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Productivity Commission

RESTORING EQUITY IN THE HORIZONTAL FISCAL EQUALISATION (HFE)/GST DISTRIBUTION SYSTEM
MAIN POINTS
Refer Appendix for Supporting Notes and Source References

1.Federal Treasurer instigated a Productivity Com. review of HFE, two successive PMs having made three (futile) ad hoc payts. to WA.

2.The implementation of HFE in federations world-wide, has varied over time and place, there being no precise, authoritative definition.

3.Reforming HFE in CGC procedures is simpler than having to seek all-States agreement to amending 2000 legislation ushering in GST.

4.That Act re-arranged Cwlth.-State taxation: States discarded disparate bank taxes, the Cwlth. discarded sales tax, passed total GST proceeds annually to the States & had subsidies paid to weaker States from stronger ones by mandating HFE.

5. The present task is to ensure the concept of mandated HFE is properly captured in CGC procedures, ensuring the consequent system for GST payments to individual States is reviewed.

6. CGC pursues its own HFE objective/definition but acknowledges that its first articulation of the current definition was as recent as in the CGC 2010 Review.

7. The CGC describes its HFE procedures as measuring the "fiscal capacity" of each State in financing its services from own Revenue, claiming that adjustments result in State "capacities" being equalised as per HFE.

8. CGC procedural difficulties are 1. that CGC method-complexity limits its value and understanding; 2. that the CGC has to make multiple "adjustments" for practical purposes; and 3. that volatility

in economic conditions have reflected in extreme/unacceptable results.

9. CGC's procedure (necessarily) relies on equalising "price" per capita of Revenue & of Services as compared with State standards, but "price" can be an imprecise, unreliable +/- index which does not capture Revenue foregone nor extravagant/inefficient expenditure on Services.

10. Fiscally weaker, and indeed all States, do need subsidy arrangements additional to this GST system, possibly guided by broader economic indicators such as employment, vacancies etc., or by statistical measures eg. regression analysis, more advanced than this price per cap. system. Presently other Cwlth. payments are made via general revenue assistance and for major specific purposes.

11. My understanding of HFE differs from CGC's & is as follows: for a typical citizen irrespective of State-location, HFE means States securing uniformity/Equalisation in net per capita (pc) aggregates of common items of each State's Revenue (R) and Services (S) expenditure.

To achieve this uniformity, annual, all-State standards should be calculated for each of aggregate R & S, being of their (weighted arithmetic) averages of such items as are common to each State. The net for each State, of their actual + or - deviations from R & S standards, when multiplied by each State-population, represent the + or - equalisation adjustments needed to each State-share of GST (originally calculated on pc basis), to derive GST shares, HFE basis.

12. My basic departure in procedure from CGC is that I confine HFE only to those items of R & S which in general nature, are common, ie in usage in all States. It would follow that my standard for R (as for S) would be the all-State average (because my common items of R would exclude WA's uncommon mineral royalties.

13. In my view, HFE aims at unifying for a typical resident irrespective of State-location, the cost of State expenditure in providing customary Services provided State-wide, and as funded by State Revenue from customary sources. HFE does not equalise the whole of living advantages, natural or human-made, nor provide uniformity in State spending or revenue-raising on projects or sources beyond usual capacity of every State because of differences in policies, resources, climate and economic, historic or other factors. State revenue from gambling facilities, or mining for example should be excluded because mining is dependent on accidental, marketable deposits of coal. gas, iron ore, uranium etc. and is also reflective of State differences in community environmental attitudes, native titles etc. CGC procedure on the other hand, mainly confines excluded items to ones without reliable or significant measurements. CGC's inclusion of mining revenue within the Revenue standard raises this to WA's level, impossible of achievement by any other State, thereby unjustifiably elevating subsidy levels. (An issue for later consideration could be whether in calculating S & R standards, NT & ACT should be omitted because of their special features & Cwlth. relationships).

14. The table below shows that WA and its $7.7B Revenue contribution to other States was the dominant feature of CGC's adjustments to GST in 2015-16. Of this, $3.4B went to Vic, $1.6B to NSW and $2.7B elsewhere. Overall, WA's contribution totalled $4.5B, supplemented by $1.5B from Vic, and $0.9B from NSW. From these amounts, $4.0B went to the three Recipient States and the $2.9B residue to NT/ACT.

CGC's HFE Adjustments (to GST per cap. shares) 2015-16 $B

	WA	NSW,Vic	Qld,SA,Tas	NT,ACT	Total
Revenue	-7.7	5.0	2.3	0.4	0
Services etc*	3.2	-7.4	1.7	2.5	0
NetAdjustments	-4.5	-2.4	4.0	2.9	0

*Includes some relatively minor items. Rounding $B occurs.

