New South Wales Submission to the GST Distribution Review

November 2011

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Executive Summary

New South Wales considers that the system of horizontal fiscal equalisation (HFE) in Australia requires a fundamental reappraisal. The current process was put in place at a time of a closed inward looking economy and does not fit comfortably with a more outward looking and globally integrated economy. Suitable changes to the system are required to enhance economic efficiency and equity rather than stifling them, and increase Australia's ability to gain from global economic developments.

Horizontal fiscal equalisation as currently implemented by the Commonwealth Grants Commission results in a system that:

- produces volatile outcomes
- discourages economic reform
- discourages policies designed to boost a state's fiscal capacity
- is complex
- is reliant on the use of data of questionable quality.

The current HFE system redistributes the benefits of reform across all the states, reducing the benefit to the state which undertakes the initiative. Strengthening the incentive for reform by eliminating arbitrary distribution would lead to higher productivity growth and make the HFE system consistent with the micro economic reform agenda of other arms of government policy.

Continued divergence of state circumstances arising from global trends as well as differing state demographic pressures will aggravate pressures on the current system. HFE is not suitable for addressing entrenched disadvantage or significant demographic or other structural differences between the states. This is better handled by direct Commonwealth funding.

New South Wales believes that the Review should recommend an equalisation system which encompasses the following key principles:

- less volatile and more predictable outcomes
- encourages economic reform
- encourages policies designed to boost a state's fiscal capacity
- is transparent
- is less reliant on the use of data of questionable quality.

Consistent with this, 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.

Should the Review favour only incremental change at this time, New South Wales suggests the following changes to the HFE system:

- greater guidance and direction being given to the CGC in the terms of reference to overcome disincentive effects in the current system
- revenue being assessed based on broad tax bases
- expenditure being assessed based on a limited number of core services.

1. Introduction

The GST Distribution Review

On 30 March 2011, the Prime Minister and the Treasurer jointly announced a review of the distribution of GST revenue among the states and territories (collectively 'the states'), aimed at building 'a stronger Australian economy' and making for 'better, more efficient delivery of essential services'.

New South Wales welcomes the Review and the opportunity that it provides for a fundamental reappraisal of the system of fiscal equalisation in Australia. New South Wales has argued the need for such a review for many years. This submission has been prepared in response to the Issues Paper and invitation for submissions issued by the Review on 1 July 2011.

In announcing the Review, the Commonwealth noted that 'a key principle of GST distribution is that States and Territories have the ability to provide broadly equivalent services in areas such as education, health and public transport' but that, under the current arrangements, there is not enough incentive for reform, there is a need for more certainty and predictability and there is a need for greater simplicity and transparency.

The Terms of Reference for the Review note the long-term challenges confronting Australia in relation to globalisation, climate change, population growth and demographic change, innovation and technological change, and tackling the entrenched disadvantage of many Australians, especially indigenous Australians. The Review is asked '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.'

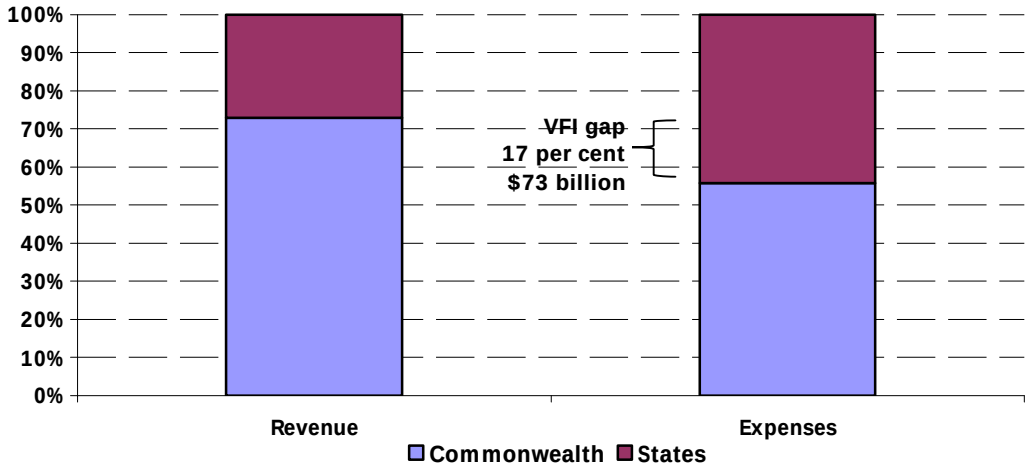
In considering any changes to the form of equalisation, the Review is to have regard to principles of efficiency, equity, simplicity and transparency, and predictability and stability set out in the Terms of Reference. However, GST revenue will continue to be distributed to the states as untied, equalising payments based on the recommendations of the Commonwealth Grants Commission.

Vertical Fiscal Imbalance

By international standards, Australia's intergovernmental financial system exhibits a high degree of vertical fiscal imbalance and a highly comprehensive and complex system of horizontal fiscal equalization.[1]

The Commonwealth collects around 73 percent of Commonwealth and state government revenue (and around 83 per cent of their tax revenue, including the GST) but is responsible for only about 56 percent of total government spending. In contrast, the states collect around 27 per cent of all Commonwealth and state government revenue (17 percent of all tax revenue), but are responsible for around 44 percent of their spending (see Chart 1.1).

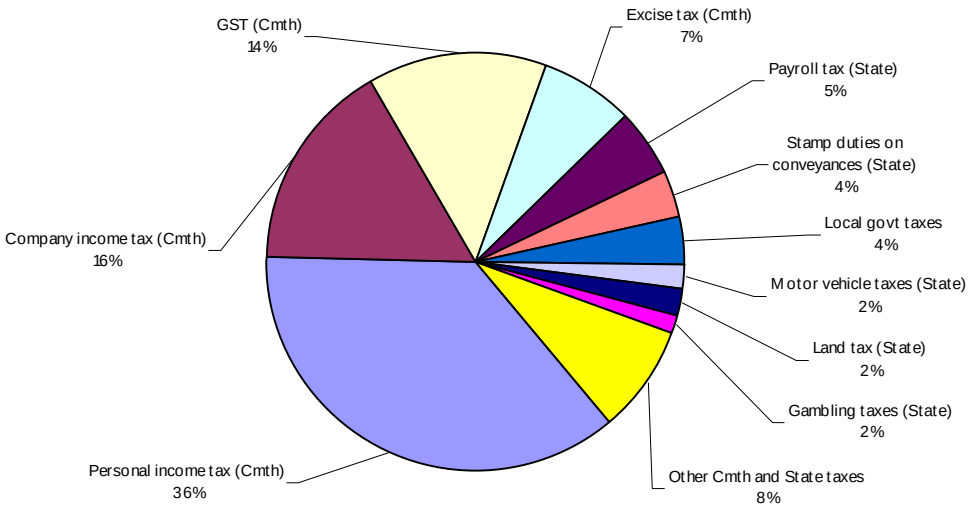
Chart 1.1: Commonwealth-State Vertical Fiscal Imbalance, 2009-10



The Commonwealth dominates the most efficient, broadest and largest revenue yielding tax bases. The largest four taxation bases in Australia – personal income tax (accounting for 36 per cent of all Australian taxation revenue), company income tax (16 per cent), GST (14 per cent) and excise tax (7 per cent) – are controlled by the Commonwealth (see Chart 1.2). Overall, the Commonwealth raises over 80 per cent of tax revenue in Australia while the states are primarily responsible for the delivery of most government services.

[1] **Warren, N. (2006),** *Benchmarking Australia's Intergovernmental Fiscal Arrangements*.

Chart 1.2: Composition of Total Australian Tax Revenue, 2009-10

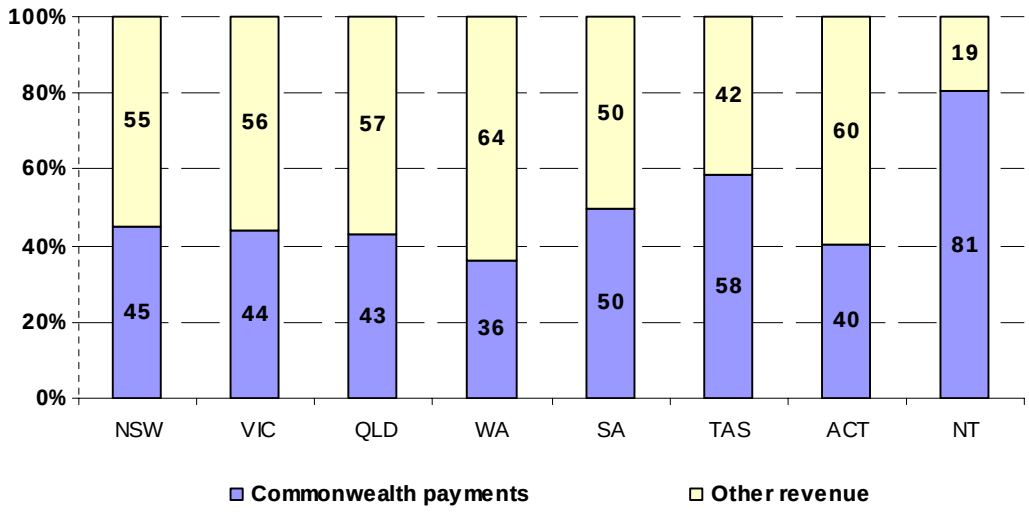


Source: ABS, *Taxation Revenue*, 2009-10 (5506.0)

The high level of vertical fiscal imbalance in Australia implies a very high reliance by the states on transfers of revenue from the Commonwealth government, as illustrated in Chart 1.3 below. The high level of vertical fiscal imbalance accentuates the importance of the method of distribution of the grants to the states.

Commonwealth payments are the largest single broad source of revenue for every state in Australia. On average, Commonwealth payments will account for 45 per cent of total state government revenue in 2011-12. For South Australia and Tasmania, Commonwealth payments are 50 per cent or more of total revenue. For the Northern Territory, Commonwealth grants constitute more than three-quarters of total revenue.

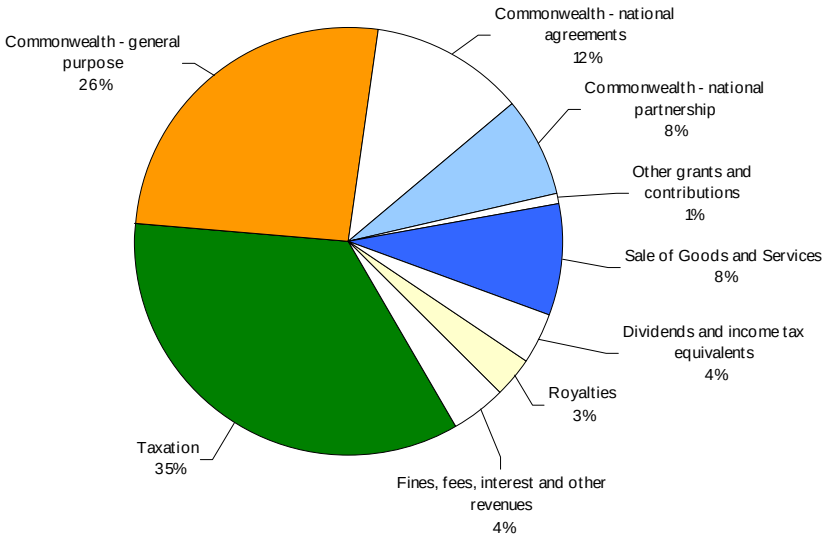
Chart 1.3: Composition of State Revenues, 2011-12



Source: State Budget Papers, 2011-12. Figures exclude Commonwealth payments 'through' the states.

Commonwealth payments are estimated to constitute 45 per cent of NSW total revenue in 2011-12 (Chart 1.4). These payments include both untied GST, which can be used for general purposes, and tied funding provided under National Agreements and National Partnerships that must be used for specific purposes and which, in many cases, is only provided for a limited time.

Chart 1.4: Sources of NSW Revenue, 2011-12



Source: NSW Budget, 2011-12.

NSW revenue is forecast to grow at an annual average rate of 3.7 per cent over the four years to 2014-15, in part reflecting the expiry of a number of National Partnership payments over that period. However, those National Partnerships fund critical areas of service delivery.

This represents a potentially large risk to the people of New South Wales and underlines one of the significant problems in the current funding arrangements. States need certainty in their funding and an ability to control their funding so citizens can rely on a stable level of government services. New South Wales has recently made a submission to the Australian government (on behalf of all states) proposing a mechanism for dealing with expiring National Partnerships where they are funding service delivery that should continue.

