]

Western Australia uses a tax compliance example to illustrate the potential effects of differences in effort:

> *An extreme example is for land tax levied on properties worth less than $1 million in Western Australia. If the Office of State Revenue increases its compliance effort on these properties, Western Australia loses GST grants equal to about five times the additional land tax revenue raised.*[3]

2 Western Australian submission to the GST Distribution Review, October 2011, page 35.
3 Western Australian submission to the GST Distribution Review, October 2011, page 35.

Changes in tax policy may also have an influence on the size of a State's tax base. The CGC notes:

> *The Commission is aware that tax policies, especially tax rates, may affect the size of a tax base and that State tax rates differ across States and from the average.*[4]

A State's expenditure needs are based on a range of factors, including the size of the user base, population dispersion and demographic factors. While the CGC attempts to select factors that are beyond State control, Victoria argues that:

> *Very few service costs are truly beyond a state's control over time. Improvements in infrastructure, transport, information technology and medical technology can assist in enabling cheaper delivery of services over long distances. State investment in these enablers should be recognised and rewarded, not punished.*[5]

Similarly, New South Wales says:

> *The current system of fiscal equalisation can give rise to disincentives to the adoption of efficiency enhancing innovations. This includes areas that involve subsidies for the parallel provision of public services by the non-government sector, such as in the education or health arena ...*
>
> *To illustrate this effect, consider a potential arrangement with a non-government education or health services provider, under which the state pays above average subsidies to encourage a shift in demand away from the government sector. Under current assessment methods, the state government would lose GST revenue because of the assessed reduction in its need to provide services, without being compensated for its above-average cost of subsidies. As a result, the state could suffer a net deterioration in its fiscal position.*[6]

How material are capacity effects to State decisions?

In relation to economic development, Western Australia argues that equalisation may:

- *reduce the willingness of States to undertake micro-economic reform to improve their economic performance where the reform involves pain for some sectors, particularly if the gains from micro-economic reform are difficult to see;*
- *reduce the willingness of States to allow developments that involve risks or trade-offs for the community, such as mining activity that may conflict with agricultural and environmental interests (for example, new coal and coal seam gas projects); and*
- *reduce the willingness of States to invest in infrastructure to facilitate new industry.*[7]

4 CGC submission to the GST Distribution Review, August 2011, page 4.
5 Victorian submission to the GST Distribution Review, October 2011, page 1.
6 New South Wales submission to the GST Distribution Review, November 2011, pages 28-29.
7 Western Australian submission to the GST Distribution Review, October 2011, page 26.

However, South Australia disagrees, arguing that:

> *Economic development policy decisions are however influenced by the economic and social benefits to the community not fiscal impacts (for example, increasing per capita incomes in the State through the generation of more highly paid employment opportunities, and possibly reduced unemployment particularly if the development occurs in a region with underutilised labour).*
>
> *In practice the South Australian Government has actively pursued expansion of mining through investments in geological mapping and regulatory certainty and efficiency — even though additional royalties would be shared with other States through HFE. According to the Fraser Institute South Australia is the highest ranked Australian jurisdiction in relation to Government policy support for mining and the 10th highest ranked in the world.*[8]

Former South Australian Under-Treasurer, Peter Emery, notes in his submission that:

> *... to the best of my knowledge ... there is no evidence of a factual nature to support this proposition [that HFE dulls incentives for economic development] and no-one putting forward this kind of view has cited a specific example of this happening in the real world. As a senior official in the South Australian Treasury involved in both Grants Commission and State development issues over a significant period I can recall no instance of any connection whatsoever of this kind.*[9]

Some academics also argue that it is appropriate for HFE to discourage States from expanding their revenue base if they are only doing so at the expense of other jurisdictions, rather than increasing the overall national revenue base.[10]

Average policy effects

In addition to the concern that HFE discourages policies that would improve fiscal capacity, there is concern that it may encourage States to manipulate their policies to maximise their GST share.

If average policy changes, a State's GST payment changes in proportion to its population share and relative revenue raising capacity or expenditure needs. For example, Western Australia has 10.3 per cent of the Australia population and its share of the motor tax base is 12.9 per cent. Therefore, Western Australia will lose 2.6 cents of GST for every additional dollar of motor tax collected, regardless of which State that dollar is raised in.

Average policy effects encourage States to decrease their level of tax or spending in areas where they have an above average capacity and increase it in areas where they have a below average capacity. For example, at present New South Wales, Victoria, Western Australia and the Australian Capital Territory would gain GST by abolishing stamp duty, while Queensland, South Australia, Tasmania and the Northern Territory

8 South Australian submission to the GST Distribution Review, September 2011, page 11.

9 Peter Emery submission to the GST Distribution Review, September 2011, pages 11-12.

10 See, for example, Bucovetsky, S. and Smart, M., The efficiency consequences of local revenue equalization: tax competition and tax distortions, *Journal of Public Economic Theory*, 8 (1), 2006, pages 119-144.

would lose GST. Of course, there would be significant reduction in revenue for all States, regardless of the changes in their GST shares.

How material are average policy effects to State decisions?

Despite the theoretical incentive, average policy effects are generally relatively small, as most States have close to average capacity on most things. As a first approximation, for all categories except mining, the change in GST grants from one State changing policy is less than 5 cents in the dollar and the median is 0.68 cents per extra dollar of tax or spending. In mining, effects range from minus 41.8 cents per additional dollar of revenue for Western Australia to 24.3 cents per additional dollar of revenue for Victoria.[11]

The segmentation of some categories can also influence the size of these effects. The primary example of this is mining revenue, where minerals are currently split into high rate or low rate categories. Here Western Australia argues that:

> *[B]y adjusting its royalty rate up or down, a State may cause a mineral to be reclassified between the 'low rate' and 'high rate' categories, resulting in more dramatic changes in assessed needs.*
>
> *A 'real life' example is Western Australia's decision in 2010 to remove a long standing royalty rate concession available to State Agreement Act producers of iron ore 'fines' (BHPB and Rio Tinto) — the concessional 3.75 per cent royalty rate (which reflected a previous era when 'fines' were less marketable than 'lump' iron ore) was replaced by the general 'fines' concessional rate under the Mining Act of 5.625 per cent (which increased the average 'fines' rate from less than 5 per cent to more than 5 per cent).*
>
> *Had this led the CGC to reclassify iron ore fines from 'low rate' to 'high rate' Western Australia would have faced a loss in GST grants equal to about three times (about $1 billion per annum) the additional royalty revenue raised (about $300 million per annum).*[12]

Changes in State policy can compound or offset each other when a State reduces revenue in one area and accompanies it by an increase in revenue or a reduction in spending in another. For example, if NSW reduced its payroll tax by $1 it would gain 2.3 cents in GST[13] and if it then increased its motor tax by $1 it would gain 3.6 cents[14] in GST for a net gain of 5.9 cents.

If a single State introduces a new tax to replace an old one, the average policy effect means that revenue from the new tax will not be included in the CGC's calculation of the State's GST share and the State will still be assessed as though it could raise the old tax. However, if enough other States follow and the new tax comes to be regarded by the CGC as average policy, States with lower capacity in the new tax compared to the old tax

11 Average policy effects can be calculated by subtracting a State's population share from its actual share of the revenue base or service delivery costs for a particular tax or expenditure category.

12 Western Australian submission to the GST Distribution Review, October 2011, pages 33-34.

13 As NSW has 32.3 per cent of the population and 34.6 per cent of the payroll tax base.

14 As NSW has 32.3 per cent of the population and 28.7 per cent of the motor tax base.

would benefit and vice versa. The same would be true if enough States decided to adjust their tax-free threshold on land tax or payroll tax.

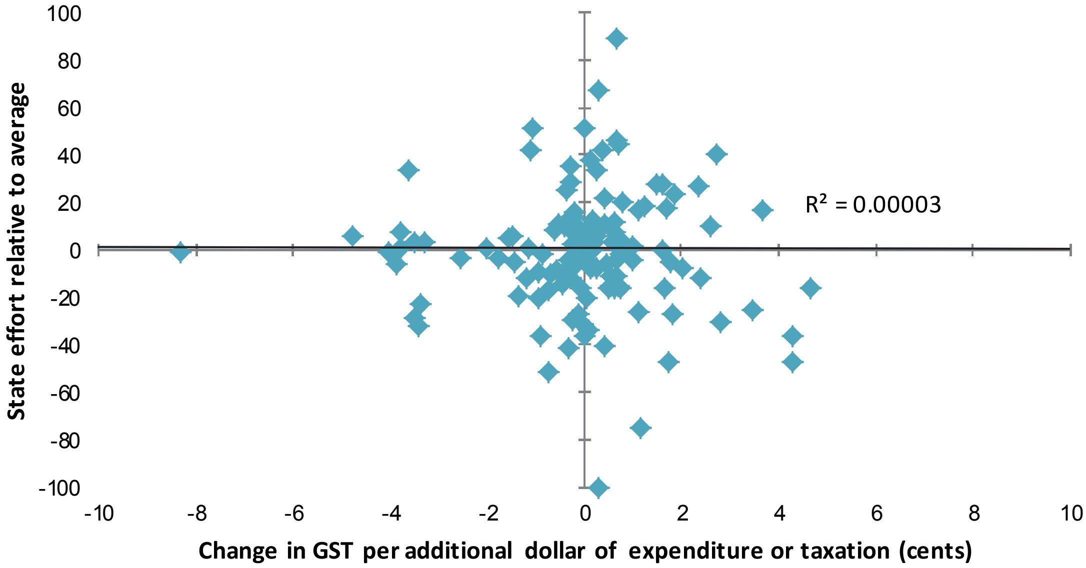
Multilateral changes will generally have a greater influence on State GST shares than unilateral changes, particularly for small States, as the effect on their GST from changes in their own revenue is multiplied by the change in revenue in all other States.

Regardless of the size of the incentive a State has to change its policies, it is more difficult for some States to raise an additional dollar of tax or add an additional dollar of spending. For example, while Victoria gains 24.3 cents for every additional dollar of mining revenue, the value of mining production in Victoria is very low, so it would need to increase its royalty rate significantly to have any discernible impact.

Discussion of the impacts of average policy effects on royalty rates and tax reform will be pursued in the Panels' second interim report. As with capacity effects, there is little evidence of average policy effects actually influencing State decisions.

Figure 4.1 shows a simple analysis of the relationship between average policy incentives and a State's revenue and expenditure effort relative to the average. [15] The pattern suggests that there is no discernible relationship. For example, effort varies significantly even where there is virtually no difference in incentive. This is reflected in large differences between the regression line and the data points (represented by a correlation coefficient or R^2 of just 0.00003).[16]

Figure 4.1 Correlation between effort and average policy incentives in all tax and expenditure categories, 2010-11



Source: Review analysis, CGC 2012 update.

15 It is also important to note that effort is an imperfect measure of State policy choices as it reflects differences in efficiency and, to the extent that they may exist, errors in the CGC's assessments (including data and methodology).

16 As the incentives are largest in respect of mining revenue, it is included in the analysis even though it generates outliers.

Outcome effects

Some jurisdictions and commentators raise concerns about the influence that the GST distribution may have on State decisions. Again, for ease of discussion, these are divided into two categories.

The 'flypaper' effect

In their 2002 review of the distribution of the GST and Commonwealth payments, Garnaut and FitzGerald argued that intergovernmental transfers like the GST tend to 'stick' with Governments and are used to fund public services rather than being allocated back to citizens in tax cuts resulting in excessively large public sectors in recipient States.[17] This is known as the flypaper effect.

Overseas empirical evidence shows that the majority of non-tax increases in government revenue are used to fund public services. Proponents of the flypaper effect claim that this means that governments are providing inefficiently high levels of public services, against the preferences of its citizens.[18]

GST payments above a State's own-source revenue represent a non-tax increase in State revenue and, according to the flypaper effect, should result in inefficiently large public sectors in recipient states.

The Commonwealth Treasury notes previous attempts to quantify the flypaper effect:

> *Previous work has been done to model the efficiency impacts of the Australian HFE system and compare it with a move to an EPC distribution. For example, Dixon, Picton and Rimmer undertook computable general equilibrium analysis in 2005, and broadly found: 'that the welfare gain from a change to equal per capita funding would be small, no more than $150m or about 0.3 per cent of the amount distributed from the Commonwealth to the States.'*
>
> *Similar results drawing on earlier work by Dixon et al are referenced in the Garnaut-Fitzgerald review of 2002, which reported efficiency gains of moving to an EPC or similar system would be in the region of $150 to $300 million.*[19]

The Commonwealth Treasury submission analyses whether recipient States have above average public sectors, concluding:

> *... there does appear to be a pattern showing recipient States have larger public sectors than donor States. However Western Australia (the main per capita donor) has an above average share of public sector employees while the Australian Capital Territory, a recipient State, has a below average share.*
>
> *Given this, it may be that the necessary size of the State public sector is not influenced by whether the State is a donor or recipient, as much as it is influenced by expenditure disabilities. New South Wales, Victoria and the*

17 Garnaut, R. and FitzGerald, V., *Review of Commonwealth-State Funding, Final Report*, August 2002, page 135.
18 Inman, R., *The Flypaper Effect*, National Bureau of Economic Research No. 14579, 2008.
19 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 33.

> *Australian Capital Territory are the only donor States on the expenditure side ... and are the only States to have a below average share of public sector workers.*
>
> *States that are net recipients on the expenditure side could be expected to need a larger public sector to overcome the difficulties (such as remoteness) that the HFE system seeks to compensate States for. This is what makes it so difficult to determine whether or not the HFE system is resulting in an inefficiently large public sector: some States will require more resources to deliver average services than others.*[20]

The grant dependency effect

Garnaut and FitzGerald also argue that a larger proportion of public sector workers in recipient States creates distortions in the local political economy. The theory is that States with a larger proportion of public sector workers will be more inclined to prefer social and environmental objectives to economic ones. Garnaut and FitzGerald note that the scale of this effect is difficult to quantify, but suggest that it may be significant.[21]

There seems to be little firm evidence to support these concerns. Garnaut and FitzGerald argue that grading of State policy indicated a systematic tendency for South Australia and Tasmania to pursue anti-development policy. However, Tasmania argues that any failure to pursue economic development is because:

> *... Tasmania has had its economic development capacity restricted through land use decisions that have reflected national, rather than simply, Tasmanian preferences.*[22]

South Australia refers to its recent decision to expand the Olympic Dam mine and to the high levels of support that it provides to mining development. Moreover, both Western Australia and Queensland appear to have strongly pursued economic development despite their larger than average public sectors and past status as recipient States.

The Panel's view on the effect of HFE on States' policy choices

The Panel notes the diverse views about the process and outcome effects of HFE on States' policy choices.

While the Panel cannot conclude that the incentive effects of HFE in any particular case (other than mining) are large, the concerns are so widespread that all practical options to reduce or eliminate them must be fully explored, especially in the light of the Panel's new Terms of Reference requiring it to consider incentives for tax reform.

The Panel's priority for exploring options will be on tax changes, as the arguments have been made more convincingly and the effects are likely to be more significant in that context than for expenditures.

20 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 35.
21 Garnaut, R. and FitzGerald, V., *Review of Commonwealth-State Funding, Final Report*, August 2002, page 13.
22 Tasmanian submission to the GST Distribution Review, October 2011, pages 21-22.

4.2 Location effects

Promoting efficient migration

A number of submissions to the Review canvass the effect of the HFE system on interstate population migration.

Some submissions draw on a longstanding academic argument that HFE encourages people and businesses to make decisions about where to locate based on their economic productivity and non-monetary wellbeing, rather than differences in tax or service levels that arise from arbitrary differences in the fiscal capacity of jurisdictions.

According to this argument, without HFE, Western Australia would fully retain its mining revenue and therefore might be in a position to abolish, say, its payroll tax, while other States would need to increase taxes to compensate for the reduction in GST revenue. As a result, Perth may attract firms and employees from other States in finance back office functions, even if, based on true economic factors (such as advantages of co-location with the front office), those resources were more productively located where they were. So the conclusion is drawn that, without HFE, there would a less efficient spatial allocation of resources, at least in the long-term.[23]

In this vein, South Australia says:

> *HFE ensures that location decisions in a federation are independent of the fiscal effects that arise from accidental variations in regional physical and human resource endowments, and that those location decisions can instead be driven by inter-regional variations in marginal productivity for particular resources as in a unitary nation.*[24]

Modelling submitted by South Australia indicates that:

> *Following a move away from full equalisation, households can be expected to move from the fiscally disadvantaged states to the fiscally advantaged states… this inefficient, fiscally-induced migration leads to a loss in living standards. Specifically, abolishing the current HFE system and moving to a modified EPC system is estimated to lead to a permanent loss in annual living standards of $295 million in 2009/10 terms.*[25]

The Australian Capital Territory also notes that:

> *HFE emulates what would happen under a unitary government where all revenues are pooled and expenditure occurs equitably where the need is located.*[26]

Similarly, Emery draws attention to implicit and explicit equalisation, arguing that:

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23 See Buchanan, J., Federalism and Fiscal Equity, *American Economic Review,* 40, 1950, pages 583-599.
24 South Australian submission to the GST Distribution Review, September 2011, page 5.
25 South Australian supplementary submission to the GST Distribution Review, February 2012, pages vi-vii.
26 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 0.

> *The former is achieved by the Commonwealth Government in Australia through its uniform tax and expenditure policies across the nation which no-one (to my knowledge) argues is inconsistent with economic efficiency.*[27]

Victoria appears to distinguish between the equalisation of mining revenue and other forms of equalisation:

> *Accidents of natural and human endowments that allow States to levy lower tax rates will induce non-productive migration and lead to spatial inefficiencies ... [M]ining revenue equalisation serves an important efficiency role while equalisation of other categories may stymie efficient factor movements.*[28]

On the other hand, Ergas and Pincus say:

> *While this argument [that fiscal advantage will tend to distort decisions about where to settle if the population is mobile] is correct as far as it goes, it rests on strong assumptions ... [O]ther policy instruments tend to impede desirable shifts in the geographical distribution of labour [in a way which] far outweighs the risk of excess movement ... As a result, this argument likely provides only very limited support for HFE.*[29]

Cost Equalisation

Some submissions suggest that HFE reinforces population settlement in high cost, more remote, locations. Ergas and Pincus say that the result is a settlement pattern that is inefficiently dispersed.[30]

Victoria raises the issue of cost equalisation arguing that:

> *A new approach is now required which places greater weight on efficiency goals and which is premised on States being able to reduce high service costs and disabilities (at least over the medium to long term) via technology and sound policy.*[31]

However, the notion of not equalising for high costs of remote operation is specifically rejected in the Western Australia submission:

> *It has often been claimed that location-specific service costs are not relevant to efficiency optimising equalisation transfers, but the theory does not support this.*[32]

Ergas and Pincus note the implied 'free' insurance provided by HFE for natural disasters:

> *Together with ever growing Commonwealth disaster relief, this amounts to a subsidy to risk taking, with the unsurprising result of promoting inefficient settlement in high risk areas.*[33]

27 Peter Emery submission to the GST Distribution Review, September 2011, page 13.
28 Victorian submission to the GST Distribution Review, October 2011, pages 12-13.
29 Henry Ergas and Jonathon Pincus submission to the GST Distribution Review, September 2011, page 7.
30 Henry Ergas and Jonathon Pincus submission to the GST Distribution Review, September 2011, page 9.
31 Victorian submission to the GST Distribution Review, October 2011, page 15.
32 Western Australian submission to the GST Distribution Review, October 2011, page 38.

HFE and structural adjustment

Western Australia argues that while HFE may indeed restrain fiscally motivated migration of resources, this restraint may not be beneficial given Western Australia is in an expansionary phase related to growth in mining production and construction.

> *... there are caveats to the standard analysis which makes it impossible to assert that the present CGC approach is in any way consistent with an efficiency enhancing distribution. The key caveats include the following:*
>
> - *Economies are often not in equilibrium (Australia is a prime example) ... the subsidisation of resource poor regions may counteract the incentive for labour to move to resource rich regions, and thus prevent or delay the maximisation of national production*
> - *The standard analysis overlooks that States have an integral role in facilitating economic growth-development is impeded without good transport, education and transport systems, and it fails to recognise the role of incentives for development, and capacity to fund infrastructure to facilitate future development ...*[34]

Queensland says that the current assessment:

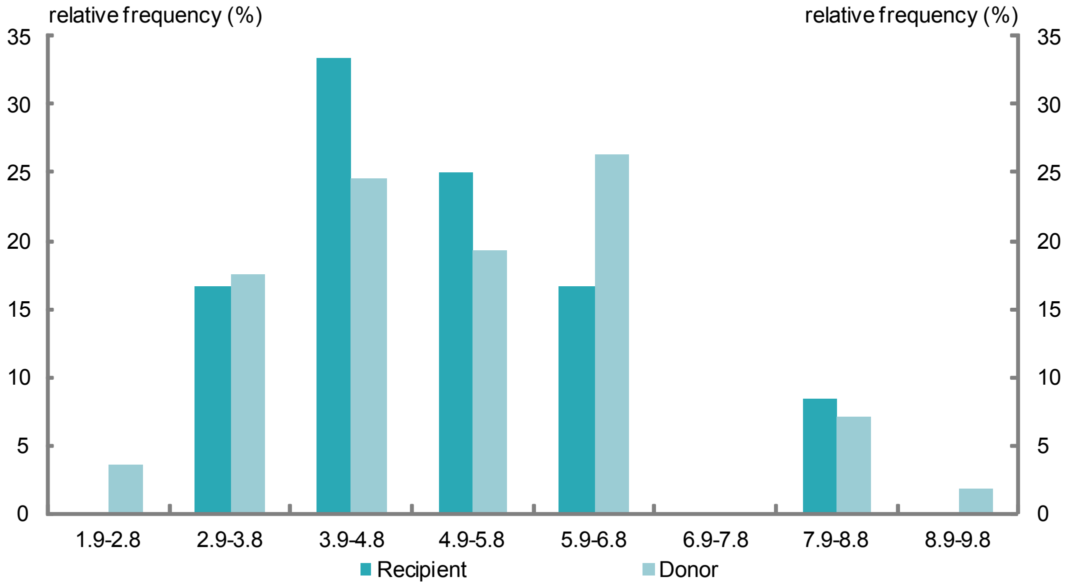
> *... does not sufficiently take into account the additional costs of projects that directly support the mining industry, or of regional growth related to mining.*[35]

The standard analysis relies on relative State needs being adequately addressed. Possible inadequacies in the assessment of services to the mining industry and economic development generally are issues of interest to the Review (see Chapter 6).

Structural change in the economy can be inhibited in a variety of ways. While the needs of remote mining and construction sectors may not all be met by fly in fly out sources, there will not necessarily be an alignment of emerging regional or industry labour needs to the HFE status of a State, whether donor or recipient. There are high and low unemployment regions in both donor and recipient States, as shown in Figure 4.2.

33 Henry Ergas and Jonathon Pincus submission to the GST Distribution Review, September 2011, page 13.
34 Western Australian submission to the GST Distribution Review, October 2011, page 38.
35 Queensland submission to the GST Distribution Review, October 2011, page 10.

Figure 4.2 Regional unemployment rates in donor and recipient States, year average to October 2011[36]



Source: ABS Cat 6202.0 — Labour Force, Australia, October 2011

In practice, it is not feasible for a 'national planner' to discern a correct interstate spatial distribution of labour or population. Rather, these things are left to individual's decisions, driven by market forces.

The Commonwealth Treasury refers to the academic literature, noting that:

> *Since HFE effectively results in a transfer of income from one region to another, it will be interfering, to a greater or lesser extent, in the mix of [migration] incentives that individuals face. The efficiency effects of HFE on location decisions have been modelled in the academic literature with varying results ... the majority of the more recent literature on HFE appears to suggest a net negative efficiency impact, although arguments are made in both directions.*[37]

The Commonwealth Treasury also says:

> *There is an argument that source-based taxes [such as mining revenues] in particular should be redistributed on the basis of efficient location decisions ... While States have policy control over the extent to which their natural resources are exploited, a key determinant of fiscal capacity, resource endowment, is a product of circumstances beyond their control. On this basis, it is difficult to argue that residents of Perth should benefit more from the Pilbara than residents of Darwin ... One could imagine a scenario in which the Pilbara sat within the borders of the Northern Territory.*[38]

Overall, the Commonwealth Treasury submission concludes that there does not appear to be a need for reform of the HFE system merely on the basis of location decisions.

36 Covers 69 Labour Force Survey regions.
37 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 31.
38 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 31.

