Queensland Government Submission

Productivity Commission Inquiry into Horizontal Fiscal Equalisation

June 2017

Queensland Government

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Executive summary

Queensland supports horizontal fiscal equalisation (HFE) – a concept which seeks to provide all States and Territories (the States) with the fiscal capacity to deliver a similar standard of services. HFE forms an essential part of the social compact in Australia. The community expects that all Australians will receive similar standards of services regardless of the State in which they live – and HFE is a key part of how this expectation is met. HFE generally equalises both for structural factors (such as the greater costs that come with a more decentralised state) and for cyclical factors (such as property or mining booms). However, greater consideration should be given to Queensland's position as the most decentralised state in the nation with a large geographical spread of regional population centres and the associated need for equitable access to services including education, health (such as regional hospitals of a standard to meet the regional population base) and transport.

The equity that underlies this principle is fundamental, and its importance should not be underestimated. While the Productivity Commission (PC) has been asked to look at potential economic costs, particularly in terms of policy disincentives, it should not ignore the high value Australian society places on the concepts of equality of opportunity and the safety net. Further, the economic evidence increasingly points to the economic importance of addressing inequalities – particularly in terms of health and education.

However, in this inquiry, the PC has been asked to consider whether HFE creates a disincentive for States to pursue economic reforms or grow their economies. While such disincentives may exist at a theoretical level, Queensland is not aware of hard evidence that these disincentives exist in practice.

Nevertheless, while Queensland strongly supports HFE, it welcomes this inquiry. It is important that governments review existing structures and processes regularly, and HFE is no exception. This inquiry presents a chance to review how HFE is conceptualised, how it is implemented, and ultimately whether there are alternative options that will more effectively achieve the desired objective.

The PC should consider the question of how precisely one should seek to equalise – and whether equalising to a 'similar' standard rather than the 'same' is a more useful way of viewing the system. In addition, Queensland suggests that HFE needs to be viewed from a broader perspective than just the GST – the distribution of GST is not the only potential mechanism for implementing HFE. Payments from the Commonwealth to the States under Special Purpose and National Partnership Payments (including special one-off payments) could also arguably be considered as part of HFE, as could other assistance the Commonwealth provides (like industry assistance, or defence contracts). The PC could consider whether the redistribution of the GST should be the sole lever to achieve equalisation.

Further, HFE is a challenging concept to implement in practice. In its quest to achieve precise equalisation, the methods employed by the CGC have been criticised for being overly complex, lacking transparency, and leading to a false sense of precision. This inquiry presents an opportunity to examine these concerns. It is also an opportunity to consider whether there are alternative options that address these concerns while still ensuring States receive the funds they need to provide a similar level of service, having regard to their particular circumstances.

Equally, alternative options also may create risks of their own – some alternatives may have unintended costs and consequences and others may not achieve equalisation.

An equal per capita distribution, for example, ignores the structural differences that exist between States (such as differences in geography, population distribution, and entrenched disadvantage) and would likely create the inequitable situation where vastly different levels of service would be provided across States. While there are other policy levers available to try to address these differences (for example, the Northern Australia Infrastructure Facility (NAIF) seeks to address some of the differences in geography), the HFE system ensures that these differences are recognised and compensated on a regular and reliable basis (unlike policies such as the NAIF, which can be subject to delay).

The existing system also has the advantage of recognising the importance of State Governments providing services in a way that takes account of the differences and preferences of their State – this recognition of the importance of state autonomy is sometimes not seen in other areas of Commonwealth-State relations, such as with the asset recycling initiative, which fails to acknowledge the clear policies of the Queensland Government to keep our key Government owned corporations in State ownership and in fact disadvantages Queenslanders by withholding funding from Queensland for not selling public assets.

Exploration of different models of HFE is a complex task with significant ramifications for the ability of States to deliver services and infrastructure to their community. Given the complexity of this subject and the short time frame for this inquiry, Queensland suggests that the outcomes from this review should be presented to the Council of Federal Financial Relations (CFFR) and the Council of Australian Governments (COAG) for further consideration.

Introduction

1. As the PC has identified in its guidance note, in order to evaluate the economic impacts of the current HFE system, the PC must consider questions around the objective of HFE. Analysis of the objective will help the PC evaluate the economic impacts of the current HFE system, and whether any potential alternatives exist that may better meet the objective of HFE.
2. Accordingly, Queensland's submission begins with a discussion of equalisation as a concept. Then, given the PC's focus on the economic impact of HFE, the submission discusses the issues relating to efficiency, policy neutrality and disincentives to reform. Finally, the submission discusses some of the other challenges facing the current HFE system, and analyses the potential ability of some alternatives to deliver equalisation while also addressing any of the shortcomings of the current system. It will also seek to identify other issues which need to be properly assessed for these alternative models.
3. While Queensland strongly supports HFE, it welcomes this inquiry. It provides an opportunity to review the criticisms of HFE and assess whether they are supported by evidence, and also to consider whether there are alternative mechanisms that will more effectively achieve the desired objective of equalisation.
4. While Queensland believes the PC can make a useful contribution to guiding what the objective of HFE should be and how best this could be delivered, it is ultimately the role of governments to collectively determine what the most appropriate objective for HFE is, and how it is to be achieved.