State taxes are estimated to provide 35 per cent of NSW total revenue in 2011-12. These taxes are generally narrowly based and volatile, particularly in the case of transfer duty. The states face ongoing pressure to provide services to growing and ageing populations. The ability of states to fund the services from their own tax bases is, however, not sustainable. As the Report on Australia's Future Tax System found, 'increasing the rates of tax on existing state taxes would not be a sustainable way of funding services in the future'.[2]

In these circumstances, the future nature and form of Commonwealth payments to the states is of vital concern to the states.

Grants to the states need to be transparent, stable, simple and understandable (with judgement a last resort). The system supporting the grants distribution needs the support of the states, not just their acquiescence. The current system of horizontal fiscal equalisation (HFE) does not meet these criteria and does not improve the degree of vertical fiscal imbalance.

The Commonwealth Grants Commission

The Commonwealth Grants Commission (CGC) and its processes were developed in an era of a more inward looking and less globally integrated Australian economy. This is no longer the case and the CGC's processes need to reflect the changed environment.

An assessment of states' 'need' for revenue – based on an assessment of their own revenue capacities and spending needs – has long been a feature of the distribution of Commonwealth general purpose payments to the states.

[2] **Australia's Future Tax System (December 2009),** *Report to the Treasurer*, **Part 2, Vol. 2, p. 680.**

The CGC was established in 1933 to provide advice on the size of 'top-up' grants to be paid to financially weaker states. From the late 1970s the CGC's task was broadened to fiscal equalisation across all states.

Grant sharing arrangements, based on the principle of horizontal fiscal equalisation, were implemented in 1982-83, initially to distribute personal income tax sharing grants, and subsequently to distribute Financial Assistance Grants (FAGs) among the states. In 2000-01, the GST revenue was introduced as a dedicated pool of funds for distribution among the states. This pool exceeded the amount of FAGs as it took into account not only FAGs but also the abolition of a number of state taxes.

The Intergovernmental Agreement on the Reform of Commonwealth-State Financial Arrangements, signed in 1999, and the Intergovernmental Agreement on Federal Financial Relations (IGA[3]), which replaced it in 2009, specified that GST revenues are to be distributed among the states in accordance with the principle of horizontal fiscal equalisation and are available to be used for any purpose.

However, neither IGA included a definition of fiscal equalisation, nor did they indicate its specific objectives. The terms of reference for the 2004 and 2010 Reviews of State Revenue Sharing Relativities were also silent on this matter.

Horizontal Fiscal Equalisation

The definition and practice of horizontal fiscal equalisation in Australia have evolved progressively – largely embodied in the work of the CGC. Governments have largely been passive by not objecting to the CGC's definition of HFE, rather than actively seeking to shape the definition and objectives of HFE through the terms of reference issued regularly to the CGC.

The CGC seeks to achieve full equalisation of state government fiscal capacities – revenues, expenses, and investment in infrastructure and financial assets. This contrasts with the income tax/welfare system in Australia which aims only to moderate the income distribution of individuals.

The Commission currently defines horizontal fiscal equalisation (HFE) as:

> 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 and operated at the same level of efficiency.[4]

[3] **Throughout this submission, the acronym 'IGA' will be used to apply to whichever of the abovementioned agreements was operative at the time.**

[4] **CGC (2011),** *Report on GST Revenue Sharing Relativities – 2011 Update***, p. 31.**

To put fiscal equalisation into effect, the Commission developed a set of supporting guidelines. These guidelines were updated in the 2010 Review. The principles now indicate equalisation should be implemented through methods that:

- reflect what states collectively do
- are policy neutral
- are practical
- deliver relativities most appropriate to the application year.[5]

It is important in any discussion of HFE to be clear on what the current system is designed to achieve.

The system does not seek to ensure the same standard or range of government services across Australia. HFE provides for the equalisation of each state's fiscal capacity to provide the average standard of services, after allowing for the non policy related differences in costs associated with providing those services or raising the revenue.

The current system of fiscal equalisation is not based on any principle of interpersonal or interregional (i.e. sub-state) equity, nor is it directed towards achieving increased efficiency in the delivery of government services. Rather, it is directed towards providing states with the capacity to perpetuate average levels of efficiency and average levels of service delivery. The CGC has stated:

> Equalisation does not attempt to equalise the capacity of States to provide services to a standard required to achieve an external policy objective – for example, reducing hospital waiting lists or increasing literacy and numeracy levels. Such an approach would require judgments about matters that are the province of Government. Governments have not asked us to do that.
>
> Similarly, equalisation is not directed to interpersonal, community or regional equality because States do not follow such policies. States do not provide residents of rural and remote areas with the same access to services as people in metropolitan areas. Accordingly, the equalisation standards reflect the different amounts States spend per person in different areas and on different groups of people. Equalisation is not intended to provide States with the capacity to implement policies they do not, on average, already follow. The Australian Government has other policy measures such as the tax and social security systems to address interpersonal equity.[6]

The equalisation system does not seek to provide states with the means to address the issues confronting them or, in CGC terminology, the disabilities they face. Rather, the equalisation system is viewed by the CGC as a mechanism for providing retrospective compensation to states for the relative disabilities they suffer. This was expressed most

[5] **CGC (2010),** *Report on GST Revenue Sharing Relativities – 2010 Review*, **Vol. 1, p. 35.**

[6] **CGC (2010), Vol. 1, p. 36.**

clearly by the CGC in its 1999 Review, but the sentiments have continued to be echoed up to the present time:

> It was said to us in this review that Tasmania suffers from …[an economic] decline, and that the Commission should give it special consideration on that account. Assuming that Tasmania's economic performance is indeed in long-term decline, the equalisation system can compensate it retrospectively so far as the decline has given rise to relative reductions in its income bases and relatively greater calls on State resources to provide welfare payments and other outlays. … [It] is far from clear that attempts to reverse such a decline (as opposed to coping with some of its symptoms) could, or indeed should, be financed through the equalisation system. Other forms of Commonwealth-State co-operation would be needed.[7]

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.[8]

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. This will become increasingly important as the Australian economy grapples with the challenges of structural change and entrenched disadvantage outlined in the Terms of Reference for the GST Distribution Review.

Greater government direction will be required to change the current CGC definition to a definition which allows for efficiency effects and acknowledges the adverse impact that HFE can have on productivity.

[7] **CGC (1999),** *Report on State Revenue Sharing Relativities – 1999 Review*, **Vol. 1, p. 12.**

[8] **Commonwealth of Australia (2011a),** *Australia's Federal Relations*, **2011-12 Budget Paper No. 3, p. 106.**

2. Evaluation against the Terms of Reference

The Terms of Reference ask the Review to consider whether the current form of horizontal fiscal equalisation will ensure that Australia is best placed to respond to the challenges of globalisation, climate change, population growth and demographic change, innovation and technological change, and the entrenched disadvantage of many Australians, especially indigenous Australians.

States are being affected by structural changes leading to greater divergence in their fiscal capacities and the challenges confronting them. HFE cannot cope with these structural changes, which should be addressed outside of the HFE system, leaving HFE to deal with cyclical changes.

The current HFE system creates incentives and disincentives for innovation and reform. The CGC should be directed, through its terms of reference, to treat reforms in ways which provide an incentive to states. This is compatible with the need for productivity and welfare enhancing reform in Australia.

The structural changes underway in Australia are unprecedented in their diversity and magnitude. They are creating challenges for national economic management and widening the differences between the states. They are exposing Australia to new competitive forces and tying us more closely to the fortunes of the world economy, while simultaneously providing new opportunities for economic development.

The Rise of China and India

The emergence of China and India, which together hold approximately one-third of the world's population, as major economic powers is having a profound impact on the global economy and, in particular, on the Australian economy. In the absence of a major mishap, their continued expansion should provide an engine for several decades of global economic growth.

The rapid industrialisation of China has driven strong demand for raw materials – particularly iron ore and coal – and shifted the terms of trade strongly in Australia's favour. According to the 2011-12 Commonwealth Budget Papers, the terms of trade are forecast 'to reach their highest sustained levels in 140 years' before gradually declining 'as increased global supply comes on line.'[9] The 'prospect that strong resource-intensive

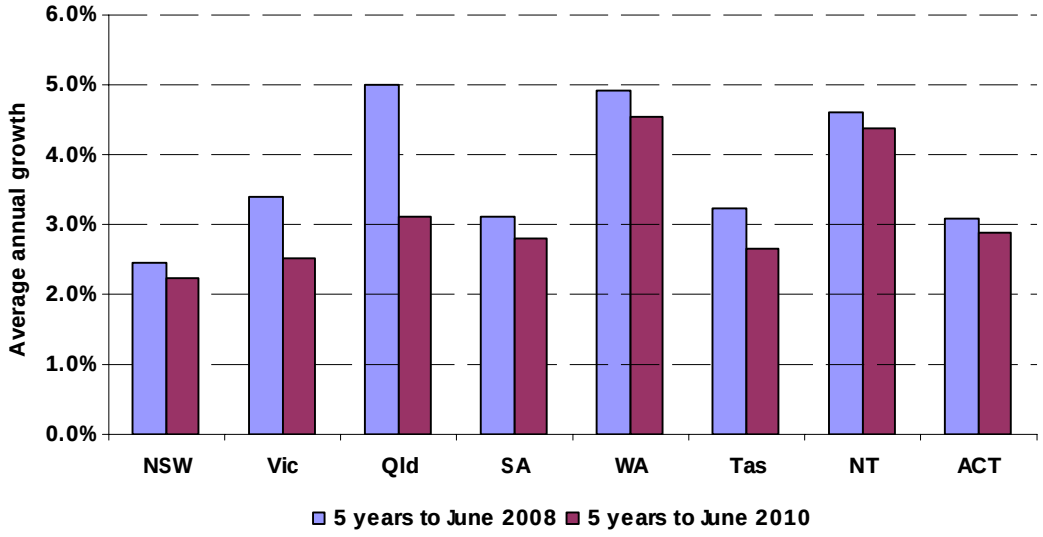
[9] **Commonwealth of Australia (2011b),** *Budget Strategy and Outlook 2011-12*, **Budget Paper No. 1, p. 2-8.**

investment in China and India … will continue for many years underpins expectations that this fall will be gradual.'[10]

States have widely differing allocations of natural resources. Those with resources in high demand already receive increased royalty revenue. They are also benefiting from increased investment (recognising that both involve government budget impacts) and employment. The higher exchange rate accompanying Australia's currently more favourable terms of trade is having a differential impact on state economies. States with a relatively high exposure to traditional manufacturing industries are being adversely affected.

Chart 2.1 shows the increase in Gross State Product over two overlapping 5-year periods – the first before the Global Financial Crisis (GFC), the second including it. This illustrates the effect of both our strong ties with the global economy and the increase in the global demand for resources. The slowdown due to the GFC is evident in all states – particularly Queensland where it was compounded by the effects of natural disasters – but the pattern of higher growth in the mining states is unmistakable.

Chart 2.1: GSP Growth



Source: ABS, *Australian National Accounts: State Accounts* **(5220.0)**

Strong global demand will lead to sharper divergence in economic performance between the states and significantly improve some states' revenue capacities, particularly for revenue sources affected by global demand, e.g. royalties.

The magnitude of these improvements in revenue capacity has already had a significant effect on relativities and, if the current system of fiscal equalisation continues, will have

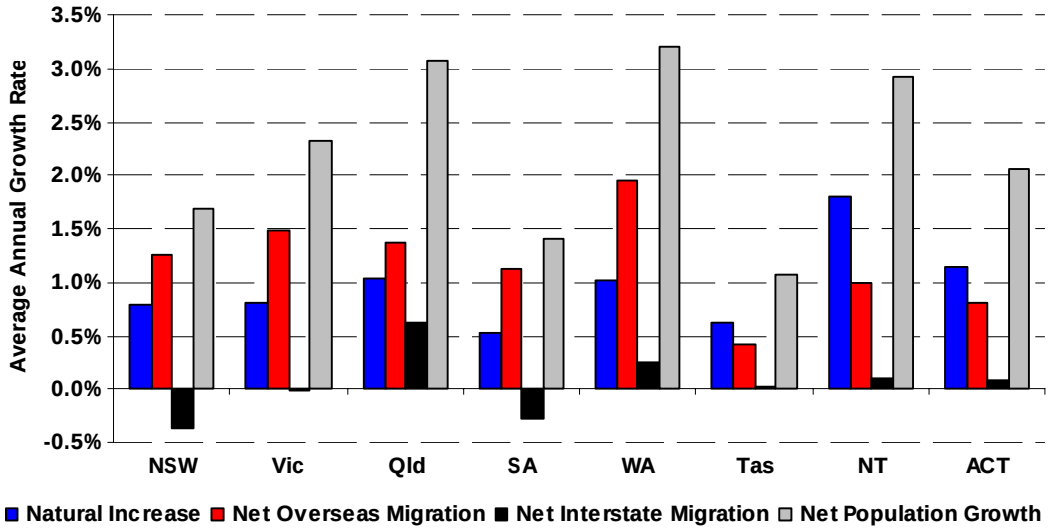
[10] **Commonwealth of Australia (2011b), p. 1-7.**

an increasingly large effect on relativities in the future, potentially reducing some relativities to extremely low levels.

