ACIL ALLEN CONSULTING

REPORT TO
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ASPECTS OF AUSTRALIA'S SYSTEM OF HFE

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IMPLICATIONS OF HFE ON INCENTIVES FOR TAX REFORM AND SPENDING DECISIONS BY THE STATES

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C O N T E N T S

1 INTRODUCTION

1.1 This submission

This submission by Jerome Fahrer and Vince FitzGerald of ACIL Allen Consulting concerns aspects of Australia's system of Horizontal Fiscal Equalisation (HFE). While we have over many years advised various governments and other organisations on HFE Federal-State financial relations and tax policy generally,[1] the opinions in this submission are ours alone.

As we said when we appeared at the Commission's public hearing in Melbourne on 17 November, there is a lot wrong with Australia's system of HFE. The fact that is so complex in its operation that so few people understand it is in itself a major problem, because it is very difficult for people to have confidence in a system they don't understand. The 'zero sum' nature of the system means that any partial reform of the system, such as those canvassed by the Commission in its Draft Report, will just result in a redistribution of GST revenues among the States. Since any State can apparently veto any reform of the system, any attempted partial reform is likely to fail, since the States that will lose money relative to the status quo will just say no. However, reform of the HFE system combined with reform of Australia's other problematic aspects of Federal-State financial relations, in a way which significantly reduces Vertical Fiscal Imbalance (VFI), could succeed. Even better would be simultaneous reform of HFE, VFI, State taxes and Federal taxes.[2] We note that the Draft report acknowledges the problem of VFI, and the need to reform federal state financial relations, and the complex interaction between HFE and Commonwealth and State finances.

We commend the Commission on the Draft Report which thoughtfully covers a broad range of issues. We certainly do not agree with commentary by some that the Commission's draft findings and recommendations indicate some kind of bias to Western Australia and its interests. In our view, the Western Australian 'problem' should be seen as the residual effect of the biggest mining boom in over a century, which might never be repeated, and any attempt to 'fix' the system specifically to deal with its effects on Western Australia could be another case of fighting the last war. Moreover, as we show later in this submission, Western Australia's fiscal problems are largely of its own making.

What the recent Western Australian experience does highlight is that it is far from obvious that completely equalising the fiscal capacity of the States via the HFE system is good practice; in fact there is nothing is the theory in the theory or international practice of fiscal transfers that says that completely equalisation is desirable. We discuss this point at length in this submission.

In the remainder of this submission we discuss how much equalisation is desirable, how HFE affects expenditure incentives by the States, the Northern Territory and Indigeneity, and the interaction between direct Commonwealth payments to the States and HFE.

[1] In particular, Ross Garnaut and Vince FitzGerald, *Review of Commonwealth State Funding,* Report to the Treasurers of NSW, Victoria and Western Australia, August 2002.

[2] We note that this the approach the Commission has advocated in its productivity review, Shifting the Dial.

2 HOW MUCH EQUALISATION?

2.1 The purpose of HFE – national social welfare

Many countries – not just federations – have systems of fiscal transfers between the centre and the regions; that is, horizontal fiscal equalisation (HFE). The academic literature on HFE discusses the economic reasons why some equalisation is desirable. The reasons include both efficiency and equity, mostly equity. The literature also discusses the downsides of HFE, again in terms of both efficiency and equity, but mostly in terms of efficiency.

Thus the story that emerges from the literature is that there is a trade-off between more equity and less efficiency. Implicitly, there is an optimum point[3] in which just the right amount of HFE is achieved, but there is no literature (that we know of) that points exactly to observable conditions that would characterise this optimum, nor is there is a literature which tries to evaluate in practice whether a country or group of countries is at or near the optimum.

What this means is that we cannot conclude from the literature that the efficient amount of HFE in Australia is a system where, say 60% of GST revenues, are distributed EPC with the remaining 40% re-distributed according to the equalisation criteria – there is no mathematical model that can be solved for the optimum amount of equalisation. This is not surprising. The purpose of HFE should be to contribute to the maximisation of national social welfare, and views will differ about what this means and how it should be achieved.

Uniquely among OECD countries that are federations, Australia's system is one of full equalisation.[4] The literature is quite clear that whatever the right amount of equalisation is, it is not 100 per cent.

The Draft Report's Recommendation 2.1 is that the Commonwealth Government should clearly articulate the objective of HFE and that the objective should aim for reasonable rather than full equalisation.

We agree. In our view, HFE (like all Commonwealth Government policies) should contribute to the maximisation of national social welfare. The current system of HFE does not do this, because it equalises the fiscal capacity of the States, but what matters is the welfare of the people who live in the States, not the States themselves. In our view, a national social welfare objective for HFE not only cannot be achieved by the current system, it can't be achieved by minor reforms to the current system (such as those discussed in the Draft Report: equalisation to the average of the 'donor' States etc).

Instead, we propose a system closer to that which existed prior to the mid 1970s. In our view all Australians should be able to receive services from their States at (at least) a nationally-determined decent minimum level. If some States are unable to provide those services at the minimum level

[3] There might be more than one optimal point. In economic theory, unique optima tend to exist only by convenience or assumption.
[4] The United States was not examined by the OECD.

because they lack the fiscal capacity, then those States should receive sufficient horizontal transfers to provide them with the necessary capacity. Assuming that these transfers continue to be financed out of the GST pool, then what is left in the pool after the transfers have taken place can be distributed to the States on an equal per capita basis.

The important point here is that the minimum level of services so determined in this system would be an absolute standard, and so the system would do away with the relentless series of relativity calculations that are the *sine qua non* of the current system. This would greatly reduce the opacity and complexity of the current system (though work would be needed to determine the absolute standards). It would also mean that some States would be able to provide their residents with a higher level of service than this minimum, if they have the fiscal capacity and willingness to use it – without being penalised by the HFE system. This would be an entirely desirable outcome; States ought to have the policy autonomy to make these policy choices. (Amelioration of VFI would greatly assist this process – the more control States have over their own finances, the less their need for distributions via HFE.) But overlying these State decisions would be national social welfare, which would require levels of service in all States at or above the minima. There is nothing to stop these minima from being high, or very high, if that is what the nation wants, provided the resources exist to provide the services. The implied national social welfare function would be quasi-Rawlsian: national social welfare would be the higher of the nationally determined minimum level of service provision and the lowest level of service provided by any State.

In summary: States would decide on the level of service provision, but these levels of service would have to be at or above nationally-determined minima, and States which do not have the fiscal capacity to provide the minimum level of service would receive horizontal fiscal transfers that would provide them with that capacity.

2.2 OECD 2007 Report

In a report published in 2007, *Fiscal Equalisation in OECD Countries*,[5] the OECD described and analysed the type, extent and effects of fiscal equalisation across the OECD. While this report is now a decade old, its analysis and conclusions are still relevant.[6] [7]The theoretical benefits and costs of equalisation the OECD discusses are enduring, as are the inter-country analyses, especially since fiscal systems are slow to change. As with all OECD research reports, it draws on both the academic literature and specific country experiences, makes cross country comparisons. The OECD does not appear to have updated this report.

The OECD report identified the following reasons for fiscal equalisation.

1. Equity:
    — To equalise per capita tax revenue raising capacity and the per-beneficiary cost of providing public goods and services across regions
    — To equalise the marginal benefit of public spending across regions
2. Externalities
    — To avoid fiscal externalities resulting in a misallocation of labour and/or capital across regions i.e. to avoid *inefficient migration* of labour and capital between regions so as to locate in high tax base (not high tax rate) regions.
        i. The key phrase here is "inefficient migration". Migration of people from low income (low fiscal capacity) to high income (high fiscal capacity) regions might be efficient for a nation as a whole, though a bad income for the region from which people leave. In the Australian context, it is undoubtedly bad for Tasmania if high-skilled people leave Tasmania because their prospects are better on the mainland, but it is good for the States they go to, and it is unclear whether the outcome is good or bad for Australia as a

[5] https://www.oecd.org/ctp/federalism/39234016.pdf
[6] The Brumby Carter Greiner (BCG) 2012 review did not make a reference to this report.
[7] The OECD report is about both horizontal and vertical fiscal equalisation but mainly the former.

whole. The argument that Tasmania should receive fiscal transfers to help keep these people is an equity argument.

3. To provide insurance against asymmetric income or employment shocks. Redistributive grants may provide regions with insurance against the adverse effects of asymmetric shocks on income or employment.
   - In Australia, these events are handled by direct payments from the Commonwealth. The HFE system is not well-designed to mitigate against short-term shocks.

According to the OECD, "in all countries, the driving force for equalisation is equity, i.e. having similar tax raising capacity and equal access to public services across jurisdictions".[8]

The *effects* of equalisation are

— Fiscal equalisation makes up around 2.3 percent of GDP on average across countries.

— Equalisation significantly reduces disparities. On average they are reduced by about two-thirds.