Section one: Equalisation

The importance of equalisation

5. Queensland places great value on HFE. HFE is not about the Commonwealth providing funding to the States. Rather, at its core, it is about Australia existing and operating as a single nation, rather than as loosely connected quasi nation-states. HFE is the mechanism by which Australian Governments collectively ensure that Australians living in different parts of the country will be provided with broadly similar levels of service.
6. HFE is built upon the notion of 'equal treatment for equals' and reflects an understanding that while there are many factors beyond the influence of an individual State's control, the effect of these factors can be shared across the nation. These factors can be both structural and cyclical – and Queensland considers that HFE plays an important role in equalising both types of factors. Equalising structural factors helps ensure States have the capacity to provide similar levels of services despite underlying differences such as their geography or population distribution, whereas equalising for cyclical factors provides a valuable way for States to share risks, and spread the impact of fiscal shocks across the nation.
7. In doing so, HFE ensures that Australians have the opportunity to receive similar services, regardless of where in an economic cycle their State is at a particular point in time, or whether their State experiences structural disadvantages. For Queensland, the decentralised nature of the State presents challenges when it comes to providing services. Queensland has several regional population centres spread across the second largest State in the nation, in addition to residents in remote or very remote areas.
8. Ideally, Commonwealth programs would also respond to regional cost pressures and other structural disadvantages (however, in practice, support for regional cost pressures is not always forthcoming – for example, the Northern Australia Infrastructure Fund which is yet to allocate funding to a single project).
9. HFE has, and has had for many years, a significant nation-wide impact. From the 1930s onward (and arguably before the 1930s), HFE has been a part of the nation's landscape, and has played a key role in keeping our federation cohesive and resilient throughout this time. This role remains no less important today. HFE continues today to play a key role in helping States deliver similar levels of services and infrastructure to the community. Given the broad service delivery responsibilities of the States, and the pressures that some of those service delivery areas will face into the future, HFE is essential.

The concept of HFE

10. HFE is an important concept, and a fundamental part of the Australian federation. Equally, given the significance of HFE, it is important that Australia's system of HFE is robust, is seen as credible, and receives broad support. Ensuring the system is underpinned by confidence is not an easy task, and

requires firstly a clear understanding of the objective of equalisation – what exactly does HFE seek to achieve?

11. While noting that the answer to this will continue to generate considerable debate, Queensland suggests equalisation is most helpfully viewed as a system designed to provide each State and Territory with the fiscal capacity to deliver similar levels of services and infrastructure. It does not, however, prevent States from making policy choices about the revenue and expenditure mix and effort.

12. The Commonwealth Grants Commission (CGC) has, over many years, applied an ever-evolving set of principles to assist it to conceptualise HFE. The goal of the CGC has long been to achieve precise equalisation – that is, providing States with precisely the same fiscal capacities.

13. However, despite the dedication of the CGC, this goal has proved elusive. Data limitations, the difficulty of separating policy choice from underlying capacity, and the need to consider simplicity, contemporaneity and transparency, have all meant that HFE has probably never provided States with precisely the same fiscal capacity. Viewing the aim of the system as seeking to achieve similar capacities recognises the challenges faced by the CGC.

14. Queensland's objective for HFE also potentially allows for the consideration of a wider range of approaches to deliver equalisation. It may allow for a form of equalisation that does not attempt to adjust for every possible factor, or one that is less subject to the criticisms of false precision that are sometimes directed at the current system.

15. Although the current system of HFE is often seen as limited to the distribution of the GST, Queensland considers it important the PC recognise that the distribution of GST forms only one part of a wider framework of Federal Financial Relations, the various elements of which all have a part to play in achieving equity across States. As well as National Partnerships or Special Purpose Payments, these elements may include Commonwealth industry assistance focused on specific areas, or Commonwealth legislative change that impacts one State more than another.

16. While the GST is the mechanism for achieving HFE at present, this is not a given. HFE existed before GST, and can be achieved using other or additional mechanisms. It is possible that the GST distribution system is being expected to do too much, and the Commonwealth is not adequately sharing the task of equalising the fiscal capacity of the States.

17. Given this, while Queensland strongly supports HFE, Queensland suggests it's more helpfully viewed as a concept that seeks to achieve similar capacities, rather than precisely the same.

Economic benefits of HFE

18. The PC is considering whether HFE has a negative impact on economic growth and prosperity. Alongside consideration of potential negative impacts, the PC should also consider the positive economic impacts of HFE, and the funds it redistributes.

19. The most immediate benefit brought about by HFE is arguably in the services it allows States to provide. Any change proposed to HFE on the grounds that it will reduce disincentives to pursue economic growth must be balanced against the social costs of any potential reduction in services in some parts of the country – and the important role those services play in the long-term health of the economy.

20. HFE seeks to ensure States have the capacity to provide similar levels of services in their areas of responsibility, including the key service areas of health and education. Provision of health, education and social services are critical foundations to an efficient, competitive and resilient economy. An educated, skilled and healthy population is likely to be more productive and obtain higher wages, to remain engaged in the labour market for longer, and to transition better into new forms of employment when structural changes in the economy alter the mix of skills and knowledge required by industry. As well as contributing to stronger economic and employment outcomes, a healthier and more educated labour force also helps reduce the fiscal burden on Governments associated with structural and demographic change over time, as well as the better utilisation of government-funded services, such as housing, child protection and justice. This enables funding to be directed to more productive endeavours that further support jobs opportunities, growth in real incomes and improved living standards.