Population Growth and Migration

Population growth and its drivers vary considerably between states. Chart 2.2 shows average population growth rates for each state over the five year period from 2005-06 to 2009-10 and the contributions to that growth due to natural increase, net overseas migration and net interstate migration. There are major differences between the states, with clear implications for the level and type of public services each state needs to provide.

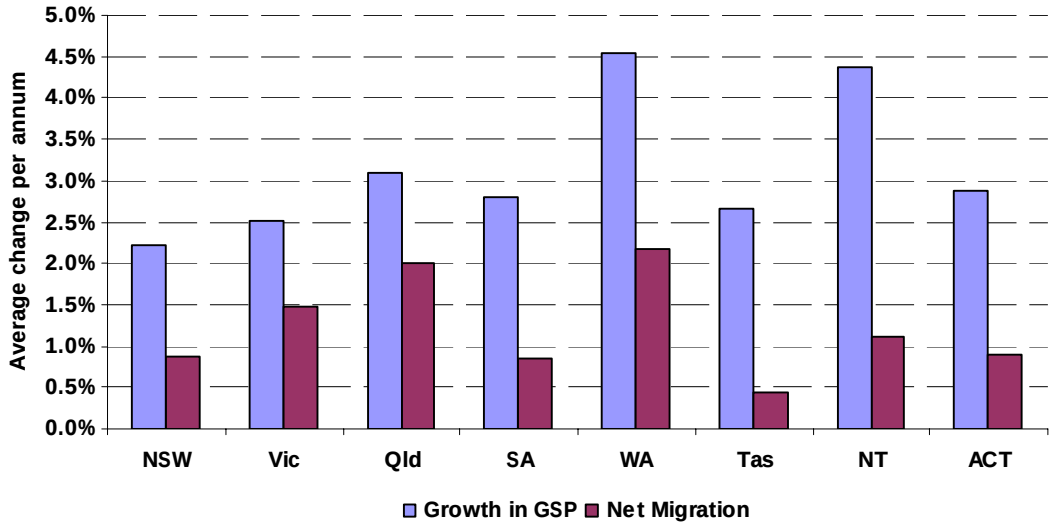
Chart 2.2: Population Growth by State: 2005 – 2010



Source: ABS, *Australian Demographic Statistics* **(3101.0)**

The pattern of migration – both overseas and internal – reflects, to some extent, the pattern of economic growth, as is shown in Chart 2.3. However, other factors may also be at work, for example, relatively high capital intensiveness – and hence low demand for labour – associated with mineral developments may explain the large difference between the growth in real GSP in Western Australia and the level of migration to that State.

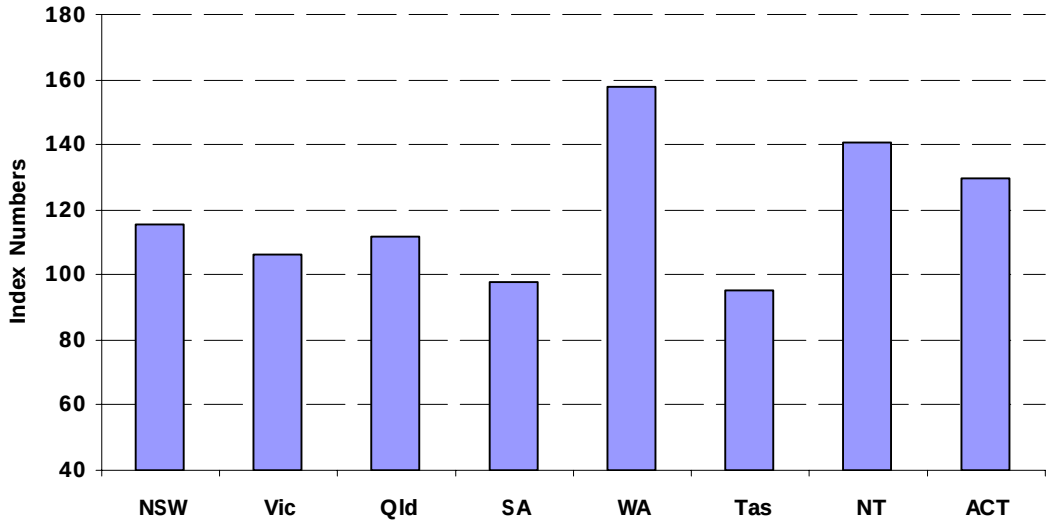
Chart 2.3: Growth and Migration: 2005 – 2010



Sources: ABS, 5220.0 and 3101.0.

General perceptions of the opportunities available for employment in the different states may also play a role. The generally lower level of workforce productivity (see Chart 2.4) in Tasmania and South Australia may be part of the explanation for the relatively low levels of migration to those States.

Chart 2.4: Real GSP per Employed Person



Sources: ABS, 5220.0 and *Labour Force Australia* **(6202.0)**

Australia's population is highly urbanised. Approximately 60 per cent of the population resides in the five capital cities of more than one million people. Around 75 per cent of the population resides in the 18 cities of more than 100,000 people. The population in the cities is growing faster than the population in most of the other regions.

Continued expansion of major cities would place considerably different cost burdens on the states. A number of major cities already suffer problems of congestion. This is particularly the case in Sydney, where the costs of congestion are compounded by the impact of its geography which often leads to higher costs in addressing the congestion and other urban factors.

There is also the question of finding sufficient water resources for a major expansion and of upgrading electricity supplies, sewerage systems and other infrastructure as well as ensuring that food production is not seriously disturbed by encroachment of cities into their agricultural hinterlands. Whether it is desirable to sustain the current pattern of population settlement going forward, with its implications for the formation of mega-cities, is a key policy issue.

Ageing

Over the last 50 years, life expectancy has risen sharply as a result of improved health care and the increasing ability to treat conditions which formerly had high mortality rates. Coupled with decreased fertility rates, this has led to an increase in the proportion of the population aged 65 and over from 8 per cent in 1971 to 14 per cent today. The Commonwealth Intergenerational Report (IGR) projections suggest that, by 2050, 23 per cent of the population will be aged 65 and over. Moreover, the proportion of the population aged 85 or more will almost triple from 1.8 per cent today to 5 per cent by 2050.[11]

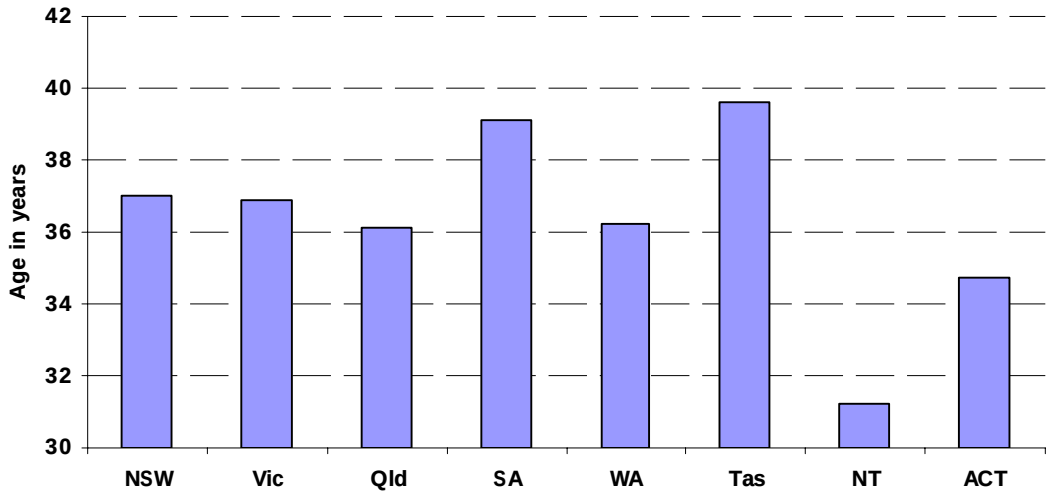
The ageing of the population has major implications for the ability of the working population to sustain Australia's high living standards. In 1971 there were 7.5 people of prime working age (15 – 64) for every aged person (65 and over). Today there are 5.0, and by 2050, the IGR projects, there will only be 2.7.[12] This particularly affects the Commonwealth Budget. However, there will also be implications for state budgets, and these impacts will differ from state to state.

Differences in the age structure of state populations are already evident, as is shown in Chart 2.5.

[11] **Australian Government,** *Australia to 2050: Future Challenges*, **January 2010, pp. 9-10.**

[12] **Intergenerational Report, pp. 5-6.**

Chart 2.5: Median Age by State



Sources: ABS, *Population by Age and Sex, Regions of Australia* **(3235.0.0)**

Population ageing reduces, in per capita terms, states' capacity to raise revenues in a number of areas on which they currently rely. These include payroll tax (reflecting reduced labour force participation rates and hence lower per capita levels of employment and wages), land taxes, stamp duty on conveyances and council rates (reflecting reduced demand for real estate and hence land values), reduced duty on life insurance premiums (reflecting reduced demand for life insurance products) and reduced revenues from motor vehicle taxes and fees.

It is difficult to gauge the likely impact of ageing on the various revenue streams because of the number of factors that impinge on the results, but approximate estimates can be obtained in some cases. For example, an examination of labour force participation rates suggests that current differences between the age profiles of the states affect payroll tax revenues as shown in Table 2.1.

Table 2.1: Effect of Age Structure on the Level of Potential State Payroll Tax Revenue

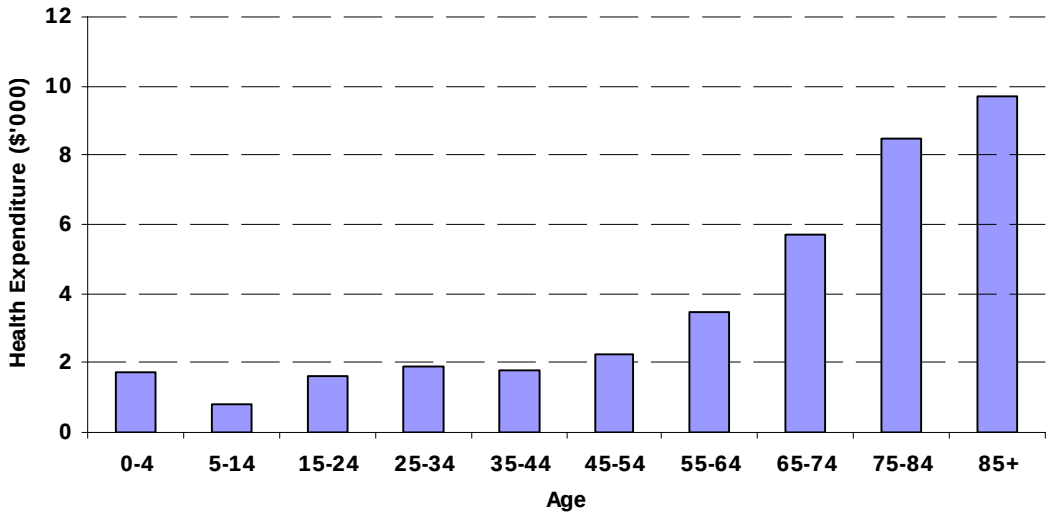
State	NSW	Vic	Qld	SA	WA	Tas	NT	ACT
Impact [(a)]	-0.8	+0.1	+0.8	-3.0	+1.8	-4.1	+9.4	+3.8

(a) Per cent difference from the level that would apply if the state had the average age profile for Australia. Based on the assumption that differences in age profiles are fully reflected in participation rates and that these differences in participation rates are fully reflected in state payroll tax revenues.

Ageing is also likely to increase the costs of health care and the cost of concessions and tax exemptions granted to senior citizens. Offsetting this, there are likely to be reductions in the cost of education and justice services (reflecting the reduced level of younger age group offenders).

