Productivity Commission inquiry into Australia's system of horizontal fiscal equalisation

Response to draft report

Contents

1. Towards a fairer and more efficient approach to horizontal fiscal equalisation

Key points

- New South Wales considers that the current system of GST revenue allocation penalises states that are fiscally responsible and pursue reform to propel increased productivity, efficiency and economic growth. At the same time, the current system fails to achieve the key objective of interpersonal equity, and instead redistributes the benefits of fiscally responsible states to other states and territories (states).
- New South Wales believes that the Productivity Commission's (PC) draft report overstates the equity outcomes achieved by the current horizontal fiscal equalisation (HFE) system.
- New South Wales has consistently argued that the HFE system employed in Australia is one of the most complex systems of equalisation in the world, and welcomes the PC's draft findings confirming that view.
- In particular, New South Wales welcomes the draft findings highlighting HFE's numerous flaws and noting that the current system "…provides for limited consideration of efficiency; and it results in a complex system."
- New South Wales believes the distribution of GST revenue on an equal per capita (EPC) basis between the states represents the best model for Australia. As the Government's first submission to this Inquiry noted, EPC is the only model capable of achieving fairness, efficiency, simplicity, accountability and stability. In particular, fairness is delivered by providing an equal amount of GST revenue to each Australian resident, regardless of where they live.
- If necessary, New South Wales accepts that equalisation to a reasonable standard could be considered an improvement on the current approach (and a step in the right direction), provided that it is on the basis of equalisation to the average fiscal capacity of all states.
- Equalising to the average fiscal capacity of all states will enable each state to provide a reasonable standard of service not appreciably different to the same standard currently pursued by the Commonwealth Grants Commission (CGC). Importantly, it would reduce the current perverse incentives for productivity enhancing reform.
- Equalisation to the second strongest state is not favoured. Where the strongest and second strongest states have a similar fiscal capacity, this approach will simply default to the existing CGC approach — thus achieving no reform at all.

- While the PC has argued the second strongest state approach may deal with "outliers[1]" this would be designing a GST distribution system to deal with an event — a mining boom — that has only occurred five times in the past 200 years of Australia's history.[2]
- It would also introduce additional perverse incentives impacting economic efficiency and productivity.

- Ambitious, far reaching and fundamental reform to both HFE and Australia's model of fiscal federalism is vital to address vertical fiscal imbalance (VFI) and properly recognise the sovereignty and fiscal autonomy of states to deliver valued services such as health, education and justice. In particular, these reforms should include governance reforms.
- New South Wales considers a revised governance framework for the distribution of the GST could involve the newly established Board of Treasurers which could make recommendations to the Commonwealth Treasurer on HFE policy and overseeing simplification of the CGC's methodology. The CGC Commissioners could then be responsible for the implementation of that policy, and for guiding the work of the CGC Secretariat.
- New South Wales expects the PC to be ambitious in its final report. Modest reforms to HFE risk inaction and failure to realise meaningful change. Far-reaching and specific recommendations from the PC are needed to help break the impasse that characterises the dialogue between the Commonwealth and states on HFE, and federal financial relations more broadly.

[1] PC Draft Report p.151 "Australia's system of comprehensive and full equalisation works well when the States are reasonably similar. But it struggles with extreme events and outliers."

[2] Ric Battellino, 2010, Reserve Bank of Australia, Mining Booms and the Australian Economy https://www.rba.gov.au/speeches/2010/sp-dg-230210.html

1.1 Introduction

New South Wales welcomes the PC draft report and recognition that Australia's system of HFE is in need of repair, and that the pursuit of perfect equalisation comes at a significant cost to economic efficiency and productivity.

A better balance must be struck between equity, efficiency, transparency, simplicity and accountability. HFE reform is needed so that states undertaking sound, fiscally responsible reform to drive economic growth, increased efficiency and productivity are not unfairly penalised.