The Panel's view on the effect of HFE on the efficiency of population distribution

HFE may have effects on 'location efficiency', but the magnitude and significance of those effects is disputed and unclear. The Panel is not convinced that HFE should be altered in order to influence inter-State migration. If a different pattern of inter-State migration is a policy goal, the Panel suggests that be pursued more directly, through appropriately targeted policies.

4.3 Administration Costs

The CGC's approach to HFE is comprehensive and this suggests it may be expensive to administer. States did not raise this as an issue of primary concern.

As a subsidiary point in its submission, Victoria notes that:

> *The system's complexity also produces large administrative overheads, including the need for state Treasuries to maintain specialist resources to support the HFE process. The complexity of the assessment methodology also means that the CGC has a relatively high resource requirement. It is not apparent that the process is cost effective; a similar outcome could be achieved through a simpler process that is less resource intensive.*[39]

Some other commentators viewed administration costs as a significant concern. The New South Wales Business Chamber notes in its submission a 2005 interview with former Commonwealth Treasurer Peter Costello, in which he says:

> *The State Governments spend huge resources putting their cases to the Commonwealth Grants Commission ... In fact, State Treasuries probably spend more time on this than practically anything else ...*[40]

The Institute of Public Affairs says:

> *The CGC's HFE model creates a strong incentive for states and territories to expend scarce taxpayers' resources to maximise their grant share ... While differences in commonwealth and state departmental annual report presentations make it difficult to calculate the administrative costs of administering the HFE system, it is not unreasonable to suggest that these costs alone could be up to $10 million per annum, and with 100 staff nationally engaged in this system ...*[41]

The Commonwealth Treasury says:

> *... approximately $11 million annually in direct costs of administering the system ... [T]hese overhead costs of managing the distribution of the GST are reasonable*

39 Victorian submission to the GST Distribution Review, October 2011, page 17.
40 NSW Business Chamber submission to the GST Distribution Review, October 2011, page 2.
41 Institute of Public Affairs submission to the GST Distribution Review, September 2011, page 11.

> *relative to the amount of funding distributed and the importance of achieving a robust outcome ...*[42]

To examine this issue more closely the Panel sought information from States and Territories on the resources that they devote to HFE.

New South Wales, Victoria, Queensland, Western Australia, South Australia and Tasmania have provided information on estimates of their resource allocations. Queensland provided information on Treasury and non-Treasury costs for peak and non-peak years, Western Australia provided information on its total costs during a non-peak year and Victoria, South Australia and Tasmania provided costs for Treasury staff. Adding in the costs of the CGC and extrapolating missing data from the information provided, the costs of administering HFE, including data collection, appear to be around $10 million in normal years and $15 million during peak years (such as during the CGC five-yearly reviews).

> ### The Panel's view on administration costs of HFE
>
> *Based on information provided by the States and the Commonwealth, it is estimated that the administration costs of HFE are in the range of $10-15 million per annum.*
>
> *While the Panel will be alert for administrative savings, it does not see how this avenue alone could produce significant gains.*

4.4 Alternative approaches to address efficiency concerns

Although, as explained above, the Panel has not found the arguments for all of the various effects convincing, it believes that efficiency improvements should be considered. A number of alternatives that have been suggested to address concerns relating to the effect of HFE on efficiency are discussed below. As some have previously been examined as options to improve stability or simplicity, they are only considered briefly in this Chapter.

EPC, floors and partial equalisation

As noted in previous Chapters, several proposals would explicitly limit the level of equalisation. For example, Western Australia proposes a relativity floor, while New South Wales and Victoria suggest moving to an EPC distribution (with caveats).

Such approaches would reduce the size of any capacity effects as well as the magnitude of the ability of States to influence average policy. They may also have effects on the location of people and capital, though the influence seems likely to be small.

However, such sweeping changes may have a considerable effect on outcomes between States, or introduce perverse incentives to other payment categories. As a result, they may give rise to significant consequences for a comparatively small efficiency gain. The Panel's view on various forms of limiting relativity changes is set out in Chapter 2 at page 41.

42 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 43.

Freezing relativities between reviews

One way of delaying the redistribution of the fiscal benefits of improvements in State fiscal capacity, and therefore reducing the potential for this redistribution to influence State decisions, would be to freeze relativities between reviews. However, to the extent they exist at all, policy effects may still occur in the years immediately prior to the reviews where relativities are updated.

The Northern Territory suggests freezing expenditure disabilities as a simplification measure, but explicitly rejects completely freezing relativities between reviews on the grounds that it would lead to unequal outcomes:

> *Locking in expenditure factors would reduce the considerable effort required in each major review associated with the re-examination of expenditure methodologies, allowing the Commission to focus on the revenue assessments which drive volatility in the GST distribution ... [But] locking-in relativities between major reviews or introducing a floor on relativities would lead to inequitable financial outcomes between states unless there was no change in relative state circumstances over that period.*[43]

As noted in Chapter 3, there may be some merit in freezing expenditure disabilities on simplicity grounds by simplifying the CGC's annual update process, but this would not address other underlying causes of complexity.

Adopting broader indicators of State fiscal capacity

As noted in Chapter 3, New South Wales, Victoria, Queensland, Western Australia, the Australian Capital Territory and the Commonwealth Treasury have suggested using broader indicators for assessing the revenue raising capacity of States. New South Wales, Victoria, Queensland and Western Australia also raise using broader indicators for expenditure assessments.

Using broader indicators would not generally address concerns that HFE dilutes incentives for reforms that enhance a State's fiscal capacity, as improvements in fiscal capacity would continue to be distributed based on State population shares. However, the approach may resolve Western Australia's concerns about disincentives for additional tax compliance if it means that the CGC's assessment of revenue raising capacity is no longer reliant on State data.

To the extent that a broader indicator grouped multiple expenditure and revenue categories together, it would reduce incentives for States to manipulate their tax and expenditure policies to maximise their GST share (average policy effects). In some instances, it may also reduce the effects of changes in average policy on State incentives by averaging out differences in capacity between categories. Nevertheless, average policy effects would remain to the extent that States did not have average capacity in different assessment categories. The Panel view on adopting broader indicators is set out in Chapter 3 at page 53.

43 Northern Territory submission to the GST Distribution Review, October 2011, pages 6-7.

'Equalising' to a minimum (or lower than average) standard

As noted in previous Chapters, Victoria and Queensland suggest that the expenditure needs for the distribution of the GST could be calculated as if all States applied the policy of the lowest taxing or spending State.

Victoria says that:

> *Compensating to a minimum standard would encourage reform and improvements in productivity.*[44]

Queensland argues that:

> *One of the main benefits of this method [a minimum standard] is an increased level of policy neutrality, as an individual State's decision to provide a higher level of services or make a greater revenue effort does not impact on their GST share unless they are the State with the lowest effort. For that individual State, there is still little scope for policy choices to affect the GST distribution as:*
>
> - *the COAG process of setting standards and outcomes for service delivery through National Agreements and National Partnership agreements ensures that no State's effort is unacceptably low and that States do not significantly reduce their effort; and*
>
> - *the effort level of the next lowest State is an effective ceiling on the potential impact of the minimum State's policy change, as increases to effort by the minimum State (increasing the standard and level of redistribution) would simply result in another State setting the standard.*
>
> *In most cases, the relative effort levels of States at a category level are not widely spread, so a change from the average standard to the minimum standard is not likely to produce an outcome that is substantially different from that of the current process.*[45]

The benefits of this approach could be maximised while the risk of giving one State even greater incentive to manipulate its policies than under the current model could be minimised by using a standard lower than the average, but not actually that of the lowest taxing or spending State. For example, the all-State average could be discounted by a factor, or the standard could be set by the *second* lowest State, or the State immediately below the average.

'Equalising' to an external standard

Instead of focussing exclusively on 'what States collectively do' and the circumstances in which they operate, the standard of tax and expenditure policy could be determined with reference to an external standard of what States *should* do and the circumstances they *should* operate in.

States do not explicitly argue for an external standard. However, New South Wales says:

44 Victorian submission to the GST Distribution Review, October 2011, page 2.
45 Queensland submission to the GST Distribution Review, October 2011, page 16.

> *A more outward looking and globally integrated Australia needs a HFE system that provides incentives for reform and promotes efficiency. This will require governments to provide more guidance to the CGC in the implementation of HFE. This is especially the case with the ongoing need to encourage states to undertake productivity and welfare enhancing reforms and to align HFE with other policies directed towards boosting Australia's productivity performance.*[46]

The key problem with the approach of equalising to an external standard is that it is not clear how such a standard would be determined. Determining the standard and the administration of compliance with it may significantly increase the administrative costs of HFE.

Adopting measures to reward good policy

Rather than seeking to adjust the HFE process itself, measures could be taken within a more broadly defined GST distribution mechanism to reward States that undertake positive reforms. Under such an approach, a proportion of GST revenue could be set aside to form a reward pool. Relativities would remain the same and the reward pool would be subtracted from all States on an EPC basis.

As with using an external standard to determine the distribution of the entire GST pool, challenges for this approach include determining how the 'good' standard is set, how much of the GST pool should be used and what resources would be required to assess compliance.

Standards could be set through agreement between States, perhaps based on the advice of an independent body like the Productivity Commission, or in a range of other ways.

The Panel's summary view on alternative approaches to address efficiency concerns

While the Panel is not convinced that efficiency concerns provide grounds for radical changes to the HFE process, it is interested in views on whether any of the approaches outlined above would address concerns about the relationship between HFE and efficiency.

As previously noted, the Panel intends to investigate whether providing comparable capacities for States would be an approach more suitable to current challenges than the present one of providing materially the same capacities. This would improve efficiency by reducing the size of any capacity effects as well as the ability of States to influence average policy. Further, the Panel would be keen to explore the practicalities of equalising to an external standard, or a standard below the average of all States.

Finally, the Panel will explore the concept of creating a reward pool to assist States improve efficiency and consider this further in the Panel's second Interim Report.

46 New South Wales submission to the GST Distribution Review, November 2011, page 50.

5 HFE and Commonwealth payments to the States

As explained in Chapter 1, in addition to GST, States receive other payments from the Commonwealth in the form of other general revenue assistance (GRA) and payments for specific purposes (PSPs), comprising national specific purpose payments and national partnership payments.[1] In the current equalisation process, some of these payments are taken into account in calculating States' GST shares, while others are not.

There seems to be agreement throughout consultations and in submissions that other GRA (which is relatively small) and most PSPs should be included in the GST share calculations. However, the Panel has received a variety of views on whether all PSPs should be included. Most of the comments relate to PSPs for capital purposes.

In this Chapter the Panel has reviewed whether Commonwealth payments other than GST should affect GST shares in principle, before turning to the key question of whether certain types of Commonwealth payments, such as PSPs for capital purposes (or a subset of them), should be excluded for particular reasons.

5.1 Scope and effect of Commonwealth payments

Commonwealth payments are a major source of State revenue. Table 5.1 shows total Commonwealth payments to the States for selected years starting from 1980-81. In 2010-11 the Commonwealth provided the States with payments totalling $98.5 billion, comprising payments for specific purposes of $51.6 billion and GRA, including GST payments, of $47.0 billion. Since the introduction of the GST in 2000 GRA has tended to exceed PSPs. The higher level of PSPs since 2008-09 is largely the result of increased Commonwealth funding for capital purposes in response to the global financial crisis.

Table 5.1: Commonwealth payments to the States

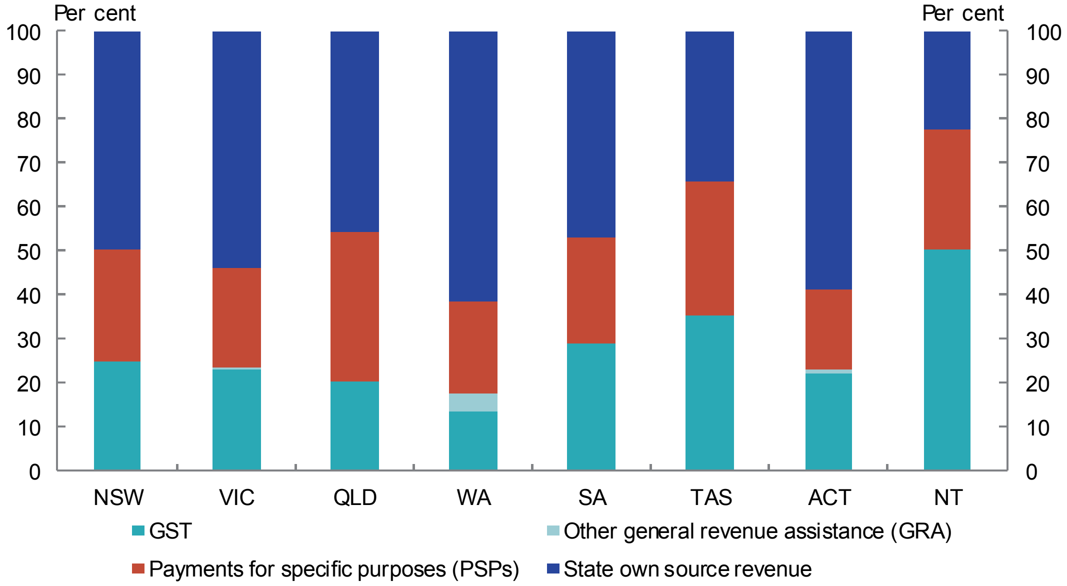
	1980-81	1990-91	2000-01	2007-08	2008-09	2009-10	2010-11
General revenue assistance incl. GST	7,090	13,932	27,635	42,454	42,352	44,693	46,953
Payments for specific purposes	5,683	14,638	19,207	32,036	41,655	52,521	51,566
of which							
National specific purpose payments						24,402	26,241
National partnership payments						28,119	25,325
- for recurrent purposes						7,511	13,054
- for capital purposes						20,608	12,271
Total payments to the States	12,773	28,570	46,841	74,489	84,007	97,214	98,519

Source: Commonwealth Government Final Budget Outcome, various years and Commonwealth Grants Commission 2011 Update Report, table 1-2. Figures are not exactly the same as FBOs due to rounding.

In 2010-11 total Commonwealth payments to the States accounted for about 50 per cent of total State revenue, with PSPs accounting for just over one-half of total payments. Figure 5.1 shows that in 2010-11 total Commonwealth payments accounted for 77.6 per cent of revenue for the Northern Territory and 38.7 per cent of revenue for Western Australia.

1 From 2012-13 PSPs will also include National Health Reform funding.

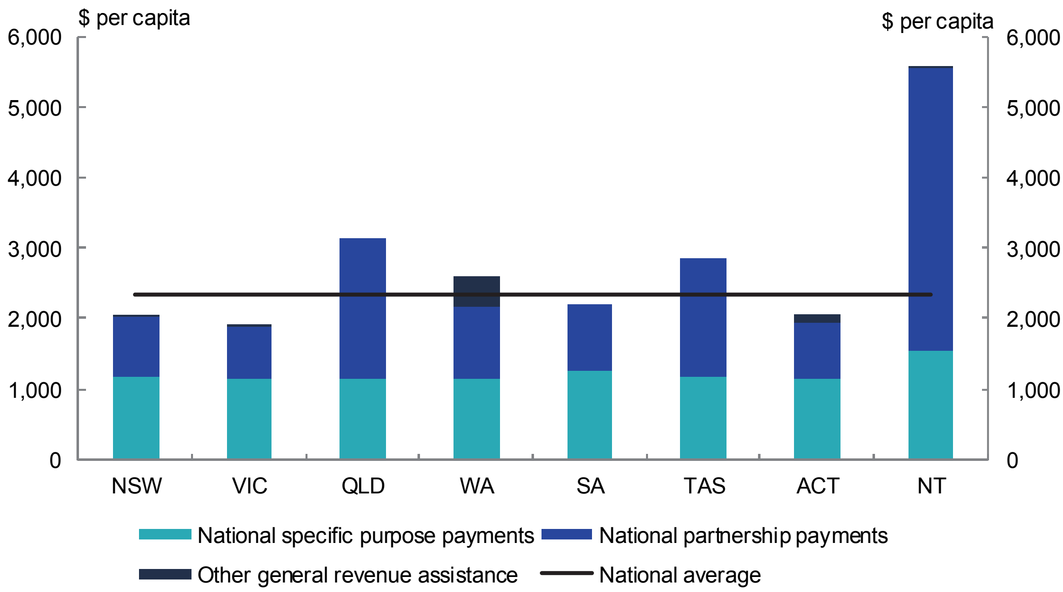
Figure 5.1: Sources of State revenue as a percentage of total revenue 2010-11



Source: Commonwealth Government Final Budget Outcome, 2010-11. State budget papers 2011-12.

There are large differences in the level of PSPs and other GRA provided to the States. Figure 5.2 shows that in 2010-11 the average payment per person was $2,345 ranging from $1,884 per person for Victoria to $5,579 for the Northern Territory. On a per capita basis, Queensland, Tasmania and the Northern Territory received more than the national average per capita payment in 2010-11.[2] The distribution of payments in 2010-11 is representative of the distribution since the introduction of the GST, with the exception that South Australia has received more than the national average per capita payment in most other years.

Figure 5.2: Commonwealth Government payments to States, 2010-11



Source: Commonwealth Government Final Budget Outcome, 2010-11. Australian Bureau of Statistics estimated resident population at 31 December 2010.

2 If other general revenue provided to Western Australia is regarded as a Commonwealth payment, then Western Australia would also be above the national average per capita payment.

Why do Commonwealth payments affect GST shares?[3]

Commonwealth payments are a significant source of State revenue and, where they are effectively a supplement to a State's revenue to be used for normal State functions, they are taken into account in calculating GST shares. If these revenue sources were not included in the calculation, a State that received more than their population share of payments would end up with an above average fiscal capacity, thus undermining the point of the current HFE process.[4]

In principle, therefore, Commonwealth payments affect GST shares if:

- they provide States with general budget support to deliver services and provide infrastructure, and
- needs related to the expenditure of the payments are taken into account by the Commonwealth Grants Commission (CGC) when calculating GST shares.[5]

As most Commonwealth payments fall into this category, most affect GST shares.[6]

The general principle that Commonwealth payments should be taken into account in calculating GST shares is set out in the current Inter-governmental Agreement (IGA) and the terms of reference provided by the Commonwealth Treasurer to the CGC. These documents specify that some payments should affect GST shares, namely:

- National Specific purpose payments and National Health Reform (NHR) funding
- National Partnership project payments
- general revenue assistance excluding the GST.

The IGA and terms of reference also specify that some payments should *not* affect GST shares, namely, National Partnership facilitation and incentive (reward) payments. However, the IGA and terms of reference give the CGC discretion to treat any National Partnership payment differently if it considers that to be more appropriate, subject to consultation with the Commonwealth and State Governments. Broadly, this discretion allows the CGC to look to the substance of a payment, rather than its form, to determine whether it should be excluded from equalisation.[7]

One implication of the approach of including most Commonwealth payments in the calculation of GST shares is that the equalisation system may effectively redistribute payments that have been agreed between the Commonwealth and the States.[8] The

3 In the discussion that follows Commonwealth payments refers to PSPs and other GRA.
4 Designed to produce materially the *same* fiscal capacities for States, as explained in Chapter 1.
5 If the CGC took account of a State's needs in relation to the expenditure of a particular payment, but disregarded the revenue provided by the Commonwealth to address that need, States' fiscal capacities would not be equalised.
6 The outcomes of recent Commonwealth Government reviews of funding arrangements for health (National Health Reform) and education (the *Gonski Review of Funding for Schooling*) may have implications for the GST distribution process in the future.
7 The terms of reference for the 2012 Update of GST Revenue Sharing Relativities specify that National Partnership Agreement reward payments should not affect the relativities.
8 There is no net effect on GST shares if the Commonwealth distribution of the payment matches the CGC's assessment of needs.

benefit of the approach is that it allows for the prioritising of particular projects, while still achieving equalisation. In addition, States that receive greater than a population share of Commonwealth payments have use of the extra funds for two years before they begin to be included in the equalisation process. However, there may be advantages for simplification and transparency if all Commonwealth payments to States that provided general budget support were allocated on a population share (EPC) basis and all service and infrastructure equalisation needs were determined by the CGC. Alternatively, where the distribution is intended to 'stick', the payments could be excluded from equalisation.

Which Commonwealth payments are currently excluded?

In aggregate, over one third of Commonwealth payments do not affect GST payments.[9] These include the following types of payments:

- payments 'through' the State to third parties where the payment has no impact on State fiscal capacities (for example, payments to local government and non-government schools)
- payments to fund a purchase by the Commonwealth Government (for example, natural disaster relief and recovery payments)
- payments for which expenditure needs have not been able to be assessed by the CGC (for example, the payment to the Queensland Government for red ant eradication)
- payments for which the Commonwealth Government distribution of the payment is assumed to reflect the expenditure needs (for example, 50 per cent of the payments for the construction of national network roads)
- payments specified by the Commonwealth Treasurer in terms of reference (for example, Closing the Gap payments).

What is the effect of including Commonwealth payments?

Commonwealth payments influence the GST distribution because they increase the revenue available to States and increase total State spending. On the revenue side, States that receive more than a population share of total payments have their GST reduced by that amount (and vice versa). On the expenditure side, States assessed by the CGC as needing to spend more than the average to provide the average level of services and infrastructure have their GST increased (and vice versa).[10]

Table 5.2 shows the net effect of Commonwealth payments on the distribution of the GST in 2012-13. By way of illustrating the points in the previous paragraph, Victoria received a below average share of payments (leading to a revenue benefit), but the CGC assessed it needed to spend less than the average to deliver the average level of services and infrastructure, causing it to lose almost as much GST. The net effect is that a small amount of additional GST flows to Victoria as a result of Commonwealth payments.

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9 Calculation based on CGC Supporting Information for the 2012 Update. 'No impact' payments include payments assessed EPC plus the National SPP for non-government schools, the Remote indigenous housing NPP and fifty per cent of the payments for the construction of national network roads.

10 All other things being equal, anything that increases State spending (like Commonwealth payments) will increase the size of the GST redistribution due to expenditure assessments.

Despite making up a large proportion of State revenue, the total effect of Commonwealth payments on GST shares in 2012-13 was relatively small for most States.

Table 5.2: Effect on the GST distribution of including Commonwealth payments, 2012-13

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	TOTAL
Revenue effect ($m)	218	732	-275	-62	-264	-227	77	-199	1 027
Spending effect ($m)	-97	-575	55	159	155	76	-88	316	760
Total effect ($m)	121	157	-221	97	-109	-151	-12	118	493
Total effect ($pc)	16	27	-47	40	-65	-293	-31	495	21

Source: CGC, 2012 Update, Box 5-3.

5.2 Submissions on the treatment of Commonwealth payments

Through submissions and consultations the Panel has received a variety of views on the appropriate treatment of Commonwealth payments in the equalisation process.

The general principle of including ongoing Commonwealth payments in the HFE calculation seems relatively uncontroversial.[11] However, a large number of submissions propose changes to the treatment of certain categories of non-ongoing or one-off Commonwealth payments for capital purposes. The main arguments for the different treatment of large capital payments are that equalising them:

- creates funding problems for States that rely on Commonwealth funding to complete the projects, potentially risking the delivery of the project or forcing States to delay or reduce the scope of the projects, or cut other programs[12]
- is a major cause of volatility in the relativities when the payments are unevenly allocated to the States[13]
- distorts the ‘real’ funding and risk-sharing outcomes agreed between the Commonwealth Government and the States to deliver nationally significant infrastructure priorities,[14] and
- results in a larger share of GST funding being redistributed to other States on an untied basis to pursue spending policies, potentially without the same level of economic benefit or priority.[15]

Many of the largest one-off capital payments are for road and rail projects. Table 5.3 shows the net effect on the GST distribution of Commonwealth payments by expenditure category in 2012-13. The net effect of rail payments is reflected in the transport services category and the net effect of road construction payments is in the

11 Only one submission (from WACCI) advocates a change to the existing treatment of Commonwealth payments for recurrent purposes.
12 Meaning that the Commonwealth Government ‘gives with one hand and takes away with the other via GST redistribution’: Victorian submission to the GST Distribution Review, October 2011, page 19.
13 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 22.
14 Queensland Treasury Corporation submission to the GST Distribution Review, October 2011.
15 Queensland Treasury Corporation submission to the GST Distribution Review, October 2011.

investment category. Both the transport and investment categories make a significant contribution to the redistribution from Commonwealth payments in 2012-13. One factor contributing to the redistribution is the uneven allocation of road and rail payments among the States.