21. Additionally, when considering the potential negative impact on the economy, it is important to consider how growth is distributed. Economic growth can have highly variable impacts on different groups within the population. A growing body of research suggests high inequalities are damaging to economic growth.

Income inequality as well as inequalities in non-income outcomes, including educational attainment, health conditions and employment opportunities, can be expected to cause social and political unrest; reduce labour and social mobility; and worsen intergenerational poverty.

22. It has also been suggested that societies with greater inequality are less likely to make public investments which enhance productivity, such as in public transportation, infrastructure, technology and education. Therefore, addressing inequality can be key for sustainable economic growth.

23. There are many mechanisms in Australia for addressing inequalities within our population (such as community services designed for disadvantaged groups), and HFE is only one of those mechanisms. However, when considering the impact on economic growth, it is important to also take into account the broader economic benefits of policies focused on equity, such as HFE.

Section two: Efficiency issues

24. Delivering equalisation is a complex and difficult task, which involves balancing several principles.

25. The overarching principle of HFE currently used by the CGC is that distribution of the GST should mean that, after allowing for material factors affecting revenues and expenditures, each State 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.

26. However, to help distribute GST, the CGC has also developed a number of supporting principles, including policy neutrality, which aims to ensure that a State cannot affect its own HFE funding through policy choice.

27. This section discusses some of the challenges faced by the current HFE system relating to policy neutrality, both the need to avoid creating disincentives to reform generally, and the particular challenges created by mining revenue. Alternative options that seek to address concerns relating to efficiency, or to avoid any potential disincentive to reform, are also discussed.

Policy neutrality

28. Policy neutrality is a longstanding principle of HFE. Policy neutrality is the principle that a State's own policies should not affect its share of GST funding. This principle aims to ensure the HFE system creates no incentives or disincentives for States to choose one policy over another. Queensland believes this principle is an important cornerstone of HFE and violation of it risks both undermining the ability of the system to equalise States' capacities, and distorting incentives for States to change their tax or spending policies.

29. However, while an important principle, policy neutrality is challenging to implement.

30. The current system's approach of using an average of policies of all States, on the assumption all States apply the same service delivery and revenue raising policies, is conceptually simple and transparent and likely to be reasonable in most circumstances, given the similarity between 'what States do'.

31. However, collectively, the policies of States set the 'standard' (that is, the average) so each State policy does ultimately affect the average to some degree, with some States' policies affecting it more than others. For instance, more populous States have a greater effect on average per capita revenues and expenses. Similarly States with high mineral production have a greater effect on average royalty rates, and States with high proportions of Indigenous people have a greater effect on the costs of providing services to Indigenous people. An approach based on internal standards of 'what States do' therefore cannot be completely free from State policy choices. That is, it can never be completely policy neutral.

Potential disincentives

32. Reflecting on this, the current system has been criticised for a lack of neutrality, and for consequently creating a range of perverse incentives which influence policy decision making and undermine efficiency. Frequently identified disincentives include:

- reducing the incentive for a State to promote growth;
- reducing the incentive to improve efficiency of service delivery;

- providing incentives for States to over provide services where they have above average costs of service delivery and vice versa;
- providing incentives for States to over tax revenue bases where they have a revenue raising disadvantage and vice versa;
- providing incentives for States to invest resources in identifying 'disabilities' (that is, areas of expense where they may be at a disadvantage to other States) and developing more sophisticated ways of measuring them.

33. As an example, consider the claim that HFE reduces the incentive to promote economic growth: it is theoretically possible that the incentive to pursue economic growth enhancing reform (through levers such as micro-economic reform, developing industries or investing in infrastructure to facilitate new industry) could be diminished because a State would only retain its population share of any increase in its revenue capacity.
34. On this issue, as the PC has suggested in its guidance note, evidence is critical. A distinction must be made between incentives or problems that exist in theory, and those where there is evidence of the problem in practice. While it may be technically possible for states to influence their GST shares at the margin by changing their expenditure or tax mix, Queensland is not aware of any evidence that this is a factor for governments in the setting of expenditure and revenue policies.
35. The policy focus for States is on economic development, service provision and sound fiscal management. Governments focus on the benefits and risks that come from any particular policy change, rather than on possible outcomes of the CGC's processes.
36. Even where CGC distribution is considered, the impact on the distribution is often uncertain, as CGC processes can change, and cannot always be clearly predicted.
37. Furthermore, if the claim that the current system creates a disincentive to reform is true, the impact of the distribution would need to be large enough to have a material impact on the decisions of State Governments. Queensland suggests that this is often not the case. Any reduction in GST would be outweighed by the benefits of reform.
38. Where potential HFE impacts are considered in the policy decision making process, they are at best fourth or fifth order considerations. This means that many of the incentives or disincentives that are identified in the literature, and mentioned above, exist in theory but not to any material degree in practice. A similar conclusion was reached by the 2012 GST Distribution Review, which suggested that while the current system creates perverse theoretical incentives in some instances, there is little practical evidence of efficiency losses.
39. As discussed above, given the importance of HFE to the federation, it is important that there is broad support for HFE and confidence in the system that delivers it. As such, it is arguable that even a theoretical disincentive that does not exist in practice is still harmful, to the extent that it undermines the credibility of the HFE system. On the other hand, attempts to fix these theoretical disincentives may come at the expense of equalisation, and may create unintended consequences of their own. In this context, before contemplating significant changes to HFE, it is reasonable to question: first, what are the particular policy areas of concern?; second, where do they rank in terms of the national economic reform opportunity set?; and third, what other mechanisms could be used outside of HFE to incentivise reform?.