— Equalisation can pose a problem for budget stability, but this is a problem for the central government if the equalising revenue come from its budget. In contrast, Australia's system of horizontal equalisation does not pose a budget stability issue for the central government

- o The OECD does not say that horizontal transfers can pose a budget stability problem for the regional governments, but the Australian experience shows that they can.

— Revenue equalisation can reduce tax and development effort, especially in poorer regions. It is worth quoting the OECD verbatim on this point

> "A high "equalisation tax" – the rate at which additional own tax revenue is equalised away – can reduce a jurisdiction's effort to develop its economic and fiscal base and slow down regional convergence within a country. Poor regions are particularly affected since they often face an equalisation tax rate of 100 or more percent."[9]

- o This is important because the Brumby Carter Greiner report of 2012 said that it could find no evidence that such disincentives exist in Australia. The OECD report shows that disincentives can and do exist in systems of fiscal equalisation. However the OECD report also said that it is possible to design equalisation arrangements to promote the tax and development efforts of regional governments and reduce their strategic behaviour e.g. by using centrally-levied taxes to assess regional revenue-raising capacity. In the Australian context, this would mean, for example, that a high income State such as the ACT would be assessed as having a high revenue raising capacity.[10]

— Cost equalisation is prone to rent seeking and can become ineffective. This is especially a problem where cost equalisation is based on actual costs, not standard costs as in Australia, so is less of a problem in Australia. Nonetheless, the Australian HFE method can create incentives for a State to inflate its costs which are paid for in part by the other States.

— The choice of standardised revenue or cost bases can mitigate disincentives.

- o Australia uses standardised revenue and cost bases, yet the HFE system is full of disincentives to grow tax bases and deliver services efficiently. The difference between Australia's experience and those which led the OECD to this conclusion is that that conclusion was based on countries which used absolute standardised revenue and cost bases. If regions' cost bases are based on efficient costs of service delivery, they won't be equalised by inflating their cost base. But the use in

[8] OECD, page 7.

[9] OECD page 6.

[10] High income Australian States could argue, with a measure of justification, that under the current Australian tax system, they have limited ability to raise revenue from their high-income residents. This a problem that can be fixed by reducing the degree of vertical fiscal imbalance,

> Australia of an average cost of service delivery for equalisation changes these incentives: States with cost disabilities have incentives to expand services in those areas where they are not efficient at delivering them.

The OECD analysed fiscal equalisation in seven countries that are federations or are what it calls "regional countries". They are Australia, Austria, Canada, Germany, Italy, Spain and Switzerland.[11] Australia stands out in two respects. First, the degree of fiscal inequality[12] before equalisation between States is the lowest among the countries examined. That is, on equity grounds, there is less need for fiscal equalisation in Australia than any other comparable country. Secondly, Australia – the country that needs it least – undertakes more fiscal equalisation than any other comparable country. In fact Australia is the only country that undertakes complete fiscal equalisation

Specifically, the Australian Gini coefficient of fiscal capacity is 5 per cent before equalisation and zero after equalisation (because the HFE process equalises fiscal capacity). The Canadian Gini coefficient is 10 per cent (twice as unequal as Australia) and 7 per cent after equalisation. Germany's Gini is 6 per cent before equalisation (i.e. Germany has a bit more fiscal capacity inequality than Australia) and 2 per cent afterward, so Germany's outcomes are similar to Australia, but it doesn't go all the way and fully equalise. Switzerland's Gini is 15 per cent before equalisation and 11 per cent afterwards, so Switzerland starts with fiscal capacity inequality three times as high as Australia and equalises such that its fiscal capacity inequality is just higher than Australia before it equalises.

The average across all countries examined is a 'before' Gini of 14.3 per cent and 'after' Gini of 5.2 per cent, so on the whole about two-thirds of fiscal capacity inequality is equalised.

Australia is the world leader of fiscal equalisation. Its starting position is one where the least needs to be done on equity grounds - its measure of fiscal capacity inequality is the lowest – and uniquely removes all of this inequality. In fact only one country, Spain, manages to achieve an after-equalisation level of fiscal capacity inequality that is lower than Australia's starting position,

2.3 Recent literature

The pick of the recent literature in the Australian context is a conference volume edited by Neil Warren in 2012, *eJournal of Tax Research*, Volume 10, Number 1, Special Edition: State Funding Reform in the Australian Federation, February 2012.

Robin Boadway ("International Lessons in Fiscal Federalism Design") makes the usual arguments for horizontal fiscal transfers without saying what the efficient amount of transfer is. He makes an interesting link between vertical fiscal imbalance (VFI) and HFE. Some amount of VFI is necessary in order to give effect to transfers between States. Put another way, if all levels of government were self-sufficient, with no surplus accruing to the central government, there would be no mechanism that could transfer resources between States.

This means that if VFI was reduced in Australia, not only would there be less need for HFE, there would be less ability to bring it into effect. Assuming the dual premises that the current system of HFE is inefficient and there is too much of it, a simple – in principle –way of addressing both problems is to reduce VFI.

While Boadway is in favour of some VFI because it facilitates HFE, he argues against too much VFI because it reduces State accountability and gives the central government too much say in State programs. How much is the right amount of VFI (and by extension, HFE) Boadway is not prescriptive, saying

> The appropriate balance will be unique to each federation, since it depends on such things as the extent of heterogeneity of the population, the degree of consensus and social cohesion in the country as influenced by its history, and political institutions.

[11] It also examined seven "unitary" countries (Denmark, Finland, Japan, Norway, Portugal, Sweden and Turkey) but the results are not comparable to the federations/regional countries.
[12] Measured by the Gini coefficient.

Boadway also makes some interesting if inconclusive observations on equalisation of natural resource revenues, which is a major issue in his native Canada.

> First, the horizontal imbalance resulting from the unequal pattern of state resource endowments leads to the potential for fiscal inequity and fiscal inefficiency unless equalization transfers are able to offset it. Undoing the horizontal resource imbalance is costly and strains the viability of the equalization system. It also effectively undoes the property rights of the states over the natural resources in their jurisdictions that lead to the states' right to tax them in the first place. This stress between state ownership of natural resources and the constitutional obligation of the federal government to equalize state fiscal capacities has led to enormous amounts of unresolved tension in the Canadian case.

Finally, Boadway notes that Canada applies equalisation to revenues not expenditures. Very importantly, provinces with below average revenue capacity are topped up by the federal government, but above-capacity provinces are not penalised.

Bernard Dafflon ("Solidarity and the design of equalization: setting out the issues") argues that items that are within the scope of sub-national governments (SNGs) should not be taken into consideration for equalisation, but "external" items that are outside the scope of SNG decision making should be compensated, at least partly.

With regard to revenue equalisation, Dafflon argues for the use of Representative Tax Systems (RTSs) to estimate revenue capacity. The important feature of RTSs is that they are independent of SNG actions and so are not manipulable by strategies aimed at maximising HFE transfers. Also, they have the desirable feature that rich SNGs pay rather than receive.

On the limits of equalisation, Dafflon argues that a case can be made that only SNGs with very weak fiscal capacities should receive equalisation payments. He also notes that it is undesirable to give SNGs with low levels of fiscal capacity too many disincentives to grow their revenue bases.

On expenditure equalisation, Dafflon notes the difficulty in distinguishing between genuine and unavoidable high costs and those created by poor policy choices.

Dafflon concludes as many others do

> Equalisation is about solidarity. And solidarity is normative: it is first a matter of ethical and political choices. It is not feasible to solve equalization in practice by quantitative methods only.

But he does say a stronger case can be made for revenue equalisation than expenditure equalisation.

Neil Warren ("Fiscal equalisation and State incentive for policy reform") notes the interaction between direct grants from the national government, vertical fiscal equalisation (VFE) and horizontal fiscal equalisation (HFE), with VFE bringing States up to national minima, while the role of HFE would be redistributive between States. By implication, whether there is *any* HFE would depend on whether the goal of policy is only to bring States up to the national minima or whether in addition there is redistributive objective of policy. Therefore, by implication from Warren's analysis the efficient amount of HFE depends critically on the policy objective. If policy is set national minima for service delivery and that all States achieve that objective, which arguably satisfies most reasonable equity objectives, this can be achieved through a combination of direct Commonwealth Government payments and repair of VFI. If equality between States (a relative concept) is the policy goal, then HFE is the instrument to achieve this objective.

Warren also notes the disincentives faced by the States to grow their revenue bases under the current system.

3

EXPENDITURE INCENTIVES

3.1 Introduction

A fundamental feature of the CGC's HFE methodology is that it is policy-neutral, which is to say that that States are not (supposed to be) rewarded or penalised for the policy choices that they make. When it comes to expenditure, this means that they receive (or lose) GST revenue *as if* they provide services to the national standard and at the average level of efficiency, but they don't have to actually deliver the services.