Table 5.3 Net Effect on the GST distribution of Commonwealth Payments by Expenditure Category in 2012-13

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Investment	-43	332	-170	34	-44	-156	29	18	413
Admitted patients	18	-148	-15	16	54	29	-31	77	194
Transport services	143	-67	-52	24	-39	-22	9	5	180
Welfare and Housing	-19	-14	-41	-23	32	18	-24	70	120
Services to Communities	27	9	32	17	-80	-12	0	6	91
Schools education	-17	-35	22	40	-15	-6	2	9	73
Roads	21	28	10	-16	-5	-7	-4	-27	59
Post-secondary education	-24	24	-10	9	-12	-2	6	9	48
Community and other health	21	18	3	3	-6	1	2	-42	47
Other	-6	11	0	-7	6	4	-1	-7	20
Total impact	121	157	-221	97	-109	-151	-12	118	493

Source: CGC, 2012 Update, Box 5-3.

On the treatment of Commonwealth payments Victoria makes the general statement:

> *To improve the predictability and transparency of the system, the default treatment of Commonwealth payments should be inclusion, with payments excluded only in extraordinary circumstances.*[16]

However, Victoria says project payments from the Building Australia Fund, the Health and Hospitals Fund, the Education Investment Fund, and the COAG Reform Fund should be excluded from the equalisation process, and that this could be addressed by the Commonwealth instructing the CGC to treat one-off grants for infrastructure projects by exclusion. Victoria argues:

> *... including one-off Commonwealth funding for extra-ordinary projects within the HFE assessments creates a substantial anomaly ... [it] causes large impacts on the annual relativities of years when payments are made, despite the project funding itself not impacting on a state's underlying fiscal capacity in the short-term. It causes the Commonwealth to give with one hand, and take away with the other via GST redistribution, thus appearing inconsistent with the objective of the agreed investment decisions ... [This treatment] could risk the delivery of the projects themselves ... [and] force states to delay or reduce the scope of large infrastructure projects.*[17]

On the specific issue of road payments Victoria argues that the current treatment of payments for road and rail projects is inconsistent because the CGC only includes 50 per cent of payments for the construction of national network road (NNR) projects, whereas 100 per cent of the Commonwealth support for rail construction affects the GST distribution. Victoria says:

16 Victorian submission to the GST Distribution Review, October 2011, page 3.
17 Victorian submission to the GST Distribution Review, October 2011, page 19.

> *The current system penalises states that receive a greater proportion of ongoing Commonwealth assistance for rail relative to road investment. Consistent treatment of infrastructure grants across transport modes would add transparency and consistency to the HFE process and remove potential distortions to infrastructure investment decisions ... Victoria considers that HFE would be better achieved if all ongoing infrastructure payments were fully included and assessed in investment.*[18]

Similar views were expressed by the Business Council of Australia (BCA):

> *Additional transport infrastructure payments made by the Commonwealth to the states should be neutral in their treatment of different modes. One-off payments for long-term infrastructure projects such as those made under the Building Australia Fund should be excluded from the assessment. States should not be penalised with lower and more volatile revenues on account of their investment in long-term infrastructure.*[19]

South Australia supports the current principles for the treatment of Commonwealth payments, noting:

> *A failure to include Commonwealth specific purpose grants in the needs assessment would undermine equalisation outcomes. A jurisdiction that has received an above equal per capita share of Commonwealth payments has been granted a fiscal capacity advantage relative to other jurisdictions. .... While this conceptual approach is well accepted in relation to grants which underpin the core areas of State service delivery such as education, health and housing, the Commonwealth also provides States with grants for specific projects, such as infrastructure, which are often bilateral arrangements with no related funding flows to any other jurisdiction. In these instances, a State may receive a grant from the Commonwealth to contribute to the cost of a one-off project, but lose all but its population share of the grant through the needs assessment. This is still likely to be the appropriate outcome according to the principle of HFE, to the extent that the Commonwealth funding effectively substitutes for a State Government funding contribution. The issue needs to be considered in the broader context of revenue capacity across the full range of services and infrastructure needs facing State Governments ... It is recognised, however, in relation to capital grants that the treatment by inclusion may result in a large impact on the relativity at the time of incomes recognition of the grant payment as per GFS accounting standards. Given that the CGC assess needs for the use of the asset based on depreciation it may be more appropriate for capital grants treated by inclusion to be assessed over a longer timeframe rather than as a lump sum in the year of receipt in line with a revenue and expense matching principle.*[20]

On the issue of the treatment of capital payments for mining related infrastructure, South Australia notes that capital payments for general government functions to support mining activities and townships (roads, schools, hospitals, water supplied through community service obligation arrangements) should be included because the

18 Victorian submission to the GST Distribution Review, October 2011, pages 3 and 18.

19 Business Council of Australia submission to the GST Distribution Review, December 2011, page 26.

20 South Australian submission to the GST Distribution Review, September 2011, pages 16 and 17.

CGC recognises depreciation needs pertaining to these functions. On the other hand, capital payments for ports, electricity or water supply for mining projects should not be included because these activities are out of scope of the CGC depreciation assessments and they are either provided by the private sector or are delivered through government business enterprises (GBEs) under commercial user pays arrangements. As such, this infrastructure spending does not impact on State Government budgets in the long term. Furthermore, South Australia says that:

> *If there is national economic interest in accelerating the removal of mining development bottlenecks in a targeted way, the Commonwealth can assist that directly*.[21]

Western Australia says:

> *... the full equalisation of States' actual revenue bases and lack of assessment by the CGC of infrastructure support for future economic development place much importance on the Commonwealth providing direct economic infrastructure payments to States. However, Commonwealth budgetary constraints may result in an inadequate level of assistance, and there is a risk that the available assistance may not be allocated to areas of greatest national economic return.*[22]

The Australian Capital Territory says that the HFE system should include Commonwealth recurrent and capital payments paid as subsidies to specific industries such as to agriculture, defence, automotive and textile clothing and footwear manufacturing industries:

> *These payments are not evenly distributed among the States and, as they are often directed to industry, do not appear on State government budgets, but nonetheless provide valuable economic stimulus to some States.*[23]

In consultations the Australian Capital Territory has said that if the equalisation system continues to assess State capital expenditure in the year of acquisition, then Commonwealth payments for capital purposes should affect GST shares. However, in the event that the CGC changes its approach to assessing State capital needs (to a consumption basis), Commonwealth payments for capital purposes should not affect GST shares or, alternatively, these payments could be included, but be equalised over a longer period.

The Northern Territory supports the CGC treating all tied Commonwealth payments by inclusion, noting that the alternative would be a 'scatter gun' approach which would undermine the fairness of the system and greatly increase the administrative costs and complexity of tied funding distribution arrangements. The Northern Territory also notes that the total redistribution of GST revenue arising from Commonwealth payments is relatively small and that the Northern Territory is the largest contributor to the redistribution with about $950 per capita of GST revenue being redistributed away from the Territory.[24]

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21 South Australian submission to the GST Distribution Review, September 2011, page 14.
22 Western Australian submission to the GST Distribution Review, October 2011, page 8.
23 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 9.
24 Northern Territory submission to the GST Distribution Review, October 2011, paragraphs 3.31 to 3.32.

New South Wales, Queensland and Tasmania have not commented on the treatment of Commonwealth payments.

Queensland Treasury Corporation (QTC) says:

> *... the assessment of states' GST payments should, by default, exclude any Commonwealth payment made directly to a state to support the delivery of nationally significant projects, which are assessed under a COAG-agreed or -endorsed national prioritisation framework .... [The current] approach ... fails to take into account the Commonwealth and States' recognition that a higher level of fiscal capacity may be required at a time and at a specific location to deliver priority infrastructure of regional and national strategic importance … [and] distorts the 'real' funding- and risk-sharing outcomes agreed between the Commonwealth and the states to deliver nationally significant infrastructure priorities. At the same time, a larger share of GST funding is redistributed to other states on an untied basis to pursue spending policies, potentially without the same level of economic benefit or priority.*[25]

The Western Australia Chamber of Commerce and Industry (WACCI) says that Commonwealth payments should be removed from the equalisation process to reduce the complexity of the system and alleviate the administrative burden, arguing that it seems counter-intuitive that, by taking account of generally tied payments, a State's untied payments are affected.[26]

Former South Australian Under-Treasurer, Mr Peter Emery supports the general principle of inclusion for the treatment of Commonwealth payments to the States. However, he considers there should be exceptions to this, particularly for one-off payments made to particular States to achieve very particular national outcomes. Mr Emery notes the current exclusion of 50 per cent of some road grants should be regarded as arbitrary and probably deserving further examination.[27]

The Commonwealth Treasury says that, in the context of HFE, the allocation of Commonwealth infrastructure payments should be considered in totality and over time. It notes there is a strong rationale for including Commonwealth infrastructure payments in determining GST relativities, in that infrastructure is a significant area of State general government sector expenditure, States largely fund general government infrastructure from tax and grant revenue rather than user charges, and the CGC assesses infrastructure needs. The Commonwealth Treasury concludes that continuing the current arrangements will ensure that Commonwealth infrastructure funding is distributed equitably among jurisdictions.[28]

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25 Queensland Treasury Corporation submission to the GST Distribution Review, October 2011. QTC also notes that any change to the existing arrangements would require 'a suitable transition arrangement to ensure that states whose GST relativities have recently been impacted by the existing arrangements are equitably treated by changing the arrangements'.

26 Western Australia Chamber of Commerce submission to the GST Distribution Review, October 2011, page 11.

27 Submission from Mr Peter Emery, the former South Australian Under-Treasurer, to the GST Distribution Review, September 2011, paragraphs 29 and 30.

28 Commonwealth Treasury submission to the GST Distribution Review, October 2011, pages 12 to 16.

5.3 Alternative approaches for capital payments

There are a number of advantages of including Commonwealth payments in the GST calculation. For example:

- States do not generally need to devote significant resources to securing a 'fair share' of payments.
- The principles and guidelines for the treatment of payments are known to the main stakeholders and the CGC seeks to apply them consistently, consulting the Commonwealth and State Treasuries before reaching a final decision on the treatment of new payments.
- The payments are distributed on the basis of a consistent set of needs that are identified and measured by the CGC.

However, the Panel recognises that the counter arguments in the case of capital payments are powerful and has therefore considered a number of alternatives. Some of these approaches were raised expressly in submissions, while others have occurred to the Panel as either being possible ways to overcome drawbacks identified with suggested approaches, or as the logical extension or variation of a particular proposal.

Equalising capital payments, but over a longer time

Since one of the main concerns raised is that equalising large, one-off, capital payments creates funding problems for States, a clear case could be made for equalising capital payments over a longer period that more closely matches the life of the assets. This approach would reduce the volatility in the relativities that arises when large, one-off, capital payments made to the States are equalised, without adding much complexity to the current process. The Panel notes that this type of approach would be consistent with a capital assessment that recognises State capital needs over time rather than in the year of acquisition.[29]

> *The Panel's view on equalising capital payments over a longer time*
>
> *The Panel considers that equalising capital payments over a longer period would reduce the impact of capital payments on GST shares in any one year, without adding much complexity. The Panel notes that equalising capital payments over a longer period would be consistent with a capital assessment that also recognises States' capital needs over time.*

Excluding certain categories of capital payments

The Panel has considered approaches that would exclude certain types of capital payments, namely:

- payments from the Building Australia Fund, Education Investment Fund, Health and Hospital Fund and COAG Reform Fund

29 Such an approach could continue to recognise the impact of population dilution on net worth.

- payments to promote future economic development
- payments for nationally significant infrastructure projects, and
- payments for transport infrastructure.

Many projects that receive Commonwealth funding are jointly funded by State governments. Excluding only the Commonwealth funding from the equalisation process would result in different treatments of expenditures from different funding sources. All of the approaches considered below potentially suffer from this drawback.

Excluding payments from the Building Australia Fund, Education Investment Fund, Health and Hospital Fund and COAG Reform Fund

Victoria proposes excluding payments from the Building Australia Fund, Education Investment Fund, Health and Hospital Fund and COAG Reform Fund. Payments from these funds are subject to certain degrees of independent assessment, for example, Building Australia Fund projects are assessed by Infrastructure Australia.

Under this approach the same project or similar projects funded by different programs would be subject to different treatments. Payments from one program (for example, Building Australia Fund) would not affect GST shares while payments from another program (for example, Nation Building Program) would affect GST shares. By way of illustration, the Commonwealth is currently providing funding to Queensland for the construction of the Ipswich motorway. Some funding for this road is being provided through the Building Australia Fund ($884 million) and some through the Nation Building Program ($2,069 million).[30] The BAF payment would not be equalised, but the NBP payment would be equalised.

The Panel's view on excluding payments from the Building Australia Fund, Education Investment Fund, Health and Hospital Fund and COAG Reform Fund

The Panel doubts that only excluding payments from the designated funds would address all the concerns raised in submissions about the current treatment of capital payments and is concerned that it may introduce other difficulties, such as placing great weight on the labelling of programs, or casting doubt on the merit of projects not financed through the designated funds and programs. However, these particular payments could be part of a broader group of capital payments to be excluded from the equalisation process.

Excluding capital payments to promote future economic development

Western Australia and South Australia raise the idea of excluding capital payments in the context of the high upfront costs associated with providing mining related infrastructure and the national economic benefits that could arise from accelerating the removal of export bottlenecks.

30 Sourced from http://www.nationbuildingprogram.gov.au/projects/ProjectDetails.aspx?Project_id=qnh021 .

Such an approach would ensure that payments to States facing high upfront economic development costs would 'stick', thereby arguably providing the greatest national economic return.

The Panel's view on excluding capital payments to promote future economic development

The Panel notes that the difficulties associated with measuring economic development infrastructure needs mean that the equalisation process does not fully recognise State expenditure needs in this area.

The Panel sees potential in excluding capital payments to promote future economic development, but notes that there may be considerable difficulty in identifying relevant payments, as precisely what constitutes 'economic development' would prove problematic in the absence of an agreed definition or process for determining eligible payments.

Excluding capital payments for nationally significant infrastructure projects

The QTC and Mr Peter Emery propose excluding capital payments for nationally significant infrastructure projects.

This approach would ensure that Commonwealth Government funding that is allocated to a nationally significant project (that is, one with a high level of economic benefit for the whole country) is not redistributed to other States. Excluding capital payments for these projects could be justified because of the difficulties associated with recognising all the relevant factors that influence State expenditure on them.

The current equalisation process seeks to recognise State infrastructure needs for all types of State general government infrastructure assets as well as assets held by government business enterprises (for example, urban passenger rail and social housing providers). The capital assessments give significant weight to population growth while also recognising other influences on State general government infrastructure requirements. Other influences are approximated using recurrent service use and cost disabilities and no capital specific disabilities are recognised.

The main issue with this approach is that it could be difficult to identify 'nationally significant' projects. The size of the project alone would not be the determinant of whether the project qualifies. Nationally significant projects could include projects that improve productivity, enhance global competitiveness or address a significant national policy challenge.

The Panel's view on excluding capital payments for nationally significant infrastructure projects

The Panel recognises that the current assessments do not recognise all the complex and multi-faceted factors that influence State infrastructure spending. This is more likely to create problems for infrastructure projects that seek to deliver national benefits or outcomes rather State specific benefits or outcomes. However, a difficulty with excluding these payments is that a satisfactory process to identify eligible projects does not currently exist. While the Infrastructure Australia priority list is a useful starting point, it cannot be regarded as a comprehensive list of all nationally significant projects.

The Panel sees potential in excluding capital payments for nationally significant infrastructure projects provided a workable process for identifying eligible projects could be developed.

Excluding capital payments for transport infrastructure projects

The approach of excluding payments for transport infrastructure (that is, road, rail and ports) from the equalisation process has been considered by the Panel, largely prompted by concerns that road and rail transport are being treated differently.[31]

Such an approach would mean greater certainty for States because capital payments for different modes of transport would all receive the same treatment in the equalisation process. Further, as noted previously, the current capital assessments may not effectively recognise all the factors that influence State infrastructure requirements and this problem may be more pronounced in the case of transport infrastructure compared with social infrastructure.

The Panel's view on excluding capital payments for transport infrastructure projects

The Panel notes that, unlike some of the approaches considered above, identifying Commonwealth payments for transport infrastructure would be straightforward. A case may exist to exclude these payments due to the difficulty in measuring transport infrastructure spending requirements.

Excluding all capital payments

Finally, the Panel has considered excluding all capital payments.

31 Victoria raised these concerns and proposed including all ongoing road and rail infrastructure payments. See Victorian submission to the GST Distribution Review, October 2011, page 18.

The Panel's view on excluding all capital payments

While excluding all capital payments would eliminate any funding difficulties, it would add complexity to the equalisation process because all related expenditure would also need to be excluded. Also, needs for the State funded part of projects jointly funded by the Commonwealth and the States would continue to be assessed and this would result in different treatments of expenditures from different funding sources.

Moreover, the Panel is concerned that the long term workability of this approach would depend completely on the Commonwealth Government ensuring that capital payments are distributed equitably among jurisdictions. If the Commonwealth felt it was necessary to adopt a process that relied on a needs assessment to determine where payments should be made and how much, the apparent benefit of excluding the payments in the first place would be largely undone.

5.4 Summary of the Panel's views on the treatment of Commonwealth Payments

The general principle of equalising ongoing Commonwealth payments in the current system seems uncontroversial. However, some States say that they experience short term funding difficulties when large one-off capital payments for expenditure on assets of lasting value are redistributed. Further, equalising these payments increases volatility in GST payments.

Changes to address problems with the current capital assessments are unlikely to ameliorate all of these concerns.

The analysis above demonstrates that there are many possible approaches to the 'problem' of the proper treatment of Commonwealth capital payments. Recognising the interconnected nature of the issues, the Panel prefers sustainable solutions that cause minimum disruption to other aspects of the system, thus narrowing the options.

The Panel's overview on the treatment of Commonwealth payments

Of the various approaches considered to overcome the difficulties experienced by States when large one-off capital payments for expenditure on assets of lasting value are redistributed, the Panel sees most merit in:

- *equalising all capital payments, but doing so over a longer time frame to recognise the lasting nature of the asset being funded and reduce the impact of the payments on GST shares in any one year, or*
- *equalising most capital payments, but excluding capital payments for nationally significant projects.*

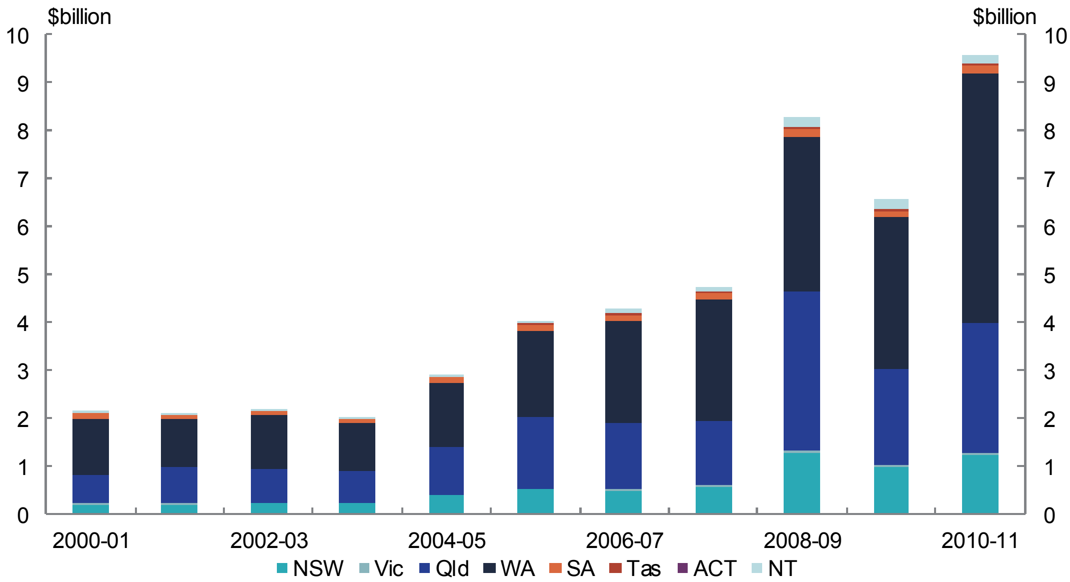
If capital payments for nationally significant projects are to be excluded, a process for identifying the precise scope of these projects will need to be determined. The Panel seeks views on the appropriate way to identify these projects.

6 HFE and the mining boom

6.1 What effect is the mining boom having?

Mining activity in Australia has increased substantially over the past decade, primarily because of increasing demand for iron ore and coal from a rapidly developing China. Due to the location of key mineral resources in Western Australia, Queensland and New South Wales, the largest shares of mining production and mining revenue are in those States. Figure 6.1 shows mining revenue by State from 2000-01 to 2010-11.

Figure 6.1: Mining revenue by State, 2000-01 to 2010-11



Note: Includes Grants in lieu of royalties.
Source: CGC Updates and Reviews, various years.

Total State mining revenue more than quadrupled from 2000-01 to 2010-11, with two distinct periods of strong growth. Mining revenue grew strongly between 2004-05 and 2007-08 and, from 2008-09, there was a step change in total revenue. Even with the effects of the Global Financial Crisis evident in 2009-10, total State mining revenue doubled from 2007-08 to 2010-11.

Figure 6.1 also shows that growth in mining revenue has varied across States, with New South Wales, Queensland and the Northern Territory recording stronger than average growth over the period 2000-01 to 2010-11. Western Australia recorded growth around the national average of nearly 345 per cent, while South Australia recorded significantly lower growth than average, at 47 per cent.

As key minerals are mainly located in only a few States, the capacity to raise revenue from mining royalties is markedly different between States. The most plentiful mineral resources in Australia are coal and iron ore. Table 6.1 shows that while coal is present in most States, differences in coal quality result in a different pattern of extraction. Although South Australia has about a third of Australia's identified coal resources, it extracts only about one per cent of the total. Queensland and New South Wales extract over 90 per cent of coal in Australia. Iron is concentrated in one State — Western Australia has 97 per cent of iron ore resources and extracts 97 per cent of iron ore.

Table 6.1: Proportion of key minerals and extraction by State

Commodity	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Coal Identified resources (%)	21	4	38	3	33	0	-	-
Black coal production (%)	44	-	52	2	1	0	-	-
Iron Identified resources (%)	0	0	1	97	1	0	-	0
Iron ore production (%)	-	-	-	97	2	1	-	0

Source: Derived from AGSO, National Mineral Deposits Dataset.
Note: a dash (-) indicates the State has none of that type of mineral or does not extract that mineral, whereas a zero indicates the State has a relatively small amount of that mineral.

Many of the other plentiful resources have much lower values and do not tend to have as large an impact on GST shares. Similarly, some of the more valuable commodities, such as copper and gold, have a smaller impact on fiscal equalisation as they are more broadly distributed amongst the States.

While mining revenue is a relatively small component of State Budgets in total, it is of great importance to some States. Table 6.2 shows for Western Australia and Queensland mining was 21.8 per cent and 6.4 per cent respectively of total revenue in 2010-11, while in all other States it was less than 4 per cent of total revenue.

Table 6.2: Mining revenue as a proportion of State revenue, 2010-11

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	TOTAL
(%)	2.2	0.1	6.4	21.8	1.0	0.9	-	3.2	4.8

Source: State Government outcomes reports for 2010-11.
Note: ACT does not have any mining royalties, but its revenue is included in the calculation of the Total.

Equalising mining revenue shares the benefit of the development of mineral resources located in any one State across all the States through changes to the GST redistribution. The Commonwealth Treasury describes the effect in the following way:

> *HFE shares the benefits of the resources boom with States that do not benefit as directly from the boom as those States with large natural resource endowments.*[1]

No State, including the resource-rich States of Western Australia and Queensland, specifically seeks to prevent the benefits of mineral resources being shared.

6.2 Concerns with the current treatment of mining revenue

Through its consultations and from submissions received the Panel has discerned that there are three main areas of concern in relation to the treatment of mining revenue:

- First, the two-rate structure of the assessment of mining revenue in the current HFE system can have extreme consequences for certain rate change decisions by States.

1 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 5.

- Secondly, there are questions about whether the current assessment takes certain expenditures into account adequately.
- Thirdly, concerns have been raised about whether the sheer size of the redistribution from the assessment of mining revenue is 'fair'.

These issues are examined in turn in the paragraphs below.