The impact of ageing on health cost is likely to be considerable. Data provided by the Australian Institute of Health and Welfare (AIHW) show that average health expenditure per person increases significantly in the latter years of life, from around age 55 onwards, as shown in Chart 2.6.

Chart 2.6: Health Expenditure per Person by Age



Source: Australian Institute of Health and Welfare (AIHW), *Health Expenditure Australia.*

In addition to health care, the elderly also require higher levels of other forms of social support. The proportion of the population of each state employed in the health care and social assistance (healthcare) industry rises significantly as the proportion of the population in the older age groups rises.[13]

Further divergence in state age structures appears likely due to the pattern of overseas migrant arrivals (which have a younger age profile than the existing population) and because higher age structures tend to be self-perpetuating (due to their lower birth rates). These developments will have significant differential effects on state budgets.

ICT Revolution

Whereas the rise of India and China and the associated growth of Australia's minerals sector are driving a shift in comparative advantage away from manufacturing towards mining, the information and communication technology (ICT) revolution is driving pervasive changes through many industries, including wholesaling and retailing, transport, distribution and logistics, telecommunications, entertainment, community services and health, banking and business services and many more. There is reason to

[13] **The pattern in the Northern Territory is significantly different from that of the other states due to the high proportion of Indigenous people in the population. The relatively poor health status and short life expectancy of the Indigenous population means that the Northern Territory is a relatively 'young' State with a relatively high health cost.**

believe that many of the changes already observed are in their infancy and that the pace of change is likely to accelerate.

This is likely to have significant ramifications for state governments. ICT could facilitate new patterns of development and settlement that reduce the transport and logistics tasks currently fundamental to the operation of major cities. It may facilitate new patterns of delivery of government services such as education, justice and aged care. It may transform the need for infrastructure. It may affect both revenues and expenditures by providing employment opportunities to older aged population segments.

The HFE processes that were developed at a time when Australia was less globally integrated are not suitable in the current global economic environment, with sharply diverging circumstances of individual states.

The states' fiscal positions will be affected by these structural changes in different ways and they will place increasingly large pressure on the sustainability of the present HFE system, with its broad coverage and focus on 'average' standards. The structural differences faced by the states need to be addressed by fundamental changes to the current way in which HFE is applied.

Entrenched disadvantage or significant structural changes should be addressed outside of the HFE system.

3. Disincentives in the Current System

The CGC seeks to distribute the GST pool in a policy neutral manner as one of its pillars of equalisation. That is, it aims to ensure that a state's own policies do not directly affect its GST share. Equally, the CGC's decisions should not affect a state's policy decisions.

However, examination of incentive and disincentive effects of the current system of fiscal equalisation in the context of tax reform led Professor Neil Warren to conclude: 'there is no incentive for [States] to pursue any of the Henry reforms given their impact on State tax revenue and grants'.[14] This is of particular concern, given the large efficiency costs many state taxes impose on the economy.

There are two aspects to the CGC's approach to determining policy neutrality:

- whether a policy is average state policy[15]
- if a policy is average state policy, determining the measurement of that average policy.

A state may be able to influence the determination of whether a particular policy is the 'average state policy' – and hence assessed for equalisation purposes – or is not average state policy – and hence is excluded from the equalisation process. This can occur through analysis of how many other states apply that policy and whether that state's decision will cause the status of the policy to change. The state retains all of the revenue, without any equalisation, if a policy is not 'average state policy'

The CGC uses a weighted average across all states to measure the size of an average policy. All else being equal, states assessed as having below average capacity in that category receive an above equal per capita (EPC) GST share and states assessed as having an above average capacity in that category receive a GST share that is less than their EPC share.

This can create an incentive for states to expand their activities in areas where they are assessed as having below average capacity as they will continue to receive above EPC GST share as well as the direct returns from the policy. On the other hand, states can have an incentive to scale back activities in areas where they are assessed as having relative strengths.

The interaction of policy decisions and GST outcomes leads to an incentive for states to analyse the net outcome of policy decisions, i.e. calculate the direct impact of the policy

[14] **Warren, N (2010),** *Intergovernmental fiscal arrangements as a constraint on State tax reform under Henry*, **Paper presented at Conference on "Australia's Future Tax System: A Post-Henry Review, 21-23 June 2010, Sydney.**

[15] **Typically, a policy is determined to be average state policy if it is applied in the majority of states and to the majority of the tax base.**

decision as well as the impact of the policy decision on its GST share. This can influence a state's willingness to implement a policy decision and the timing of that decision.

The interaction of states' policy decisions and HFE is illustrated by the examples in the following sections.

Disincentives for Tax Reform

Unilateral State tax reform

The current form of fiscal equalisation can provide a disincentive for a state to act unilaterally to abolish inefficient taxes.

Under the Intergovernmental Agreement (IGA) associated with the introduction of the GST, states agreed to abolish certain inefficient taxes on particular dates and abolish others following reviews of their need to retain them.

The Victorian government decided on the early elimination of some of the financial transactions taxes (FTT) due for abolition under the IGA (stamp duty on leases, mortgages, debentures, bonds and other loan securities, and a number of other minor duties).

Victoria's decision had two impacts on its budget:

- it reduced its own-sourced revenue
- it changed the GST share it received.

The first impact was clearly a reflection of its own policy choice. The second, however, requires further consideration.

The Commission assessed Victoria as having an above average capacity to raise FTT and requiring less GST as a consequence – in fact $48 million less GST than its population share in 2003-04. Victoria's abolition of FTT changed its GST share because:

- Victoria's abolition of FTT reduced national FTT collections by around $284 million
- the FTT tax base remained unchanged, as FTT was still average policy, and the average rate of FTT fell
- the lower average FTT rate caused each state's assessed FTT revenue to fall
- states with an above average capacity to raise FTT – essentially New South Wales and Victoria – found their GST 'losses' from the FTT assessment reduced and states with a below average capacity saw a fall in their GST 'gains'

- Victoria improved its GST share by around $9 million ($39 million loss of GST revenue after abolishing FTT compared to a $48 million loss had it not abolished FTT)[16]
- Victoria would have gained $48 million if the tax was no longer assessed by the CGC.

Victoria received a marginal increase in its GST, but was still $39 million below the level that would have applied if the tax was no longer assessed, which could be achieved by guidance given to the CGC in their terms of reference, or if all states had simultaneously abolished their financial transactions taxes.

Victoria had acted in the interest of productivity and welfare enhancing reform (by the early abolition of inefficient taxes), but still received less than EPC GST revenue (though marginally higher than previously) on account of taxes it no longer levied.

There would be a greater incentive for states to undertake reform if, after abolishing a tax, the state did not continue to lose GST because of a tax they no longer imposed.

New South Wales faced a similar situation when it abolished debits tax ahead of other states on 1 January 2002. As well as losing its own tax revenue, it continued to lose GST revenue because of a tax it did not levy, until all states abolished the tax from 1 July 2005.

These effects could be eliminated if the CGC were given a direction on how to handle these policy decisions in their terms of reference.

Joint State tax reform

Even when tax reform is being undertaken by all states there can be significant disincentives in the HFE system, and the system can have a marked influence on the timing of the implementation of the joint policies.

The smaller states lost both their own tax revenue and the positive GST effect they had previously enjoyed when they abolished the financial transaction taxes as agreed under the IGA. The size of the GST loss also can be affected significantly by the abolition timetable.

South Australia included the following tables in its 2005-06 Budget showing the impact on its revenues from the abolition of the IGA taxes.

Under the original Commonwealth timetable for the abolition of the taxes, South Australia calculated that it would lose significant GST revenue as a result of the abolition of the taxes, as well as the direct tax revenue.

[16] **These figures are taken from CGC,** *Effect of Victoria abolishing FTT*, **cgc.gov.au/gst_distribution/presentation_on_the_work_of_the_Commission.**

Table 4.1: Estimated impact on South Australia of Commonwealth's proposal for abolition of IGA taxes ($ million)

	2006-07	2007-08	2008-09	2009-10	2010-11
State tax revenue	-91	-137	-146	-153	-159
Indirect CGC effects	-32	-54	-54	-59	-62
Total impact	-123	-191	-200	-212	-221

The 'Indirect CGC effects' row in the table shows the effect on states' GST revenues associated with the abolition of the agreed taxes in accordance with the Commonwealth's proposed timetable.

Six states wrote jointly to the Commonwealth proposing an alternative schedule of tax abolition. The impact on South Australia of the alternative schedule is shown in the table below.

Table 4.2: Estimated impact on South Australia of States' proposal for abolition of IGA taxes ($ million)

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
State tax revenue	-24	-28	-51	-78	-128	-159
Indirect CGC effects[(a)]	—	-2	-3	-8	-39	-41
Total impact	**-24**	**-29**	**-54**	**-86**	**-167**	**-200**

(a) Reflects later timing of abolition of taxes compared to Commonwealth proposal.

The phased reduction shown in the second table considerably reduces South Australia's loss of GST revenue.

This example shows clearly the incentive effects of the current system of fiscal equalisation on a state's decisions. The impact was sufficiently powerful to motivate a number of states to approach the Commonwealth seeking a delay in the abolition of taxes that they all recognised as having undesirable characteristics.

The HFE system clearly can have an effect on a state's policy decisions.

Changing the Tax Mix

The current system of fiscal equalisation can also provide disincentives for states to alter their mix of taxation.

Property transfer (conveyances) duty is widely regarded as one of the most inefficient of current state taxes, given its narrow base and impact on transactions. Land tax is regarded as a much more efficient tax. Therefore, even if the overall revenue take remained the same, there would be a net efficiency gain to the Australian economy if a state reduced revenue from the inefficient tax and switched revenue raising to the more efficient tax.

However, in a purely hypothetical example, such a switch would result in deterioration in the NSW GST position.

Table 3.1 shows that New South Wales currently is assessed to have an above average capacity to raise land tax revenue. An increase in New South Wales' land tax revenue from a higher tax rate on existing taxable properties would increase aggregate land tax revenue. This would increase assessed revenues for all states, with New South Wales maintaining its above average capacity. This would reduce New South Wales' share of GST.

Table 3.1: NSW Land Tax and Transfer Duty Capacity Ratios 2007-08 to 2009-10

	Land tax	Property Transfer duty
2007-08	**107.44**	**92.26**
2008-09	**100.43**	**96.69**
2009-10	**99.77**	**100.59**
3 year average	**102.55**	**96.52**

Source: CGC, www.cgc.gov.au, *2011 Update*, Supporting Information, Data downloads – Excel spreadsheets supporting the relativities, Revenue and Expense Ratios, Table S3-1.

New South Wales is currently assessed as having a below average capacity to raise transfer duty revenue, so New South Wales receives above average GST revenue on this assessment. If New South Wales reduced transfer duty revenue, total transfer duty revenue would fall and New South Wales would receive less GST.

While the switch from transfer duty to land tax would be revenue neutral in terms of direct revenue, the overall revenue result from the substitution of a more efficient tax for a less efficient tax would be undermined by the loss of GST revenue.

One State Impacting the Tax Base

The impacts of state tax policy decisions on the GST distribution are generally slight. But there can be larger influences when one state's activities are large enough for its tax policies to affect the assessed tax base.

Western Australia's recent changes in its tax rates on iron ore fines also illustrates how tax policy can impact on assessed tax bases in a situation where one state dominates a tax base.

The 2010 Review mining revenue assessment essentially divided the mining revenue base into two categories: a high royalty (rates above five per cent) mineral category and a low royalty (rates less than five per cent) mineral category. Iron ore fines (with an average effective rate of 4.69 per cent in 2008-09) were placed in the low royalty rate group and lump iron ore (with an average effective rate of 6.79 per cent) in the high royalty rate group.

From 1 July 2010, Western Australia – the dominant producer of iron ore – removed the concessional iron ore fines royalty rates (3.75 per cent) applying to two producers, covering about half of total iron ore fines production in that State. This took the royalty rate for these producers to the general fines royalty rate of 5.625 per cent, in turn taking the average effective iron ore fines royalty rate above five per cent.

Removal of the concessions raised the issue of whether iron ore fines should be moved from the low royalty rate mineral category to the high royalty rate category in the assessment of mineral revenues.

Doing so would produce a significant redistribution of GST revenue through its impacts on the assessed tax bases. It would move a large proportion of Western Australia's mineral revenue tax base to the category where higher average rates of royalty are applied to assess mineral revenue capacity, thereby increasing Western Australia's assessed mineral revenue and reducing its assessed need for GST revenue payments.