Furthermore, states who deliver poor outcomes and inefficient services should not continue to be unduly rewarded. As NSW outlined in its original submission, HFE should not provide states GST revenues to address their assessed disabilities if recipient state governments continue to underinvest in the government services and programs they have received GST revenues for. A failure of HFE reform to address these concerns risks perpetuating the poor outcomes delivered under the HFE system, at the cost of Australians' living standards, wellbeing and future prosperity – whether they be in donor or recipient states. Moreover, these poor outcomes will continue to arise without achieving the fundamental HFE objective of interpersonal equity.

More broadly, New South Wales welcomes the PC's conclusion that fundamental and systemic reform of Australia's model of fiscal federalism is required. This must necessarily encompass HFE and the way in which general revenue assistance is provided to states. The high degree of VFI that characterises Australia's federation means states are unduly reliant on Commonwealth revenue support, including through HFE and the provision of tied payments, to provide vital services to citizens. The consequence is a loss of accountability, transparency and efficiency which, ultimately, results in poorer outcomes for all Australian citizens.

A failure to deliver meaningful reform will mean confidence in the CGC and acceptance of HFE distribution outcomes will continue to deteriorate.

The PC must be ambitious. Modest reforms to HFE risk inaction and a failure to realise meaningful change. Far-reaching and specific recommendations from the PC are needed to help break the impasse that characterises national dialogue between the Commonwealth and states on HFE, and federal fiscal relations more broadly.

Successful and enduring reform also depends on rigorous, high quality governance arrangements that ensure all decision making is subject to a high accountability standard. This high standard requires separation of the policy and implementation functions currently undertaken by the CGC, with states given a meaningful role to define the objective of HFE.

The newly established Board of Treasurers could recommend to the Commonwealth Treasurer the definition of HFE, the appointment of CGC Commissioners and the terms of reference for CGC reviews, recognising that the GST is the states' tax, and the importance of GST revenues to state budgets more broadly.

Establishing a role for elected representatives in this way is essential to ensuring that the objective of HFE aligns with community expectations. Indeed as Dr Anwar Shah, a World Bank expert on fiscal federalism notes:

> "*Australia has the most advanced institutions of executive and legislative federalism of any federation and only those institutions are the appropriate venue to reach agreements on the appropriate degree of equalization.*"[3]

Those most directly affected by the distribution outcomes of CGC decision making should have an institutional role in setting HFE methodologies.

In addition, simplification of HFE methodologies pursued by the CGC, as recommended by the PC, will not be realised in the absence of a robust accountability mechanism. As the PC draft report notes:

> *"…the CGC is unlikely to pursue such simplification absent of direction to do so and while it remains singularly focused on achieving full equalisation. The CGC needs to be directed, via the terms of reference it receives, to consider approaches to assessment that deliver significant simplification and 'good enough' (that is, slightly less or slightly less precise) equalisation outcomes.[4]"*

An ongoing external check is needed on the decision-making powers of the CGC. New South Wales considers the Board of Treasurers could play a role in this area.

Poor transparency, combined with a high degree of complexity and subjective decision making means credibility and confidence in the CGC and HFE is diminishing. A failure to address this accountability deficit will mean any acceptance of HFE distribution outcomes and confidence in CGC decision making will be placed at further risk.

1.2 Moving towards an equal per capita distribution – a preferred model

New South Wales continues to support an equal per capita (EPC) basis for the distribution of GST revenues between states. An EPC model is the best way to achieve outcomes that are efficient, equitable, simple, transparent and predictable. It is also easily replicated. Perverse incentives are eliminated and unintended consequences

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[3] Shah (2017), Horizontal Fiscal Equalization in Australia: Peering Inside the Black Box, p. 29

[4] PC Draft Report, p. 154

avoided. In addition, equity is delivered by providing an equal amount of GST revenue to each Australian resident, regardless of where they live.