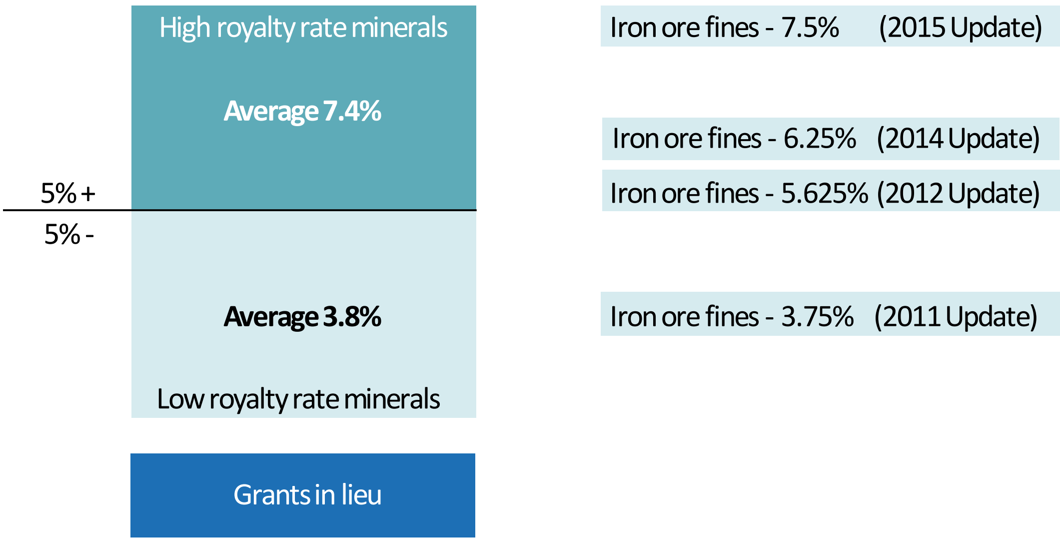
Consequences of the two-rate structure of the mining revenue assessment

As explained in Chapters 1 and 2, GST is used as a balancing item in the equalisation calculation, with the result that changes in a State's assessed capacity (say, through rapidly improving revenue from mining royalties) will change GST shares.

As shown in Figure 6.2 below, in its 2010 Methodology Review the CGC introduced a new method for assessing State mining revenue, comprising three components, namely:

- high royalty minerals (royalty rates above five per cent)
- low royalty minerals (less than five per cent)
- grants in lieu of royalties.[2]

Figure 6.2: The current mining revenue assessment



Source: CGC, review and updates, 2010 to 2012.

The classification of minerals in this way can cause a dramatic effect on GST shares if the CGC moves a mineral from the low royalty minerals component to the high royalty minerals component (or vice versa).

For example, Western Australia has announced a series of proposed changes to its iron ore fines royalty rate, as shown in Figure 6.2. First, a concessional royalty rate on iron ore fines for certain companies was removed from 1 July 2010, effectively increasing the

2 Grants in lieu of royalties are Commonwealth payments mainly for off-shore oil and gas (North West Shelf) revenue sharing. These grants are assessed by the CGC on an actual per capita basis.

royalty rate to 5.625 per cent and potentially shifting fines from the low to the high rate. If the CGC had decided to move iron ore fines into the high royalty component, after equalisation Western Australia would lose more GST than the additional royalties it collected. The CGC did not have to finalise its decision until the 2012 Update and the Commonwealth Treasurer has directed the CGC (in the 2011 Update and 2012 Update terms of reference) not to move iron ore fines into the high royalty component between reviews, so this consequence has been postponed for the time being.

However, in a second change, in its 2011-12 Budget, Western Australia announced that the royalty rate for iron ore fines will increase in stages to be the same as the lump iron ore royalty rate of 7.5 per cent by 2013-14. These further royalty rate changes may lead the CGC to reconsider whether iron ore fines should be moved to the high royalty minerals component, although, as Figure 6.2 above indicates, the increases would not affect GST shares until the 2014 and 2015 Updates.

The Panel's view on the consequences of the two-rate structure of the current mining revenue assessment

The Panel notes that the current mining revenue assessment has the potential for Western Australia to lose more revenue than it raises from a change to its royalty rate for iron ore fines, with effect from the 2014 Update, if the CGC chooses to move iron fines into the high rate category. Whatever the original justification for the two-rate structure, this outcome seems to be a perverse and inappropriate result.

The Panel encourages the CGC and other stakeholders to review the current mining revenue assessment method at the earliest opportunity. This may involve reconsidering whether the two-rate model is appropriate.

Notwithstanding this suggestion, this Review will report before the results of any CGC decisions on movement between rates need to take effect, and some of the Panel's recommendations (whether about mining, infrastructure or generally) may lessen the impact of the current mining revenue assessment on changes to GST shares.

Does the current assessment take certain mining expenditures into account adequately?

Accounting for the costs of enabling mining production

States incur expenditure to encourage economic development. For resource States that expenditure ranges from geological mapping, through provision of infrastructure, to directly supporting the mining industry or the population where resources are located.

The Business Council of Australia notes:

> *Productive capacity is necessary to fully exploit opportunities flowing from strong demand for natural resources in the mining states and also to put states on a sustainable path for continued growth of their economies.*
>
> *In theory, the public infrastructure necessary could be funded from the fiscal dividend from economic growth received by the state in the form of increased own-source revenues. However, vertical fiscal imbalance means that the*

> *Commonwealth will receive a substantially larger share of increased revenues flowing from this, and GST revenues are not redistributed in a manner that recognises these challenges.*[3]

Resource-rich States believe that the costs they face to enable the mining industry to function are not fully recognised in the current fiscal equalisation system. These costs include mining related infrastructure and other mining related expenditure, as well as less direct costs relating to increasing populations in remote areas.

Mining related infrastructure includes capital expenditure on infrastructure such as ports, road and rail, electricity and water. Other mining related costs include expenditure on geological mapping, environmental impact assessment and monitoring, planning, and purchasing land for development of ports, roads and rail.

Western Australia argues:

> *Successive Western Australian governments have worked hard and borne substantial fiscal and political costs (and/or risks) to develop the State's natural resource endowment (and enhance economic growth generally), including through:*
>
> - *a pro-development economic, legal and regulatory framework, encompassing industrial relations, property rights and environmental management;*
> - *facilitation of land access, development agreements and timely delivery of necessary economic and social infrastructure; and*
> - *provision of research and information dissemination services (for example, geological surveys)...*
>
> *In the 1970s and 1980s the State played a pivotal role in securing the development of the North West Shelf gas project through agreements, financial assistance and infrastructure provision. This project helped to provide the energy needed to develop other State resources and established Western Australia as a prospective location for natural gas development in the face of significant global competition.*[4]

Queensland says:

> *When an assessment has a common base in every State it can be assumed that where there are costs arising from the required development and maintenance of associated economic and social infrastructure, each State will have borne these costs. In these cases, it is not relevant whether the assessment process considers these costs as the treatment will be consistent across States*.[5]

3 Business Council of Australia Submission to the GST Distribution Review, December 2011, page 21.
4 Western Australian submission to the GST Distribution Review, October 2011, page 12 and 13.
5 Queensland submission to the GST Distribution Review, October 2011, page 8.

Queensland argues that, in the case of mining, not all States have the same scale of costs and, therefore, if any mining related infrastructure costs or other mining related expenditure are not considered, States with these costs are treated inconsistently.[6]

Mining related infrastructure

Mining related infrastructure is essential to enable the extraction and export of mineral resources. While infrastructure is primarily funded by mining companies, it can also be funded by all three levels of government. Much mining related infrastructure funded by governments is provided on a 'user pays' basis, or with the aim of fully recovering the cost of the infrastructure from the users. In the context of fiscal equalisation, the costs ultimately borne by State governments are the most important.

South Australia says:

> *Much of the infrastructure requirements associated with economic development, such as ports, electricity or water supply for mining projects, are out of scope of the CGC assessments because they are either provided by the private sector or are delivered through Government business enterprises under commercial user pay arrangements. Infrastructure spending of this type is funded from borrowings and a full rate of return on total investment will be recovered from user charges and as such doesn't impact on State Government budget in the long term*.[7]

The South Australian position is based on the ability of States to fully recover costs, but even when full cost recovery is pursued, it is likely to take many years or even decades.

Queensland says:

> *Although cost recovery is implemented for some of these projects over time, upfront costs affect Queensland's capacity to provide infrastructure in other areas.*[8]

The costs borne by State Governments may be timing related, such that infrastructure may be required ahead of any extraction (or export), or before it is possible for cost recovery to occur in a reasonable timeframe.

Western Australia argues:

> *Western Australia has limited capacity to fund the large scale public investment needed to support the future growth of the resources sector — including in ports, roads, rail, water, electricity and allied social infrastructure and services.*[9]

The Northern Territory says:

> *Western Australia argues that the Commission equalises its mining revenue but does not equalise differences in expenditure to support the energy and resource industry, such as the investing in infrastructure to support mining companies. This*

6 Queensland submission to the GST Distribution Review, October 2011, page 9.
7 South Australian submission to the GST Distribution Review, September 2011, page 13.
8 Queensland submission to the GST Distribution Review, October 2011, page 9.
9 Western Australian submission to the GST Distribution Review, October 2011, page i.

> *will become an increasingly important issue as resource development expenditure become more significant.*[10]

Tasmania notes:

> *Broader infrastructure requirements (for example, ports and electricity supply for new mining ventures), tend to operate on a commercial, user-pays basis, and as such, are not assessed under the HFE system.*[11]

South Australia says:

> *If there is a national economic interest in accelerating the removal of mining development bottlenecks in a targeted way, the Commonwealth can assist that directly.*[12]

The Panel's view on mining related infrastructure

The Panel recognises the importance of States having the capacity to provide infrastructure to enable development of mineral resources.

While the current system includes an assessment of infrastructure costs, this primarily recognises the relative growth of each State's total population. This assessment of infrastructure costs does not therefore directly account for the costs borne by States for mining related infrastructure, particularly when it is not recorded in the General Government sector.

The Panel is inclined to the view that changes to the current arrangements are required to ensure that all mining related infrastructure is appropriately recognised. The Panel therefore seeks more detailed information from the States on these costs and ways an alternative or improved assessment might be implemented.

Other mining related expenditure

Resource-rich States suggest that, in addition to mining related infrastructure, they incur other mining related expenses that are not adequately recognised in the current system.

Queensland says:

> *... there are increased costs to the State in provision of planning for these [mining] regions and the assessment and review of the environmental impact of mining projects and supporting infrastructure.*[13]

The current fiscal equalisation system includes a *Services to Industry* assessment category, which the CGC says includes State expenses on the regulation and support of businesses and industries.[14] This assessment category could potentially include an

10 Northern Territory submission to the GST Distribution Review, October 2011, page 39.
11 Tasmanian submission to the GST Distribution Review, October 2011, page 22.
12 South Australian submission to the GST Distribution Review, September 2011, page 14.
13 Queensland submission to the GST Distribution Review, October 2011, page 9.
14 Commonwealth Grants Commission, Report on GST Revenue Sharing Relativities - 2010 Review, Volume 2 – Assessments of State Fiscal Capacities, March 2010, page 397.

assessment of at least some of the issues resource-rich States claim they face. However, there are substantial practical difficulties for the CGC, including determining the underlying drivers of expenses for all industries, not just mining, and that State expenses are highly related to State policy choices.

Tasmania notes:

> *On a practical level, it is difficult to see how such an assessment could be undertaken given the different reasons put forward for undertaking economic development. For example, while Western Australia argues that its abundance of natural resources requires it to incur costs to support their exploitation, Tasmania would argue that the absence of natural resources that it can exploit requires it to undertake expenditure to develop other opportunities.*[15]

The Panel's view on non-infrastructure mining related expenditure

From the information presently available, the Panel believes that non-infrastructure mining related expenditure is not fully accounted for in the current system of fiscal equalisation. The Panel notes the practical difficulties in equalising other mining related expenditure, but seeks further input from States on ways to recognise the costs incurred in pursuing mining activity.

Is the redistribution from the assessment of mining revenue 'fair'?

As noted above, State mining revenue has increased substantially over the past decade and, based on forward estimates of mining revenue in State Budgets, total State mining revenue looks set to be strong in coming years. Demand for Australian mineral resources is expected to remain strong in coming years. The Western Australian 2011-12 Budget forward estimates indicate it expects the Western Australian relativity will fall to 0.33 by 2014-15.[16]

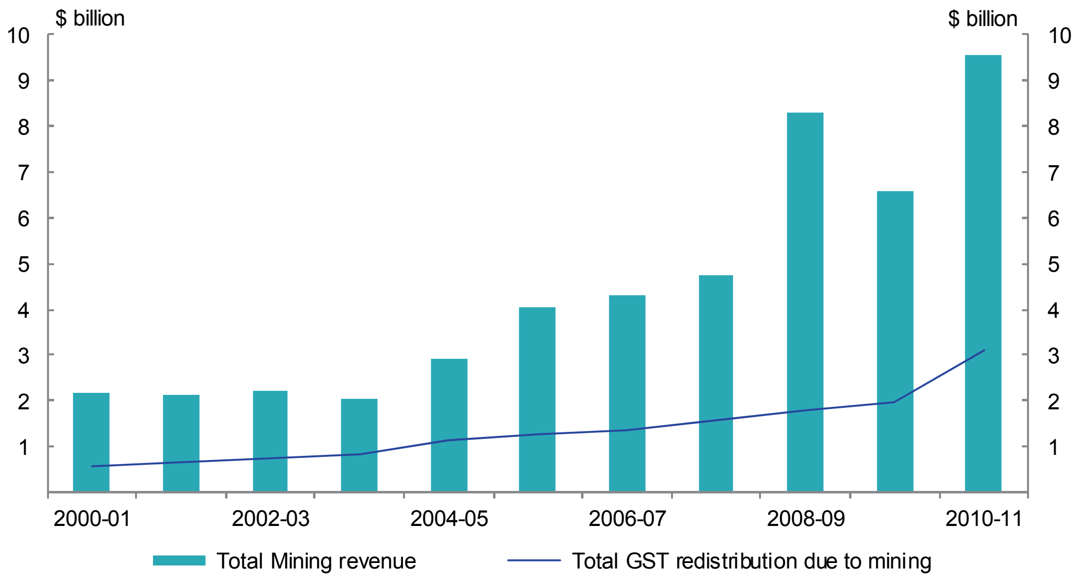
Identifying the size of the redistribution of GST due to mining revenue can be done in a range of ways, many of which are used to demonstrate a particular point of view on whether the redistribution is appropriate.

The Panel has decided to illustrate the impact of the redistribution of mining revenue on a 'budget impact' basis. This presents the actual mining revenue raised in a year and the GST redistribution due to mining revenue that applies in that year.[17]

Figure 6.3 shows that, as mining revenue increases, the size of the GST redistribution increases, albeit with a delay.

15 Tasmanian submission to the GST Distribution Review, October 2011, page 22.
16 Estimates of future GST shares (including relativities) are highly dependent on the assumptions used.
17 The GST redistribution in that year reflects the mining revenue collected in prior years.

Figure 6.3: Total mining revenue and GST redistribution due to mining, 2000-01 to 2010-11



Source: CGC Updates and Reviews, various years.

Presenting the impact on a budget impact basis includes the lag inherent in the CGC's current methods. For example, in Figure 6.3, the GST redistribution for 2010-11 is based on the actual revenue collected in the years 2006-07 to 2008-09 inclusive. On a budget impact basis, around 30 per cent of total State mining revenue collected within that particular year is redistributed.[18]

In relation to the impact of the lag during and after mining booms, the CGC states:

> *Our experience is that when a boom commences, the State experiencing the boom benefits most — because the lags in the equalisation process mean the GST redistributions still reflect pre-boom conditions. When a boom dissipates, the State that had experienced the boom suffers most — because the lags in the equalisation process mean the GST redistributions still reflect boom conditions.*[19]

Lags and their effects are discussed in more detail in Chapter 2.

Resource-rich States say too much is shifted and this is unfair

Although no State, including the resource-rich States of Western Australia and Queensland, specifically seeks to prevent the benefits of mineral resources being shared, low relativity numbers in recent years have raised questions about the fairness of the current system.

Western Australia and Queensland both note the disparity between the importance of mining revenue to State Budgets and the size of the redistribution due to the mining assessment. Mining revenue comprised 9 per cent of total State own-source revenue in 2010-11 and the mining assessment resulted in 85 per cent of the GST redistribution due to revenues.

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18 Another way to analyse the redistribution is to set aside the impact of the lag, in that case the redistribution is in the order of 50 per cent.

19 CGC, Additional questions on revenue issues, June 2011, page 12.

On this point, Queensland says:

> *This [disparity] suggests the current approach places undue emphasis on mining revenue, when other revenues, such as stamp duty on conveyances and payroll tax, are arguably more important sources of State revenue.*[20]

Western Australia argues:

> *Notwithstanding the increased revenue streams from economic growth, the rapid expansion of the mining industry in Western Australia, with accompanying population growth, has created substantial budget pressures for the State, particularly in terms of the infrastructure necessary to support this expansion.*
>
> *The State Government's budgets have sought to balance the twin objectives of sustainable finances, while expanding and improving services and infrastructure to facilitate the State's economic growth opportunities. To finance its massive capital investment program, the State has had to generate substantial operating surpluses, as well as undertake additional borrowings.*
>
> *The recent and prospective decline in Western Australia's GST share, which is by any measure extreme, has damaged public confidence in the equalisation system and put the State's development potential at risk. In the short term, the decline is being covered by debt growth, but this is not sustainable in the longer term.*[21]

Other States say the system is working

Some States consider that the disparity in the GST shares caused by the mining assessment simply reflects the concentration of mineral resources in a small number of States, and represents the right outcome.

Tasmania notes the claims made by Western Australia and Queensland about bearing an unfair equalisation burden, but dismisses the claim by noting that New South Wales and Victoria have been donor states since 1978 while Western Australia and Queensland, although currently donor states, were significant beneficiaries of the HFE system up to the mid-2000s.[22]

Tasmania notes that this aspect of the GST distribution demonstrates:

> *As revenues increase from state mining royalties, GST revenue to those states has, appropriately, decreased reflecting the fact that they have become more self-sufficient.*[23]

Several other States point out that a primary reason that GST shares change is an increase in a State's own-source revenue (although, as explained above, there is not a direct one-for-one relationship).

20 Queensland submission to the GST Distribution Review, October 2011, page 6.
21 Western Australian submission to the GST Distribution Review, October 2011, page 3.
22 Tasmanian submission to the GST Distribution Review, October, 2011, page 7.
23 Tasmanian submission to the GST Distribution Review, October, 2011, page 7.

The Northern Territory says:

> *Examining the impact of equalisation on states' GST shares in isolation can be misleading as it does not provide an indication of changes in states' total revenue.*[24]

6.3 Options to change the GST redistribution for mining

While maintaining an open mind on the fairness of the size of the redistribution as a result of mining for the present, the Panel has considered a number of possible changes to the current system, some that have been directly raised in submissions and others that occur to the Panel as being possible variants or extensions of particular suggestions.

For convenience, the alternatives are considered in the following groups:

- Changes outside of the current fiscal equalisation system.
- Changes within the current fiscal equalisation system:
  - on the revenue side
  - on the expenditure side.
- Changes that apply after the current system has operated.

Changes outside the current system

Taking mining outside the current fiscal equalisation system

Queensland suggests that assessments such as mining are outliers and could be made outside the current fiscal equalisation system:

> *Outlier assessments could be assessed externally from the general Commonwealth Grants Commission process, or excluded from the GST distribution process entirely with differences in State capacities addressed using mechanisms other than the GST.*[25]

The Northern Territory considers how mining revenue could be removed from the fiscal equalisation system, but concludes that this type of approach would not be simpler. Victoria and Tasmania reject the notion of excluding mining revenue from fiscal equalisation, with Tasmania stating that the redistribution of mining revenue is a core component of HFE. Victoria thinks the system is working as it should, saying:

> *Exclusion of specific revenue sources now is not justified, any more than excluding stamp duty during property booms.*[26]

South Australia suggests that the Commonwealth could provide direct assistance to reduce mining development bottlenecks.

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24 Northern Territory submission to the GST Distribution Review, October 2011, page 4.
25 Queensland submission to the GST Distribution Review, October 2011 page 11.
26 Victorian submission to the GST Distribution Review, October 2011, page 2.

Temporary loading approach outside the current fiscal equalisation system

Under this approach, a trigger could be used to determine part of the GST pool to be used for mining related infrastructure and other mining related expenditure.[27]

This approach could address resource-rich States' concerns about significant unmeasured needs in mining related infrastructure and economic development. However, there are practical issues with the approach including determining an appropriate trigger and ensuring that the revenue is used in the mining industry.

> ### *The Panel's view on changes to mining outside the current system*
>
> *While the Panel recognises the superficial appeal of taking mining outside the current system, such an approach would merely transfer concerns to another process.*
>
> *If direct methods of measuring the needs cannot be found, the Panel sees some potential in the temporary use of part of the GST pool to address established, but unmeasured needs for mining related infrastructure and expenditure.*

Alternative approaches within the current system on the revenue side

Making the redistribution more contemporary

While most of the suggestions for change in this area head in a different direction, South Australia says:

> *The main deficiency in current arrangements is a lack of contemporaneity. The lags in the system mean that mining revenues in their current growth phase are not being fully equalised. This needs to be addressed.*[28]

In theory, the GST redistribution could be made more contemporaneous by reducing the averaging period further from three to two years, removing averaging altogether or introducing an 'advances and completions' approach to the distribution of GST.[29] However, it is not possible to remove the lag completely because data used in the CGC's assessments are not available until after the year in which they are collected.

> ### *The Panel's view on making the mining redistribution more contemporary*
>
> *As explained in Chapter 2, the Panel does not favour increasing contemporaneity at the expense of creating further unpredictability and instability of State GST shares. Moreover, the Panel has concerns about applying this approach to mining only.*
>
> *In the present circumstances, greater contemporaneity would be likely to exacerbate the concerns of the revenue-rich States about the fairness of current arrangements.*

27 This approach lends itself to the creation of a 'notional wealth fund' similar to that mentioned by Prof. Pincus in his submission.

28 South Australian submission to the GST Distribution Review, September 2011, page 3.

29 See Chapter 2 for a full explanation of an 'advances and completions' approach.

Discounting the current mining assessment

A few possibilities for discounting the current mining assessment have been suggested in submissions, including references to the Canadian approach to equalisation of mining revenue. A discount could be applied either at the end of the mining assessment, or could apply to the revenue collected and/or the revenue base (currently, the value of production).

Western Australia suggests a range of possible ways to reduce the severity of the mining outcome[30], including discounting the extent to which mining revenues are included in the fiscal equalisation process (as occurs in Canada):

> *The mining revenue assessments (including the North West Shelf grants in lieu of royalties) should be discounted by 50 per cent, as is done in Canada. ... One of the stated reasons is that full equalisation would reduce incentives for Provinces to develop or price their natural resources in an efficient way.*[31]

Queensland says:

> *A partial approach to the assessment of mining revenue would address many of the critical problems with the current assessment. It would ensure that the infrastructure and social costs of the mining sector are recognised…Further, there would be an improvement in policy neutrality and a reduced distortion to incentives.*[32]

However, Victoria and the Australian Capital Territory consider that the Canadian approach is not appropriate in Australia.

Victoria argues:

> *Nor is it appropriate to look at examples such as Canada to justify partial exclusion of mining revenue because, as noted throughout this submission, the Australian system is unique, and all aspects of the system need to be considered.*[33]

The Australian Capital Territory says:

> *Given the underlying differences that exist between the Canadian and Australian equalisation systems, the Canadian model should not be used as a basis for rationalising the removal of mining royalties from HFE.*[34]

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30 Suggestions such as adopting a floor of 75 per cent of a State's population share of the GST pool, limiting the extent to which a State's GST share can fall in any one year, allowing States to agree among themselves on a GST distribution outcome and simplified methods based on broader indicators of underlying differences in States' relative need are dealt with in Chapters 2 and 3.

31 Western Australian submission to the GST Distribution Review, October 2011, pages 51 to 53.

32 Queensland submission to the GST Distribution Review, October 2011, page 12.

33 Victorian submission to the GST Distribution Review, October 2011, page 2.

34 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 17.