Alternative models to address efficiency

40. The challenge of removing policy effects and more explicitly targeting efficiency has often led to calls for the setting of standards other than the average. Examples include external standards, equalising to a proportion of the average, incorporating an efficiency discount and the inclusion of a relativity floor.
41. While conceptually some of these approaches could achieve greater policy neutrality and efficiency, there are significant challenges in how to define these standards and what is used to determine them.

Discounting States' own source revenue and/or expenditure

42. The 2012 GST Distribution Review referred to an equalisation system that discounts States' own source revenue or expenditure, or a part of the revenue or expenditure, to address efficiency concerns. As an example, revenue assessments under the current system could be discounted by 50% before being equalised. In this scenario, States with more revenue than average could have a smaller proportion of their

revenue redistributed away compared to the current system that equalises total revenue. On the other hand, States with more expenditure would receive smaller equalisation payments after discounting.

43. A system that discounts the States' revenue or expenditure (or a subset of the revenue or expenditure) is purported to allow more efficient States to keep a greater share of gains from efficient operations, gains that are purportedly being redistributed away under the current HFE system.

44. However, when seeking to incorporate an efficiency discount, the first question that would arise is how big the discount should be, and to which assessments it should apply. Finding evidence to indicate any higher actual spending by a particular State is a reflection of a distortion created by the HFE system is challenging and ultimately requires the ability to differentiate between cost and use elements – which may not be feasible for many key assessments.

45. The 2012 GST Distribution Review found this to be a significant challenge. The review showed that small discounts could produce only very small benefits and would result in only very small costs to 'equity,' while large discounts would have severe impacts on recipient States, and greatly impact their ability to provide services. The 2012 GST Distribution Review found determining the appropriate discount rate is difficult, even on a theoretical level.

Equalising to alternative standards

46. One option to absolutely ensure policy neutrality would be to equalise to an external standard. Supporters of this option argue that if the standard has no basis in 'what States do', then there can be no incentive or disincentive for the States to pursue particular policy changes. In addition, the standard that is chosen could possibly represent an 'efficient' standard.

47. The key challenge with the option of creating an external standard will be the subjectivity involved. For example, when setting an external standard, who should decide how much funding is allocated to prison accommodation versus the education system? Or how many years of schooling should be free? These are important questions, but also inherently subjective (and arguably value-based) questions, and they are arguably best answered by democratically-elected State Governments. While there are limitations with the current approach, it does have a strong basis in what States actually do, rather than trying to create a nominal approach which is likely to be subjective or directive (that is, potentially reducing State sovereignty).

48. Other options that have been raised include equalising to a set proportion of the strongest State's capacity; equalising recipient States to the average capacity of some or all donor States and equalising to the average of the seven States. Compared to the current system, these systems provide less funding to recipient States and more to donor States.

49. Similar to the option of an external standard, establishing the right standard is vital for such a system to deliver real benefits to the nation. Establishing which standard should be used remains contentious and setting the appropriate standard remains a challenge for such a system. In addition, for these options to promote economic growth or incentivise efficiency, there would need to be some evidence that the current system is discouraging States from prioritising economic development and reform. In the absence of such evidence, these options would reduce equity, with no corresponding benefit.

Distribution floor

50. Significant differences in fiscal capacities in recent years have led to unprecedented low relativities for Western Australia. These outcomes have led to public discussion of the insertion of a floor in GST relativities – that is, a figure below which no States relativity could fall. Such a model would allow a State with an improving fiscal capacity to an additional benefit of an inflated GST share, and would equally mean some other States would receive less.

51. A GST floor is often discussed as necessary to stop the federation from fracturing. If it were to be considered on this basis, it should be set quite low – that is, no higher than is required to keep the federation together.

52. Nonetheless, there is no clear rationale for a floor in and of itself – that is, the option does not have its basis in a substantive concern with the current system. A floor would result in a system that did not achieve equalisation, and may be more complex than the current system.

Appropriate treatment of mining revenue

53. The treatment of mining revenue poses a particular challenge when it comes to policy neutrality. The challenge stems from two key facts: mining revenue is concentrated in two States (Western Australia and Queensland) and is not spread evenly across the country like many other revenue bases; and mining revenue has been large, and volatile, in recent years.

54. These two facts together have meant that mining revenue has been responsible for a large amount of redistribution of funds over the last decade or so. Under the current HFE system, the assessment of mining revenue leads to the largest redistribution impact of all current assessments. In 2015-16 mining revenue comprised around 6.99 per cent of all State revenue in aggregate, yet represented 80.3 per cent of the GST redistributed as a result of revenue assessments. Compared to an equal per capita basis, the mining assessment redistributed $5,758 million for the CGC's 2017 update.

55. The mining assessment is the primary reason Western Australia has experienced such a low relativity outcome recently, with the mining assessment accounting for 82 per cent of Western Australia's revenue redistribution.

56. As the mining revenue is concentrated in two States, so too does the impact of the redistribution fall disproportionately on two States. Specifically, Queensland with coal, and Western Australia with iron ore dominate the revenue base for different mining activity. Unlike other State own-source revenues such as conveyance duties or payroll taxes, which are broadly similar in each State, mineral reserves are disparate.