None of the alternative models proposed by the PC address the many flaws of the HFE system identified throughout the draft report. This is because, on their own, each model operates within the existing framework employed by the CGC and therefore continues to perpetuate the perverse economic incentives that work against productivity and growth enhancing reforms. Moreover, the zero-sum game nature of HFE means changes within these parameters are extremely challenging and offer little prospect of success.

However, New South Wales considers that if an EPC model is not pursued, then equalisation to the average fiscal capacity of all states is a step forward for HFE reform.

Equalising to the average fiscal capacity of all states ensures each state has the fiscal capacity to deliver services at a level that is not appreciably different to the national average. This is consistent with notions of fairness as states would retain at least some portion of those GST revenues they raise, representing a pragmatic and sensible mechanism by which a reasonable degree of equalisation may be set. This model could also represent a transitional step towards EPC.

The PC has also proposed an alternate model of equalisation to the second strongest state. New South Wales does not support this approach as it defaults to the existing HFE arrangements where the fiscal capacity of the strongest and second strongest states is equal. This approach also introduces new perverse incentives for gaming by states.

Under any transition path, governance reform must address the oversight of the CGC and strengthen democratic engagement with the principle of HFE and its application. New South Wales therefore considers that combining a new distribution model (EPC or equalisation to the average fiscal capacity of all states) with a new role for the Board of Treasurers, responsible for acting as an intermediary in defining the principle and objectives for HFE, represents a step in the direction of reform.

1.3 The Equity objective vs. the Equity reality

The PC draft report states that equity is at the heart of the HFE system.[5] New South Wales believes this is overstating the level of equity that is actually being achieved through the HFE system.

The current HFE system provides a greater share of GST funding to a state that is affected by a higher cost of providing the average range of services because of factors beyond its control (that is, not influenced by government policy). This can include, for example, population characteristics within the state (including Indigeneity and socioeconomic status) and a state's geography and physical environment (e.g. remoteness).

In reality, variations in the cost of providing services in any given state cannot be disentangled from the past and present policy decisions of state governments. The current HFE system fails to fully recognise this.

In broad terms, GST distributions arising from state expenditure disabilities are driven by:

- a state's share of a particular social group, or geographic attribute
- the increased costs of providing services to that social group, or particular geographical setting.

As additional GST revenues are tied to both of these factors, the current HFE system provides perverse incentives for states with these disabilities to:

- Neglect to address disadvantages faced by particular social groups that qualify that state for a greater share of GST
- Underinvest in infrastructure, or other efficiency-enhancing initiatives, that would lower the cost of providing services to a remote area or particular group. For example, if it costs 35 per cent more to provide schooling to remote Indigenous communities, the incentive to invest in better roads or new technologies that might reduce this cost over the long run is reduced, as the cost is met through redistributed GST.

For example, in 2015-16 the national average expense for housing per capita was $119. Due to its disabilities, South Australia was assessed as needing to spend $131 per capita to provide the same national average standard of services, however its actual

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[5] PC Draft Report, p. 2

expenditure was only $42 per capita (i.e. 32 per cent of its assessed expense). This suggests that equity is not being achieved for the people of South Australia seeking housing services. Furthermore, ongoing underinvestment risks widening this dispersion.

Similarly, Table 1.1 shows instances of underspending relative to assessed expenditure by Tasmania across a range of expenditure categories. It shows, for example, that Tasmania was allocated $2,956 per person for health expenditure – but spent only $2,575. In simple terms, this means that the CGC has calculated that it costs $2,956 to provide a national average standard of hospital services in Tasmania – but Tasmania spends roughly $400 per person less than allocated. Tasmania is not using its funding to achieve equitable hospital care outcomes.

Table 1.1: Tasmania underspend per capita in 2015-16

		National average expense	Assessed expense	Actual expense	Difference
Health	($ per capita)	2,387	2,956	2,575	(381)
Welfare	($ per capita)	703	853	745	(108)
Services to communities	($ per capita)	250	268	93	(175)
Justice	($ per capita)	764	798	651	(147)
Roads	($ per capita)	267	244	180	(65)
Transport	($ per capita)	530	228	153	(75)

Source: CGC, 2017, *Report on GST Revenue Sharing Relativities – 2017 Update*, Attachment 4 (The Assessed Budget Category Tables).