This leads to odd incentives and odd outcomes. For example, the Garnaut and FitzGerald review noted that because family and child welfare services are expensive to deliver in the Northern Territory (because of remoteness and other disabilities) in 1999-2000 the NT was allocated over $250 per person for these services, compared to the national standard of $69 per person. But the NT Government spent only $65 per person, which was not only much less than what it was allocated, but less than the national standard.

Underspending in this way by the NT Government on these services continues to this day, but the NT is certainly not the only State to do it. This chapter sets out all the cases where this happens according to the latest data.

The analysis shows that the HFE system as it applies to States expenses on services is replete with rewards for inefficient behaviour by States, penalties for efficient behaviour and dynamics in which inefficient behaviour begets more inefficient behaviour.

- There are many examples of States receiving HFE payments because they have a disability (compared to the other States) in the delivery of a service, but then spending less than their assessed level of expense. This practice is contrary to the broad intent of fiscal equalisation in federations which is that States should be compensated for difficulties they face in providing a minimal level of service that everyone in the nation ought to be able to receive.
- States with a disability which choose not to spend on services could see that disability increase. This could result in widening disparities of community well-being between States, which is the opposite of what fiscal equalisation is supposed to achieve.
- The current HFE system makes no distinction between inherent disabilities in the provision of services (e.g. those arise from the presence of remote communities) and disabilities that are of a State's own making, due to poor policy decisions or poor service implementation.
- Even if States are inclined to undertake efficiency-enhancing reforms, knowing that these will most likely reduce their GST distributions, the opaque nature of the CGC's assessment process means that they will be uncertain about how much they will be penalised. This uncertainty is likely to chill the appetite for reforms.

3.2 The data

The data in this chapter come from a spreadsheets related to the 2017 Update on the CGC's website.[13] They are called *Revenue and Expense Ratios* and *Analysis of Relativities – Difference from EPC.*

3.3 Actual and assessed expenses

For each of the eight States, for each of 12 expense categories,[14] the CGC calculates for each State the ratio of assessed to average expenses, and the ratio of actual to assessed expenses.

A State which has a high ratio of assessed to average expenses has a high level of positive disability in that expense category.[15] By definition, the ratio of assessed to average expenses for Australia is 100.0, but in some expense categories, States can be well above or well below 100.0. For example, for housing, the Northern Territory's ratio in 2015-16 in 2015-16 was 351.4, meaning that the CGC estimated that it costs the NT Government 3.514 times the national average cost to provide a standard housing service.

A State which has a ratio of actual to assessed expenses greater than 100.0 spends more than its assessed amount, relative to the national average (which by definition is 100.0) Again taking housing as an example, the NT's ratio was 152.2, meaning that it actually spent 52.2 per cent more than its assessed expense. Putting the two ratios together, if it cost $100 on average in Australia to provide a standard housing service, the cost in the Northern Territory was $351.40, and it received GST revenue as if it provided the standard housing service. What it actually spent was 1.522*$351.4 = $534.8. The implication is that the NT Government spends a great deal on housing compared to the national average, and this is borne out in the CGC data. The national average for housing spending by State governments per capita in 2015-16 was $119. The Northern Territory spent $636 per capita. National assessed spending per capita was, by definition, the same as actual spending per capita, i.e. $119. The Northern Territory's assessed expenses per capita were $418, so it spent $218 more capita than its assessed expense.

In contrast, on welfare spending, compared to the national average spending of $703 per capita, the Northern Territory Government spent $1169 per capita n 2015-16. This seems like a lot, but its assessed expense was $1728 per capita, for which it was funded in GST revenue, so it underspent its assessed expenses by $559 per capita. These numbers reflect the NT's ratio of assessed to average expenses of 245.9 and its ratio of actual to assessed expenses of just 67.6.

Thus, just considering housing and welfare, the Northern Territory received GST revenue for welfare spending as if it provided the standard service, but it didn't spend it on welfare, it spent part of it on housing instead. Of course, there are more than two services and there other States to consider. As it happens, all of them underspend or overspend on some categories of expenses, though the small States have considerably more capacity to shift spending around in this way because GST revenues make up a relatively large proportion of their overall revenues.. The next section of this chapter analyses each State in turn.

3.4 State by State analysis

Rather than laboriously reporting each State's actual and assessed expenses in each spending category, which would not be insightful, this section shows the expense category[16] where each State actually spends significantly more or less per capita than its assessed expenses, where significantly more or less per capita is defined (arbitrarily) as $50. There are many such cases.

13 https://www.cgc.gov.au/index.php?option=com_content&view=article&id=263&Itemid=542

14 Schools education, post-secondary education, health, housing, welfare, services to communities (e.g. utilities, environmental services), justice, roads, transport, services to industry, depreciation and other services (e.g. natural disasters, capital grants to local governments for community amenities)

15 A State whose assessed expenses for a service is less than the national average has a negative disability for that service.

16 Excluding depreciation

3.4.1 NSW

TABLE 3.1 NSW SIGNIFICANT OVERSPEND OR UNDERSPEND PER CAPITA 2015-16

	Actual expense ($pc)	Assessed expense ($pc)	Difference ($pc)	National average expense ($pc)
Health	2135	2347	-212	2387
Transport	688	565	124	530
Other expenses	1276	1196	80	1271
Total expenses	**8985**	**9089**	**-104**	**9372**

The first column in Table 3.1 shows actual expenses per capita by NSW Government, for health and transport expenses, and expenses as a whole. The second column shows assessed expense i.e. what the NSW Government would spend if it provided a standard (national average) service at an average level of efficiency. The differences between actual and assessed expenses, shown in the third column, therefore, reflect purely policy choices by the NSW Government.[17] NSW therefore chose to spend less on health per capita and more on transport per capita than the national average, even though it was funded through the CGC process to spend the national average amounts. (We note though that by the very nature of the HFE methodology and zero sum game that it is virtually true by definition that donor states will be below the national average especially in relation to the big expenditure categories like health.)

Overall, in terms of policy decisions, NSW spent $104 less capita than the national average. NSW is a low-spending state. The contrast with some of the other States is marked. For example, in 2015-16 the ACT spent $2877 per capita more than the national average, and the Northern Territory spent $2409 more, after accounting for spending due to efficiency differences and other disabilities.

There are no categories of expenses for which NSW is compensated for disabilities but which it spends less than it assessed expenses. In fact in the 2017 Review, NSW was assessed by the CGC as having negative disabilities compared to the national average, with NSW losing GST revenue (compared to a per capita distribution) in all categories except transport, with equalisation across all categories of expenses causing NSW to lose $327 per capita.

One response to the fact that NSW (and the other States, as seen below) chooses as a matter of policy to spend more or less than the national average on particular categories of expenses and overall, might be, so what?, that is its choice to make. While this is true, the problem is that the HFE process and States' policy choices are not independent and the HFE process affects the States' incentives to spend their money more efficiently. Section 4 of this chapter discusses this issue in more depth.

3.4.2 Victoria

TABLE 3.2 VICTORIA SIGNIFICANT OVERSPEND OR UNDERSPEND PER CAPITA 2015-16

	Actual expense ($pc)	Assessed expense ($pc)	Difference ($pc)	National average expense ($pc)
Schools education	1851	1961	-110	2104
Health	2098	2230	-132	2387
Justice	722	667	55	764
Roads	295	236	59	267
Other expenses	1096	1195	-99	1271
Total expenses	**8507**	**8689**	**-182**	**9372**

17 Assuming that the CGC has measured the standard service, disability and efficiency correctly.

Like NSW, Victoria as a matter of policy chooses to spend less overall than the national average. Victoria underspends on schools education, health and other expenses, and overspends on justice and roads.

Also like NSW, Victoria was assessed by the CGC to have negative relative disabilities across all expense categories except transport. The total expense equalisation was a loss of $775 per capita.

3.4.3 Queensland

TABLE 3.3 QUEENSLAND SIGNIFICANT OVERSPEND OR UNDERSPEND PER CAPITA 2015-16

	Actual expense ($pc)	Assessed expense ($pc)	Difference ($pc)	National average expense ($pc)
Health	2673	2429	244	2387
Welfare	637	756	-119	703
Services to communities	200	271	-72	250
Justice	646	811	-165	764
Transport	402	478	-76	530
Other expenses	1422	1265	157	1271
Total expenses	**9658**	**9666**	**-8**	**9372**

Overall, Queensland spends about the same per capita as the national average as a matter of policy, but with considerable variation among expense categories. Queensland spends more on health and other expenses, but less on welfare, service to communities, justice and transport.

Queensland does receive equalisation payments for expense categories where it significantly underspends its assessed expenses. In the 2017 Review, it received $52 per capita (compared to an equal per capita distribution) for welfare services, which it underspent by $119 per capita. It also received $26 per capita for services to communities (underspend $72) and $45 for justice (underspend $165).