57. While the core of the challenge – the concentration of mining revenue in two States – cannot be altered, it is worth considering whether the method used by the CGC to assess mining revenue is appropriate, given the concentrated nature of the revenue stream.

58. Under the current system, mining revenue is assessed mineral by mineral. Given the dominance of Western Australia and Queensland in iron ore and coal respectively, the policy of one State effectively becomes the policy average for HFE purposes, which in turn can create problems for the policy neutrality principle.

59. While acknowledging this issue, the CGC is yet to find an alternative approach that would allow equalisation to occur without risking creating a policy incentive for a particular State.

60. Queensland suggests an aggregated mining revenue assessment could be examined and considered. Under this approach, all mining revenue would be considered together – rather than assessing each mineral separately. This approach could greatly enhance the policy neutrality of the assessment while still assessing each State's relative capacity to raise revenue through mining royalties. It could also remove the potential for minerals to redistribute a substantial proportion of revenue when a single State opts to change a commodity's royalty rate. While no option is without its problems, an aggregated mining revenue assessment may strike a better balance between the need to equalise for differences in revenue raising capacity, and the benefits of the system remaining policy neutral.

61. While all alternative options require further examination and consultation before implementation can be considered, the challenges posed by mining suggest further effort may be warranted.

Section 3: Other challenges

62. Even aside from policy neutrality, and concerns around creating disincentives for reform, delivering equalisation is a complex task. It faces a range of challenges, and requires the CGC to balance several principles.

63. In addition to policy neutrality, the CGC has other supporting principles which it takes into account when making assessments, including practicality, 'what States do' and contemporaneity. Other factors considered include the materiality of an assessment, and the need for simplicity. These supporting principles are important: practicality helps ensure the assessments are grounded in evidence; 'what States do' minimises the level of subjectivity in the system, and contemporaneity helps States manage budget volatility. Nonetheless, while they are important, delivering HFE while also having regard to these other principles is difficult, and creates a range of challenges for the CGC.

64. This section discusses some of these challenges, including challenges relating to its impact on State budgets, including the contemporaneity and volatility of funding, and challenges relating to the treatment of Commonwealth payments. The section also canvasses some of the alternative options that have been put forward to address these challenges.

Impact on state budgets

65. States face uncertain outcomes from the current HFE system, which can create challenges for States seeking to plan for the sustainable provision of services. This has become more of a concern in recent times, as relativity outcomes under the HFE system have become increasingly volatile.

66. For example, Western Australia experienced reductions in its GST share of approximately $450 million each consecutive year between 2012-13 and 2015-16 ($790 million in 2012-13, $450 million in 2013-14, $280 million in 2014-15 and $280 million in 2015-16). Smaller jurisdictions have not been immune, and have also experienced volatility since the CGC's 2015 Methodology Review. For example, the Northern Territory will experience a fall of $270 million in GST revenue in 2017-18, approximately 4 per cent of their total revenue.

67. This volatility is a concern for all States, and presents significant challenges for governments when managing their budgets. The volatility stems not only from changes to a State's own economic circumstances, but also from changes to the circumstances facing other States - which can make the volatility even harder to predict.

68. Steady growth of the GST pool in earlier years provided a buffer against volatility in CGC relativities to States. Conversely, now with reduced growth in the GST pool the fiscal impact of this volatility has become more apparent.

69. This volatility appears to be the result of a combination of factors, including changes in different States' fiscal capacities relative to each other, and is magnified by methodology issues.

70. Possibly because of this recent volatility, and the resulting impact on States' budgeting, there have been renewed calls to ensure the system takes into account two additional factors: the 'contemporaneity' of the HFE system, and stability.

Contemporaneity

71. 'Contemporaneity' is one of the CGC's supporting principles. This principle is that, as far as reliable data will allow, the distribution of GST provided to States in a year should reflect State circumstances in that year. Without that, the capacity to provide services and the associated infrastructure at similar standards can arguably be compromised.

72. The volatility seen in recent years often appears inconsistent with the economic activity and the structural fiscal position of a particular jurisdiction at a particular time. Recently, this may be what we have seen in Western Australia. The effects of HFE can magnify the fiscal experience of states – distributing more GST as a State's fiscal position improves and then distributing less when a State's fiscal capacity reverses. This feature of the system makes it even more challenging to manage State budgets, and ensure that essential ongoing services continue to be provided as required.

73. This principle, while broadly supported, is challenging to implement given lags in the data used to calculate States' relative fiscal capacities.

Stability

74. While not recognised as an official 'supporting principle' of the current system, stability has long been a goal discussed in the context of an ideal HFE system.

75. The current system's use of a two-year lag and three-year averaging process attempts to provide stability and certainty for States and to smooth away any short term cyclical effects. However, if a State's circumstances change between the assessment period and the application year, the relativities could be out-of-date by the time they are applied. This lagged approach has led to criticisms of the CGC's methodology as the relativities do not react quickly to changes in States' economies (that is, they are less contemporaneous). This can increase budget instability.

76. To the extent that these developments are cyclical, rather than ongoing structural trends, the ability of the system to achieve HFE over time is not impacted. However, they can contribute to budget instability.

Treatment of Commonwealth payments and support

77. Another challenge faced by the current system relates to the treatment of Commonwealth payments. The Commonwealth supports States in a range of ways, most notably tied funding – Special Purpose Payments and National Partnership Payments.