5.4.18

RESTORING EQUITY IN THE HFE/GST SYSTEM: APPENDIX
Supporting Notes and Source References for Main Points

1. HFE is under present (and constant) review by the CGC (as well as the Prod. Com.). States may also comment on procedure & results.

2. Refer OECD Economic Paper 44 2007 by Blochliger & Charbit on Fiscal Equalisation in OECD countries.

3."States" hereon include NT & ACT, creations of the Cwlth.

4. States favour GST as an assured, substantial revenue-source.

5.Legislation initiating GST, mandated HFE but did not define it.

6. CGC's HFE definition:2020 Review, Executive Summary pg1.

7.CGC's formal HFE definition is as follows: .
"State Govts. should receive funding from the GST pool such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency".

8. Problems: 1. Method-complexity: eg terminology & definitions (effort, efficiency, capacity, etc.) tend to complicate the simple relationship of own Revenue to Services expenditure. 2.Examples of "Adjustments": limiting to 50% , "own- rev. effects of discretionary changes in royalty rates" and "minimising tax reform disincentives" (2020 Review pg. 2); " materiality disability threshold" set at $35; "data adjustments threshold "remains at $10 per cap."; "3 levels of discounts for data reliability measurements at CGC option"; 3/5 yr. moving aves. Whereas the basic State-wise GST distribution is on a per capita basis, one might question whether "actual" receipts by

individual States, of data on GST might alternatively have been secured without too much effort and greater accuracy.

9. In CGC's system, for a price per capita (pc) compared with the all-State Services (S) and Revenue (R) standards, CGC's rule is :

a + pc for S and a - pc for R causes a favourable GST increase,
a - pc " S " a + pc for R " an unfavourable GST decrease.

In T2, pg.5 of 2015 review, CGC has estimated for each State, the individual likely causes of the departures from the standards of S & R. Nevertheless, the interpretations of the + and - pc prices may sometimes be quite misleading, eg, if over-spending or spending extravagantly on S did in fact occur, the advantage of the HFE increase in GST would be unwarranted. Also, if State policy prohibits mining development or poker machine gambling which would otherwise earn Revenue, there would be an unwarranted HFE gain of GST under the system despite these foregone opportunities. The CGC acknowledges its system gives approximate results and that the ideal is unattainable. There could be confidence in a simpler system (and redress on subsidies, if necessary, taken through other avenues eg general revenue or specific purposes).

10. CGC admits in the 2020 Review that it "does not aim to achieve precise (only approx.) equalisation, as not all disabilities are included"; items available but "not reliably measured or of small effect", are omitted from CGC's standards for R & S.

For Services, CGC implies that all or most items are included but for Revenue, the coverage is lower, closer to 60%, including WA's royalties. Confining the Revenue coverage to "common" items of all States and to exclude the unique, uncommon which I recommend, would reduce coverage still further, to a target of say, 50% or lower if necessary.

The equalisation/equity principle embodied in the HFE concept, does not aim at offsetting natural or human-made State (or private owned advantages in mining, land, land fertility, climate etc. .

11 on. My procedure would remove the WA and similar problems because revenue from iron ore, coal, gas and other mining, & possibly from poker machines, would be omitted in the HFE calculations as being not significantly common to each and every State.

For expenditure on Services, the CGC explains that these items are generally common to all States (it includes spending on "associated infrastructure", which needs clarification). For Revenue, the CGC coverage is lower than the apparent 100% for Services, and in recent years as per CGC data, has trended to about 60%, including WA's royalties. The choice about the R and S standards and the selection of the R & S items for inclusion therein, is vital to the impact of HFE. HFE means that a citizen is not disadvantaged by location within a federation, in regard to R & S, though in my view, the equalisation should extend only to R & S items common to all States. The equalisation should not extend to State resources and not impinge on policies and revenue that are the legitimate responsibilities of sovereign States, in mining, land fertility, climate advantages/ disabilities, size & nature of population, and similar wealth and resources, whether natural or human. WA's mining resources and revenue therefrom are unique, cannot be duplicated and cannot & should not be equalised under HFE. This would be discriminatory. The inclusion of this WA revenue in the Revenue standard inflates the scale of the deviations (subsidies) above the levels if the All-State averages were used, by a calculable margin. (In other instances such as in awards of defence contracts or other Cwlth. payments, it could well be appropriate to have a system which takes account of broad economic features and States' resources, as mentioned earlier).