The Australian Capital Territory also says:

> *However, when making any changes to the form of HFE, it is important to consider that the mining boom may be temporary. As such, the form of HFE needs to be fit for purpose in its ability to respond to changing economic circumstances of the States over time, including during years of a mining boom and also when there is a downturn in the demand for mining.*[35]

The Australian Capital Territory goes on to make the point that, if mining revenues were discounted, the resource-rich States would have a much stronger fiscal position than States with less natural resources.

A variation of the approach of discounting the current mining assessment is to discount only the growth in mining revenue. Queensland suggests, in the context of a partial assessment of mining revenue, that a proportion of the growth in mining revenue could be excluded from equalisation in each year.[36] If such an approach was adopted it would address the issues raised by the resource-rich States, but at a much slower rate when mining revenue is increasing.

The Panel's view on discounting or assessing only a proportion of the growth in mining revenue

The Panel considers that discounting the mining revenue assessment, or excluding some of the mining revenue and/or mining revenue base, could potentially address some of the concerns about unmeasured needs in relation to mining related infrastructure and other mining related expenditure. This approach could also be seen as addressing efficiency concerns, and has the potential to reduce the current policy neutrality issue. This approach could be scaled if the discount is not fixed, but can be adjusted to reflect changing circumstances. The Panel seeks views on how a discount rate could be determined and how and under what circumstances it should be applied.

Temporary loading approach within the current mining assessment

Another approach within the current fiscal equalisation system would be to use a 'trigger' price (or other factor) to determine whether to exclude some mining revenue from the CGC's assessment, with a view to allowing and encouraging mining States to spend it directly on development of the mining industry.

The Panel's view on temporarily loading the mining assessment

The Panel sees some merit in the temporary nature of such an arrangement, but recognises that there are practical issues with the approach, including determining an appropriate trigger and ensuring the mining revenue is used to develop the mining industry. Further, with this type of approach the rationale for having the mechanism could become lost over time, or be challenged or overturned in the course of a CGC review of methodology.

35 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 8.
36 Queensland submission to the GST Distribution Review, October 2011, page 12.

Alternative approaches within the current system on the expenditure side

Recognising unmeasured mining related infrastructure and other expense needs

Under this approach the CGC would simply be instructed to recognise the costs associated with mining related infrastructure and other expenditure explicitly.

> ### *The Panel's view on the CGC recognising costs associated with mining*
>
> *While this approach would be consistent with the current HFE system, the Panel recognises the practical limitations the CGC faces in attempting to measure and equalise for these needs. For this approach to be viable, more detailed information from the States on what these costs are and how an alternative assessment might be implemented is required.*
>
> *In particular, the Panel seeks further advice from States on:*
>
> - *the disability that is being recognised*
> - *the costs faced by States because of the disability, and*
> - *whether a policy neutral assessment method could be devised.*

Alternative approaches that apply after the current system

Alternative approaches that make adjustments at the end of the current fiscal equalisation system include introducing a floor on relativities or limiting annual falls in relativities have been considered in Chapter 2.

6.4 Summary of the Panel's views on mining

Mining revenue is an important element of States' revenue, particularly as the mining industry is experiencing boom conditions and its role in the HFE calculations is important. As captured in the formal views above, irrespective of any other changes, the Panel considers that the current two-rate structure needs to be reviewed by the CGC and other stakeholders.

Beyond that, it will be important that any modifications to the current assessment have a consistent approach for mining-related infrastructure and Commonwealth infrastructure payments and are made with a view to the long term, rather than merely being a response to immediate pressures.

The Panel's overview on HFE and the mining boom

The Panel is not inclined to recommend excluding mining revenue from equalisation because, as explained in Chapters 2 and 5, in principle, all sources of recurrent general purpose revenue should be considered when gauging the impact on State Budgets of GST payments.

While it seems clear that all States accept that the benefits of mining should be shared, the extent to which this currently occurs, and how it is done, needs to be reconsidered. Specifically, the Panel is inclined to the view that not all mining related infrastructure, mining expenses and economic development costs are appropriately recognised in current arrangements. As the degree and effect of this omission is open to debate, the Panel has identified more detailed information that could be provided by States on these costs and ways an alternative assessment might be implemented.

Should it not prove possible to adequately recognise the costs faced by resource-rich States within the current system, the Panel would be inclined to further investigate other possible approaches in this Chapter that might indirectly achieve that aim.

The Panel also notes that some approaches considered in other Chapters relating to other objectives may also address issues relating to the mining assessment.

7 HFE and the costs of services to the Indigenous population

The redistribution of GST revenue that occurs as a result of differences between the proportion of Indigenous people in States' populations is referred to (in CGC parlance) as the effect of *Indigeneity*.

The CGC does not directly or separately measure the overall difference between spending on Indigenous and non-Indigenous people to determine its estimate of the redistribution due to *Indigeneity*. Instead, the estimate is derived by assigning Indigenous people non-Indigenous cost weights and / or spending levels in each expenditure category, with all else unchanged, then comparing the resulting GST redistribution with the GST redistribution from the actual assessments. Estimates for other disability factors are obtained in a similar fashion, by applying average spending for (or removing) that disability, holding everything else constant, and comparing the resultant redistributions with the actual assessment redistributions.

It often appears that stakeholders have more interest in the CGC's tables showing the redistribution by disability (Table 7 in the 2012 Update report) than in the tables showing the redistributions by expenditure category. *Indigeneity* comes under notice in the HFE calculation because of the significant amount attributed to that disability in those tables.

7.1 Why does *Indigeneity* redistribute GST revenue?

On average, States spend more on providing services per Indigenous person than per non-Indigenous person, especially in areas such as health, justice and welfare and housing, which are increasing as a proportion of State budgets. It follows that (all else being equal) States with a higher proportion of Indigenous people than average will be assessed as having higher service costs overall and will be given a higher than average proportion of GST revenue.

The Northern Territory is the main recipient of GST due to *Indigeneity* because the Northern Territory's proportion of Indigenous population, at around 30 per cent, is substantially greater than the average, at around 2.5 per cent.

Figure 7.1 below shows the proportion of each State's population represented by Indigenous people.

Figure 7.1: Indigenous population proportions, 2006

Source: ABS Experimental Estimates and Projections, Aboriginal and Torres Strait Islander Australians, 1991 to 2021, Cat. No. 3238.0; ABS *Population Projections, Australia 2006 to 2101*, Cat. No. 322.0.

7.2 How much GST revenue does *Indigeneity* redistribute?

Indigeneity has the biggest influence on GST distribution on the expense side, and the second largest overall, after revenue from mining royalties. Table 7.1 below shows the amounts of GST revenue redistributed due to *Indigeneity* in the 2012 Update.

Table 7.1: Amount redistributed due to *Indigeneity* in 2012-13

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Indigeneity	-434.0	-1637.4	655.4	529.7	-215.0	40.1	-73.2	1134.3	2359.6

Source: CGC, 2012 Update, Table 7.

As shown in Table 7.1, the Northern Territory can expect to receive around $1.1 billion more GST revenue in 2012-13 than if it had the average proportion of Indigenous people in its population.

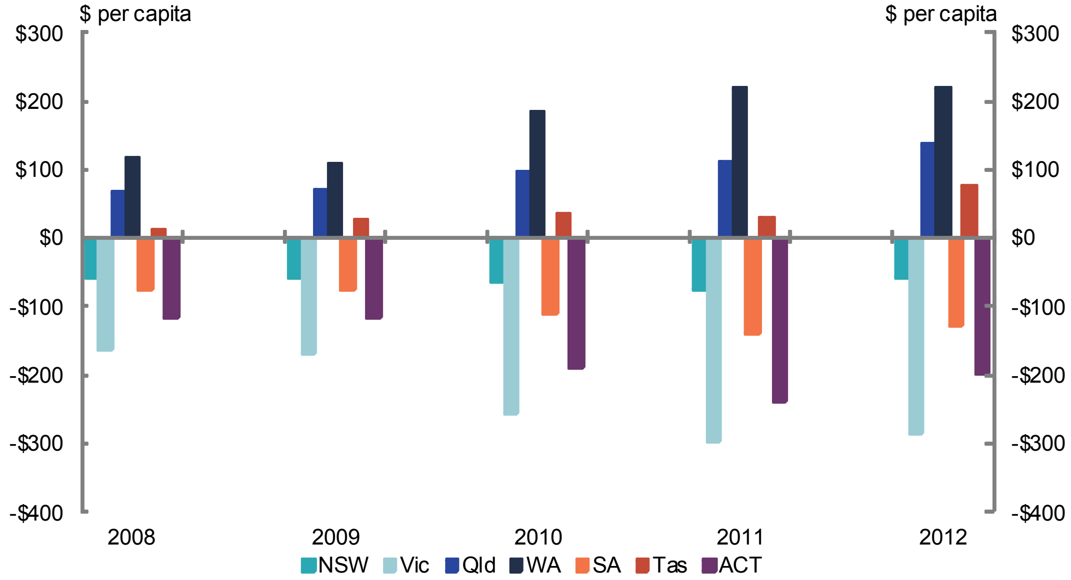
The amount redistributed due to *Indigeneity* has generally increased over time, because:

- State spending per Indigenous person is increasing faster than State spending per non-Indigenous person, as governments seek to address entrenched disadvantage;
- the GST pool is growing (averaging 6.6 per cent per annum between 2000-01 and 2010-11).[1]

Figures 7.2 and 7.3 respectively show the GST redistributions per capita to all States (except the Northern Territory) and to the Northern Territory itself, from 2008 to 2012.

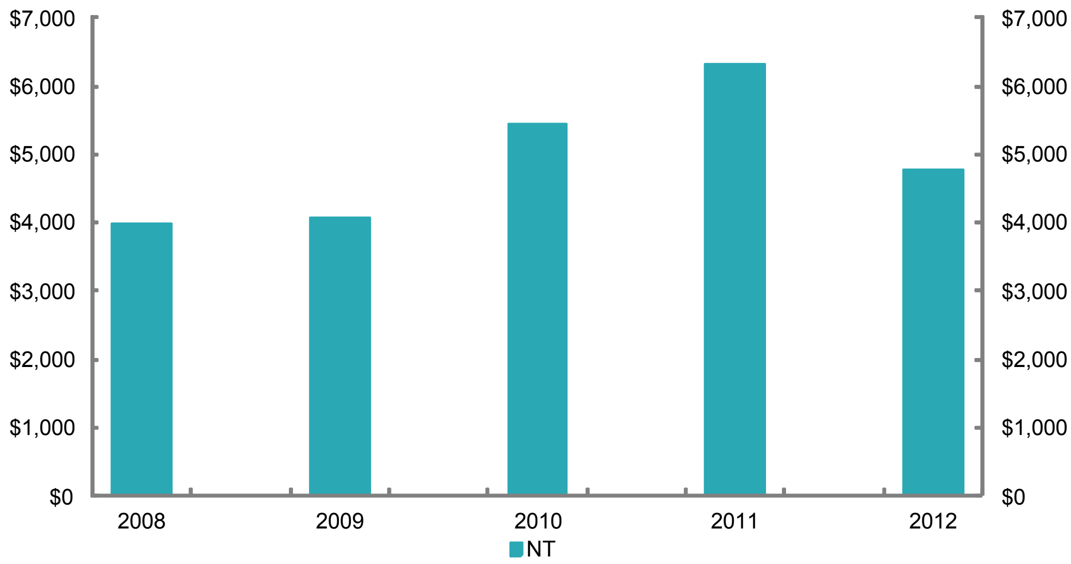
1 As discussed in Chapter 2, page 26, historical needs are indexed by the growth in the GST pool between the assessment and application years. The result of this is that the redistribution due to Indigeneity in an application year represents the combination of base needs from the assessment years, inflated by the growth in the GST pool between the assessment years and the application year.

Figure 7.2: GST redistributed due to *Indigeneity* ($pc), all except NT



Note: Figures from 2010 and onward are not directly comparable with earlier years due to method and presentational changes.
Source: CGC, Update and Review reports, various.

Figure 7.3: GST redistributed towards the Northern Territory due to *Indigeneity* ($pc)



Note: Figures from 2010 and onward are not directly comparable with earlier years due to method and presentational changes.
Source: CGC, Update and Review reports, various.

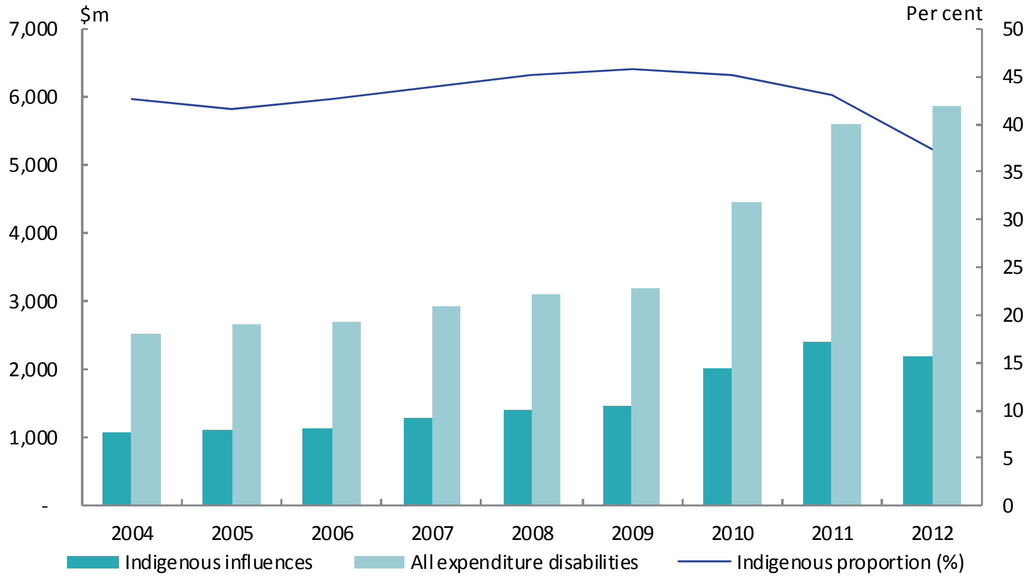
Until the current year, the redistribution attributed to *Indigeneity* had been increasing, in line with the increase in the redistribution from all expenditure disabilities in recent years. From 2004[2] to 2011, the redistribution broadly represented around 43 per cent of the total redistribution due to expenditure disabilities. The *Indigeneity* share peaked at around 45 per cent from 2008 to 2010, before returning to the average share in 2011.

2 2004 corresponds to the introduction of the methods developed in the 2004 Review.

The redistribution actually reduced in 2012, falling to 37 per cent of the total redistribution from expenditure disabilities.

Figure 7.4 shows the redistributions over the period 2004 to 2012.[3]

Figure 7.4: Redistribution of GST revenue due to Indigenous influences and all expenditure disabilities



Source: CGC, Update and Review reports; Secretariat calculations.

Although increases in average spending and growth in the GST pool increase the size of the redistribution of GST due to Indigeneity, the main driver of the redistribution is the diverse distribution of Indigenous people across States. If each State had the same proportion of Indigenous people, an increase in spending on Indigenous people would have little or no effect on the GST redistribution.

7.3 What is the 'problem'?

Over time, several perceptions have developed around the redistribution of GST attributed to *Indigeneity* that cast doubt over the 'fairness' of the HFE system. These perceptions are that:

- the cost differential for Indigenous populations (the Indigenous 'disability') should reduce over time, or at least should not increase
- the Northern Territory can influence the amount it receives
- redistributed GST revenue is not spent on Indigenous services.

The validity of these perceptions is examined in the paragraphs below.

3 As a result of presentational changes from the 2010 Review, the redistributions in 2010 and subsequent years have been rescaled for comparison with earlier years.

'The Indigenous 'disability' should reduce over time'

Some commentators have suggested that the level of Indigenous 'disability'[4] should reduce over time, or at least not increase. The same expectations do not appear to be applied to other disabilities, such as the costs associated with an above average proportion of older people in a population.

No State submission specifically argues that the redistribution as a result of *Indigeneity* should decrease over time, although Victoria makes a similar, more general point:

> *In a robust methodology, cost disabilities should be used to make allowances for unavoidable factors that impact on state service delivery. Ideally they should be based on issues that are completely beyond a state's control, such as natural disadvantages or changes in age profiles. In other words, disabilities should be policy neutral. This is not the case where the underlying issues can be mitigated through successful policy or programs. The methodology should not create incentives for poor policy performance or act as a deterrent to good policy performance.*
>
> *Disabilities that can be reduced through policy interventions should be handled through direct Commonwealth assistance — not through the HFE system. This approach would be an improvement on efficiency, equity, transparency and accountability grounds.*[5]

As the current system of fiscal equalisation is based on average spending across all States, the CGC will give each State the average capacity to address disadvantages and make no assessment of what needs to be spent to tackle any particular disadvantage.

In an address to the Charles Darwin Symposium in 2003, the then Chairman of the CGC said:

> *Giving [the Northern Territory] the same fiscal capacity as other States to deliver services to its citizens means maintaining any pre-existing differentials. If this capacity has to be applied to communities facing very different circumstances, particularly with respect to access to services — and this is what we see in the Territory — outcomes will not narrow over time. The Territory's financial support (including GST revenue) does not provide it with catch up capacity.*[6]

The averaging approach of the current system therefore does not provide sufficient funds to 'fix' any particular disadvantage. To achieve above average spending, any additional funding must be external to the equalisation process. This has occurred in recent years, with the Northern Territory Emergency Response (NTER) and subsequent (Northern Territory) Closing the Gap programs that address Indigenous disadvantage in the Northern Territory.

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4 The CGC defines a 'disability' as an influence beyond a State's control that requires it to spend more (or less) per capita than the average to provide the average level of service.

5 Victorian submission to the GST Distribution Review, October 2011, page 4.

6 Alan Morris, *Powerhouse or Mendicant? Is the Territory an Engine of Growth or a 'drag' on the Federation*, paper presented to the Charles Darwin Symposium, Charles Darwin University, 2003.

In summary, under the current system, as long as the Northern Territory (or any other State) has a disproportionately large share of its population being Indigenous, there will be a substantial effect on the GST distribution from *Indigeneity*. If States spend more per capita on services to Indigenous residents than others, the redistribution will be primarily toward the Northern Territory. Should the gap between what States spend on average on Indigenous people compared to others decline, the GST distribution effect would also decline. Finally, in the unlikely event that per capita spending per Indigenous person becomes less than for others, the HFE system would redistribute GST revenue *away* from the Northern Territory.

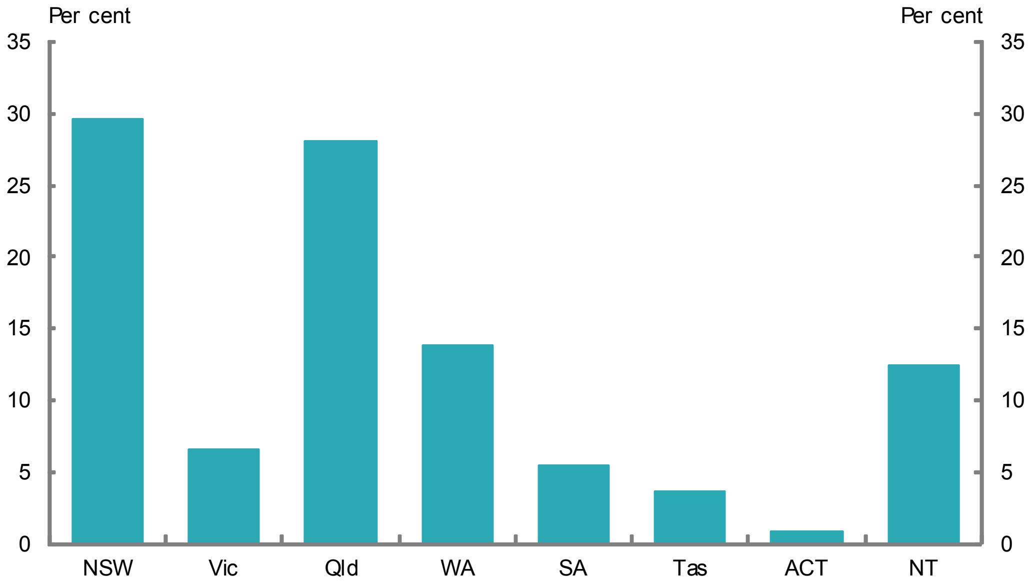
'The Northern Territory can influence in the amount it receives'

Some commentators have said that 'excessive' spending by the Northern Territory on services to Indigenous people acts to maintain the size of the Indigenous disability and ensures that the Northern Territory continues to receive a large GST distribution.

In fact, because the CGC's assessments are based on a calculation of average spending by States on Indigenous people and States contribute to the average level of spending in proportion to their share of total Indigenous residents, the States with the most Indigenous people have the greatest effect on the average. For this reason the States with the most capacity to influence the CGC's *Indigeneity* assessment are New South Wales, Queensland and, to a lesser extent, Western Australia, as they have the highest absolute number of Indigenous people.

Figure 7.5 below shows the distribution of the Indigenous population across the States.

Figure 7.5: Proportion of total Indigenous population, 2006



Source: ABS Experimental Estimates and Projections, Aboriginal and Torres Strait Islander Australians, 1991 to 2021, Cat. No. 3238.0; ABS *Population Projections, Australia 2006 to 2101*, Cat. No. 3222.0.

While it may be true that the Northern Territory has a bigger influence with regards to remoteness — and there is some overlap between *Indigeneity* and remoteness influences — this was not raised in any of the submissions received by the Review.

'The funding isn't spent on Indigenous services and it should be'

The Northern Territory says:

> *It is sometimes alleged that the Territory receives additional GST revenue as a result of its large Indigenous population but spends these funds in Darwin or on services and infrastructure not directly related to Indigenous people.*[7]

The Northern Territory refutes this claim, based upon the findings from the *2010 Indigenous Expenditure Report* (IER) released by the Indigenous Expenditure Report Steering Committee in February 2011. For example, the Northern Territory says:

> *The main findings from the 2010 IER for the Territory were ... On a per capita basis, Indigenous related expenditure in the Territory was $32 230 per Indigenous person, the highest of all jurisdictions and 17 per cent higher than Western Australia, the second highest jurisdiction.*[8]

Other States have not directly made claims regarding the expenditure of the Northern Territory on Indigenous people, however, a few States suggest that Indigenous influences should be treated as a 'special case' and removed from the HFE system.

Queensland says:

> *... the redistribution of the GST for Indigenous expenditure may not be the most appropriate mechanism through which to address Indigenous issues. . Arguably, the current GST distribution process... may not be the best means of improving outcomes for Indigenous Australians. Indigenous expenditure is an issue of individual and community equity, which may be dealt with more appropriately through payments for specific purposes rather than untied funding.*[9]

Victoria says that the system of untied grants works best when governments vary the level of service delivery only marginally from the Australian average:

> *From a layman's perspective... it is arguable whether the resources that are redistributed toward the recipient states are being 'efficiently' used to address the cost disability in respect of which the money is being redistributed.*[10]

The 2010 IER found that, in 2008-09, 53.9 per cent of Northern Territory general government expenditure was Indigenous related, so that spending per capita on Indigenous people was 2.7 times that spent per capita on non-Indigenous people. This spending ratio places the Northern Territory slightly above Queensland (with spending per capita on Indigenous people 2.5 times that on non-Indigenous people) and below Western Australia, which had the highest ratio, with spending per capita on Indigenous people 3.4 times that on non-Indigenous people.

Table 7.2 below shows the spending per capita ratio on Indigenous to non-Indigenous people for each State and for the Commonwealth government.

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7 Northern Territory submission to the GST Distribution Review, October 2011, page 65.
8 Northern Territory submission to the GST Distribution Review, October 2011, page 66.
9 Queensland submission to the GST Distribution Review, October 2011, page 10.
10 Victorian submission to the GST Distribution Review, October 2011, page 13.

Table 7.2: Indigenous to non-Indigenous expenditure per head of population ratio and Indigenous expenditure share, 2008-09

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	C/W
Indig /non-Indig spending ratio	2.4	2.9	2.5	3.4	3.3	1.4	2.5	2.7	1.7
Indig. Exp. Share (%)	5.2	1.9	8.5	10.7	5.7	5.4	3.2	53.9	4.1

Source: Indigenous Expenditure Report Steering Committee, 2010 Indigenous Expenditure Report, tables 3 and 4.

Of course, 53.9 per cent of the Northern Territory's expenditure and a per capita spending ratio of 2.7 may not necessarily be 'enough' to address Indigenous disadvantage. However, the IER data[11] suggest that the Northern Territory's spending on Indigenous people relative to non-Indigenous people is comparable to other States, indicating the Northern Territory is meeting 'average' spending requirements.