3.4.4 Western Australia

TABLE 3.4 WESTERN AUSTRALIA SIGNIFICANT OVERSPEND OR UNDERSPEND PER CAPITA 2015-16

	Actual expense ($pc)	Assessed expense ($pc)	Difference ($pc)	National average expense ($pc)
School education	2371	2193	178	2104
Health	2786	2483	303	2387
Housing	221	131	91	119
Welfare	811	682	128	703
Services to communities	669	315	355	250
Justice	1064	837	227	764
Transport	366	537	-170	530
Services to industry	344	272	72	227
Other expenses	879	1370	-490	1271
Total expenses	**10639**	**10014**	**624**	**9372**

Western Australia is a big-spending state, with the WA Government spending overall $624 more per capita than its assessed expenses i.e. as a policy choice. This overspend is across most expense categories. Western Australia has high, by national standards, assessed expenses, reflecting its size, remoteness of some of its communities and other factors, but it chooses to spend significantly even more than this high amount.

Western Australia receives equalisation payments for the two categories of expenses where it underspends its assessed expenses, $12 per capita for transport (underspend $170 per capita) and $85 per capita for other expenses (underspend $490 per capita). Overall Western Australia receives $796 per capita for its expense disabilities, with positive contributions for all but one expense category (welfare).

To put WA's $624 overall policy-driven overspend into perspective, in the CGC's 2017 Review for 2017-18, Western Australia was allocated $878 per capita, compared to the $2543 per capita that it would have received under an equal per capita distribution, a difference of $1665 per capita. The Western Australian Government has said that the CGC's distribution has put its budget under considerable stress, but it chooses as a matter of policy to spend an amount above national average expenses equivalent to 37.5 per cent of the shortfall (actual versus equal per capita GST receipts), where 37.5%=$624/$1665, and moreover its makes this choice knowing that the HFE system, for better or for worse, will take away a large portion of its mining revenues. Thus a material part of Western Australia's budget difficulties is of its own making.

3.4.5 South Australia

TABLE 3.5 SOUTH AUSTRALIA SIGNIFICANT OVERSPEND OR UNDERSPEND PER CAPITA 2015-16

	Actual expense ($pc)	Assessed expense ($pc)	Difference ($pc)	National average expense ($pc)
School education	2178	2125	53	2104
Health	2605	2491	114	2387
Housing	42	131	-89	119
Welfare	853	723	129	703
Services to communities	220	272	-53	250
Justice	789	754	34	764
Roads	145	301	-155	267
Transport	279	455	-176	530
Other expenses	980	1312	-332	1271
Total expenses	**9035**	**9599**	**-564**	**9372**

South Australia in some respects is the mirror image of Western Australia, spending in total $564 per capita less than its assessed expense. In this respect, South Australia appears to be a small spending State.[18] South Australia's assessed total expense is $227 per capita above the national average, but it chooses to spend $337 less than its assessed expense, while spending more than its assessed expense in some categories (e.g. health) but less in some others (e.g. transport).

The expenses where South Australia receives equalisation payments while actually spending less than its assessed expenses are housing, where it receives $15 per capita but underspends by $89, services to communities (receives $28 per capita, underspends by $53 per capita) and roads (receives $43 per capita, underspends by $155 per capita). Overall, in the CGC's 2017 Review, South Australia received $193 per capita for its expenses.

3.4.6 Tasmania

TABLE 3.6 TASMANIA SIGNIFICANT OVERSPEND OR UNDERSPEND PER CAPITA 2015-16

	Actual expense ($pc)	Assessed expense ($pc)	Difference ($pc)	National average expense ($pc)
Health	2575	2956	-381	2387
Welfare	745	853	-108	703

[18] This finding is premised on the assumption that the CGC accurately estimates SA's disabilities and thus its assessed expenses.

	Actual expense ($pc)	Assessed expense ($pc)	Difference ($pc)	National average expense ($pc)
Services to communities	93	268	-175	250
Justice	651	798	-147	764
Roads	180	244	-65	267
Transport	153	228	-75	530
Services to industry	366	242	124	227
Other expenses	1731	1636	94	1271
Total expenses	**9509**	**10386**	**-877**	**9372**

Tasmania spends less than its assessed expenses by the greatest amount of any State, $877 per capita. This is not because the Tasmanian Government is a low spender *per se*. Tasmania's actual expenses per capita are about $1000 more per capita than Victoria, but it does have a lot of disabilities, and its assessed expenses per capita are the highest of any State other than the Northern Territory, which is a special case. Tasmania's underspending occurs across nearly all categories of expenses, but it does spend significantly more per capita than its assessed expense on services to industry and other expenses.

Tasmania receives equalisation payments for several categories of expenses for which it underspends the national standard. The largest are health ($550 per capita, underspend $381 per capita), welfare ($155 per capita, underspend $108 per capita) and justice ($38 per capita, underspend $147 per capita). Overall Tasmania receives $956 per capita for its expenses in the HFE process.

3.4.7 ACT

TABLE 3.7 ACT SIGNIFICANT OVERSPEND OR UNDERSPEND PER CAPITA 2015-16

	Actual expense ($pc)	Assessed expense ($pc)	Difference ($pc)	National average expense ($pc)
School education	2180	2000	180	2104
Health	2664	2130	534	2387
Welfare	658	579	79	703
Services to communities	146	198	-53	250
Roads	92	177	-85	267
Transport	263	369	-167	530
Other expenses	1731	1636	94	1271
Total expenses	**11927**	**9050**	**2877**	**9372**

The ACT spends more overall relative to its assessed expenses than any other State. Partly this is because it has the second lowest level of assessed expenses per capita and partly because its actual expenses are third only to the NT and WA. The standout category where ACT spends big is health, $534 per capita above its assessed expense.

There are no expense categories where ACT receives equalisation payments but spends less than the national standard.

3.4.8 Northern Territory

TABLE 3.8 NT SIGNIFICANT OVERSPEND OR UNDERSPEND PER CAPITA 2015-16

	Actual expense ($pc)	Assessed expense ($pc)	Difference ($pc)	National average expense ($pc)
Post-secondary education	541	257	283	188

	Actual expense ($pc)	Assessed expense ($pc)	Difference ($pc)	National average expense ($pc)
Health	5124	4106	1018	2387
Housing	636	418	218	119
Welfare	1169	1728	-559	703
Justice	2461	2407	54	764
Transport	297	215	82	530
Services to industry	1050	334	716	227
Other expenses	3502	2413	1089	1271
Total expenses	**21657**	**19248**	**2409**	**9372**

The Northern Territory is truly a special case. Its assessed total expenses per capita are just about more than double any other State as are its actual expenses per capita. Its overall overspend, $2409 per capita, is second only to the ACT.

But while the NT overspends on just about every category of expense, it underspends on welfare by $550 per capita. This is despite receiving equalisation payments for welfare of $1093 per capita. Where does this money go? The NT overspends on services to industry by $716 per capita, which is at least six times the overspend of any State (the second highest is Tasmania at $124 per capita). It also overspends on health by $1018 per capita, which is double the second highest, the ACT.

Another issue raised by the NT's overspend on some services (notably health, but not just health) is whether its assessed expenses have been accurately estimated by the CGC. It might be the case that the NT Government chooses to spend a lot of money on health, but it might also be the case that the CGC has underestimated the NT's disability in providing health services, particularly to indigenous people, who face a potent mix of chronic disease, drugs, alcohol and underfunded welfare services.[19]

Without a detailed examination of how the CGC estimates disability for each service in each State (its periodic reviews provide insufficient explanation) it is not possible to conclude definitively that the CGC's estimates of disability for the NT (and elsewhere) are inaccurate. What can be concluded definitively is that these estimates are not at all transparent, and have to be taken on faith. This is not a good basis for Australia's system of horizontal fiscal equalisation.

While far removed from the CGC's remit, the way the NT affects and is affected by the HFE process (together with direct Commonwealth payments; see the following chapter), raises the question of whether the money spent by the NT Government, especially on services for Indigenous people, is being spent effectively, as well as whether enough of it is being spent (especially on welfare).

The evidence suggests not. According to the latest *Closing the Gap* report,[20] outcomes for Indigenous people in the Northern Territory are poor not just compared to non-indigenous people in the NT but compared to Indigenous people elsewhere in Australia.

— The Indigenous child mortality rate in the NT is 333 per 100,000. In the other States it varies from 111 to 189 per 100,000.

— Indigenous student attendance is the lowest in Australia.

— The proportion of Indigenous students reaching National Minimum Standards for Year 3 reading is by far the lowest in Australia (42 per cent; the next lowest is WA at 71 per cent).

— The proportion of Indigenous 20-24 year olds in the NT with Year 12 or equivalent attainment is by far the lowest in Australia (29.7 per cent, the next lowest is WA at 58.4 per cent).

[19] In its 2015 Review, the CGC estimates the NT's health disability to contribute $518 million in GST distribution above an equal per capita distribution. The major contributing factors were remoteness ($399 million) and Indigenous Status ($186 million). The CGC thus estimated that remoteness contributes more than double than indigeneity to the NT's disability in delivering health services. This seems questionable, not least because it suggests the NT faces not much of a disability in delivering health services to indigenous people who do not live in remote areas.