When removing the concessional rates on iron ore fines from 1 July 2010, Western Australia sought an indication from the Grants Commission of its attitude to the reclassification of iron ore fines to the high royalty rate group, though the policy change would not affect the GST relativity calculations until the 2012 Update. Western Australia argued that reclassifying iron ore fines would cause the State to lose more GST revenue than it raised by removing the royalty concessions.

This issue was determined by the treatment of royalties on iron ore fines being specified in the terms of reference for the 2011 Update.

> The Commission should ensure that, with regard to the removal of iron ore fines royalty rate concessions in 2010, the classification of iron ore fines should not move between royalty rate groups in between methodology reviews.[17]

The Disincentive to Expand Capacity

If a state government adopted policies that successfully promoted economic development, it could reasonably expect to receive a boost to its financial position by way of a growth dividend in its revenue collections, without any need to vary tax rates. There would also be a growth dividend to the Commonwealth through higher Commonwealth tax revenue.

The current system of HFE can redistribute the effects of an increase in assessed revenue raising capacity, with no change in the tax rate. This can be particularly the case with a small state that levies a tax at a below average rate, for example, payroll tax in Tasmania.

[17] **CGC (2011), p. vii.**

Table 3.2 below shows the effect on states' revenues of economic growth in Tasmania (i.e. an increase in assessed revenue capacity in Tasmania) which leads to an increase of $5 million in its payroll tax revenue, assuming no other changes. The result is a reduction of $5.4 million in Tasmania's assessed GST share, giving a net loss of revenue to Tasmania of $0.4 million.

Table 3.2: Impact on State Revenues of Economic Growth in Tasmania[(a)]

	NSW	Vic	Qld	SA	WA	Tas	NT	ACT	Total
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Change in:									
Payroll tax revenue	..	..	..	..	..	5.0	..	..	5.0
Assessed GST share	1.8	1.4	1.1	0.4	0.6	-5.4	0.1	0.1	..
Total	1.8	1.4	1.1	0.4	0.6	-0.4	0.1	0.1	5.0

(a) Differences in own payroll tax revenues and assessed GST shares resulting from economic growth in Tasmania that yields an additional $5 million of payroll tax revenue in that State, assuming no change in the structure of payroll tax or changes in rates, based on the Grants Commission's assessments for 2008-09 contained in its 2010 Review Report. For the purposes of calculation, no progressivity in the incidence of the tax has been assumed, i.e. the increase in tax yield has been assumed to be proportional to the overall increase in compensation of private sector employees.

However, if Tasmania's payroll tax base were to decline, and this decline were to result in a reduction of its payroll tax revenue by $5 million, the effect on states' revenues would be as shown in Table 3.2 with the signs reversed. Thus a decline in Tasmania's assessed revenue capacity would lead to a net improvement in its total revenues as the decline in its payroll tax revenue would be more than offset by an increase in its GST share.

In a similar vein, if a small State such as Tasmania were to lag behind growth in the rest of the economy, it would receive a net boost to its revenues, greater than it would if its economy kept pace with the rest of Australia.

For the larger states, there are also offsets to the impact of economic growth on their own revenues, but these are generally of a lesser magnitude. Table 3.3 below shows the impact of growth in New South Wales above the national average, which results in additional payroll tax revenue of $100 million above that which would be produced by growth at the average rate, again assuming no change in tax rates. In this case, $62.5 million would be equalised away, leaving New South Wales with a net benefit of $37.5 million.

Table 3.3: Impact on State Revenues of Economic Growth in New South Wales[(a)]

	NSW	Vic	Qld	SA	WA	Tas	NT	ACT	Total
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Change in:									
Payroll tax revenue	100.0	..	..	..	..	..	..	..	100.0
Assessed GST share	-62.5	22.9	18.7	7.0	9.3	2.2	1.0	1.5	..
Total	37.5	22.9	18.7	7.0	9.3	2.2	1.0	1.5	100.0

(a) Differences in own payroll tax revenues and assessed GST shares resulting from economic growth in New South Wales that yields an additional $100 million of payroll tax revenue in that State, assuming no change in the structure of payroll tax or changes in rates, based on the Grants Commission's assessments for 2008-09 contained in its 2010 Review Report. For the purposes of calculation, no progressivity in the incidence of the tax has been assumed, i.e. the increase in tax yield has been assumed to be proportional to the overall increase in compensation of employees.

The Disincentive to Innovate

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. This is because provision of services by the non-government sector, whether in the form of community self-help or provision by voluntary or private sector organisations, is regarded by the CGC as reducing the burden on state governments, thereby reducing their need for GST revenue.

This issue was debated by the Commissioners during the course of the 1993 Review of Grant Sharing Relativities in relation to the education assessment:

> For Primary and Secondary Education the assessments include the effects of a decision to assess government and non-government schools as separate categories … The minority view (held by R D Barnes) is that the assessment should be of one combined category, that the eligible population to be served in a State should in principle be all children of specified ages (perhaps with some adjustment for cross-border flows), and that all Commonwealth SPPs for schools should be treated by inclusion. This view is that the efforts of people in a State community who send their children to non-government schools and thereby save a government money should not lead to an assessment of a smaller grant to that State. This would have the effect of distributing the results of their efforts to other States. The majority believe that a combined assessment would depart too far from what States actually do, which is to spend much more for each government school student than for each non-government school student.[18]

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

[18] **CGC (1993),** *Report on General Revenue Grant Relativities*, **Volume 1 – Main Report, p. 35.**

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.

Table 3.4 below provides a numerical example of the effects. The hypothetical reform is a state (shown as Victoria for the purposes of illustration) that agrees to pay a subsidy of $8,000 per student to a group of private schools for the provision of a particular type of education service specially suited to a specific segment of the student population. These private schools are assumed to be also able to charge fees for students to attend the schools to enable them to provide the education services to the required standards.

In this table, it is assumed that 5 per cent of government school students voluntarily migrate to the new private schools but there is no migration from existing private schools. In the example, Victoria is assumed to realise direct savings per migrating student equal to the national average cost per student of public school education, but these savings are offset by the cost of the additional subsidies. The table shows a net saving to Victoria's overall government expenditure of $80 million per annum. However, the effects on the GST distribution would result in an overall deterioration of $101 million in the fiscal position of the state initiating the reform.

Table 3.4: Impact of Reform on State Fiscal Positions[(a)]

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Reduction in own expenses	..	80	..	..	..	..	..	..	80
Change in assessed GST share	78	-181	47	26	18	5	5	3	..
Net Effect	78	-101	47	26	18	5	5	3	80

(a) Figures are based on the assessment for schools education for 2008-09 shown in the Grants Commission's Report of the 2010 Review. The postulated reform is of a state (shown as Victoria for the purposes of illustration) that agrees to pay a subsidy of $8,000 per student to a group of private schools for the provision of a particular type of education service specially suited to a specific segment of the student population. These private schools are assumed to be also able to charge fees for students to attend the schools. In this table it is assumed that 5 per cent of the government school population voluntarily migrates to these schools but there is no migration from existing private schools. In the example, Victoria is assumed to realise direct savings per migrating student equal to the national average cost per student of public school education (since, for the purposes of this illustration, the particularities of Victoria's cost structure are not important) but these savings are offset by the cost of the additional subsidies. The example is for illustrative purposes only.

Conclusions

The Australian economy is undergoing significant structural changes which are affecting the states in different ways. This differential impact will place increasing pressures on the

existing HFE system. It was not envisaged that the current HFE system would need to handle significant structural changes in the economy, leading to long term significant changes to relativities. Structural changes should be addressed outside the HFE system.

Despite the neutrality objective of the Commission, states can affect whether a policy is deemed to be average policy or not, and states can affect the measurement of that average policy. Both of these factors can distort state decision making and lead to sub optimal outcomes.

The current HFE system incorporates disincentives for states to undertake various efficiency enhancing taxation changes and or policies designed to boost their state's fiscal capacity.

The effect of HFE is to redistribute the benefits of reform across all the states, reducing the benefit to the state which undertakes the initiative. Strengthening the incentive for reform will lead to higher productivity growth and make the HFE system consistent with the micro economic reform agenda of other arms of government policy.

The HFE system needs to remove the disincentives for states to undertake reform and should not distort state decision making. A system based on an equal per capita distribution of the GST pool is consistent with these objectives.

4. Evaluating Australia's Current HFE System

The 2010 Review included a simplification agenda which led to a decline in the number of assessments. Until 2010 the CGC's approach to full equalisation resulted in on-going efforts by the states to expand the range of state activities subject to equalisation and increase its precision. This has contributed considerably to the complexity of the current system, its intensive use of often inadequate data, its overreliance on judgement, and its lack of transparency.

Despite all the 'activity' in the current assessment processes, at the aggregate level the 'net' GST redistributed, as a share of the total GST pool, has remained fairly constant. This raises the question of whether the 'activity' is justified by the outcomes, or whether there might be a much simpler way to proceed.

In summary, the current HFE system is complex, data intensive, requires the use of judgement by the CGC, lacks transparency and is volatile and unpredictable.

Complexity

The 'correct' or underlying equalised redistribution is unknown and unobservable. It is impossible to know whether the CGC's changes in each methodology review bring the redistribution closer to the ideal or not. Despite the unobservability of the correct outcome there has been a tendency, at least until the 2010 Review, to view an increase in the number of assessments and disabilities as a movement towards the true redistribution.

At its simplest, the complexity in Australia's current system of HFE can be seen in the number of assessments and sub-assessments (or components) in the CGC's calculations. These figures are shown in Table 4.1 and Chart 4.1, covering the three methodologies used by the CGC since the introduction of the GST: the 1999 Review, the 2004 Review and the 2010 Review.

Table 4.1: HFE Assessments and Disabilities

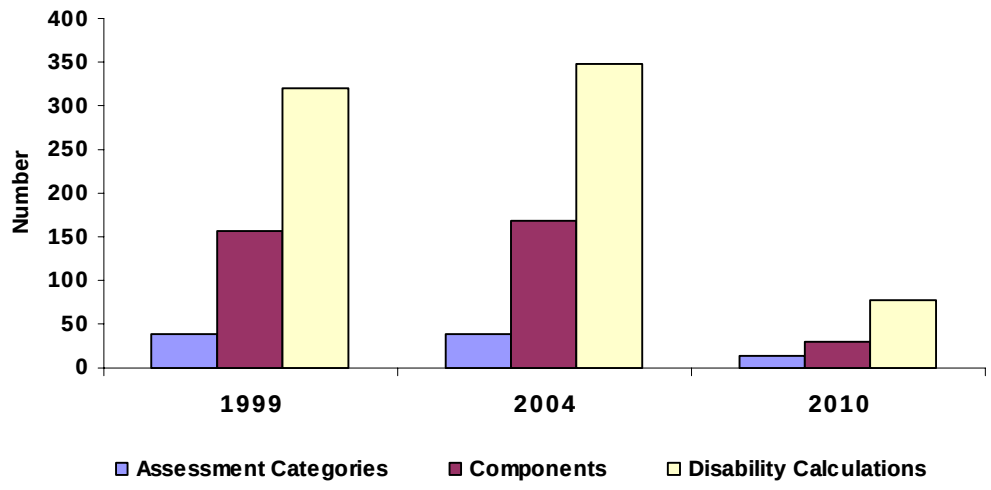
Review	Expense Assessments			Revenue Assessments	
	Categories	Components	Disabilities	Categories	Components
1999	39	157	321	31	33
2004	38	168	347	21	29
2010	14	30	78	8	13

The 1999 Review methodology involved 31 revenue categories and 39 spending categories. The spending categories were subdivided into 157 components. Acting on those 157 components were 321 disabilities.