Other factors to consider

HFE is not the right vehicle to address entrenched disadvantage

GST revenue distributed to the States is untied, so States can spend it as they choose. This principle comes under pressure in relation to *Indigeneity* as there seems to be an 'expectation' in some quarters that the Northern Territory will spend their above-average funding on Indigenous services to address disadvantage.

Leaving aside the fact that the Northern Territory asserts that it *does* indeed spend its funding on Indigenous services, as the current system of fiscal equalisation is based on average spending across all States, it is not the appropriate vehicle to promote above average spending in a particular State or States. As explained above, while funding outside the GST distribution would ensure above average spending in any particular year, the equalisation process will redistribute the additional funding over time.

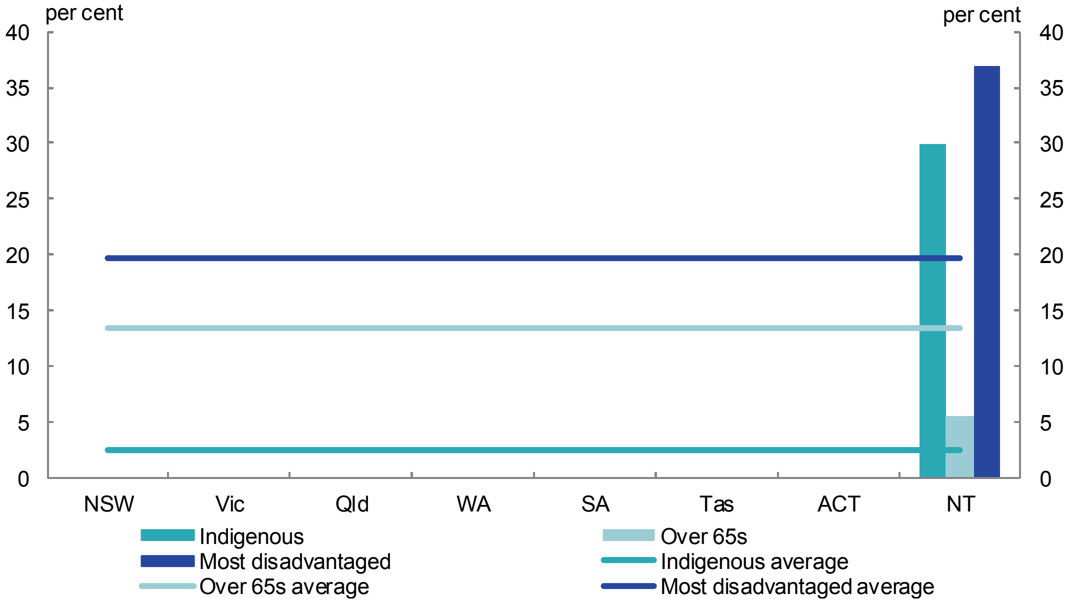
Why should Indigeneity be treated differently to other needs?

Older people (aged over 65 years) and people living in low socio-economic areas are also higher cost user groups for State services. The main reason that these groups do not lead to a larger redistribution of GST is that the distribution of these groups across States is not as diverse as for Indigenous people.

Figure 7.6 below shows the distribution across States of higher cost population groups.

11 The IER was the first of its kind and the task it faced was complex. Not surprisingly, there are some concerns with the reliability of the estimates. Caution should therefore be exercised before drawing more detailed conclusions from the report's figures. Nonetheless, these are regarded as the best available, recent, figures on Indigenous Expenditure by State.

Figure 7.6: State shares of higher cost population groups



Note: Indigenous data are CGC estimates based upon 2006 ABS Census data.
Source: CGC, 2012 Update, Supporting information.

7.4 Possible ways to change the treatment of *Indigeneity*

Notwithstanding that some of the perceptions of the need for change cited above may not be entirely well-founded, the Panel has considered several suggestions for how the treatment of *Indigeneity* might be improved. The changes considered are:

- Changing the mix of tied and untied funding for individual States, so that Indigenous needs are dealt with through SPPs/NPPs rather than the GST distribution.
- Removing the Northern Territory (or the Northern Territory and the Australian Capital Territory) from the equalisation pool completely, and treating them separately.
- Recognising extra costs in Western Australia, as discussed in its submission.

Dealing with Indigenous needs through SPPs/NPPs

Removing that part of the GST redistribution relating to *Indigeneity* from the equalisation process and funding it through other payments would change the mix of tied and untied funding, but not the total Commonwealth funds to each State.

While this approach would not change the total funding of any State, it is advocated by some as a way to ensure that the funding allocated to services for Indigenous Australians is spent in that way, by moving it into the accountability-focussed pool of SPP/NPP funding. The new Indigeneity SPP/NPP payments would not affect the relativities for GST redistribution purposes, if excluded from the CGC's assessment.

Table 7.3 below shows the change in the mix of tied and untied funding for each State of this approach for 2012-13.

Table 7.3: Removing *Indigeneity* and replacing with SPPs/NPPs, 2012-13

($m)	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Change in GST	434	1,637	-655	-530	215	-40	73	-1,134
Change in other Cwth payments (SPP/NPP)	-434	-1,637	0	0	-215	0	-73	0
New *Indigeneity* SPP/NPP	0	0	655	530	0	40	0	1,134
Total change	0	0	0	0	0	0	0	0
Current relativity	0.95	0.92	0.99	0.55	1.28	1.58	1.18	5.53
New relativity	0.98	1.05	0.92	0.45	1.34	1.55	1.27	3.37

Note: The change in GST is a one year impact

This approach would not strip out all *Indigeneity* costs from the HFE system — only those related to the difference between average costs and having above (or below) average costs to provide services to Indigenous people. Removing all costs of providing services to Indigenous people (including average costs) would be complex and would result in much larger dollar changes in GST/SPP funding.[12]

Advantages of this approach might be increased certainty around the funding levels for Indigenous service delivery, without any change to the total level of funding received by all States.

On the other hand, the approach could be criticised for 'just shifting money around'. As Tasmania and the Northern Territory have highlighted, there may be risks of creating inefficient dual service delivery models. In addition, there is a practical problem that the amounts involved are large in relation to some States' SPP funding. For example, the reduction in Victoria's SPP funding required by this approach of around $1.7 billion represents around half its national payment for schools.

State views on removing Indigeneity from HFE

While there is some support from States for removing *Indigeneity* from the HFE system, the support is usually conditional on extra funding being made available.

New South Wales says:

> *Indigenous disadvantage should be addressed outside HFE as its inclusion introduces significant measurement difficulties for the assessments. This may require additional Commonwealth funding in order to at least maintain current service levels.*[13]

While the Victorian submission does not mention *Indigeneity* specifically, some points are made that relate to *Indigeneity* by implication:

> *Disabilities that can be reduced through policy interventions should be handled through direct Commonwealth assistance — not through the HFE system. This*

12 The CGC has included in its 2012 Update report (page 71) that total assessed spending by States on Indigenous people in 2010-11 was around $15.4 billion.

13 New South Wales submission to the GST Distribution Review, November 2011, page 46.

> *approach would be an improvement on efficiency, equity, transparency and accountability grounds.*[14]

The Australian Capital Territory says:

> *The ACT suggests reviewing the Indigeneity assessment as it is a significant source of disparity in the relativities but is currently based on unreliable data.*
>
> *In the absence of reliable data, HFE is an inappropriate and ineffective tool for addressing Indigenous disadvantage ...*
>
> *... any Specific Purpose Payments and National Partnership Payments for Indigenous purposes should also be excluded and incorporated as part of a separate funding mechanism.*[15]

Queensland says:

> *The redistribution of the GST for Indigenous expenditure may not be the most appropriate mechanism through which to address Indigenous issues.*[16]

Queensland suggests separate treatment for assessments that do not have a common base across all States, terming these 'outlier assessments':

> *[S]uch assessments can be responsible for a disproportionate amount of the GST redistribution between States, resulting in distortion of equalisation outcomes. Examples of such assessments include the assessment of mining revenue and the treatment of Indigeneity.*
>
> *Outlier assessments could be assessed externally from the general Commonwealth Grants Commission process, or excluded from the GST distribution process entirely with differences in State capacities addressed using mechanisms other than the GST.*[17]

The Northern Territory is opposed to any approach that would remove *Indigeneity* from assessments:

> *Removing Indigenous influences from equalisation and funding Indigenous services separately would create significant complexity in intergovernmental relations and is unlikely to lead to any of the intended results such as improving outcomes for Indigenous Australians.*
>
> *Removing Indigenous influences would result in differences in the way services are funded for Indigenous and non-Indigenous people, potentially creating segregated service arrangements such as separate Indigenous and non-Indigenous schools, hospitals, community health clinics and police services.*[18]

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14 Victorian submission to the GST Distribution Review, October 2011, page 4.
15 Australian Capital Territory submission to the Review of GST Distribution, October 2011, pages 18-19.
16 Queensland submission to the Review of GST Distribution, October 2011, page 10.
17 Queensland submission to the Review of GST Distribution, October 2011, pages 10-11.
18 Northern Territory submission to the Review of the GST Distribution, October 2011, page 64.

Tasmania raises similar concerns to the Northern Territory:

> *In relation to the suggestion that indigenous influences be removed from the HFE system and addressed separately, it is not clear to Tasmania how this would actually result in greater simplification. This is because indigenous influences would still need to be assessed to determine the amount to be netted off the GST pool for each state (and subsequently addressed outside the HFE system). This approach may also result in dual service delivery models and/or overlap in responsibility of policy and service delivery between the Commonwealth and the states.*[19]

Removing the Northern Territory (and the Australian Capital Territory) from equalisation calculations

Another approach, also based on the notion that HFE works best when States are relatively homogenous, could be to remove the Northern Territory (and, possibly, the Australian Capital Territory) from the HFE system in some way and treat the two territories separately. Allocating the Territories fixed relativities or fixed proportions of the pool would improve predictability for them and could simplify the process. It would recognise the Northern Territory's outlier status and treat it differently. The remainder of the pool would then be distributed amongst the remaining States, applying the usual equalisation calculations. The other States could be better or worse off, depending upon how the Territories are funded and how circumstances change in the future.

In this way there may be some simplification gains in the CGC's calculations as, with the Northern Territory excluded, fewer data adjustments would meet the CGC's materiality thresholds. While under this approach *Indigeneity* would continue to be assessed across the States (excluding the Territories), it would have substantially less redistributive effect on GST revenue than currently.

A key question for such an approach would be at what level to fix the Northern Territory and Australian Capital Territory's relativity or GST payment. For example, the relativity could be fixed at its present level, or at an average of past relativities, or a projection of future relativities. Each approach would have differing impacts on other States. Without a clear conceptual basis for any one method, securing agreement could be challenging.

Depending upon how frequently the Australian Capital Territory and Northern Territory's allocations of the pool were reviewed, this approach would not recognise changes in their fiscal circumstances in the same way as for the other States. For example, if the Australian Capital Territory and Northern Territory's proportion of the pool was fixed, and subsequently the relative capacities of other States fell, the situation could arise that the Australian Capital Territory and Northern Territory have a higher fiscal capacity than all other States (including donors). Any process designed to regularly review the Northern Territory and Australian Capital Territory's payments (to minimise the risk of this happening) would risk re-introducing complexity.

19 Tasmanian submission to the Review of GST Distribution, October 2011, page 31.

State views on removing the Northern Territory (and the Australian Capital Territory) from equalisation calculations

Queensland supports consideration of this approach, however its suggestion includes additional funding from the Commonwealth to the Territories (around $1.6 billion to $2.4 billion). Queensland says:

> *One possible approach could be to remove the ACT and the Northern Territory from the assessment process, on the basis that the Territories face unique situations and issues that may distort the current process, and which could potentially be addressed more effectively through other means...*
>
> *... Excluding the Territories' redistribution from the process could allow the Australian Government to directly address the issues facing the Territories and tailor funding arrangements to their needs...*
>
> *... Greater simplicity would be achieved through the removal of factors that are only material for the Territories and which may be distorting the current process.*[20]

The Northern Territory opposes this approach, saying that it would have significant implications for the Territory's objectives of Statehood and 'impede' the Territory's sovereignty. In addition, the Northern Territory opposes this option on equity and complexity grounds. It says:

> *Under the current equalisation framework, the [Northern] Territory is treated the same as every jurisdiction. This is an essential concept recognising the need to treat residents of Australia on an equal footing. The proposal to remove the Territory from the equalisation process and fund on a separate basis would impede the Territory's sovereignty and would draw distinctions between Territorians and all other Australians based purely on jurisdictional borders.*
>
> *Removing the Territory would also not reduce complexity as there would need to be a system operating in parallel with equalisation for all other jurisdictions to assess the Territory's financial basis, presumably on a basis comparable with the states.*[21]

Tasmania raises some questions about how the approach would work in practice:

> *It has also been suggested that both territories could be taken outside of the CGC assessment process, with the Commonwealth assuming direct funding responsibility. Presumably, one option of achieving this would be to dedicate a proportion of the GST pool to the territories, which would raise question/judgement as to how much, indexation and how often it would be reviewed.*[22]

20 Queensland submission to the GST Distribution Review, October 2011, pages 12-13.
21 Northern Territory submission to the Review of GST Distribution, October 2011, pages 51-52.
22 Tasmanian submission to the Review of GST Distribution, October 2011, page 31.

Recognising extra costs in Western Australia

In its submission, Western Australia says that its *Indigeneity* costs are not fully recognised due to population undercounts and insufficient recognition of higher costs.

Western Australia considers that ABS population estimates undercount its Indigenous population and also argues that the CGC wrongly assumes that Indigenous persons are equally disadvantaged across the nation in comparable areas, whereas Western Australian Indigenous people in fact suffer higher disadvantage. Western Australia estimates the adverse annual impact on its GST share of a range of issues it has with current CGC methods. Western Australia estimates that the Indigenous population undercount costs it $50 million per annum and that differences in Indigenous disadvantage cost it $300 million per annum.[23]

Western Australia says:

> *The CGC assumes that indigenous persons are equally disadvantaged across the nation in comparable areas (apart from an indirect socio-economic status measure for hospitals that may produce perverse results). However, Western Australian indigenous people are considered to suffer higher disadvantage (reflecting in part the higher incidence of recent separation and dislocation), as shown by their hospital use, their higher funding in the State education budget and their higher imprisonment rates. The estimate [$300 million] assumes a 20 per cent increase in the indigenous cost weight for Western Australia.*[24]

In relation to the population dispersion assessments, Western Australia says that its costs relating to providing services in remote areas are higher than in most States. It says:

> *... [in] the dispersion assessments ... data is poor and costs in remote areas vary widely depending on economic circumstances ...*
>
> *... Western Australia has a virtually unique set of circumstances that lead to very high costs in its remote areas (e.g. the buoyant mining sector competes with the public sector for staff and drives high wages and other costs in remote areas) — it is therefore difficult for the CGC to determine an 'average policy' assessment of Western Australia's remote area costs.*[25]

23 Western Australian submission to the GST Distribution Review, October 2011, pages 65-66.
24 Western Australian submission to the GST Distribution Review, October 2011, page 66.
25 Western Australian submission to the GST Distribution Review, October 2011, page 18.

The Panel's view on Indigeneity and HFE

While the Panel recognises Western Australia's interest in a more comprehensive assessment of Indigenous costs and cost weights, to do this would increase complexity, could lead to further claims of false precision and, if additional costs were found, would actually increase the amount redistributed because of Indigeneity. The CGC would be the appropriate body to determine the merits of these arguments.

The Panel also encourages the CGC to explore whether assessments could be developed to more directly measure needs due to disabilities than the category of spending approach currently adopted.

The Panel believes that Indigeneity (and, indeed, the Territories) should continue to remain in the HFE system, noting that the Terms of Reference state that GST revenue will continue to be distributed to the States as untied payments.

The Panel considers that where additional measures to address disadvantage are required, these measures would best be undertaken outside the HFE system through other mechanisms.

8 Governance and communication

This Chapter deals with aspects of the governance of the GST distribution system and the communication of its processes and outcomes. Most submissions only touch on these issues briefly. However, it is clear that effective governance and transparent communication are essential to public confidence in the HFE system. As such, the Panel is keen to promote further discussion on the room for improvement in current governance and communication arrangements.

8.1 Governance

The current governance structure is set up under a combination of legislation, agreements, executive power and custom. Under the *Federal Financial Relations Act 2009* (FFR Act), the Commonwealth must allocate GST revenue according to State population, adjusted by a relativity determined by the Treasurer, in consultation with States and in accordance with the 2008 Intergovernmental Agreement on Federal Financial Relations (IGA) and any other agreements with States.

The key requirements of the IGA are that:

- The Commonwealth must distribute GST according to the principle of horizontal fiscal equalisation (HFE).

- The Treasurer must determine relativities based on the recommendations of the Commonwealth Grants Commission (CGC).

The IGA also:

- sets out criteria for determining the treatment of Commonwealth payments subject to the judgement of the CGC and the Treasurer, and

- specifies that the recommendations of the CGC must be subject to discussion by Standing Council on Federal Financial Relations prior to the Treasurer's determination of the relativities.

The Treasurer issues terms of reference to the CGC annually, requiring it to inquire into and report on relativities for the distribution of GST revenue, pursuant to the IGA.

The CGC itself is established under the *Commonwealth Grants Commission Act 1973* (CGC Act), which empowers the CGC to advise the Commonwealth Treasurer on financial assistance to allow States to function, by reasonable effort, at a standard 'not appreciably below' that of other States.

Defining HFE

A notable feature of the current governance framework is that HFE is not strictly defined in the IGA or in legislation. Instead, is HFE has been defined and refined by the CGC through its periodic methodology reviews.

In 2002, following the introduction of the first IGA in 2000, the then Chairman of CGC argued that:

> *Since the Agreement doesn't define HFE, and it is not defined in any legislation, the Commission has assumed that Heads of Government, when they signed the Agreement, understood the principle of HFE to be that articulated by the Commission in its 1999 Review Report.*[1]

The current definition of HFE, developed from the 1999 definition through the 2004 and 2010 Methodology Reviews, specifies that:

> *State Governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.*[2]

While, at face value this explanation seems to differ from the words of the FFR Act, the Commonwealth has chosen not to exercise its authority under the IGA to override the CGC's advice or to specify its own definition of HFE in the CGC's terms of reference.

In their 2002 review of federal financial relations, Garnaut and FitzGerald contend that States had expressed a range of different views on equalisation prior to signing the original IGA and the CGC may have overstepped in picking up the 1999 definition. Garnaut and FitzGerald further argue that CGC had historically equalised to a 'comparable' or 'not appreciably different' standard and that the idea included in the 1999 definition of equalising to the same standard reflected a break from tradition in the CGC's 1993 Review.[3]

In contrast, the CGC argues that the use of 'same' instead of 'comparable' or 'not appreciably different' in the 1993 Review was the result of pressure to be more specific about what HFE means.[4]

Should the CGC continue to 'define' HFE?

Debate about how about HFE should be defined gives rise to the question of whether the CGC should be responsible for both defining and interpreting HFE. It is often regarded as good governance to separate the development of policy from its interpretation and implementation.

Without such separation, it is arguable that the CGC's role in adjudicating disputes between States about competing needs and specific capacities will tend to drive it inevitably toward a 'full' version of equalisation.

1 Morris, A. Presentation to the National Forum on Commonwealth-State Funding, March 2002, Canberra quoted in Garnaut, R. and FitzGerald, V., Review of Commonwealth-State Funding, Final Report, A review of the allocation of Commonwealth Grants to the States and Territories, August 2002, page 37.

2 CGC, *Report on GST Revenue Sharing Relativities — 2010 Review*, Volume 1, page 34.

3 Garnaut, R. and FitzGerald, V., Review of Commonwealth-State Funding, Final Report, *A review of the allocation of Commonwealth Grants to the States and Territories*, August 2002, page 37.

4 CGC, *The Last 25 Years*, 2008, pages 32 to 36.

One approach would be for an alternative body to take responsibility for the definition of HFE, while the CGC continued to be responsible for its interpretation and implementation.[5] The definition of HFE could be overseen by any one of a number of existing entities, such as:

- the Commonwealth
- the Standing Committee on Federal Financial Relations
- the Council of Australian Governments (COAG)
- the Commonwealth Parliament (a legislative approach).

If another body were to take this responsibility, there is also the question of whether the definition of HFE should be specified in legislation, under an agreement between the jurisdictions, or in some other way.

The CGC argues that:

> *Getting the balance right between the potential benefits of equalisation and its possible adverse impacts on the economy is a decision for the Commonwealth and State governments. The Commission has put this issue before Government several times. (For example, the Commission's 2004 Report suggested governments conduct a review of equalisation, including its underlying objectives, and its 1988, 1990 and 1993 Reports suggested governments consider reviewing the relationships between equalisation and efficiency.) However, there has been no change in the objective of equalising State fiscal capacities. It remains an issue for future consideration in Commonwealth-State financial arrangements.*[6]

New South Wales also argues that governments should give greater guidance to the CGC on how to treat certain changes in State policy:

> *… governments need to provide clearer guidance to the CGC. The HFE system has largely been developed by the CGC based on principles which it has articulated. This may have been sufficient when Australia was relatively small and inward looking. A more outward looking and globally integrated Australia needs a HFE system that provides incentives for reform and promotes efficiency. This will require governments to provide more guidance to the CGC in the implementation of HFE. This is especially the case with the ongoing need to encourage states to undertake productivity and welfare enhancing reforms and to align HFE with other policies directed towards boosting Australia's productivity performance.*[7]

However, Tasmania appears to reject the idea of too much government involvement in the HFE process:

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5 The Review's Terms of Reference state that the distribution of GST revenue will continue to be based on the CGC's recommendations.

6 CGC, *The Last 25 Years*, 2008, page 47.

7 New South Wales submission to the GST Distribution Review, November 2011, page 50.

Such an approach, where governments determine aims, objectives and definitions of the HFE system, leaving the administrative body (the CGC) to deal strictly with data and mechanical issues, would politicise the GST distribution process and reduce the independence, transparency and integrity of the equalisation system.

Tasmania supports the current governance arrangements underpinning the HFE system. The CGC is the appropriate, independent body, with responsibility for recommending to the Commonwealth Treasurer state GST relativities. The CGC's processes are analytical and data driven. Such processes rely on historical, empirical data on what states do and the circumstances in which they operate.

The CGC is transparent, consults with the states, and discharges its responsibility with the highest integrity and expertise.

Tasmania believes that it is appropriate that the CGC is an Australian Government body rather than a joint state or joint state/Australian Government body. This is because the Australian Government has an interest in securing arrangements that are the best interest of the nation as a whole, and does not have a vested interest in the outcome, in the way that states do.[8]

The Northern Territory also says that:

The independence of the Commission from all governments is a positive feature of Australia's approach to equalisation. Alternative arrangements such as equalisation being administrated by joint government bodies would be unlikely to result in more accepted outcomes. This option would be unworkable because states are unlikely to reach consensus positions on each state's share of GST revenue. Furthermore, this option may require greater involvement of the Commonwealth, as the umpire to rule on contentions issues between states.[9]

Western Australia also supports the impartiality of the CGC:

As a statutory body, the CGC makes impartial recommendations. These governance arrangements are seen internationally as highly desirable, and compare well to the ad hoc decision making processes relating to many National Partnership Payments.

The CGC should be more accountable, as discussed in the Transparency chapter of this submission, but it should remain apolitical.[10]

Review of CGC recommendations

In its 2004 Review, the CGC notes that:

The Commission also said that since State circumstances and approaches to delivering services were constantly changing there would be benefits in reviewing equalisation and its objectives from time to time. It did not do so because it

8 Tasmanian Submission to the GST Distribution Review, October 2011, page 15.
9 Northern Territory submission to the GST Distribution Review, October 2011, page 21.
10 Western Australia submission to the GST Distribution Review, October 2011, page 73.

> *considered it was a matter for governments to initiate a review of the financial architecture of the federation, if they judged it desirable.*[11]

There is already scope for review and consultation within the current arrangements. For example, States have an opportunity to raise concerns with the CGC's approach during its regular methodology reviews. The CGC also releases an annual paper to consult States on the treatment of Commonwealth payments. Finally, the IGA requires the Commonwealth Treasurer to discuss the CGC's recommendations with the Standing Council on Federal Financial Relations prior to determining the relativities.

Nevertheless, existing arrangements either involve consultation led by the CGC itself or discussion of the CGC's recommendations. Given the CGC's important role in maintaining Australia's federation, there may be case for a more formal and independent mechanism to review the CGC's performance against relevant legislation, the IGA and annual terms of reference issued to it by the Treasurer.