[20] closingthegap.pmc.gov.au

On some indicators, such as overall mortality rates, Indigenous people in the NT are at the national average.

The poor outcomes for Indigenous people in the NT, both in absolute terms and compared to Indigenous people in other States, might indicate policy failure, and/or the particular difficulties faced by Indigenous people in that State. But either way, these outcomes suggest that the very large sums of money being sent to the NT via the HFE process - the sums being large because of the disabilities caused by it having such a large (and remote) Indigenous population - are not having much of a positive impact on the lives of Indigenous people. This suggests that alternatives to this process might be better for the NT and for the integrity of the HFE process in Australia as a whole. This point is discussed more in the concluding section of this chapter.

3.5 Changes over time

The data in the previous section are all for 2015-16. It is reasonable to ask whether this year was a typical year, since what really matters is what States do over a run of years.

One way to see whether 2015-16 was a typical year was to compare the ratio of actual to assessed expenses, for each state, for each service, to the average of the three previous years.

For all states but the NT, for expenses as a whole, the ratios in 2015-16 were virtually identical to the average of the previous three years. For the NT, the ratio was in 2015-16 was 10 per cent higher, so perhaps 2015-16 was an unusually high spending year, or alternatively the NT has permanently increased its (policy-based) spending. The answer to this question won't be known (using this framework of analysis) until future CGC assessments are released.

Disaggregating, there was some apparent variation. Of the 88 possible cases (8 States, 11 expense categories), there were 35 instances where the 2015-16 ratios were 10 per cent or more higher or lower than the three previous years, and 21 instances where the ratios were 15 per cent higher or lower. This apparent variation probably overstates the true variation, because with only one minor exception[21], there were no instances where a State went from being a 'high'[22] spender in an expense category to a 'low' spender, or *vice versa*.

There were no instances of significant variation in the 'big ticket' categories of school education, health and justice – the ratios of actual expenses to assessed expenses were stable over time in all States.[23] The expense categories where 2015-16 seems to be especially atypical were roads (three States spending significantly more, two States spending significantly less) and housing (four states spending significantly more, two States spending significantly less). The lumpy nature of these expense categories may account for these variations.

The two States with a large number of expense categories where 2015-16 was materially different from the previous three years were the ACT and NT, the difference between them being that the ACT had an equal number expense categories where the spending ratio increased and decreased, whereas the NT only significantly decreased its spending ratio materially in 2015-16 in one category, welfare. In the three years prior to 2015-16, the NT's average ratio of actual to assessed welfare spending was 75.8; in 2015-16 it was 67.6. It is very notable that the NT chose to spend less on welfare (relative to assessed expenses) when it spent more on everything else, in some cases much more.

Another standout category for the NT was services to industry, where the ratio of actual to assessed expenses increased from 174.1 in 2012-13, to 180.0 in 2013-14, to 230.2 in 2014-15 to 314.1 in 2015-16.

3.6 Discussion

It is clear that States have different spending priorities. This is not in itself a problem. Indeed it is in many ways desirable. If a State chooses to spend a lot on, say, education and not much on health, or

[21] ACT on services to communities.

[22] Defined as a ratio more than 100.0

[23] With minor exceptions – an increase in the health ratio in the NT and a decrease in the justice ratio in the ACT.

vice versa, then people can choose (at least some extent) the State they want to live in according to their preferences for receiving different kinds of state government services.

However, what is a problem is when States' decisions to spend on different services become entangled in the HFE process. The data show that the process brings forth many different kinds of inefficiencies and poor incentives.

First, while not directly related to the incentive properties of the HFE system, its underpinning depends critically on the premise that the CGC can accurately measure standard levels of service for each type of expense and the disabilities faced by each State. The documentation on the CGC's website gives a high level overview of how the CGC makes these calculations but lacks detail, particularly for the assessment of disabilities faced by individual States in the delivery of particular services.

Second, as documented in this chapter, there are many examples of States receiving HFE payments because they have a disability (compared to the other States) in the delivery of a service, but then spending less than their assessed level of expense. This practice is contrary to the broad intent of fiscal equalisation in federations in general, including Australia, which is that States should be compensated for difficulties they face in providing a minimal level of service that everyone in the nation ought to be able to receive. It could be argued that is up to the States to decide how much of a particular service they provide. But even if this argument is accepted, if a State consistently decides not to provide a service, or to provide it at a low level, then there is no good reason for the other States to transfer money to it for the service it isn't providing so that it can provide other services (or to cut taxes), which is what happens under the current system.

Third, States with a disability which choose not to spend on services (e.g. welfare in the NT) could see that disability increase e.g. if welfare services are not delivered people who need them, then their well-being will deteriorate and they will need those services even more. This could result in widening disparities of community well-being between States, which is the opposite of what fiscal equalisation is supposed to achieve.

Fourth, the current HFE system makes no distinction between inherent disabilities in the provision of services (e.g. those arise from the presence of remote communities) and disabilities that are of a State's own making, due to poor policy decisions or poor service implementation. Indeed, the current system rewards failure by designating disabilities to States which due to their own poor policies, deliver services inefficiently (high cost and/or low productivity).

Fifth, as a corollary to the above, the current HFE system penalises (or appears to penalise) States who undertake reforms to improve the efficiency of their service delivery and thereby reduce their disabilities (as well as making the simplistic assumption that dollars spent on a service is a proxy for the quality of service).

Sixth, even if States are inclined to undertake efficiency-enhancing reforms, knowing that these will most likely reduce their GST distributions, the opaque nature of the CGC's assessment process means that they will be uncertain about how much they will be penalised. This uncertainty is likely to chill the appetite for reforms.

Seventh, States have a disincentive to spend more on services which they can provide efficiently and for which there is demand in that State (and perhaps from out of state e.g. some health services), because by increasing the national standard, States with a disability will receive funding, at the expense of the efficient States, for services that they are not efficient at providing, and for which there might not be much demand (and which might then lead to the situation described earlier where States receive funding for services they don't deliver).

Eighth, when States choose not to spend money on services for which they have receive equalisation payments and instead spend it on other services, those services might or might not be those which they deliver efficiently. If they are services which are delivered inefficiently, then by increasing the national standard level of service delivery they will then receive even more payments because of their disability.

Ninth, the Northern Territory is such a special case, driven largely (but not entirely) by the disabilities (possibly inaccurately estimated because they are so large) it faces by having a large indigenous population, that an argument can be made that it should be excluded altogether from the CGC's HFE calculations. The NT's assessed expenses of delivering services are more than double the national average. For this and other reasons, the NT, with one per cent of the national population, will receive 4.7 per cent of the GST distribution in 2017-18. This does not mean that the NT should receive less funding from the Commonwealth (from a combination of the GST pool and direct payments). Perhaps it should receive more. But the basis on which it receives funding should be re-thought. The issues facing the Northern Territory should be treated as national problems that require national solutions but the HFE process is not the instrument to help fix the problems. At present, the NT is such an outlier that it is distorting the HFE process as a whole. This is unnecessary and not in anyone's interests.

In summary, the HFE system as it applies to States' expenses on services is replete with rewards for inefficient behaviour by States, penalties for efficient behaviour and dynamics in which inefficient behaviour begets more inefficient behaviour.

4 THE NORTHERN TERRITORY AND INDIGENEITY

4.1 Introduction

The Northern Territory's inclusion in the CGC's HFE process is very problematic. Because of its high level of disabilities in delivering services, in 2017-18 it will receive an additional $2693 million in GST (compared to what it would receive on an EPC basis) which amounts to $10952 per capita. This is more than 10 times the amount received by the second-highest recipient State (for expense disabilities), Tasmania ($956 per capita). Overwhelmingly, the driver of the NT's assessed disabilities is indigeneity (contributing $3098 per capita) and remoteness and regional costs ($2721 per capita).

A very good case can be made for excluding the NT altogether from the HFE process, with the Commonwealth directly taking up responsibility for financing the service delivery difficulties that it faces. This is not a new observation. In their submission to the Brumby Carter and Greiner review, Ergas and Pincus[24] said

Without a distribution of Commonwealth grants based on HFE, and absent any alternative means of relieving NT of its disproportionate fiscal burden, the government and people of NT would likely prefer that the responsibility be passed to the federal government. The attitude of the other jurisdictions to such a passage of responsibility would depend on how the Commonwealth would then fund the services, with likely candidates being a reduction in the GST funds or in non-GST grants transferred to the states. In either case, the bulk of the burden of paying for the NT services would continue to fall on the budgets or the citizens of the other states; and the resultant redistributions of the (net) burdens would be relatively small. …

In practice, as is clear from the recently released Commonwealth Department of Finance and Deregulation's Strategic Review of Indigenous Expenditure (DOFA, 2010), the funding and even more so management of indigenous programs in the NT is in any event largely passing into Commonwealth hands and that trend seems likely to continue. As a result, this issue seems set to be dealt with outside the context of HFE, and it should not be allowed to distract or hinder the reform of HFE.