78. The provision of tied funding gives the Commonwealth the opportunity to influence expenditure in areas of State responsibility. However, they are also a source of increasing contention within federal-State relations and a potential challenge to achieving HFE.

79. Specific Purpose Payments constitute around 20 per cent of total State Government revenues. Under the current system, the financial capacities of the States are equalised by examining most (significant) revenue sources and expenditure requirements, including Commonwealth payments.

80. However, this approach can be perceived as overriding national objectives and agreements established between Commonwealth and State Governments to achieve a specific outcome. For instance, National Health Reform Funding provided on an efficient price basis is largely unwound in subsequent years and equalised as part of the CGC's assessment.

81. That is, in an initial year, funding is provided by the Commonwealth Government to the States for health expenditure. The amount of funding provided to a particular State will be based on the amount of health activity in that State, with all activity funded at a price representing what it would cost to provide the activity efficiently. Three years later, data from health departments and other sources around the country would be collated by the CGC to determine the average expenditure on health per capita, given the average policy. The CGC will then consider what factors require States to spend more or less on health (e.g. an older population, a lower socio-economic population) and will account for those factors in their assessment. The CGC will 'redistribute' the initial health funding payments made to States as part of their revenue assessment, and will provide for differing fiscal capacities with regards to health as part of their expenditure assessment. This, in effect, unwinds the initial allocation from the Commonwealth. Education payments to States are treated in a similar manner.

82. To the extent that the initial allocation is seen as preferable, it could be argued that Commonwealth payments should be excluded from the current HFE system (or treated EPC). On the other hand, States are still required to spend these funds according to the Commonwealth's policy objectives or in specific sectors – suggesting that the ability of the payments to achieve national objectives is not affected by the CGC redistribution. Of course, the redistribution occurs three years after the initial payment, and represents a change to an untied pool of funds (with no change to tied funding).

83. Perhaps even more challenging in the area of tied funding is the ability for the Commonwealth to direct the CGC to not include certain payments entirely at its discretion. Such action has the potential to undermine the equalisation process, particularly where it is exercised in an arbitrary manner.

84. In addition to tied funding, the Commonwealth supports States in a range of other ways – including through industry assistance (where provided to industries focussed in one particular State) or regulation amendments to support particular projects or areas. To the extent that these supports enhance the fiscal capacity of a particular State, it may be worth considering whether or how this assistance could be incorporated into the assessment of HFE.

State responsibility

85. One advantage of the current system of HFE is the recognition contained in the system of the importance of State sovereignty, and State Governments being responsive to the preferences of their citizens. The current HFE system provides funding to States to ensure they have the capacity to provide a similar level of service to other States, but provides the funding as untied, leaving the State to provide those services in a way that takes into account individual State circumstances and preferences. Ultimately, of course, State Governments are accountable to the people through State elections.

86. This recognition of the need to take into account individual state preference's is important, and a feature missing from some other aspects of Commonwealth-State relations. For example, the Asset recycling initiative intentionally penalises States whose citizens have chosen to keep income producing assets in public ownership and rewards States who have taken alternative decisions.

Section four: Other alternative models

87. Finding a HFE system that delivers an equitable outcome, while also meeting the objectives of simplicity, transparency, and contemporaneity is significant challenge, one that possibly exists only in the theoretical realm. There are a myriad of systems proposed by various States and academics all purporting superiority over the current HFE system. However, none is without significant complications which will need to be overcome before its implementation can deliver real benefits to Australians. A selection of alternative models, which have generated discussion in recent times, is discussed below.

Simpler and more transparent models

88. The practical challenges of achieving equalisation and the complexity of the current system have led to calls to find a simpler and more transparent system. To date, the pursuit of such a system has proved elusive. However, significant potential benefits of reducing administrative costs and increasing community understanding from a simpler model mean such models should be explored.

89. A well designed, simpler system could theoretically achieve equalisation but with considerable improvement in transparency. The GST shares received by States may not be the same as under the current system, but could still be equalisation if it allows States to provide similar standards of service to their residents, taking into account their particular circumstances.

90. Several ideas have previously been suggested to simplify the current system. They range from developing a broad indicator (based on GSP or disposable income), adopting a global revenue or expense measure to reducing the number of assessment categories, through to a materiality or reliability threshold. One that has generated particular discussion in recent reviews is the use of global revenue or expense assessments.

Global revenue and expense assessments

91. In an effort to find a simpler model, the use of 'global' revenue and expense assessments has been suggested. Under such a system, total actual revenue generated by the State, irrespective of the revenue stream, is accumulated and compared to the total actual expenses incurred by the State, to determine the State's fiscal capacity. This fiscal capacity is then equalised between the States. The resulting system with only two assessments is significantly simpler than the current system which has eight revenue categories and 14 expense categories.

92. The main criticism of adopting a system that uses global revenue and expense assessments is the system's inability to eliminate the financial impacts of policy decisions made by the states – that is, it is not a 'policy neutral' option. A State's actual revenue and expenditure captures both social and economic factors outside of the State Government's control, as well as policy factors determined by the government. Under such a system, GST distribution could likely be distorted by State policy choices, potentially leading to both greater inequality and inefficiency.