A challenge to the efficacy of the HFE system and the outcomes it delivers is presented by long-standing and entrenched levels of disadvantage facing the Northern Territory associated with Indigeneity and remoteness.

The Northern Territory's level of assessed need is based on a recognition of significant cost disabilities arising from:

- the greater cost to deliver services to rural and remote communities across the territory
- the high cost of providing welfare services to Indigenous communities.

Despite high level of funding in 2012-13 and 2015-16 at levels significantly above the national average provided under HFE, the Northern Territory Government provided funding to deliver housing and welfare services to a standard well below their assessed level.

Table 1.2 below shows the Northern Territory's consistent underspending on housing and welfare services relative to their assessed expenditure.

Table 1.2: Northern Territory housing and welfare spending per capita compared to assessed expense

		Actual	Assessed	Difference	Average assessed
2013-14	($ per capita)	1,736	2,054	(318)	791
2014-15	($ per capita)	1,651	2,119	(468)	806
2015-16	($ per capita)	1,805	2,146	(341)	822

Source: CGC, 2017, *Report on GST Revenue Sharing Relativities – 2017 Update*, Attachment 4 (The Assessed Budget Category Tables).

This underspending compares to the outcomes being achieved. The *Closing the Gap* report indicates that:

- 18 per cent of Indigenous households were living in houses of an unacceptable standard (more than two major structural problems and less than four working facilities for washing people, clothes/bedding, storing/ preparing food, and sewerage).
- There has been an increase in the proportion of Indigenous households living in houses of an acceptable standard, from 78 per cent in 2012-13 to 82 per cent in 2014-15.
- Around 26 per cent of Indigenous households were living in dwellings with major structural problems (including problems such as sinking/ moving foundations, sagging floors, wood rot/ termite damage and roof defects). This was a reduction from 2012-13 (34 per cent).
- In very remote areas, 37 per cent of Indigenous households were living in dwellings with major structural problems.

With regard to welfare related outcomes:

- The Northern Territory has experienced a decrease in employment rates amongst 15-64 year olds between 2008 (50.8 per cent) and 2014-15 (36.7 per cent).
- The Northern Territory has the lowest Indigenous student attendance rates in the nation (68.6 per cent in 2016), which is deteriorating (70.2 per cent in 2014).

Failures of Equity and Entrenched Disadvantage

Finally it is not just that underspending on important social services means equity is not actually being achieved; it is also perpetuating inequitable outcomes into the future. As the OECD has noted:

"…the more generous equalisation is the less incentive there is for poor regions to catch up or for households and firms to migrate to more prosperous jurisdictions. As a result, disparities widen rather than narrow."[6]

In effect, the CGC is entrenching disadvantage rather than addressing it.

1.4 Federal financial relations reform

PC DRAFT RECOMMENDATION 9.3

The Commonwealth and State Governments, through the Council on Federal Financial Relations, should develop a process to achieve longer term reform to federal financial relations.

In the first instance, it should assess how Commonwealth payments to the States — both general revenue assistance and payments for specific purposes — interact with each other today, given the significant reforms to payments for specific purposes that have occurred in recent years.

The process should also work to a well delineated division of responsibilities between the States and the Commonwealth, and establish clear lines and forms of accountability. Policies to address Indigenous disadvantage should be a priority in this regard.

The PC explicitly acknowledges that its draft recommendations do not represent fundamental and far reaching HFE reform. The PC also recognised that genuine federal financial relations reform is needed so that fundamental reform to HFE can be achieved.