As set out in the remainder of this chapter, the Commonwealth is already a major funder of the NT, from both the GST and direct Commonwealth payments. A shift away from the GST towards more direct Commonwealth payments would just reinforce an existing trend, as far as the NT is concerned. But it would greatly improve the integrity of the HFE process

[24] Henry Ergas and Jonathan Pincus, Reflections on Fiscal Equalisation in Australia
*

4.2 The NT sources of revenue

Table 4.1 shows the NT's revenue from three sources: own revenue, GST and direct Commonwealth payments that affect relativities.[25]

TABLE 4.1 NT SOURCES OF REVENUE 2015-16

	NT	All States
Own revenue ($m)	1167	121494
GST ($m)	3286	57250
Direct Commonwealth payments ($m)	842	41558
Total ($m)	5295	220302
GST per capita ($)	13474	2392
Direct Commonwealth payments per capita ($)	3454	1736

SOURCE: CGC, NOTE: EXCLUDES COMMONWEALTH PAYMENTS TO STATES THAT DO NOT AFFECT RELATIVITIES AND OWN REVENUE THAT DOES NOT AFFECT RELATIVITIES.

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As can be seen the NT is far more dependent than the other States on the distribution of GST revenue and on direct Commonwealth payments. The former is well-known. Not quite as well known is that the NT receives about double per capita Commonwealth payments than the national average. This reliance has increased in recent years. In 2013-14, NT received 59% more per capita than the national average and in 2014-15 it received 83% more capita. The high and increasing dependence of the NT on these direct payments is important for two reasons. First, because of the interaction between direct Commonwealth payments, GST revenue and incentives to spend in particular services (see following chapter). Second, because the NT is already highly dependent on direct Commonwealth payments, it would not be a huge leap for it to receive less in GST and more in these payments (although GST revenue is untied but direct Commonwealth payments are tied). But given the tendency of the NT to overspend its GST payments on some services (e.g. assistance to industry) and to underspend on others (e.g. welfare) it would not be a bad thing if the NT was given more direction on the money it receives from the Commonwealth.

4.3 Disaggregating Direct Commonwealth payments

Tables 4.2 and 4.3 shows total direct Commonwealth payments disaggregated by program group, in total and per capita. They show that in most payment categories the NT receives more per capita than the national average.

TABLE 4.2 DIRECT COMMONWEALTH PAYMENTS BY PAYMENT CATEGORY ($M) 2015-16

	NT	Australia
Payments to support State education services	280	16164
Payments to support State skills and workforce development services	18	1827

[25] About one third of Commonwealth payments to the States do not affect relativities e.g. those that do not affect States' fiscal capacities (such as payments to non-government schools) and payments for which the Commonwealth Government payment is assumed to reflect the expenditure needs (such as 50 per cent of the payments for national roads networks): Greiner Carter Brumby review, page 84.

	NT	Australia
Payments to support State health services	268	17568
Payments to support State community services	17	1583
Payments to support State affordable housing services	67	1729
Payments to support State environment services	1	126
Payments to support State infrastructure services	123	2395
Payments to support other State services	1	41
Commonwealth own purpose payments (COPEs)	68	125
Total	842	41558

SOURCE: CGC

TABLE 4.3 DIRECT COMMONWEALTH PAYMENTS BY PAYMENT CATEGORY ($ PER CAPITA) 2015-16

	NT	Australia
Payments to support State education services	1147	675
Payments to support State skills and workforce development services	72	76
Payments to support State health services	1097	734
Payments to support State community services	69	66
Payments to support State affordable housing services	275	72
Payments to support State environment services	4	5
Payments to support State infrastructure services	505	100
Payments to support other State services	3	2
Commonwealth own purpose payments (COPEs)	280	5

SOURCE: CGC

The standout category is Commonwealth own purpose payments (COPE), more than half of which go the NT. This category is comprised of various Grants for Indigenous Purposes, the largest of which are *Health and substance abuse* (NT receives $45 million out of $72 million nationally), *Schools education* (NT receives $11 million out of $33 million nationally) and *Other expenses* (NT receives $12 million out of $35 million nationally).

Another category where the NT receives a highly disproportionate share of Commonwealth direct payments is *Payments to support state affordable housing services*. Within this category a large sub-category is *Remote Indigenous housing for 2013-14 onwards*, where in 2015-16 the NT received $48 million out of $289 million. It is plausible (but difficult to prove on publicly available information) that, assuming that these payments are not excluded from the HFE process, or subject to special treatment by the CGC, that the HFE system actually undermines these 'higher than per capita' Commonwealth payments, and that the NT might actually benefit from being excluded from the HFE process.

The NT also receives disproportionately more direct payments for infrastructure.

The conclusion which emerges from this analysis is that a large driver of the NT's disproportionate share of direct Commonwealth payments is its relatively large Indigenous population, which not only suffers from the generic difficulties faced by Australia's Indigenous population, is also on the whole more remotely located and has a more disadvantaged socio-economic profile than the Indigenous population in the other States. As discussed in the previous chapter of this submission, outcomes for NT's Indigenous people are poor compared to the outcomes of Indigenous people elsewhere in Australia.

The fiscal disabilities created by the NT's Indigenous population are of course also a major driver of the NT's GST distribution. Indigeneity as it affects the HFE process is discussed in the next section, as well as further discussion of its impact on Commonwealth direct payments.

4.4 Indigeneity

The impact of Indigenous status on the distribution of GST relative to an EPC distribution is shown in Table 4.4.

TABLE 4.4 INDIGENOUS EFFECT ON GST DISTRIBUTION RELATIVE TO EPC 2017-18

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
$ million	-110	-1 440	679	187	-119	101	-60	762	0
$ per capita	-14	-231	137	70	-68	194	-148	3 098	70

SOURCE: CGC

The Indigenous effect is huge for the NT, adding $3098 per capita to its GST distribution. The NT's overall excess-over-EPC per capita distribution is $9339 ($11881 minus $2532), so the Indigenous impact contributes about one-third of the total. Not coincidentally, NT's Indigenous population is about one third of its total population (73,000 out of 243,000).

Queensland and Tasmania are other States where the Indigeneity effect has a large positive impact on their GST distribution. In Queensland's case the effect adds $137 per capita in GST payments, which is a large proportion (28 per cent) of its overall excess GST per capita ($137 out of $486). In Tasmania's case, the proportion is smaller (9 per cent, $194 out of $2059) but still significant.

By the way the CGC calculates the GST distribution, the excess relative to the national average that States receive for their Indigenous disabilities is paid for by the other States, with the national total equal to zero. Indigenous effects, as with other effects, in the GST distribution are thus a zero sum game. This is problematic in general but especially so for the difficulties faced by Indigenous people and their flow-on effects to the cost of delivering services. These difficulties should be seen as national problems to be fixed, and services to Indigenous people should be financed by the Commonwealth, or at the very least not affect the distribution of GST to the States.

The Commonwealth already pays large sums directly to the States for services specifically aimed at Indigenous people. (This is on top of direct payments for general payments for the population in general, including Indigenous people.) In 2015-16, these payments amounted to $420 million, or $573 per Indigenous person. As with so much else, the NT received much more proportionately than the other States, It received $118 million, $1612 per Indigenous person compared to $457 per Indigenous person in the other States.

There are good reasons for the NT to receive more per Indigenous person than the other States. The NT has about 10 per cent of Australia's Indigenous population but has 38 per cent of the Indigenous people who are in the lowest socio-economic quintile (bottom 20%) i.e. of 733,000 Indigenous people in Australia, 141,000 are in the lowest quintile of whom 53,000 live in the NT. Put another way, 73 per cent of the NT's Indigenous population (53,000 out of 73,000) are in the bottom quintile for the national Indigenous population.

Furthermore, by national Indigenous standards, a large proportion of NT's Indigenous people live in remote or very remote areas. 79% of the NT's Indigenous population lives in remote or remote areas; in the other States, the proportion is 14 per cent. Put another way, NT has 10 per cent of the national Indigenous population but has nearly 40 per cent of the Indigenous population that lives remotely or very remotely.

4.5 Indigeneity in the Draft Report

The Commission, in its Draft Report, states (with emphasis) that absent a more fundamental reform to roles and responsibilities with respect to treating Indigenous disadvantage, it remains open what taking Indigeneity out of HFE would achieve.

It is self-evident that merely taking Indigeneity out of HFE won't in itself assist Indigenous people. Making this change will be part of a new approach that treats the problems of Australia's Indigenous people as national problems requiring national solutions and national funding. (This doesn't preclude the States from being the deliverers of services, nor does it mandate a one size fits all approach to all Indigenous people in all States.)

Assuming this premise to be correct, it no longer makes sense for the HFE process to take account of State by State Indigenous disability in the calculation of relativities for the purposes of distributing GST.

The Commission for its Final Report, should undertake the following modelling, with the CGC's assistance.