93. However, even if adopting a complete 'global' measure is not appropriate, there may be some merit in examining the potential to aggregate assessments further than is done currently. Even if all expenses could not be grouped into only one assessment, there could still be benefits from reducing the eight revenue categories currently assessed to a single revenue measure and reducing the number of expense categories to a few core categories. Such a system has the advantages of being far simpler and more transparent.

94. Of course, like any alternative option, further analysis would be required to refine these options, to see how they might work in practice, and to ensure that they still provide all States with enough funds have the capacity to deliver similar standards of service.

More contemporaneous models

95. As discussed earlier, contemporaneity means that, as far as reliable data will allow, the distribution of GST provided to states in a year should reflect State circumstances in that year. Without that, the capacity to provide services and the associated infrastructure at similar standards can arguably be compromised (while noting that States should be able to manage some variation in their fiscal capacities from year to year).

96. In recent years there has been a rapid divergence in relative State fiscal circumstances. In this environment, assessed relativities, using three-year historical averages, have appeared increasing less appropriate as they do not provide States with grant shares which reflect their relative circumstances in the

application year. Under the current system, the relativities recommended by the CGC reflect State polices and circumstances that existed between two and five years before the relativities are applied.

97. Equalising State fiscal capacities in the application year could theoretically be achieved by eliminating time lags. The CGC has proposed alternative models in their Staff Research Paper CGC 2017-05-S: Options for Improving Contemporaneity, which could potentially lead to better contemporaneity and equalisation in the application year. These include a one-year model and estimating or forecasting data for the application year. While a one-year model would be more contemporaneous, volatility would likely increase, creating further challenges for State governments seeking to manage their budgets.

98. Fully contemporaneous assessments could place greater reliance on projections of important data, with revisions (completion payments) made after actual data becomes available. Any move away from using historical (real) data for assessment purposes would likely have to involve the CGC making projections about the relative fiscal capacities and expenditure requirements of States in the future.

99. While theoretically attractive, there is little evidence suggesting this method would be an improvement on the current approach.

100. Firstly, it may not be worthwhile to implement a fully contemporaneous assessment where significant revisions are required each year to offset inaccurate projections. The revisions may create as much volatility as the original movements, and may themselves result in a State not being equalised in a particular year (due to a need to compensate for an inappropriately large or small payment the year before).

101. Secondly, data required at the level of detail for forward estimates may not be readily available from States. This could lead to a process of applying trends from historical data in order to prepare forecasts, which could prove problematic where revenues are subject to fluctuating economic cycles such as housing and mining.

102. Finally, it would also be necessary to develop a methodology for creating forecasts for relativity purposes. State's own forecasts are likely to rely on different assumptions and methodologies which could make them unsuitable for use in the CGC's methodology. It is possible that forecasting the data required is not practical with the current level of complexity in the CGC's assessments.

103. In previous reviews, States have flagged that the ability to accurately predict the outcome is precisely what is lacking in the current system. Forecasting or estimating application year data may simply add a layer of complexity to the current process, and not necessarily guarantee improved results. Rather the completion payment, as a result of actual data becoming available, could come as a significant shock.

104. Contemporaneity (that is, using the most up to date data) is a very important principle. However, it should not come at the cost of simple, reliable and robust assessments with broadly stable outcomes. There are substantial practical limitations and complexities in implementing greater contemporaneity that mean a contemporaneous approach is unlikely to better achieve HFE than the current lagged average approach. In the past, New South Wales flagged that this concept does not represent a solution to the problem – it merely casts it in a different form. The current system of a two-year lag and three-year averaging period represents a compromise between contemporaneity and other considerations (accuracy, predictability, data availability and stability).

105. The three-year lagged average approach also assists States with budget management, in that any State's GST revenue is not immediately subject to the volatile outcomes in other States or the unpredictability of State own-source revenue. For example, while the equalisation system will see Queensland compensated by the other States for expenses incurred in addressing natural disasters, other States do not bear this cost unexpectedly in the year in which the disasters occur. States can plan to absorb those costs through reductions in GST revenue as the relevant year moves through the equalisation system. States are well aware of this longstanding aspect of the HFE system and manage their budgets accordingly.

106. Another relevant factor when considering contemporaneity is the practice of having major methodology reviews every five years. The PC could consider whether this approach is sufficiently flexible to accommodate changing circumstances, or whether there may be alternative options worth considering (such as having reviews more often, or having a rolling review of assessments). The PC could examine the current approach, and consider whether it appropriately balances the need for stability and contemporaneity, with the need to ensure that assessments methodologies are robust.

107. The balance between the need for contemporaneity and stability is a significant challenge for the implementation of HFE, and one that warrants further consideration by the PC.

Equal per capita distributions

108. An equal per capita (or EPC) distribution is the idea that each State should receive the same revenue per person. The benefits of an EPC distribution accrue to States that are assessed as requiring less than a population share of GST by the CGC's current process.

109. It is argued the objective of EPC focuses on equalising individuals instead of the capacity of States. Supporters of an EPC distribution option claim that equalisation is achieved as the methodology automatically redistributes GST revenue from those parts of the country that generate above average per capita GST revenue to those parts which generate below average GST revenue per capita.

110. However, these arguments ignore the critical role that State Governments play in delivering essential services to the Australian people. Under a simple EPC distribution (with no corresponding 'top up' from the Commonwealth), it is highly unlikely that States would have the capacity to provide similar levels of services – the core objective of HFE. EPC would not address the structural differences between States – such as differences in geography (e.g. the costs that come with more dispersed populations) and differences in population distribution (e.g. the costs that come with older populations). Even basic health and education services would likely suffer in recipient States, and the effects of this could potentially be experienced for generations.