Again, there are a number of bodies that might conduct such a review, such as:

- The Productivity Commission
- The COAG reform council
- The Australian National Audit Office
- An independent panel appointed by the Commonwealth, COAG or the Standing Committee on Federal Financial Relations.

Reviews would not need to be frequent, perhaps taking place every five or ten years.

Governance implications of alternative forms of GST distribution

The alternative forms of GST distribution that have been canvassed in previous Chapters also have governance implications. While many would require minimal changes to the current governance framework and thus involve similar issues to the current system, some would involve significant changes and raise new concerns.

For example, a donor and recipient approach to equalisation would require a process to share the cost of providing support for the recipients amongst the donors. Similarly, a different body may be needed to assess State performance if the distribution of GST revenue were to include a goal other than equalisation.

For some options the existing institutional framework could remain largely unchanged, but amendments to the IGA or the FFR Act may be required.

11 CGC, *The Last 25 Years*, 2008, page 44.

The Panel's view on improved governance

The Panel sees merit in separating responsibility for determining the objectives of the GST distribution and the definition of HFE from the responsibility for interpreting and implementing HFE. The Panel also sees merit in subjecting HFE outcomes to independent review from time to time.

Different reform options will have different governance implications, and these will be considered in more detail in the final report.

8.2 Communication issues

Headline relativities drive much of the current debate about HFE. However, they are only one way of representing Commonwealth support to States and, at times, they can distract attention from the underlying issues. While presentational changes alone would be of limited value, it is worth considering whether they may have a role alongside more meaningful reforms.

Some potentially useful changes to the way outcomes are presented and communicated are considered in the paragraphs below.

Making the HFE pool larger

Under the current approach to HFE, the relativity calculation is dependent upon the size of the GST revenue pool — the larger the pool, the less the relativities diverge. The GST pool represents only part of the general budget assistance provided to the States by the Commonwealth.

The Commonwealth Treasury submission observes that while some States receive less than an EPC share of GST, if all Commonwealth payments are considered, shares of total Commonwealth funding are much closer to EPC:

> *Overall, although some States receive less than an EPC share of GST, if all Commonwealth payments are considered, shares of total Commonwealth funding are much closer to EPC. For example, in 2011-12 Western Australia is expected to receive 72 per cent of an equal population share of GST, however if all Commonwealth payments (including GST) are taken into account it is expected to receive 95 per cent of an equal population share.*[12]

Given some Commonwealth payments are tied to very specific projects or outcomes it would be inappropriate to include all Commonwealth payments in the same pool as the general revenue assistance provided by GST revenue. However, even including only major SPPs, which are only very loosely tied,[13] would significantly alter relativities.

12 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 13.

13 Under the IGA, National Specific Purpose Payments (SPPs) are provided to States to be spent in five key service delivery sectors — education, health, disability services, affordable housing and skills and workforce development. To this extent these funds are tied. However, there is no provision for National SPPs to be withheld in the case of a jurisdiction not meeting a performance benchmark, and

One approach could therefore be for the HFE pool to include all 'untied' grants to the States, thus including GST revenue as well as national SPPs. (Technically, this approach is referred to as treating national SPPs by absorption.)

Treating payments by absorption may have a one-off effect on State GST payments (by removing some lag effects), but there would be no long-term change in State GST payments other than this increase in contemporaneity.[14]

Expressing HFE outcomes in dollars

HFE outcomes are currently calculated in dollars in the assessment years and converted to relativities for use in the application year. The effect of the conversion to relativities is to index the dollar needs of States by the growth in GST revenue from the assessment years to the application year.

As an alternative to relativities, HFE outcomes could be presented in dollars, with those values then being indexed by growth in the GST pool to produce the same result, without the need to calculate relativities. This could avoid the unhelpful appearance that GST raised in one jurisdiction is 'lost' to another.

Future relativities

The Commonwealth's budget papers provide projections of future GST relativities. These figures are necessary for the preparation of the Commonwealth's forward estimates and are based on the technical assumption that future State fiscal capacities will be broadly consistent with the CGC's most recent assessments. While these projections are not intended to be forecasts, there is a risk that they may be misinterpreted as an attempt to predict future CGC assessments of State fiscal capacity.

Due to the technical assumption effectively relying on 'no change in State circumstances', the Commonwealth's projections will almost invariably not match the CGC's actual assessment of State needs.

There is a question as to whether the nature of the Commonwealth projections is appropriately understood and whether any action needs to be taken on the issue.

Greater public engagement and information by the CGC

Another step to increase understanding would be for the CGC to play a more active role in educating those outside the various State Treasuries about the principles by which GST is distributed.

there are no financial or other input controls imposed on service delivery by the States as a condition of receiving these payments. In addition, all States spend more on the particular service areas supported by the national SPPs than the level of the SPP itself. For these reasons, within the HFE system, national SPPs can be considered to effectively represent 'untied' funds.

14 Compared with the current system, a State's GST payment would be higher to the extent that its share of the national SPPs was lower in the application year compared to the assessment years. In contrast, a State's GST payment would be lower to the extent that its share of the national SPPs was higher in the application year compared to the assessment years. Where State shares of national SPPs were the same in the assessment years and the application year, this approach would be merely presentational and would have no effect on States' GST payments.

The CGC already provides public access to information about its deliberations and processes, including the rationale for equalisation, in several ways. For example, the CGC produces an Update report each year to coincide with the release of the recommended relativities for distributing GST revenue. The CGC has also recently added an 'About Equalisation' section to its website that includes key information about equalisation, an outline of the CGC's methods and a list of frequently asked questions. Furthermore, the Chairman of the CGC and other staff make presentations at conferences, educational institutions and to politicians as requested.

Nevertheless, the CGC does not actively seek to promote understanding of HFE within the States outside of the various Treasuries. A more widespread program of engagement (with States and the public) may help to ensure that equalisation principles are better understood by politicians and throughout the bureaucracy, with the result that the GST distribution process is more widely supported.

Submissions expressed a desire for the outcomes of the HFE process to have increased explanatory power, rather than merely being a set of numbers.

The Northern Territory says:

> *The Territory's proposed alternative presentation focuses on the assessed per capita amount each state would need to spend in order to provide the average level of services, and the revenue sources that contribute to this amount. This approach may enhance public understanding that the GST is intended to fill the gap between assessed expenditure needs, in order to deliver the average level of services, and the amount of revenue that states raise from their own sources and receive in Commonwealth payments.*[15]

The Commonwealth Treasury says:

> *For example, it should be clear from a summary reading of the CGC's report how much funding is redistributed per Indigenous school student. While the current methodology does this to an extent, a basic understanding of what is happening gets lost in the complex calculation of cost weighted school enrolments and category factors. If the presentation could be simplified to demonstrate that all States receive an equal amount of additional GST funding per Indigenous student, it may serve to enhance understanding of what is driving the relativities.*[16]

15 Northern Territory submission to the GST Distribution Review, October 2011, page 47.
16 Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 55.

The Panel's view on improving communication

The Panel does not believe that changes in the method of presenting or explaining GST shares could be a substitute for meaningful reform.

However, a more transparent presentation of outcomes (whether by expressing outcomes in dollars, ensuring that relativities relate to the appropriate pool size, or making clearer distinctions between numbers used by various levels of government) would be good for public confidence in the system. Alternative presentations could enable debate to focus more directly on any underlying concerns with the GST distribution system.

As noted in Chapter 2, the Panel also considers that if the CGC were to include in its New Issues paper as accurate an estimate as possible of the effect on States' GST payments of possible Commission decisions, it may help reduce uncertainty and increase predictability of outcomes. In addition, there could be considerable benefit in the CGC engaging with State governments more broadly, especially in key areas such as health and education.

9 Drawing ideas together

9.1 Where to from here?

The previous Chapters have identified three avenues of future work by the Panel.

First, there are certain aspects of the implementation and communication of the current method of GST distribution that are not meeting expectations and need to be 'fixed', even if nothing else in the system changed.

Secondly, the Panel has raised the question of whether there should be a shift in the fundamental goal of the GST distribution from pursuing the *same* fiscal capacities for jurisdictions, towards a broader concept of providing *comparable* capacities.

Thirdly, there is the question of incentives for reform, which in practice may mean making room for goals other than HFE in the GST distribution process. While some things have been said about this in the current interim report,[1] there is more to come when the Panel turns its focus to incentives for tax reform in its interim report on the supplementary Terms of Reference.

To guide submissions this final Chapter highlights a number of proposals with potential and describes where they fit in terms of the broad approaches. A number of proposals could fit comfortably within any one of the broad approaches and some may help solve more than one problem.

All options are still being actively weighed and considered, and the Panel welcomes submissions on which way(s) the recommendations in the Panel's final report should ultimately come down.

9.2 Addressing concerns within the current concept of HFE

Even if one accepts that the current system is directed towards the right goal — that is, 'full' equalisation — and that it largely achieves it, the Panel sees the need to improve some aspects of the system. Depending how they are implemented, all the proposals listed below should be compatible with a definition of HFE that retained the goal of equalising to the same capacities.

Mining

The current arrangements do not appear to recognise mining related infrastructure costs, mining expenses and economic development costs appropriately.[2] While it might be possible to measure and account for these costs directly (and the Panel encourages resource States to consider this), there are several other possible ways to respond.

1 See Chapter 4.
2 See pages 96-102, section 6.2.

Excluding some of the mining revenue and/or mining revenue base, or discounting the mining revenue assessment, could potentially compensate for unmeasured needs in relation to State costs of mining related infrastructure and other mining related expenditure. These approaches to assessing mining could also be seen as addressing efficiency concerns, and have the potential to improve policy neutrality.[3]

Other possible alternatives include using part of the GST pool temporarily for States' mining related infrastructure costs and other mining related expenditure,[4] or introducing a trigger to quarantine some mining revenue to allow and encourage mining States to spend that revenue directly on development of the mining industry.[5]

Excluding certain Commonwealth payments from the equalisation process

Short term difficulties for States' budgets and financing arrangements can arise when large, one-off, capital payments for expenditure on assets of lasting value are redistributed.[6] The Panel sees two potentially suitable ways to address this difficulty:

- Capital payments could be equalised over a longer period, broadly reflecting the life of the asset. This would reduce the impact of capital payments on GST shares in any one year, without adding much complexity, and be more consistent with a capital assessment that also recognises States' capital needs over time.[7]
- Payments for nationally significant infrastructure projects (or some other identified category, such as transport infrastructure) could be excluded from the equalisation process, provided that a workable process for identifying eligible projects is adopted.[8]

Fixing annual relativities

Predictability and stability could be improved with minimal change to the system by ensuring that certain data changes are not back cast, or perhaps even by fixing annual relativities between CGC reviews.[9]

Freezing expenditure disabilities

Freezing expenditure disabilities could simplify the CGC's annual update process without affecting outcomes materially.[10]

Governance

The governance of the system would be improved by separating responsibility for determining the objectives of the GST distribution and the definition of HFE from the

3 See pages 105-109, section 6.3.
4 See page 106, section 6.3.
5 See page 108, section 6.3.
6 See page 85, section 5.2.
7 See page 90, section 5.3.
8 See pages 90-94, section 5.3.
9 See pages 33-36, section 2.3.
10 See page 48, section 3.3.

responsibility for interpreting and implementing HFE,[11] and by adopting means to regularly review the goals and outcomes of the process.[12]

Communication

More transparent presentation of outcomes by the CGC and others (such as the Commonwealth) could be good for public confidence in the system and may enable debate to focus more directly on any substantive concerns with the GST distribution system.[13] Further, there may be merit in the CGC taking a more active role in educating those outside the various State Treasuries about the principles by which GST is distributed.[14]

Simplification

A number of the simplification measures considered in Chapter 3 may prove valuable, and the Panel has encouraged further feedback on which of those might be worth pursuing further.

9.3 Targeting 'comparable' rather than the 'same' capacities

The Panel is also considering an alternative that maintains the general concept of HFE, but refines or revises the definition to refer to the goal of seeking to give States *comparable* fiscal capacities, rather than the materially the *same* fiscal capacities (as is the case currently). This alternative might prove more suitable to address present and emerging challenges than the current definition.

Both international and Australia's own past practice show that something less than pursuit of equality between jurisdictions may result in a fair outcome and can produce confidence in Federal financing arrangements.[15] A move from *same* to *comparable* capacities may facilitate moves towards even simpler, more transparent and more understandable arrangements.[16] Further, such an approach may improve efficiency by reducing incentives, to the extent they exist (or are thought to), for States to alter their policies to maximise their GST share.[17] The Panel has therefore invited submissions on how this concept might be accurately described and effectively implemented.

A move in this direction might allow some problems identified to be solved more fully or easily than the current definition. For example:

- Some broader indicators may offer the potential to 'fully' equalise, while others would allow equalisation to a broadly comparable position.[18] Using broader indicators offers the potential for significant simplification and may reduce the scope

11 See pages 128-130, section 8.1.
12 See pages 130-131, section 8.1.
13 See pages 132-135, section 8.2.
14 See pages 133-134, section 8.2.
15 See page 22, section 1.6.
16 See page 61, section 3.4.
17 See page 80, section 4.4.
18 See pages 50-53, section 3.3.

for State policy changes to affect the GST distribution.[19] Similarly, there may be benefits from removing adjustments for tax implementation differences.[20]

There are clearly some options which would not work within the current concept of HFE and could only be considered if a refined definition of HFE was adopted.

- For example, it would be difficult to design a donor and recipient model that produces 'full' equalisation, but that approach could potentially work within a refined model.[21] (Depending on how such a model was designed and how the size of the GST pool allocated to recipients was determined, it may require the adoption of a new institutional structure.)
- Similarly, if appropriate global indicators can be found, they are unlikely to produce 'full' equalisation, but could produce comparable outcomes.[22]
- Another example would be limiting relativity changes — stability could be increased by managing reductions in GST payments, perhaps by ensuring that a State does not receive a lower nominal amount of GST revenue than in the previous year (in years when the GST revenue pool grows).[23]
- A final category of options that would be compatible with this approach involves adopting standards other than the average of what States do, such as equalising to the standard of the lowest taxing or spending State, or to a another standard lower than the average of all States.[24]

9.4 Including goals other than HFE in the GST distribution

The third broad approach being considered by the Panel involves including other goals alongside HFE in the GST distribution, such as tax reform.[25]

This concept will be considered further in the Panel's supplementary report on tax reform.

19 See page 78, section 4.4.
20 See page 49, section 3.3.
21 See pages 57-58, section 3.3.
22 See pages 56-57, section 3.3.
23 See pages 37-41, section 2.3.
24 See page 79, section 4.4.
25 See page 18, section 1.5.

The Panel's view on the direction of future work

As the suite of issues being considered is large and many of the issues are extraordinarily complex, in this interim report the Panel has outlined its present thinking, informed by consultations and submissions to date.

The Panel welcomes reactions to the contents of this interim report, noting that its work in respect of incentives for tax reform is still to come. In particular, the Panel welcomes submissions on which proposals highlighted in this Chapter have most merit, taking into account the Panel's Terms of Reference.

To ensure that the Panel is fully informed before making its final recommendations, the Panel has called for more information on a range of other proposals identified throughout the report that seem attractive, but are, at this stage, somewhat underdeveloped. In particular, the Panel seeks information with respect to:

- *mining costs and alternative approaches to the mining assessment*
- *the treatment of Commonwealth payments for infrastructure (including how to determine which are nationally significant projects)*
- *a range of simplification ideas including ways to overcome perceived difficulties with global indicators and processes for selecting appropriate broader indicators, and*
- *adopting a standard other than the average of 'what States collectively do'.*

Appendix A: Terms of Reference

Issued on 30 March 2011 and additional terms (6A and 6B) issued on 17 November 2011.

Objectives and scope

1. Australia is facing a number of long-term trends that are driving pronounced and challenging structural change in the economy, including:

   a. the rise of China and India, and continuing globalisation;

   b. the challenge of mitigating and adapting to climate change;

   c. population growth and demographic change; and

   d. the continuing effects of innovation and technological change.

2. In addition, Australia has ongoing challenges in tackling the entrenched disadvantage of many Australians, especially Indigenous Australians.

3. These trends and challenges are likely to have differing impacts on the ability of States and Territories (the States) to deliver broadly equivalent levels of services and infrastructure to their residents, in ways that maximise sustainable growth and improvements in quality of life for all Australians.

4. In this context, the Review will consider whether the distribution of the GST and the current form of horizontal fiscal equalisation will ensure that Australia is best placed to respond to these challenges and public confidence in the financial relationships within the Australian Federation is maintained.

5. In considering any possible changes to the form of equalisation, the Review will have regard to the following:

   a. efficiency, including the effect of alternate approaches on the allocation of resources in the national economy and on the States' reform, service delivery and investment decisions to best meet the requirements for growth;

   b. equity, including the extent to which alternate approaches would affect States' fiscal capacities to provide for Australians' access to government services, regardless of where they reside;

   c. simplicity, including the extent to which alternate approaches would provide for reduced complexity and increased transparency; and

   d. predictability and stability in the determination of States' GST shares so as to better support long term decision making and reform by Governments.

6. The Review will be guided by the following:

a. that the long-standing practice of equalisation between the States has served Australia well;

b. that the GST will continue to be distributed to the States on the basis of equalising payments to the States, consistent with the principle that jurisdictions should have equal capacity to provide infrastructure and services to their citizens;

c. as per the current arrangements, all the GST revenue will be distributed to the States as "untied" payments;

d. that the Commonwealth Grants Commission will continue to make recommendations on the distribution of the GST; and

e. it is not intended that the Review will consider detailed methodological and data issues, however the Review will seek the assistance and advice of the Commonwealth Grants Commission on technical matters as required.

6A. The Review should examine and make recommendations on possible changes to the form of equalisation to achieve the following objectives:

a. ensure that HFE does not provide a disincentive to State tax reform,

b. utilise HFE to provide incentives and disincentives to promote future State policy decisions which improve the efficiency of State taxes and mineral royalties, and

c. examine the incentives for States to reduce Minerals Resource Rent Tax or Petroleum Resource Rent Tax revenue through increasing State mineral royalties.

6B. In considering this issue, the Review will be guided by the following:

a. the findings of the Australia's Future Tax System Review relating to existing State taxes and mineral royalties,

b. the Minerals Resource Rent Tax and Petroleum Resource Rent Tax provide a more efficient approach to charging for Australia's non-renewable resources than mineral royalties, and

c. State tax reform will not be financed by the Australian Government.

Composition and consultation

7. The Review would be undertaken by two or three eminent people.

8. The Treasurer will bring the final report to the Council of Australian Governments (COAG) for consideration before a final decision is made on new arrangements by the end of 2013.

9. The Review will be supported by a Secretariat in the Commonwealth Treasury. It is expected that the Review will second a number of staff with particular expertise, including officials from State Treasuries and the CGC. A Heads of Treasuries Advisory Committee, consisting of all States, will provide advice to the Review.

10. The Review will consult the public and State Governments and seek written submissions.

Timing

11. The Review is to provide an interim report to the Treasurer by March[1] 2012 and a final report by August/September 2012.

12. The GST shares will be distributed in 2011-12 and 2012-13 based on the current arrangements.

1 In late 2011 the Commonwealth Treasurer extended the interim reporting date to allow for the CGC's 2012 Update figures to be incorporated in this report.

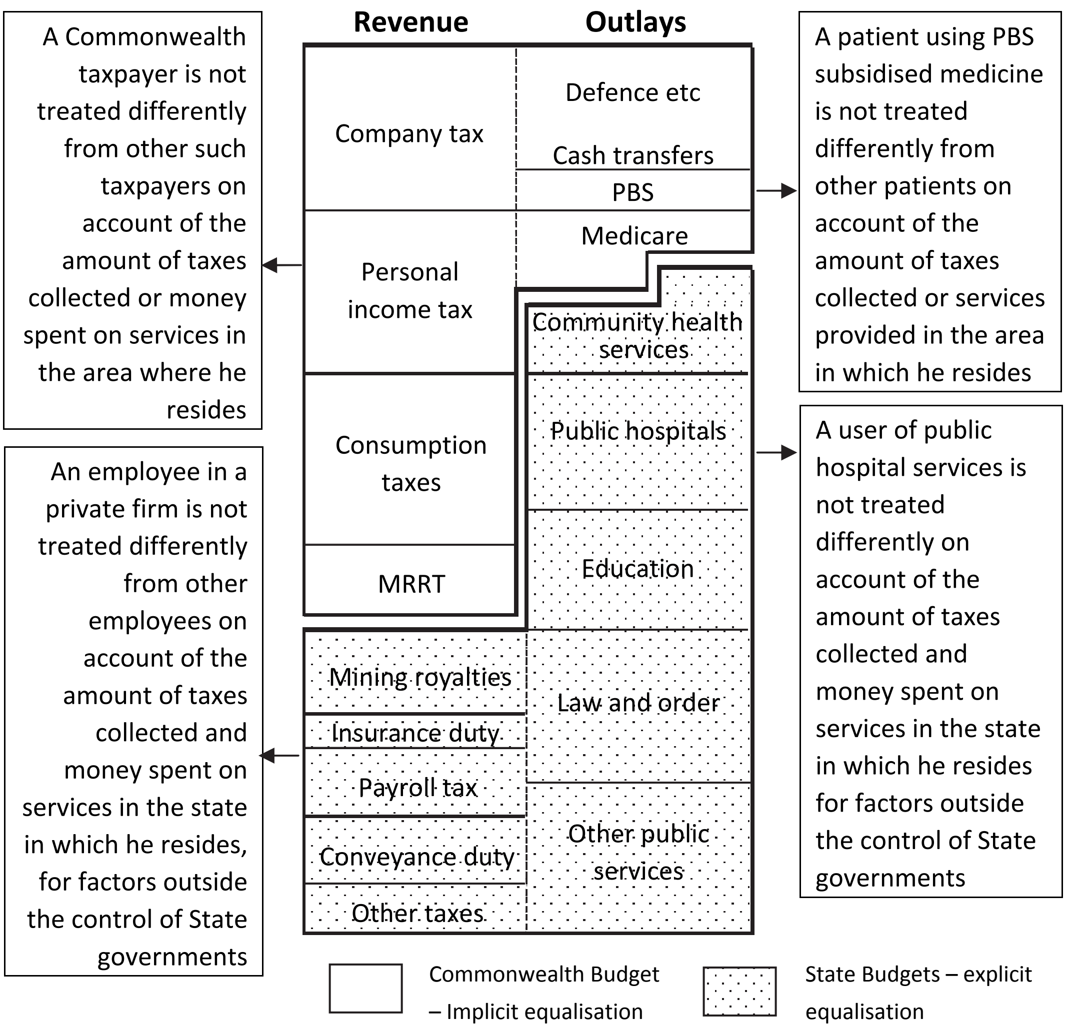
Appendix B: Supplementary argument for HFE

Analogy with Commonwealth Government and unitary system

Some supporters of HFE argue that full HFE at the State level can be seen as the counterpart of, and complementary to, implicit equalisation in the Commonwealth sphere.[1] This idea is illustrated in Figure B1.1 below.

Similarly, it has been argued that HFE provides a similar outcome to what would happen if Australia were a unitary system, although with policy differences between State governments protected.[2] Also it is said that this arrangement promotes vertical adaptability in terms of the roles and responsibilities of Commonwealth and State levels of government.[3]

Figure B1.1: Equalisation through Commonwealth and State Budgets



1 South Australia submission to the GST Distribution Review, October 2011, page 18-19.
2 Australian Capital Territory submission to the GST Distribution Review, October 2011, page 0, 4; South Australia submission to the GST Distribution Review, September 2011, page 6, 18-19.
3 South Australian submission to the GST Distribution Review, September 2011, page 21.

Although not raised specifically in submissions, the same line of argument could also be used to reason that the horizontal equity objective advances vertical equity, because States provide 'in kind' social transfers (as revenues tend to be collected proportion to income, while services are received disproportionately by the less well off).