- Estimate the GST distribution with Indigenous disability removed and all Indigenous-specific programs financed by the Commonwealth
- Estimate the GST distribution with Indigenous disability removed and all Indigenous-specific programs financed by the Commonwealth and with the Northern Territory removed from the HFE process
    - With the NT receiving its current GST allocation less the amount it receives that reflects its Indigenous disability.
- Keep Indigeneity in the GST calculation but remove the NT from the HFE process

4.6 Conclusion

The NT has to be seen as a special case whose particular fiscal disabilities, driven largely but not entirely by the difficulties faced by its Indigenous population, have profoundly distorting effects on the national HFE process. The Northern Territory should be removed from the CGC's HFE process, or have its GST distributed EPC, with the nation as a whole making up the revenue shortfall.

Removing the NT from the HFE process should be accompanied by removal of Indigeneity as a fiscal disability from the process. Taking the NT out will by itself take out about 1/3 of the total state Indigeneity fiscal disability, but this leaves 2/3 faced by the other States. The Commonwealth should likewise make direct payments to these States to assist them in delivering Indigenous-specific services and services generally where the costs of delivering them to Indigenous people is high.

5 DIRECT COMMONWEALTH PAYMENTS AND HFE

5.1 Introduction

This chapter examines the impact of direct Commonwealth payments to the States on the HFE process. There are two relevant types of payments that the Commonwealth makes, Specific Purpose Payments and payments arising from National Partnership Agreements. In principle, all of the payments can affect the GST distribution to the States, though in practice not all do.[26]

Under the CGC's HFE assessment methodology, direct Commonwealth payments to the States (in principle) affect the fiscal capacity of States and therefore affect the GST distribution. The CGC's methodology undoes part (perhaps a large part) of the direct payments by redistributing money between the States. This is not an accidental by-product of the process. It is a design feature of the process. At best, this creates churn, with the Commonwealth Government giving money to the States and a Commonwealth Government agency, the CGC, taking it away (or giving more). At worst, the process creates incentives for States to behave strategically in deciding whether or not to accept direct Commonwealth payments. As with the impact of taxes and expenditures discussed earlier in this report, these outcomes are driven by the zero sum, relativity-based design of the HFE system.

5.2 The CGC's treatment of Commonwealth payments

The CGC explains in its 2015 Review how it treats Commonwealth payments.[27] The key statement is at paragraph 16

Payments which support State services, and for which expenditure needs are assessed, will impact relativities

The CGC gives itself a great deal of discretion in deciding whether and how Commonwealth payments are assessed, and, as well, the Commonwealth can and sometimes does direct the CGC not to assess some payments. But when the CGC does assess payments to a State, it adjusts that State's GST to reflect above or below per capita receipt of the payment such that the total of the payment, GST and the State's own source revenue give it the capacity to deliver services at the national (i.e. average) standard.

What this means is that, by design, the HFE process undoes in part the financial benefit on a State of the receipt of Commonwealth payments. This is explicit and deliberate. At paragraph 63 of 2015 Volume 2 report the CGC says

[26] In the 2017 Update, the CGC considered six different SPPs, two of which ended up affecting GST distributions, and 89 different NPA payments, but only 13 had a material effect on GST distributions.
[27] https://www.cgc.gov.au/index.php?option=com_content&view=article&id=219&Itemid=318

The closer Commonwealth payments in total are to an EPC distribution, the more work the GST has to do in meeting State needs. A larger proportion of the GST will be required for equalisation purposes. If the payments are distributed in a manner consistent with the Commission's assessment of needs, this will reduce the extent to which GST is redistributed.

Here the CGC is saying that even if the Commonwealth and States decide among themselves to distribute payments for a particular program on an equal per capita basis, it will override that decision and redistribute the money among the States according to how it thinks it should be distributed, and it will take as big a piece of the total GST pie as it sees fit to do it. I

The best that can be said about this practice is that it creates churn in the process by which the States receive payments from the Commonwealth. But there is more it than that. As discussed below, the practice of the Commonwealth giving with one hand and taking with the other creates incentives for States to behave strategically.

5.3 Effect of Commonwealth payments on GST distributions

Table 5.1 shows the net impact on each State's GST distribution[28] of Commonwealth payments.

TABLE 5.1 NET EFFECT ON GST DISTRIBUTION OF COMMONWEALTH PAYMENTS (2017-18)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	National
$m	-75	-121	-129	278	126	24	-17	-85	0
Per capita $	-10	-19	-26	104	73	46	-42	-347	

In aggregate, in terms of their effects on GST distribution, Commonwealth payments create winners and losers among the States. The biggest loser is the NT, reflecting the fact that it receives so much in direct Commonwealth payments. (In 2015-16, the NT received $3454 per capita in Commonwealth payments. The national average was $1736.[29]) The biggest winner was Western Australia. Because the mechanics of the HFE process treats Commonwealth payments as affecting relativities, necessarily the aggregate effect on all States is zero.

The aggregate numbers, while informative in themselves, contain within them a large amount of useful information. Table 4.2 breaks down the aggregate by service category and also by revenue impact and expenses impact. Service categories where no State is significantly affected (defined as an effect of at least $50 per capita) are omitted.

TABLE 5.2 DISAGGREGATED PER CAPITA NET EFFECT ON GST DISTRIBUTION OF COMMONWEALTH PAYMENTS (2017-18)

	NSW $pc	Vic $pc	Qld $pc	WA $pc	SA $pc	Tas $pc	ACT $pc	NT $pc
Schools Education	5	-2	-10	20	8	-24	11	-120
Health	-16	-30	9	36	30	137	-61	288
Housing	-2	-8	2	6	6	7	-19	139
Welfare	3	-8	1	-2	0	13	-10	96
Services to Communities	3	-20	11	16	-5	-24	1	92
Investment	-8	40	-12	16	29	-60	19	-809
Total impact	**-10**	**-19**	**-26**	**104**	**73**	**46**	**-42**	**-347**
Comprising								
Revenue impact	13	44	-49	6	84	-46	155	-1361
Expenses impact	-23	-63	23	97	-11	92	-197	1014

[28] Source; spreadsheet U2017- Analysis of Relativities- Differences from EPC, from the CGC's website https://www.cgc.gov.au/index.php?option=com_content&view=article&id=263&Itemid=542
[29] Source CGC spreadsheet The Adjusted Budget- Summary.

The large States do not appear to be much affected by Commonwealth payments, but the smaller States certainly are. The Northern Territory is an interesting case that shows the interaction between Commonwealth payments and the HFE process. In 2015-16 Commonwealth payments for health and education to the States amounted to about 80 per cent of total Commonwealth payments.[30] NT has a large disability in both: its ratio of assessed to average expenses for schools education was 164.3 in 2015-16, and for health the ratio was 172.1. NT received very large amounts of school education direct payments. In the largest education sub-category, *Students first funding – government education*, NT received $526 per capita, more than double the national average $240. As a result, it lost $120 per capita in GST distributions, despite its education disability, which in itself would have increased its GST distribution.[31]

On the other hand, with health, NT's direct Commonwealth payments were not much higher than the national average. (For the largest sub-category, *National health reform funding,* NT received $867 per capita, compared to the national average of $718. The impact of its health disability saw the net effect of Commonwealth health payments increase its GST distribution by $288 per capita.

Housing is a similar story. All States received $55 per capita as part of the *National affordable housing agreement.* But because of NT's disability in housing (ratio of assessed to average expenses of 351.4), the HFE effect saw it receive an additional $139 per capita.

Where the NT lost a large amount of GST revenue was in the investment category (which comprises infrastructure and land). The NT is by far the largest recipient of direct Commonwealth payments. In 2015-16, it received $123.2 million in Commonwealth payments to support state infrastructure services, which was 5.4 per cent of national payments, far above its population share. But this caused it to lose $199 million in GST payments, or $809 per capita, much more than it received. The reasons for this seemingly strange result are not obvious, but may be related to the fact that NT's assessed investment expense per capita was *negative* $61 (compared to the national average $355 per capita). Certainly, the fact that the sum of the State effects for all equalisation calculations must always be zero would have played a part.

With the ACT, the opposite from the NT occurred with health. The ACT has a negative disability in health, with a ratio of actual to assessed expenses of 89.3 (the lowest of all the States). As a result, it lost $61 per capita in GST payments. On the hand, Tasmania, a state with a disability on health (ratio of assessed to average expenses of 123.9) gained $137 per capita in GST as a result of the Commonwealth's direct health payments.

With Victoria, the opposite from the NT occurred with investment. Victoria received $249 million in GST distributions ($40 per capita) resulting from Commonwealth investment payments. This might have been because it received just 8.7 per cent of investment payments in 2015-16, far below its population share.