111. As noted in the 2012 GST Distribution Review, this option may be more feasible in a scenario where there is better alignment of national tax bases and service responsibilities, resulting in a reduced level of VFI. However, even in such a situation, fundamental structural differences (such as a concentration of older Australians in one State, or the higher costs coming from Queensland being the most decentralised State) may still prevent equalisation from being achieved.

112. The significant costs that come from decentralisation should not be underestimated. Greater weight should arguably be given to these costs, not less weight - while an EPC distribution would ignore them completely. Queensland has a higher proportion of its population outside of the capital city area than any other State (except Tasmania). However, in addition, it is the second largest State geographically, with its population spread across many regional population centres – often thousands of kilometres from each other. This has a significant impact on the funding required to provide access to critical services including education, health (such as regional hospitals of a standard to meet the regional population base) and transport.

113. Distribution on an EPC basis could raise issues about the allocation of specific responsibilities, notably with respect to Australia's indigenous population. Ergas and Pincus note that, for the Northern Territory, due mostly to the high proportion of the population classed as remote and indigenous, the effects of switching to grants distributed by EPC would be very significant – both for their budget and their Gross State Product (GSP).

114. Fundamentally, an EPC distribution ignores the role that HFE plays as central element of Australia's federation. HFE ensures equity in fiscal capacity, but also protects States' autonomy and enables them to provide the services to their communities that reflect the specific priorities of those communities, which differ variously across the States.

EPC with Commonwealth Government top-up payments

115. EPC distribution of the GST pool with Commonwealth top-up grants has been considered in the past as part of the possible reforms to the CGC process, and was the main long-term recommendation of the GST Distribution Review.

116. Under this option, the GST could be distributed using a simple EPC formula. Equalisation could occur outside the GST through top-up grants from the Commonwealth to States with below average fiscal capacities. If this option were to be implemented, equalisation would be achieved from a larger pool of funding than the GST alone and the Commonwealth would share a greater burden of equalisation than just the States. To ensure recipient States are no worse off, and donor jurisdictions receive the benefit of the EPC distribution, top-up grants could be financed from some combination of higher Commonwealth taxes, increased Commonwealth debt, or savings against Commonwealth expenditure responsibilities. According to the Reform of the Federation Green Paper, the Commonwealth would need approximately $6.8 billion

(in 2015-16) to top-up current recipient States so they reach the average fiscal capacity and are no worse off.

117. The CGC could determine the size and distribution of the top-up grant using the same type of revenue and expense assessments under the current system. Any top-up funding to the weaker States could be provided as untied funding from the Commonwealth, as these would reflect equalisation payments similar to the GST rather than payments for reforms. Tied grants could be provided to promote national reforms or Commonwealth priorities.

118. In 2014, the National Commission of Audit suggested that the EPC with a top-up grants option would remove GST revenue from fiscal equalisation, improving GST revenue certainty for States. It would also reduce some of the institutionalised conflict between jurisdictions that arises from the current GST carve-up. The benefits from this option would result in increased revenue for donor States as they would receive extra GST.

119. However, this option does require additional funding, or a significant rearrangement of existing Commonwealth payments to States. In addition, it may create some uncertainty for States – even if the Commonwealth agreed to provide additional funding, there could be uncertainty as to how long additional equalisation grants would last – the Commonwealth may decide to withdraw its contribution to equalisation if faced with tight fiscal constraints. On the other hand, the States arguably already face this uncertainty with the current allocation of tied funding from the Commonwealth.

Conclusion

Queensland has been a longstanding supporter of HFE and of an equalisation system which provides all States and Territories with the fiscal capacity to deliver a similar standard of service. A significant portion of funding is distributed through this process, and the funding comprises critical State and Territory revenue. This, coupled with the important role HFE plays in our federation, means it is important to consider any potential changes carefully – this is not a system that should amended in haste, or without proper analysis and consultation. Given the complexity of the system, the CGC's considerable efforts in achieving HFE over many years should be recognised.

While there are a range of issues with the current implementation of HFE, there is little practical evidence the system discourages States from undertaking needed reforms, or hampers economic growth. Furthermore, there is a risk that the implementation of many of the alternative options outlined would require some trade-off in terms of equity, or could have significant unintended consequences when implemented in practice.

This review is an opportunity to evaluate the concept of HFE and its implementation in Australia. Queensland is open to exploring alternative avenues of achieving equalisation – if an option exists that addresses some of the concerns raised (such as those related to simplicity or contemporaneity), without creating different challenges, but while still providing the funds Queensland needs to provide a similar standard of services to other States, then such an option should be pursued. However, implementing HFE is complex, and such solutions have proved elusive before.

Given the short timeframe, the outcomes of this review should not be expected to provide a straight forward solution ready for implementation, but rather could initiate discussions on broader reforms with CFFR and COAG, not just on the HFE system as it currently stands, but more broadly on the role of the different levels of government in regards to HFE.

Queensland believes there is scope for a constructive reform agenda that will deliver real benefits not only to the individual States but to the nation as a whole. With any future reforms, Queensland will continue to advocate in support of the community expectations that all Australians should receive similar standards of services regardless of which State they call home.

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