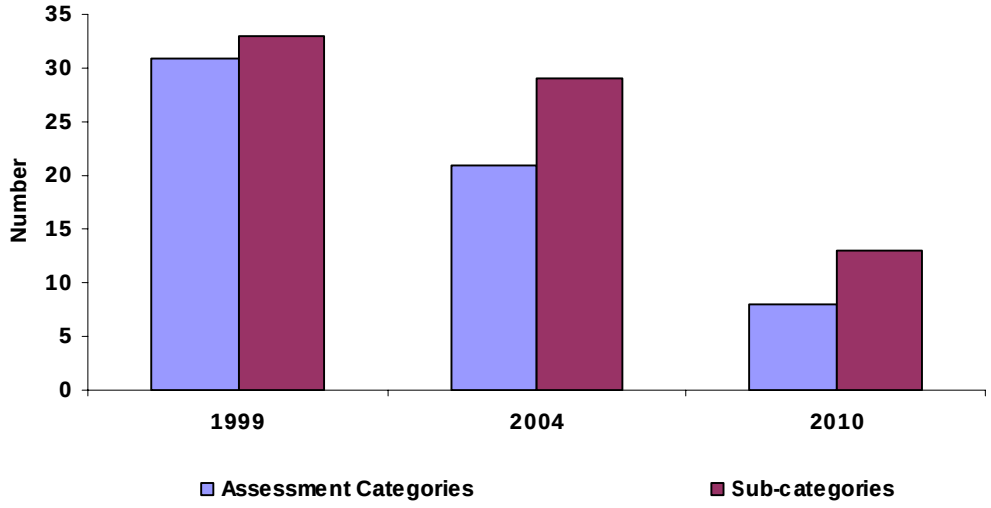
The terms of reference for the Commission's 2010 Review of GST Sharing Relativities aimed at achieving simplification and enhanced reliability of equalisation assessments. The impact of the simplification measures undertaken by the Commission is illustrated in Table 4.1 and Chart 4.1.

Chart 4.1: Assessment Categories, Components and Disabilities

Panel 1: Spending Assessments



Panel 2: Revenue Assessments



The reduced detail applied to expense assessments in the 2010 Review is clearly evident. Reduced detail in the revenue assessments was already evident in the 2004 Review due primarily to the abolition of a number of state taxes with the introduction of the GST.

This simplification significantly reduced reliance on data of questionable quality and on the use of judgement by the Commission. There is no evidence to suggest that the relativities resulting from the simplified approach produced an inferior equalisation outcome.

In undertaking simplification measures, the Commission reconsidered the structure of its assessment categories from the ground up. The result was a more logical structure and greater clarity of presentation. New South Wales acknowledges the progress made but considers that further progress towards simplification and more transparent reporting is both possible and desirable.

The current HFE methodology still involves eight revenue categories (including Commonwealth payments) with 13 sub-categories; 12 expense categories with 25 components, an investment category with four components and a net lending category (with a single component). In total there are 43 components/sub-categories and 93 disabilities. Data for each has to be provided for the three financial years of each assessment period.

Additionally, there are further complications within the assessments, even the relatively simple revenue assessments.

- In the payroll tax assessment, for example, the CGC takes account of the existence of the tax free threshold by using ABS estimates of the proportion of each state's payrolls that fall below the average tax free threshold.
- In two of the revenue categories, state data on the tax base and revenue raised is provided in 15 (for land tax) and 16 (for stamp duty on conveyances) value ranges, since most states have a progressive rate structure for these two revenue sources.
- In stamp duty on conveyances, adjustments to state revenue bases are made for four differences in the property subject to transfer duty to achieve consistent tax bases across the states.

While there was a significant decline in the number of assessments in the 2010 Review, there remains underlying pressure for increased complexity in the fiscal equalisation process. The equalisation process encourages states to attempt to influence their GST shares by bringing forward arguments to the Commission to alter assessments in the states' favour. Such arguments frequently result in the need for additional categories or sub-components, requiring additional data.

Data Demands

The pressure for detail and disaggregation places heavy demands on data. Data is sourced from the Australian Bureau of Statistics, Commonwealth and state departments

and agencies and other bodies such as the Australian Institute of Health and Welfare, the Private Health Insurance Administration Council, and the Australian Institute of Criminology.

Important requirements in using this data are that it be reliable, fit for purpose and comparable across states. Despite the CGC's efforts to improve data reliability in the 2010 Review, there remain significant issues of data availability and reliability in the current method of assessing HFE in Australia.

Perhaps the best way to gain an insight into the CGC's use of data is to look at an assessment as an example. We have chosen payroll tax, since this is an assessment that in theory should be relatively simple, given the fairly straight forward nature of the tax – a percentage rate applied to employer payrolls – and the relatively homogenous nature of the tax base, reflecting efforts by states in recent years to harmonise legislative provisions and definitions (though not the rates and tax free thresholds) in this revenue source.

At six points in the payroll tax assessment, data availability becomes a problem. Alternative data is required at each of those points. At each of those points it is assumed that the data sourced differently from the original base data of compensation of employees are measuring the same thing or, if recognised as not measuring the same thing, can be 'adjusted' to make them comparable.

Box 4.1 details the data requirements of the current payroll tax assessment.

The data issues in revenue assessments where tax bases are less homogenous and in expense assessments where data is not as clearly defined and readily available are even more problematic.

A move to broader tax bases and fewer assessment categories would reduce the number of data series required and could reduce the complexity and subjectivity of the data sourcing, calculations and analysis that are currently required.

Box 4.1: Data requirements in the payroll tax assessment

Payroll tax is legislatively imposed on wages and salaries and related benefits (employer superannuation contributions, fringe benefits, allowances, bonuses and so on) paid by employers. The starting point in the payroll tax assessment is ABS data for each state on the compensation of employees from the National Accounts.

Since a tax free threshold is common policy among the states, the compensation of employee data is adjusted to remove payrolls below an average Australian tax free threshold from the tax base.

§ However, compensation of employee data is not available by size of employer payroll.

So ABS data from other sources on private sector wages and salaries and public sector wages and salaries which can be dissected by payroll size is used to estimate the proportion of compensation of employees in each state that is taxable. This assumes that the above and below threshold proportions of compensation of employees in the private and public sectors are the same as for wages and salaries in each sector.

§ However, this alternative wages and salaries data is narrower in scope than the compensation of employees data, since it does not cover related benefits.

To allow for this deficiency the CGC uses a lower threshold to dissect wages and salaries into those above and below the threshold. It uses different thresholds for the private and public sectors (reflecting different proportions of total remuneration accounted for by wages and salaries in each sector) and assumes the proportion of total remuneration accounted for by wages and salaries in each sector is the same across all the states.

§ However, the earnings of defence force and Australian embassy personnel overseas – which are not subject to payroll tax – are included in the public sector compensation of employee data but not in the ABS survey of public sector wages and salaries.

Data on defence force and embassy staff earnings come from annual reports of the Departments of Defence, Veterans' Affairs and Foreign Affairs and Trade, and are deducted from public sector compensation of employees prior to application of the public sector taxable proportion calculated using the ABS public sector wages and salaries survey data. This assumes that data from these annual reports have the same scope as the ABS data.

§ However, the public sector compensation of employee data includes state general government agencies – for which payroll tax payments produce no net gain to state governments since the revenue is offset by payments – and higher education institutions, which are exempt from payroll tax.

Data for these payments comes from the ABS Survey of Employment and Earnings.

§ However, the data is not available in the precise form required. Wages and salaries of public trading enterprises (PTEs) are not available separately and, for confidentiality reasons, data on wages and salaries above the threshold is provided as a total number covering higher education institutions in Tasmania, the Australian Capital Territory and the Northern Territory as a whole.

Therefore, PTE wages and salaries are assumed to mirror those of industries where public sector activity is predominantly commercial, i.e. agriculture, forestry and fishing; electricity, gas, water and waste services; transport, postal and warehousing; and finance and insurance services. For higher education in the three smallest jurisdictions, the CGC uses Department of Education, Employment and Workplace Relations data on staff levels of higher education institutions to split the combined data provided by the ABS. This assumes that staff pay level profiles are the same across the three jurisdictions.

§ In the private sector, meanwhile, the agriculture, forestry and fishing industry is included in the national accounts compensation of employees data, but is not included in the private sector wages and salaries data used to estimate the taxable proportion of wages and salaries.

It is assumed that the taxable proportion of wages and salaries in the agricultural sector is the same as that in the private sector excluding agriculture.

Source: CGC, *2010 Review*, Volume 3, pp. 74-86.

Use of Judgement

The current method of implementing HFE in Australia calls on the CGC to use extensive 'judgement'. This judgement is used in filling data gaps, in assessing the merits of often arguable conceptual cases for the inclusion of disabilities and in decisions on the methods used in assessments.

In filling data gaps, the Commission's judgement is used, for example:

§ in the assessment of the interstate non-wage costs disability – which seeks to measure the variation between states of non-wage costs for interstate freight and

interstate travel expenses for government staff. There is no direct data on the level of interstate freight costs. However, based on ABS Input-Output tables the CGC estimates total expenditure by state governments on freight was around $800 million in 2004-05, and determines interstate freight is half the total freight. State shares of this total interstate freight spending are also based on the CGC's judgement

- in the administrative scale assessment – which seeks to measure the intrinsically higher per capita costs faced by states with small populations because the minimum functions of government have to be spread over a smaller number of residents. Again, there are no precise data on the extent of these costs. The current estimates are based on estimates originally made in the 1999 Review for 'minimum fixed costs' and 'scale-affected variable costs', modified in the 2004 Review by excluding all but 10 per cent of 'scale-affected variable costs', adding an amount for changes in government functions between 1999 and 2004, and up-scaling for movements between 1999 and 2004 in public sector wages and the CPI; and further up-scaling by the chain price index for state and local government final consumption expenditure from the national accounts for movements in these costs between the 2004 and 2010 Reviews.

Before making data judgements, the CGC makes more fundamental judgements about whether conceptual cases for various disabilities argued by states are sound. To continue the examples of interstate non-wage costs and administrative scale, states have advanced arguments – such as the national pricing of many material inputs to state government activities by suppliers operating on a national basis, and the variability of all costs over anything but the short run in relation to administrative scale – to suggest that these disabilities either do not exist or are much less important than might be assumed. The Commission's judgement, however, has been that the disabilities do exist.

Transparency

Associated with this detailed and complex assessment methodology and the extensive use of judgement is a lack of transparency and 'understandability'.

The CGC provides its review and update reports and discussions of new issues on its website. Until recently, it also provided working papers for each assessment. Working papers were not provided in the 2009 Update – due to the pressure on staff who were concurrently working to finalise the 2010 Review – or the 2011 Update. Working papers were last provided in the 2010 Review. The working papers provided full details of the CGC's calculations in each assessment, exampled by actual data for the final financial year of the assessment period.

This allowed interested parties, with some effort, to trace through the detailed assessment methods.

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.

In addition, the extensive use of judgement in the HFE process can limit transparency. It can often be difficult to follow the CGC's reasoning and decision-making processes when it exercises its judgement.

The development of the capital assessments provided an example of a situation where some states and the Commission seemed to be approaching the issue from opposite points of view, leading to different views on appropriate methods of assessment and little common understanding.

In the end the CGC favoured an approach that recognised new infrastructure needs as they arose. The CGC said such an approach was consistent with state practices of using revenue, including GST revenue, to fund investment in new infrastructure and providing states with the capacity to fund investment in new infrastructure when the need arises.

The CGC is in the invidious position of having to decide between the competing arguments of states whose main objective, understandably, is to gain as large as possible a share of the GST pool for themselves, meaning a lesser share for other states.

Volatility and Unpredictability

The current method of implementing HFE in Australia often produces significant and unexpected movements in states' annual GST payments, in relation to their projected budget positions, 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. Table 4.2 details the changes from year to year in states' GST payments due to relativity changes.