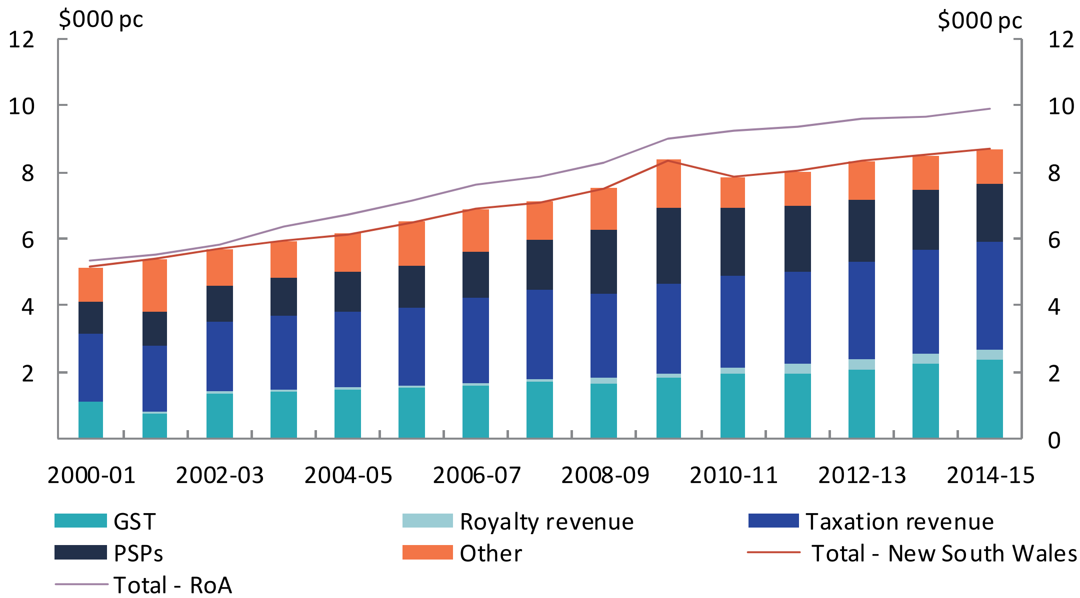
Appendix C: Total Revenue Charts — all States

The following charts show the components of total revenues for each State compared with the balance of other States, in per capita terms, from 2000-01 to the present, with estimates across the budget forward years to 2014-15.

Total revenues reflect State own source taxes, mining royalties, GST payments, Commonwealth payments for specific purposes and other revenues (such as user charges).

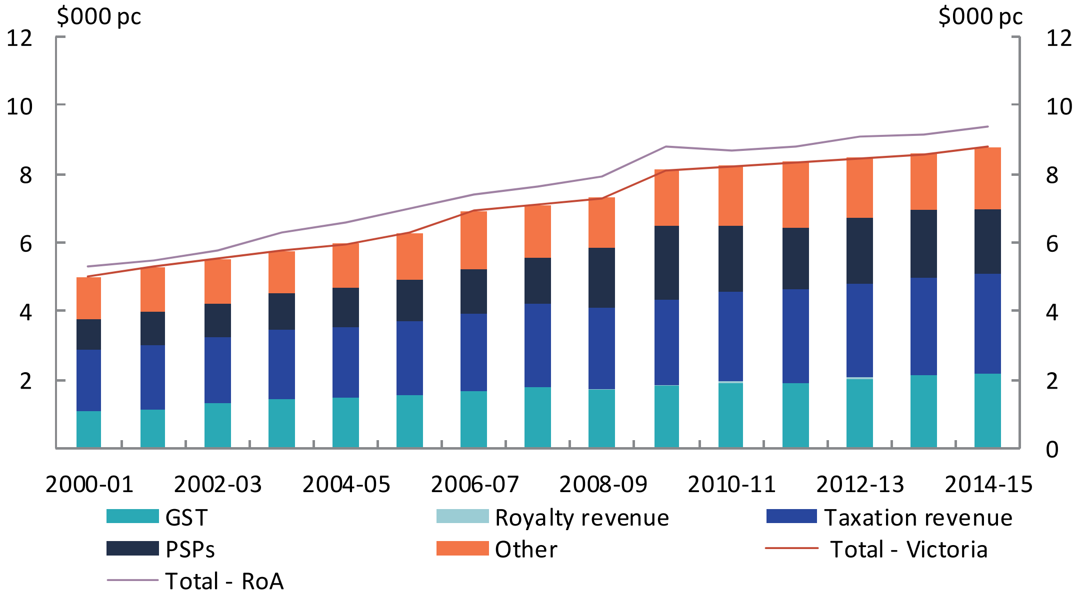
Reasons why a State may have a greater than average total revenue per capita are discussed in Chapter 2.

Fig C1: Components of total revenue, New South Wales and total revenue, balance of States, 2000-01 to 2014-15



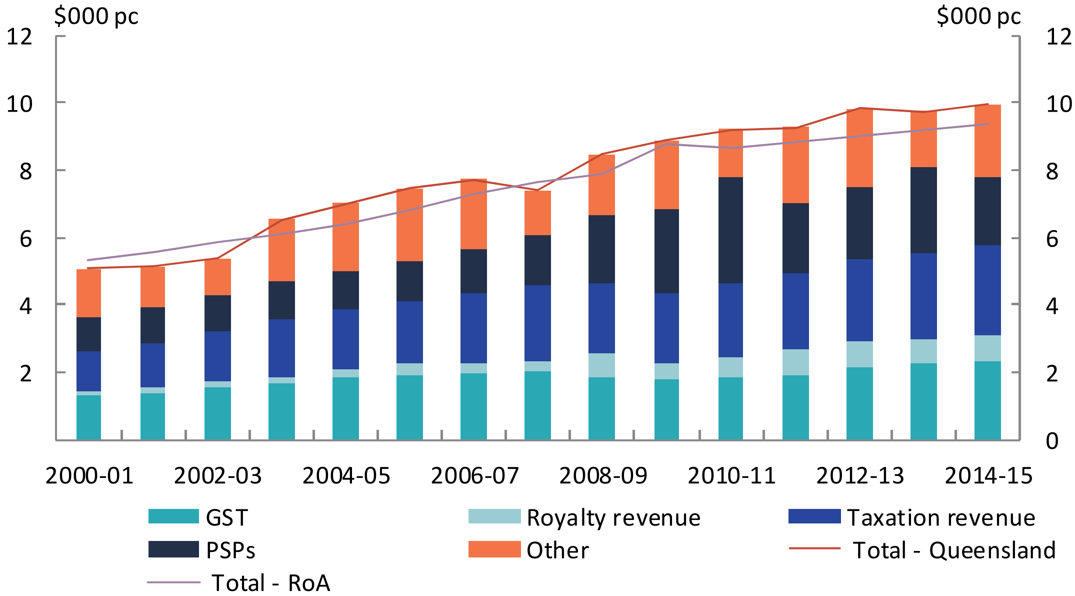
Source: Secretariat calculations, State Budget papers.

Fig C2: Components of total revenue, Victoria and total revenue, balance of States, 2000 01 to 2014-15



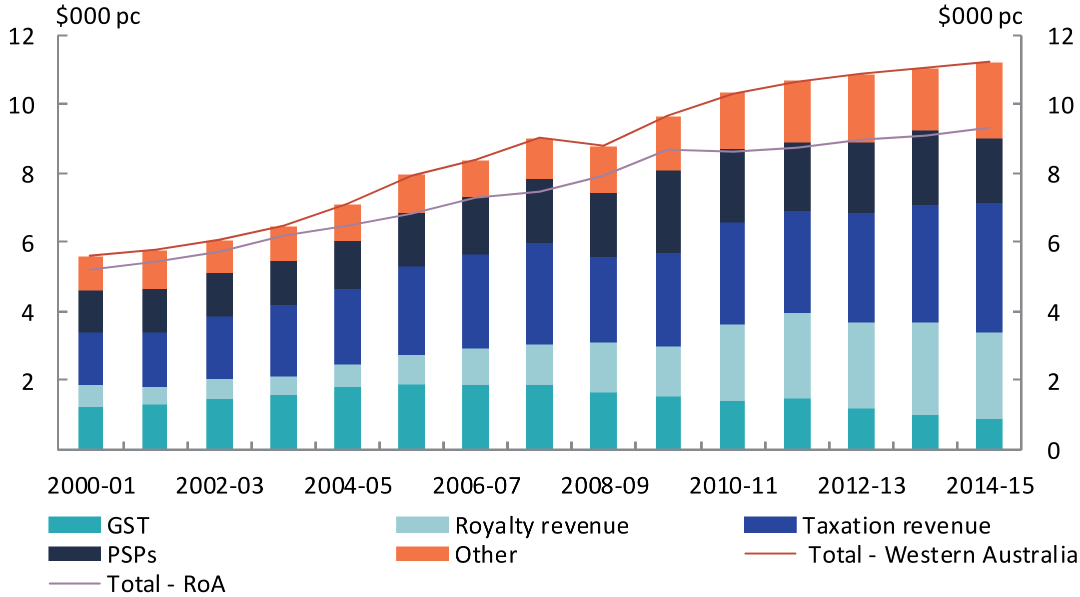
Source: Secretariat calculations, State Budget papers.

Fig C3: Components of total revenue, Queensland and total revenue, balance of States, 2000-01 to 2014-15



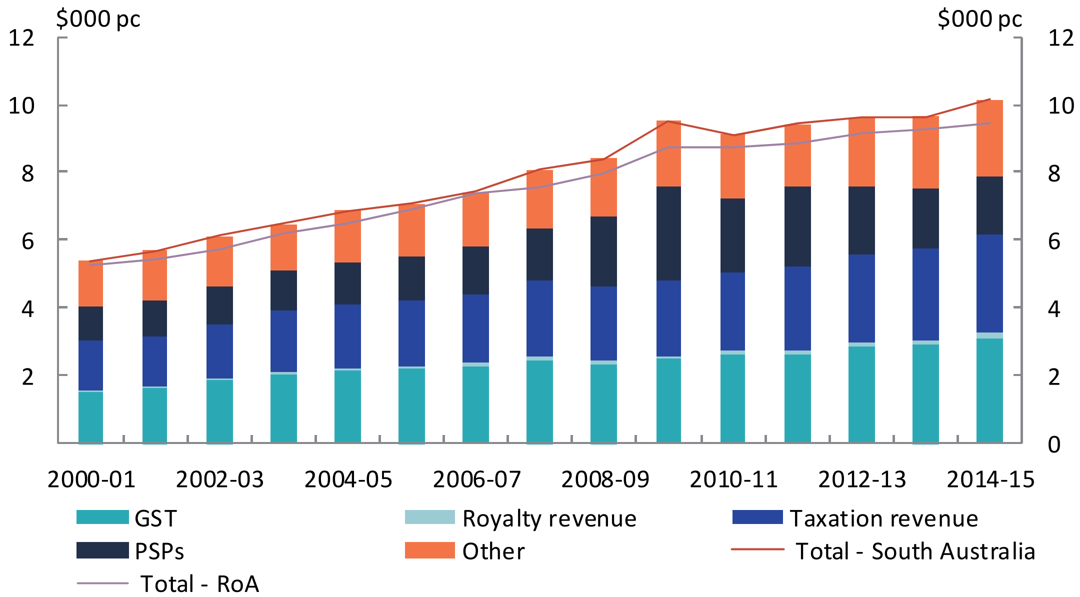
Source: Secretariat calculations, State Budget papers.

Fig C4: Components of total revenue, Western Australia and total revenue, balance of States, 2000-01 to 2014-15



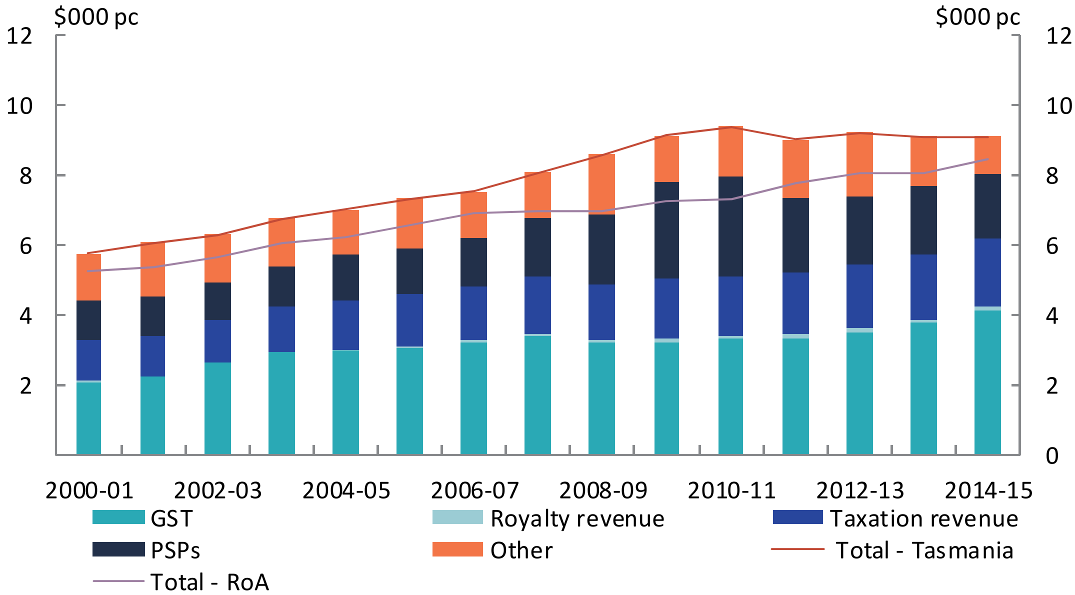
Source: Secretariat calculations, State Budget papers.

Fig C5: Components of total revenue, South Australia and total revenue, balance of States, 2000-01 to 2014-15



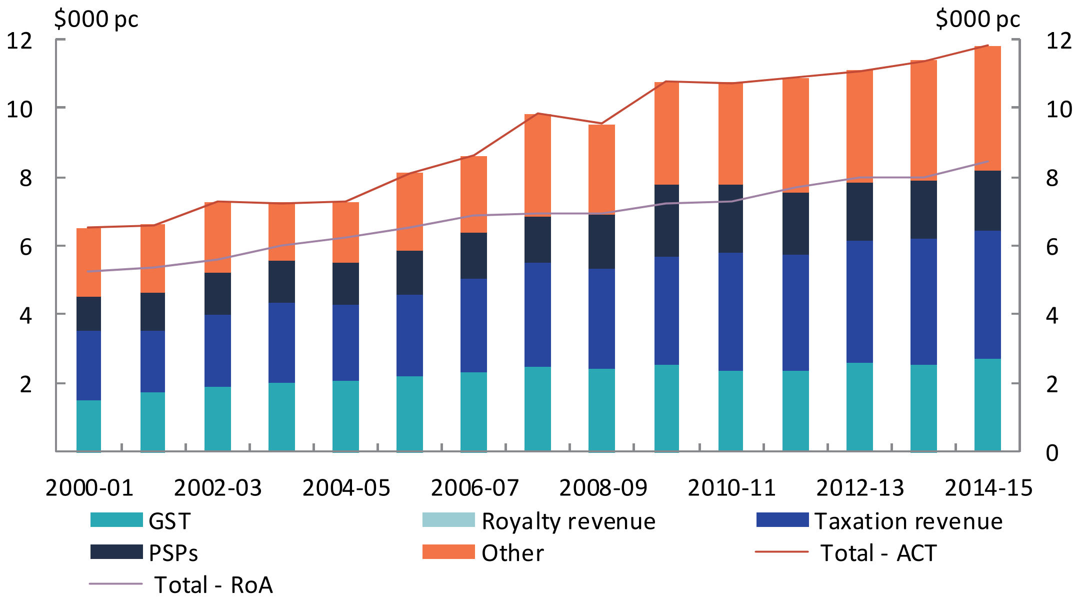
Source: Secretariat calculations, State Budget papers.

Fig C6: Components of total revenue, Tasmania and total revenue, balance of States, 2000-01 to 2014-15



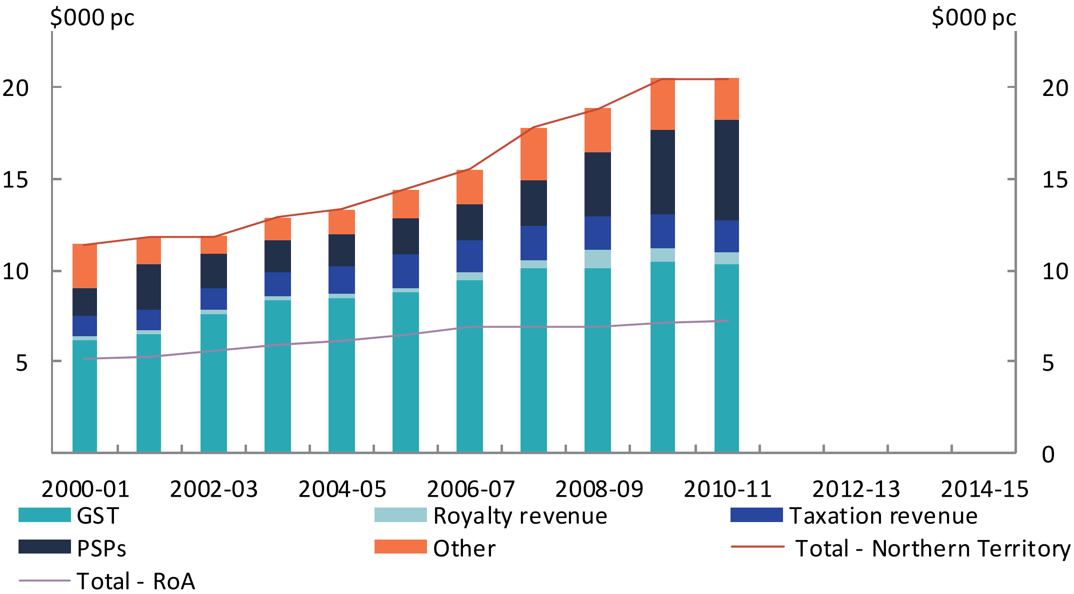
Source: Secretariat calculations, State Budget papers.

Fig C7: Components of total revenue, Australian Capital Territory and total revenue, balance of States, 2000-01 to 2014-15



Source: Secretariat calculations, State Budget papers.

Fig C8: Components of total revenue, Northern Territory and total revenue, balance of States, 2000-01 to 2014-15



Source: Secretariat calculations, State Budget papers.

Note: Data in the NT budget did not allow for a detailed analysis in the period 2011-12 to 2014-15.

Glossary

Adjusted budget

A representation of *State* budgets used by the Commonwealth Grants Commission (CGC) to calculate the *average* per capita revenue and expenses.

Application year

The year in which *relativities* are applied. For example, in the 2012 Update, the application year is 2012-13.

Assessed differences (also known as needs)

The financial impact on a *State* of its *disabilities*. They are measured, for example, as the difference between *assessed expenses* and *average* expenses, average revenue and *assessed revenue*. Assessed differences can be either positive or negative.

Assessed expenses

The expenses a *State* would incur if it were to follow *average* expense policies, allowing for the *disabilities* it faces in providing services, and assuming it provides services at the average level of efficiency. Assessed expenses exclude differences from the average due to policy choices under the control of a State.

Assessed investment

The expenditure on new infrastructure a *State* would incur if it were to follow *average* policies, allowing for *disabilities* it faces in providing infrastructure, and assuming it requires the average level of infrastructure to deliver the average level of services. Assessed investment excludes differences from the average due to policy choices under the control of a State.

Assessed net lending

The transaction-based change in net financial worth that a *State* would require to achieve the *average* net financial worth at the end of each year. The CGC's method for calculating assessed net lending assumes that each State has the average net financial worth at the start of each year.

Assessed revenue

The revenue a *State* would raise if it were to apply the *average* policies to its revenue base, and raised revenue at the average level of efficiency. Assessed revenue excludes differences from the average due to policy choices under the control of that State, for example a higher or lower tax rate applied by a State compared to the average.

Assessment years (period)

The financial years used in a *review* or an *update* to calculate *relativities*. The CGC uses data for three financial years. For example, the relativities recommended in the 2012 Update are based on the average of three annual relativities calculated for the most recent completed financial years at the time the relativities are released (2008-09 to 2010-11).

Average (or Australian average)

The benchmark against which the performance or characteristics of a *State* are assessed. It is an average derived from the policies or financial data of all States, and hence may be a financial average or a policy average.

Broader indicators

Indicators that could be used to assess *State fiscal capacities* at a level lower than a total budget level i.e. at a *category* and or *disability* level.

Category

A classification of *State* general government transactions relating to distinct services or revenue sources, used for analytical purposes.

Commonwealth payments

Payments to *States* made by the Australian Government, including general revenue grants, *National specific purpose payments*, *National partnership payments* and *Commonwealth own-purpose expenses*.

Current fiscal equalisation system

The process and methods adopted by the CGC in its 2010 Review to examine *State fiscal capacities*.

Disability

An influence beyond a *State*'s control that requires it:

- to spend more (or less) per capita than the *average* to provide the average level of service; or
- to make a greater (or lesser) effort than the average to raise the average amount of revenue per capita.

Distribution

State shares of GST as determined by the *relativities*.

Fiscal capacity

The fiscal capacity of a *State* is a measure of its ability to provide *average* services, including infrastructure, to its population if it raised revenue from its own *revenue bases* at average rates and received its actual *Commonwealth payments*, excluding the GST.

Fully contemporary GST distribution

A theoretical GST distribution where *State fiscal capacities* for the *application year* determine the GST distribution in the application year.

Goods and Services Tax (GST) revenue or pool

The funds made available by the Australian Government for transfer to the *State*s as untied financial assistance.

Global indicators

Indicators which could be used to assess *State fiscal capacities* at the total budget level.

Government Finance Statistics

Government Finance Statistics produced by the ABS that measure the financial activities of the governments. GFS statistics are used by the CGC to compile the adjusted budget.

Lag

Describes the impact of averaging *State fiscal capacities* over three years, and the two year delay in data availability. Alternatively, the lag can be described as the difference between the GST distribution in an *application year* based on historical data and a *fully contemporary GST distribution*.

Material, materiality test, materiality threshold

A test used to assist decisions on when a separate *category* of *State* activity or *disability* should be assessed or when data should be adjusted. The materiality levels are defined in terms of the amount of GST redistributed per capita for any State. Different thresholds are used for each. An assessment or data adjustment is said to be material if it exceeds the threshold set for it.

See the Assessment Guidelines, Attachment A of the 2010 CGC Review Report, Volume 1.

National partnership payments (NPPs)

Commonwealth payments to *State*s that support the delivery of specified projects, facilitate reforms, or reward those jurisdictions that deliver on nationally-significant reforms. Some *Specific purpose payments* under the previous federal financial arrangements have become *National partnership payments*.

Payments for Specific Purposes (PSPs)

Payments made by the Commonwealth to States for specific purposes, namely *National Specific Purpose Payments*, *National Partnership Payments* and other general revenue assistance apart from the GST, see also *Commonwealth payments.*

Policy neutral assessment

An assessment unaffected by the policies of individual *State*s, other than through the influence of those policies on the *averages*.

Relativity

A per capita weight assessed by the CGC for use by Treasury in calculating the share of the *GST revenue* a *State* requires to achieve horizontal fiscal equalisation.

Revenue base

A measure of the transactions, activities, or assets that are taxed by the *State*s. Differences between the revenue bases of each *State* are used by the CGC to determine the relative capacities of each State to raise a particular type of revenue.

Review of methodology

The process in which the CGC reconsiders the methods used to calculate *State relativities*, according to terms of reference given to it. From 1988 onwards, reviews have usually been done every five years. By contrast, an *update* is conducted every year other than a review year and updates the relativities using the methods determined in the last review and the latest financial data.

Specific purpose payments (SPPs)

Commonwealth payments to *State*s for specific purposes which enable national policy objectives to be achieved in areas that may be administered by States.

State(s)

Unless the context indicates otherwise, the term 'State(s)' includes the Australian Capital Territory and the Northern Territory.

Untied payments

Untied payments to *States* from the Australian Government may be spent solely in accordance with State priorities. States receive the *GST revenue* as untied payments.

Update

The annual assessment of *State relativities* undertaken by the CGC between *review*s. Update assessments incorporate new budgetary developments and the most recent available data. In general, the methods used to calculate the relativities are those adopted in the most recent review.

Acronyms

ABS	Australian Bureau of Statistics
AIHW	Australian Institute of Health and Welfare
CGC	Commonwealth Grants Commission
COAG	Council of Australian Governments
EPC	Equal per capita
GFS	Government Finance Statistics
GRA	General Revenue Assistance
GST	goods and services tax
HFE	Horizontal Fiscal Equalisation
NPP	National Partnership Payment
PSP	Payment for a Specific Purpose
SPP	Special Purpose Payment
VFI	Vertical Fiscal Imbalance

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Submissions

A list of submissions received by the Review is located at:

http://www.gstdistributionreview.gov.au