It is obvious that there is a deep relationship between Commonwealth payments and the HFE processes, though the mechanisms which determine precisely how Commonwealth payments affect GST distributions are not transparent, at least not from publicly available CGC material. What is not obvious is why Commonwealth payments should be allowed to affect GST distributions. The CGC argues that Commonwealth payments affect States' fiscal capacities, but glosses over the fact that Commonwealth payments reflect Commonwealth policies and priorities, with the States as the agent of delivery. In some cases, the CGC judges that Commonwealth payments should have no effect on relativities and hence GST distributions. One such case is Commonwealth payments to private schools. Presumably the CGC's judgement is that States have equal capacity to act as intermediaries, receiving money from the Commonwealth and passing it on the schools in the amounts decided by Commonwealth policy. In other cases Commonwealth payments have very large effects on GST payments. In these cases, the CGC's judgement on how States' fiscal capacities are affected is all important, unless the CGC is directed by the Commonwealth to disregard, in part or whole, certain payments. The process is all very arbitrary and *ad hoc* and it is certainly not transparent.

[30] Payments to support State health services, $17,6 billion; Payment to support State education services, $16.1 billion; total payments $41.6 billion. Source: CGC spreadsheet The Adjusted Budget- Summary

[31] Education payments to the States increase the national standard level of service. This would tend to increase GST payments to States with a disability in education, such as NT.

5.4 Strategic incentive effects

The interaction between Commonwealth payments and the HFE process provides opportunities for States to act strategically by not being parties to an NPA, but whether or not they do so depends on the details of the NPA and the circumstances of a State.

For example, suppose there is an NPA for a new service, i.e. one which States do not currently provide. If the funding is on a per capita basis, then this will not affect GST payments because (by assumption) all States will have an equal capacity to provide the service, provided they all sign on the NPA. But suppose that only State signs on the NPA, then it will receive the Commonwealth funding, but it will lose GST distributions as the CGC will judge that the other States will have less capacity to provide the service. The State that receives the Commonwealth direct funding will lose 100% minus its population share of the funding in the HFE process. This outcome is very similar to what happens when a State creates a new taxation revenue base. A numerical example is provided below.

In this case, the State which is in the NPA is in net financial terms better off, but there is a catch because it has received money for a particular program which might not accord with its policy priorities. The States which opt out of the NPA are worse in net financial terms, but the additional GST money they receive is theirs to spend according to their priorities.

For Commonwealth payments that are for similar services to those already provided by the States, incentives also exist for strategic behaviour, but they are more complex. States that have a disability in a service (i.e. their assessed expenses are higher than the national average) gain when the Commonwealth makes direct payments for that service because these payments increase the national standard of the service. States with a disability will receive additional GST payments so they can provide the national standard level of service. These States therefore have an incentive to lobby for Commonwealth payments for services which they provide inefficiently (or for which they have a genuine disability). While they have to spend the money provided directly by the Commonwealth, they don’t have to spend the additional GST money that they receive for that service because of their disability. Or they might want to spend it on that service, happy that the Commonwealth is providing them with the money, because it is a service that is expensive for them to provide. If the Commonwealth allocates its direct payments on a per capita basis then this will be a winning strategy. It is only when those States receive payments well in excess of their population share that they might lose in the HFE effects (such as the NT with education, discussed above).

Conversely, States which have a negative disability in a particular service (i.e. their assessed expenses are less than the national average) may have the incentive to lobby against Commonwealth payments for that service, because they will lose some of those payments in GST equalisations. Of course on balance they might decide it’s better to receive the Commonwealth money, despite the HFE effect and despite the fact that the money is tied. It will depend on the particular circumstances, but the bigger question is why should there be a system that produces these strategic considerations at all. A better system would simply direct Commonwealth payments to the States and services where it is needed without any flow-on effects on other payments.

To see how the incentives could work, consider the following hypothetical example. Suppose the Commonwealth is offering to negotiate a new NPA for Adult Public Dental Services that would provide $361.5 million in Commonwealth payments nationally i.e. $15 per person, and it is distributed to each State on a per capita basis. With each State receiving an equal per amount there is no need for any HFE since (by assumption) each State has the same capacity to provide the services under the agreement.

However, if not all States sign up to the agreement, the HFE process will distribute funds from the States that are party to the agreement to those that are not. Suppose NSW is the only State to sign up to the Agreement. (The same argument will apply to any State.) Under the agreement NSW will receive $117 million (reflecting its population of 7.8 million). The CGC will then consider that NSW has greater fiscal capacity to deliver these services than the other States, because it has received Commonwealth payments and they have not. The CGC will then seek to equalise fiscal capacity to provide these services. It will do so by redistributing the $117 million that NSW has received through the Australian population, i.e. each State will end up with $4.85 per person = $117 million/24.1 million people.

NSW will end up with just $4.85 per person, a loss of $10.15 per person from the original Commonwealth direct payment, or $79.1 million in total. This poses a dilemma for NSW. On the one hand, it gains $117 million in direct Commonwealth funding, but it is tied funding, for a specific purpose. On the other hand, it loses $79.1 million in GST payments which it could have spent according to its priorities. NSW has to choose between more money ($37.9 million in this example) and more autonomy.

For a small State, the decision could be easy. For example, if South Australia alone rejects the agreement, then it loses $25.6 million in direct payments, but gains almost as much, $23.7 million, in GST revenue.

Matters are more complicated when more than one State rejects the agreement. Suppose that as well as NSW, Victoria (population 6.1 million) rejects the agreement. Then the other six States will receive $153 million between them, and the CGC will equalise GST payments so that each State has fiscal capacity of $6.35 per capita (=$153/24.1). NSW will only gain $49.5 million in GST revenue, compared to $79.1 if it alone rejects the agreement, while still losing $117 million in direct payments.

Whether or not it is worth NSW's while to reject the direct Commonwealth funding depends on whether the other States reject it too. The same reasoning applies to the other States. If all States reject the agreement, that is worst possible outcome for them, because then no State receives anything. If all States accept the agreement, that is best possible outcome for them (collectively), because they all get the Commonwealth money, and there is no equalisation by the CGC. But there will be a temptation for a State to opt out, hoping that it will be the only one to opt out. Each State faces the same temptation. Lacking a co-ordination mechanism to bind them into accepting the agreement, the HFC process will push the States towards a sub-optimal outcome.

5.5 Reform

There is a good case for exempting all direct Commonwealth payments from the HFE process. The reasons are as follows.

First, notwithstanding the on and off extant spirit of co-operative federalism that can characterise Commonwealth-State relations, Commonwealth payments to the States largely reflect Commonwealth policy and Commonwealth priorities. The Commonwealth pays the States to implement its policies in health, education and other areas because the Commonwealth has no expertise at all in service delivery except in limited areas like defence and security/intelligence. The States are (mostly) happy to take the money and implement the policies because they substitute for State policies (to some extent), and this takes the pressure off States to deliver services that their citizens expect, and who probably don't care much which level of government is providing the financing.

This situation reflects the reality of vertical fiscal imbalance in Australia, which could be fixed by giving the States more revenue of their own (such as a share of the income tax), but that is unlikely to happen any time soon. In the meantime, though, there is no good reason for Commonwealth payments to affect the amount of GST distribution that the States receive. The CGC argues that Commonwealth payments affect States' fiscal capacities and that States have varying disabilities in service delivery, hence Commonwealth payments are subject to the HFE process. However, and this is the crucial part, Commonwealth payments are used by the States to deliver Commonwealth policies. If the Commonwealth judges that some States have more capacity than others to deliver its policies, it can adjust the payments. If the Commonwealth feels that equal per capita payments to the States are appropriate, then it can give equal per capita payments. However it is done, there is no need for the CGC to get involved, especially if its involvement is (in effect) a policy decision on its part to undo policy decisions of the Commonwealth and State Governments.

Second, the method by which the CGC decides whether and to what extent Commonwealth payments affect GST distributions is opaque and leaves the CGC too much discretion.

Third, if direct Commonwealth payments are kept separate from HFE payments then Commonwealth payments can be simply directed to where they are needed in particular States, without affecting the finances of the other States. For example, suppose the Commonwealth wants to make a payment to State to assist with infrastructure for a resource development. Under the present system, the other

States will probably gain GST revenues at the expense of the State receiving the infrastructure funding. Alternatively, if the HFE process was kept separate, the Commonwealth, especially if it wanted to be seen to treat all the States fairly, could provide economic development funds to them.

Fourth, exempting Commonwealth funding from the HFE process would eliminate the strategic behaviour discussed earlier. Commonwealth funding proposals could then be analysed by the States on their merits, without the need for them to think about the flow on effects in the HFE process.

Fifth, exempting Commonwealth funding from the HFE process would provide a clarity of demarcation around the funding of Commonwealth and State policies. Commonwealth direct funding would be for Commonwealth policies, and GST funding would be for State policies. The fact that both could be aimed at the same policy area, say health, would necessitate negotiations between the Commonwealth and States over policy consistency, overlap and gaps. To the extent that this creates tensions between the Commonwealth and the States, as all negotiations do, this might provide an impetus to fix the underlying problem of vertical fiscal imbalance.

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