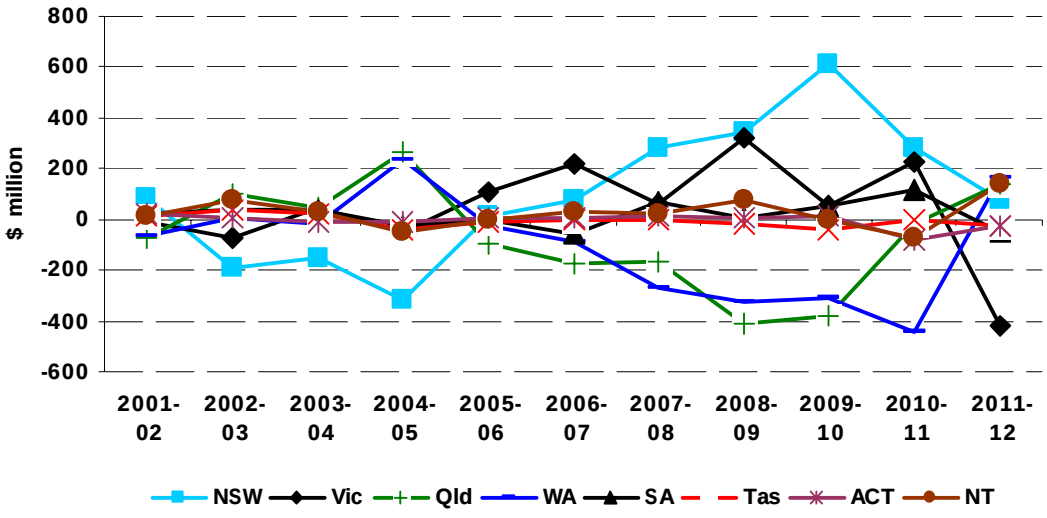
Table 4.2: Annual Changes in GST Payments due to Change in Relativities

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	$m	$m	$m	$m	$m	$m	$m	$m
2001-02	83	-12	-74	-69	21	15	22	13
2002-03	-191	-70	101	5	34	39	7	75
2003-04	-153	43	44	-20	39	25	-9	31
2004-05	-317	-51	263	231	-26	-38	-13	-48
2005-06	12	106	-94	-24	-3	-7	9	0
2006-07	73	221	-174	-89	-55	-4	2	27
2007-08	277	64	-166	-272	69	-5	13	20
2008-09	342	317	-409	-327	6	-16	8	80
2009-10	613	57	-382	-310	52	-41	11	-1
2010-11	277	223	-20	-443	118	1	-80	-77
2011-12	79	-417	142	164	-52	-24	-28	136

Source: CGC, *Review and Update Reports*, various issues. 2002-03 and 2003-04 changes use Financial Assistance Grant (FAG) relativities and FAG/Health Care Grants pools. The changes are as estimated by the CGC at the time its Review/Update reports are published, so are based on forecasts of GST/Health Care Grant or GST pools for the following financial year for which the relativities will apply.

For all states the changes from year to year in GST payments due to changes in GST relativities can be quite volatile (see Chart 4.2).

Chart 4.2: Annual Change in GST Payments due to Change in Relativities



In particular years the changes can be large. In 2004-05, New South Wales GST payments were reduced by $317 million compared to 2003-04 due to the reduction in its GST relativity. Other states have suffered losses of a similar magnitude at various times: Victoria in 2011-12 lost $417 million; Queensland in 2008-09 lost $409 million; Western Australia in 2010-11 lost $443 million. For the smaller states also, changes can be large in relation to the overall size of revenues: South Australia lost around $50 million in 2006-07 and 2011-12; Tasmania, around $40 million in 2004-05 and 2009-10; Australian Capital Territory, $80 million in 2010-11; and Northern Territory, $77 million in 2010-11.

In Update years, the changes can result from revisions in data or changes in state circumstances with the rolling forward by a year of the assessment period. In Review years, changes in the assessment methods also produce changes in relativities.

In the 2010 Review, for example, the total change in relativities reflected changes in methods – both the shortening of the assessment period from five years to three and changes in the assessment methods – and changes in state circumstances. Table 4.3 provides a disaggregation of the total change in relativities from the 2010 Review calculated by the CGC based on estimates of the GST pools in 2009-10 and 2010-11 at the time.

Table 4.3: Change in GST Payments from 2009-10 to 2010-11 due to Change in Relativities

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	TOTAL
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Change caused by:									
Assessment period shortened from five to three years	579	186	-388	-490	65	-12	14	47	891
Changed assessment methods	-701	-35	879	108	21	-1	-84	-186	1,007
Changed state circumstances	400	72	-510	-60	32	14	-10	62	580
Total change in relativity	277	223	-20	-443	118	1	-80	-77	619

Source: CGC, *Report on GST Revenue Sharing Relativities – 2010 Review*, **Vol. 1, Table 2, p. 3.**

These movements in GST can have disproportionately large effects on state finances. For example, 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.

Between 2009-10 and 2010-11, changes in the assessment methods redistributed around $1 billion of GST revenue, with the largest changes being $701 million moved away from New South Wales and $879 million moved to Queensland.

In other words, the detailed assessment methods adopted in the 2010 Review, judged to as accurately as possible reflect the relative fiscal capacities of the states, produced a $1 billion difference in the GST distribution from the detailed assessment methods used a year before that were judged at that time to as accurately as possible reflect the relative fiscal capacities of the states.

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

States generally publish budgets for the following financial year in May or June: state budgets for 2011-12 for example were generally published in May or June 2011. By February states are typically well into budget preparations, and will have based these preparations on the latest forecasts of the GST pool, usually the Commonwealth's Mid Year Economic and Fiscal Outlook forecast published in November each year, and their own forecasts of the share of the GST pool they will receive.

The actual relativity recommended by the CGC is then published in February and can be quite different to that contained in the state's forecasts, leaving very little time for states to adjust fiscal strategies to changed circumstances.

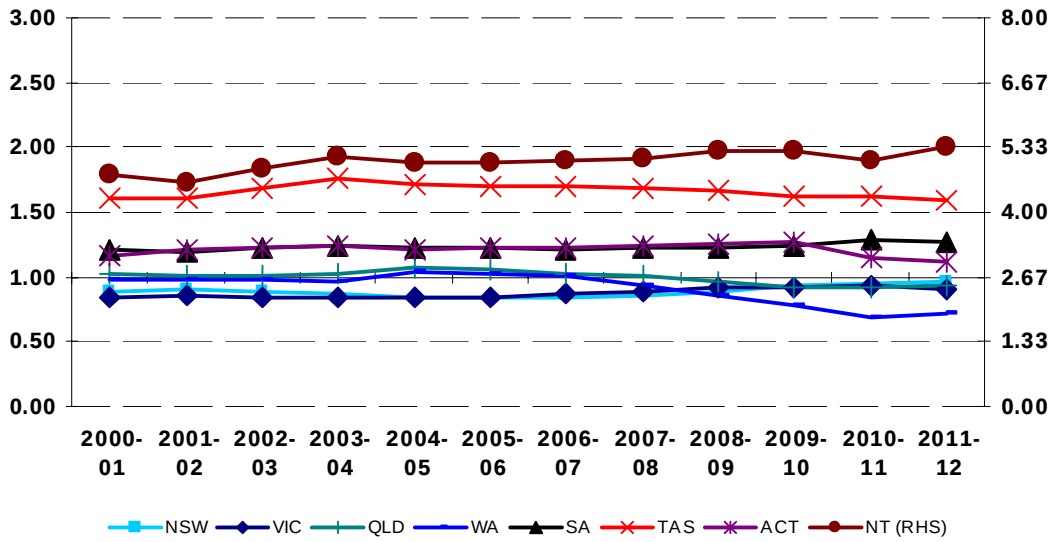
The Outcomes

The annual movements in GST can have a large impact on projected budget outcomes, despite being relatively small as a proportion of GST payments. The relativities generally change gradually over time, smoothed by the averaging process. This raises the question of whether all the effort improves the equalisation outcomes or provides an opportunity for the redirection of significant efficiencies.

GST relativities

Chart 4.3 shows relativities calculated on a consistent basis, using the GST pool only, over the period 2000-01 to 2011-12. From 2009-10 they are the actual relativities used to distribute the GST pool. For 2008-09 and prior years, relativities have been recalculated by the CGC using the GST pool only, rather than the larger GST and Health Care Grants pool used to calculate actual relativities until 2008-09.

Chart 4.3: GST Relativities (backcast prior to 2009-10)



Source: CGC, *Report on GST Revenue Sharing Relativities – 2011 Update*, **Table 6.1, p. 74.**

When viewed over this longer time horizon, the relativities have varied significantly only for one state. Western Australia had a variation of 52 per cent between its maximum relativity of 1.03811 in 2004-05 and minimum of 0.68298 in 2010-11. Five other states have shown a medium variation between 10 per cent and 20 per cent: Queensland, 17.2 per cent; Northern Territory, 16.1 per cent; New South Wales, 14.7 per cent; Australian Capital Territory, 13.8 per cent; and Victoria, 12.1 per cent. The other two states' relativities have been fairly stable, with variations under 10 per cent between their maximum and minimum relativities: Tasmania, 9.6 per cent; and South Australia, 7.1 per cent.

Share of GST pool redistributed

The redistribution has been relatively constant over the period of the GST and has also been relatively low at around 8 per cent of the GST pool, despite the overall complexity of the HFE system.

However, the headline GST redistribution underestimates the amount of 'activity' that occurs in the CGC assessments. This is because it eliminates much of that activity in arriving at that redistribution.

Each revenue, spending, capital or Commonwealth payments assessment redistributes an amount of GST revenue between the states. Adding the redistribution amounts in each assessment for each state produces that state's total redistribution amount, ignoring slight interactions between the assessments. In that addition negative redistributions in some assessments for a state are offset by the positive redistributions in other assessments, so

that the final result is a 'net' redistribution amount for each state. The total redistribution is then the sum of the negative or positive 'net' redistributions for all the states.

Adding together the amounts of GST redistributed in each of the individual revenue, spending and capital assessments provides a better idea of the 'activity' that occurs in the CGC's calculation of GST relativities. For 2010-11, while the reported redistribution is $3,598.2 million, or 8 per cent of the GST pool, the 'gross' redistribution estimated by adding together the amounts redistributed in each of the GCG's assessments is $12,829.1 million, or 28.5 per cent of the GST pool.

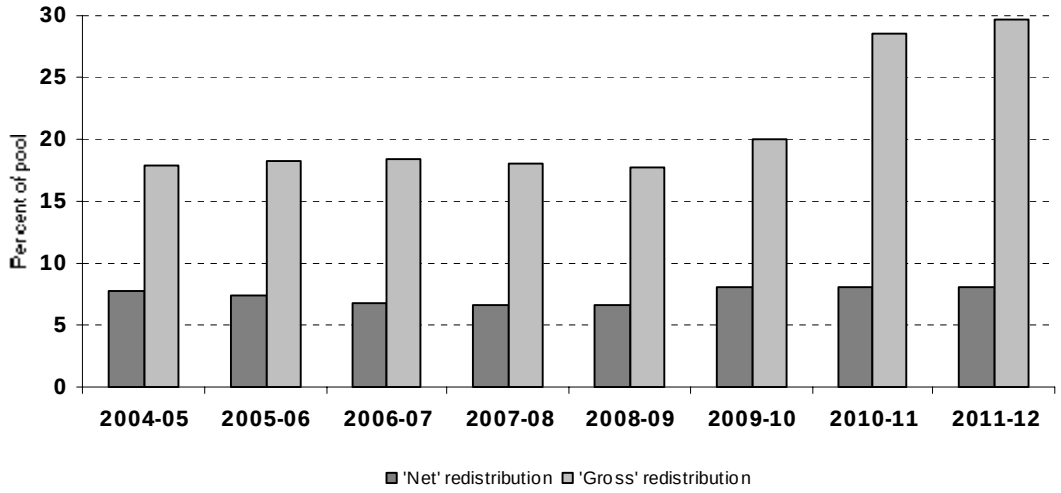
Table 4.4 and Chart 4.4 detail the amounts involved in the 'gross' and 'net' redistributions of GST for the period 2004-05 – when the CGC began estimating the redistribution based on the GST relativities – to 2011-12.

Table 4.4: 'Net' and 'Gross' Redistributions Compared to Equal per Capita [(a)]

	Pool	'Net' redistribution		'Gross' redistribution	
	$m	$m	% of pool	$m	% of pool
2004-05	41,594	3,220	7.7	7,464	17.9
2005-06	45,062	3,354	7.4	8,215	18.2
2006-07	47,537	3,226	6.8	8,771	18.5
2007-08	50,615	3,339	6.6	9,113	18.0
2008-09	54,201	3,614	6.7	9,633	17.8
2009-10	43,430	3,513	8.1	8,683	20.0
2010-11	45,060	3,598	8.0	12,829	28.5
2011-12	50,000	4,019	8.0	14,856	29.7

(a) The net redistributions as a share of the pool in this table are as calculated by the CGC, scaled to the relevant year pool where necessary. For the period until 2008-09 the pool used is the pool of GST and Health Care Grants. The CGC calculates the redistribution using the estimated pools and state populations at the time its reports are published, which differ from the estimated pools and populations on which the actual GST distribution is ultimately based. Source: Underlying data used comes from the CGC's Update and Review reports, various issues.

Chart 4.4: 'Net' and 'Gross' Redistributions Compared to Equal per Capita as a Share of the Pool [(a)]



(a) See footnote to Table 3.4.

Table 4.4 and Chart 4.4 show that the 'gross' redistribution is more than twice the 'net' redistribution to 2009-10, and more than three times the 'net' redistribution from 2010-11 . The 'gross' redistribution as a share of the total pool can move in a different direction to the 'net' redistribution: for example, in 2010-11 and 2011-12 the gross redistribution increased while the net redistribution declined slightly or remained constant.

This raises the question of whether the degree of detail that is currently pursued in the calculation of GST relativities is worthwhile when much of the detailed calculation cancels itself out. The detail and complexity in the current HFE system does not appear to be justified. Using broader revenue bases and limiting expenditure categories to core services should lead to less activity in the calculations.

Box 4.2 shows the total 'net' redistribution calculated by the CGC for the year 2010-11. Box 4.2 also adds the amounts redistributed by the individual revenue, spending and capital assessments, and the total for Commonwealth payments, to arrive at the 'gross' redistribution.

Box 4.2: 'Net' and 'Gross' Redistributions 2010-11

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Revenue assessments									
Payroll tax	-474	-58	369	-228	239	113	7	34	760
Land tax	-78	10	-66	-152	175	66	29	17	296
Stamp duty on conveyances	95	436	-713	-324	342	120	11	33	1,037
Insurance tax	-117	23	46	10	7	17	7	7	117
Motor taxes	299	-39	-101	-199	18	-4	17	8	342
Mining revenue	1,123	1,501	-973	-2,097	292	107	103	-57	3,127
Other revenue	0	0	0	0	0	0	0	0	0
Total revenue	847	1,876	-1,440	-2,994	1,076	420	173	41	4,434
Expense assessments									
Schools Education	-20	-638	216	170	-57	80	-10	259	725
Post-Secondary Education	-12	-57	-13	26	-14	0	28	41	96
Admitted Patients	101	-272	-115	-28	160	53	-71	173	487
Community and Other Health	-440	-201	52	329	-40	57	44	200	681
Welfare and Housing	-122	-422	52	-13	132	88	-58	344	616
Services to Communities	-191	-279	69	173	30	-35	-35	268	539
Justice Services	-103	-478	81	119	-30	32	5	374	611
Roads	-184	-165	85	160	50	-4	-26	83	378
Transport Services	176	176	-123	-53	-59	-67	-19	-31	352
Services to Industry	-63	-63	-5	53	31	22	-1	27	133
Depreciation	-109	-188	49	111	21	9	-19	126	315
Other Expenses	-124	-156	-62	41	2	74	86	138	341
Total expenses	-1,089	-2,741	286	1,087	226	308	-75	1,997	3,905
Capital assessments									
Investment	-316	-321	538	272	-156	-64	-52	97	907
Net lending/borrowing	-179	9	148	96	-51	-23	-4	4	257
Total capital	-494	-312	686	368	-206	-88	-56	101	1,155
Commonwealth payments	62	529	-322	55	-144	-2	68	-246	714
Total 'net' redistribution [(a)]	-680	-658	-786	-1,475	950	639	111	1,898	3,598
Total pool									45,060
Proportion of pool redistributed in 'net' terms (%)									8.0
Total 'gross' redistribution [(b)]									12,829
Proportion of pool redistributed in 'gross' terms (%)									28.5

(a) State totals are the sum of the separate assessments, though totals may differ slightly from a simple addition. This is because the impact of the individual assessments is calculated assuming all the other assessments are not made, though there is some interaction between the different assessments. The total redistribution is the sum of the positive (or negative) numbers in the row.

(b) The 'gross' redistribution is the sum of the redistribution amounts in each of the individual revenue, expense and capital assessments, plus the amount redistributed in total by Commonwealth payments.

Source: 'Net' redistribution data comes from CGC, *Report on State Revenue Sharing Relativities – 2010 Review*, **Vol. 1, Table 7-2, p. 95, and Vol. 3, Tables 4.1, 4.3 and 4.7, pp. 43-46. The CGC does not use the term 'gross' redistribution.**

Main factors behind the redistribution

Table 4.5 shows the contributions to the difference between the HFE outcome and an equal per capita distribution due to particular disability factors for 2010-11.

Table 4.5: Impact of Disabilities on GST Redistribution Compared to Equal per Capita 2010-11

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Effects on revenue raising capacity									
Mining production	1,122.5	1,501.0	-972.7	-2,097.2	292.3	107.4	103.3	-56.7	3,126.6
Property sales	94.7	436.3	-713.0	-323.6	342.1	120.1	10.8	32.7	1,036.7
Payrolls paid	-474.4	-57.7	368.5	-228.2	238.5	112.9	6.9	33.6	760.3
Motor vehicle registrations and sales	298.9	-38.5	-100.9	-198.7	18.4	-3.6	16.5	7.9	341.7
Land values	-77.8	9.5	-66.2	-151.5	174.9	65.5	28.5	17.2	295.5
Insurance premiums paid	-117.2	22.7	46.4	10.1	6.9	17.3	7.4	6.5	117.2
Effects on expenditure requirements									
Demographic features									
Indigeneity	-465.9	-1,425.6	441.1	426.8	-183.8	17.9	-68.1	1,257.5	2,143.3
Population dispersion	-458.0	-631.0	290.4	561.2	130.6	-100.2	-170.7	377.6	1,359.9
Socio-economic status	268.6	-66.4	-208.7	-396.0	441.1	169.2	-188.3	-19.4	878.9
Population growth	-178.7	9.2	147.8	96.1	-50.5	-23.3	-4.0	3.5	256.5
Other [(a)]	71.5	-10.0	266.5	-29.0	-73.7	100.2	38.2	-363.7	476.4
Economic features									
Interstate differences in wage levels	773.2	-200.8	-484.8	22.8	-125.6	-87.4	61.9	40.8	898.7
Non-state service provision	-526.5	-115.5	114.6	346.8	-51.9	27.6	28.8	176.1	693.9
Road use	-74.8	-19.0	47.1	34.5	27.4	4.0	-23.4	4.2	117.1
Other [(b)]	-118.3	-94.3	20.2	90.7	36.9	37.9	-3.0	29.9	215.6
Other features									
Administrative scale	-358.3	-221.0	-136.6	45.4	89.0	179.3	186.2	216.0	715.9
Geographic and related influences [(c)]	-20.0	2.9	73.4	-21.9	-29.5	-5.5	-6.5	7.3	83.5
Commonwealth revenues	-15.8	547.0	-334.2	54.4	-125.4	-20.2	86.8	-192.5	688.1
Other influences [(d)]	-423.0	-307.0	415.8	282.5	-207.7	-80.3	-0.1	319.8	1,018.1
TOTAL	-679.3	-658.2	-785.3	-1,474.8	950.0	638.8	111.2	1,898.3	3,598.3

(a) Includes interstate differences in age structure and cultural and linguistic diversity.
(b) Includes interstate differences in industry sizes and interstate freight and travel costs.
(c) Includes effect of state size and climate effects.
(d) Includes interactions between disabilities and components of disabilities.
Source: CGC, *Report on GST Revenue Sharing Relativities – 2010 Review*, **Vol. 3, Table 4-9, p. 47.**

Differences in the value of mining production across the states underlie the differences in GST revenue in the mining assessment, since the value of mining production is used as the tax base for the mining revenue assessment. Similarly, the conveyance duty revenue assessment is based on the value of property transactions across the states.

For the expense assessments, Table 4.5 shows the disability factors contributing most to the expense categories. Indigeneity, for example, plays a role in a number of assessments – schools and post-secondary education, admitted patients and community and other health, welfare and housing, services to communities, justice services – and Table 4.5 shows the combined impact of Indigeneity across those assessments.

The main disabilities redistributing GST revenue compared to an equal per capita assessment in the expense categories are Indigeneity and population dispersion.

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.

Population dispersion is a factor which also presents significant measurement difficulties and requires the use of judgement by the CGC. This is a factor which should be excluded from the HFE process unless the data issues can be satisfactorily resolved.

5. An Alternative Distribution Model

The current HFE distribution model has a number of shortcomings despite the simplification undertaken in the 2010 Review, being:

- complex
- data intensive
- reliant on judgement
- non- transparent
- volatile and unpredictable in its outcomes.

New South Wales proposes an alternative distribution method which overcomes these problems.

The disaggregated and detailed approach creates a heavy dependence on data, not all of which is available in the form and to the standards required, and heavy reliance on the use of judgement by the Commission. More extensive use of data does not guarantee that results will be any more accurate and precise than what could be achieved by the use of broader data.

The current approach often produces significant (in terms of impact on fiscal outcomes) and unexpected movements in states' GST. Some of those movements are traceable to changes in states' fiscal circumstances, but others reflect revisions to data or changes in methods. This year-to-year volatility creates budgetary and planning difficulties for the states, particularly in view of the timing of the release of the Commission's reports, when budget preparation is already well underway.

The detail and activity in the current HFE system is not reflected in the size of the redistribution. The gross redistribution is large, with about one-third of the GST revenue pool shuffled around the states by the many revenue, expense, capital and Commonwealth payments assessments. But the net redistribution – the amount of GST actually redistributed after a state's gains in some assessments are offset by losses in others – is significantly smaller and has been fairly constant over time.

Complexity, data intensity and the use of judgement are intended to produce a 'better' equalisation outcome, but tend to reduce the transparency of the system, making it inaccessible to the non-specialist and eroding confidence in the system.

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.

The current distribution model can be considered as containing a base distribution, providing an equal per capita share of funds to all states, and an equalising redistribution, which provides additional funding to the four recipient states in order to provide them with the fiscal capacity to provide the average level of service.

Table 5.1 shows the CGC's calculation of the 2011-12 redistribution using this methodology, with the base equal per capita amount calibrated from WA, the state with the strongest fiscal capacity.

Table 5.1: Illustrative Distribution of 2011-12 GST

	NSW $pc	Vic $pc	Qld $pc	WA $pc	SA $pc	Tas $pc	ACT $pc	NT $	Total $
Base per capita	1,567.67	1,567.67	1,567.67	1,567.67	1,567.67	1,567.67	1,567.67	1,567.67	1,567.67
Equalisation allocation	525.58	409.73	461.85	0.00	1,209.52	1,927.95	872.43	10,140.55	615.65
Per capita allocation	2,093.25	1,977.40	2,029.52	1,567.67	2,777.19	3,495.62	2,440.10	11,708.22	2,183.32

Source: CGC (2011), *Report on Revenue Sharing Relativities – 2011 Update*, **p. 6. These figures are based on the 2010-11 MYEFO pool.**

Under current arrangements the redistribution to the recipient states of around $4 billion in 2011-12 is sourced from the GST pool.

An alternative distribution model would see the total GST pool distributed to the states on an equal per capita basis as the base distribution, with the equalising distribution to the recipient states based on a separate pool funded by the Commonwealth. This would calibrate the base distribution on the all state equal per capita distribution, not on the distribution attributable to the state with the strongest fiscal capacity.

An illustrative example of this alternative redistribution is shown in Table 5.2.

Table 5.2: Alternative Distribution of 2011-12 GST

	NSW $pc	Vic $pc	Qld $pc	WA $pc	SA $pc	Tas $pc	ACT $pc	NT $pc	AUS $pc
Total EPC	2,183.32	2,183.32	2,183.32	2,183.32	2,183.32	2,183.32	2,183.32	2,183.32	2,183.32
Equalisation allocation	0.00	0.00	0.00	0.00	593.87	1,312.30	256.79	9,524.87	
Per capita allocation	2,183.32	2,183.32	2,183.32	2,183.32	2,777.18	3,495.62	2,440.11	11,708.19	2,183.32
Current allocation	2,093.25	1,977.40	2,029.52	1,567.67	2,777.19	3,495.62	2,440.10	11,708.22	2,183.32
Difference	90.07	205.92	153.80	615.65	0	0	0	0	

This alternative distribution has a number of advantages over the current model:

- states' shares are much more stable over time, reflecting population shares
- greater stability leads to greater ability to forecast a state's GST, leading to fewer budget shocks
- greater transparency
- the additional funding required from the Commonwealth for the equalising allocation of around $4 billion in 2011-12 is only around 1 per cent of total Commonwealth receipts.

6. Incremental Revisions

Should the Review favour only incremental revisions to the status quo, other options could include:

- fiscal equalisation should be directed towards core services of national importance. Other services provided by one or more states are matters for each jurisdiction, consistent with the principle of subsidiarity. On the revenue side, equalisation should be assessed on broad tax bases
- 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
- at a practical level, the focus of the system of fiscal equalisation needs to be on ensuring that it is workable and transparent. There is no objective measure of the 'correct' equalised redistribution. The pursuit of false accuracy in trying to achieve this unquantifiable objective is ultimately self-defeating and leads to a system that is complex and incomprehensible to the non-practitioner.