Addressing Australia's acute levels of VFI is a fundamental challenge confronting Australia's federation. Without a better delineation of roles and responsibilities and a more sustainable approach to funding government services, the compact underlying Australia's federation is at risk. This jeopardises popular confidence amongst all citizens in the quality of their governments and their supporting institutions. For any reform to secure popular acceptance and be enduring, transparency and accountability must be paramount.

A new approach is needed that better reflects the equal, sovereign role of states and the services they provide across health, education and justice to the wellbeing of Australia's citizens.

[6] OECD Publishing (2013), *Fiscal Federalism 2014: Making Decentralisation Work,* p. 111

In *Shifting the Dial: 5 Year Productivity Review*, the PC has advocated a more ambitious and confident reform agenda to renew federal financial relations. New South Wales welcomes this report and urges the PC to give greater consideration to, and indeed build on, these conclusions in its final report on HFE to lay out a path for fundamental reform for HFE and, more broadly, fiscal federalism.

2. Recommended model

Key points

- Any new approach to the distribution of GST revenues must comply with the principles of fairness, efficiency, simplicity, accountability and stability.
- New South Wales believes that none of the “reasonable standard” options proposed in the draft report meet all of these objectives for HFE.
- An equal per capita distribution best achieves these objectives for Australia and would strike a better balance between equity and efficiency than the options proposed in the draft report. In particular, it would see each Australian resident receive an equal amount of GST, regardless of where they live.
- New South Wales continues to support an EPC distribution of GST and advocate for broader reform to federal financial relations.
- However, in the absence of adopting an equal per capita distribution of the GST, a revised objective for HFE which provides the states with the fiscal capacity to allow them to deliver services and associated infrastructure of a “reasonable standard” is a positive step forward if it adopts equalising to the average fiscal capacity of all states.
- Equalising to the average fiscal capacity of all states represents a step towards an EPC distribution of the GST and will provide all states the fiscal capacity to deliver a reasonable standard of services not appreciably different from the national average. This model also helps minimise costs to economic efficiency and productivity.
- Modelling by NSW Treasury (Appendix A) suggests equalisation to the average state would still allow the fiscally weakest state in 2017-18 the capacity to deliver at least 96 per cent of the national average standard of services.
- Phased implementation of new HFE arrangements over five years may represent a desirable transition path for HFE reform going forward.
- Equalising to the average fiscal capacity of all states does not address many of the existing flaws of the HFE methodology. Complementary reforms are also needed to address the complexity of the HFE methodology itself, and this will require far-reaching and effective reforms to existing governance arrangements (discussed in Chapter 4).

2.1 Equalising to a reasonable standard

The current approach to HFE sees all states given the capacity to deliver a national average standard of services, by applying national average tax rates. This is provided each state operates at a national average level of technical efficiency. In essence, the current HFE model attempts to create the capacity for states to replicate an outcome consistent with a unitary system of government, while taking advantage of the diversity benefits that arise from federation.

The PC found that the current HFE system is functioning reasonably well in some areas:

- the equity principle of fiscal equalisation is strongly supported and Australia's system achieves an almost complete degree of equalisation
- the CGC is well placed to conduct the HFE distribution process
- HFE results in reasonably stable GST payments.

However, the PC found that HFE as practised has deficiencies in a number of areas:

- equalisation is taken too far with the comprehensive equalisation to the fiscally strongest state making the redistribution task considerable
- the standard currently being equalised is potentially volatile
- the current HFE system struggles with state circumstances that differ markedly from other jurisdictions
- there is a potential for HFE to distort state policy particularly where major tax reform is being considered
- the system is poorly understood.

As New South Wales set out in its first submission, the best way of addressing concerns with the current arrangements is for GST revenues to be distributed on an EPC basis, noting that broader federal financial relations reform is also required. An EPC distribution would be fair as each Australian resident would receive an equal amount of GST, regardless of where they live.

While an EPC distribution remains New South Wales' preferred approach, if this is not ultimately supported then a revision to the HFE objective, as proposed by the PC, to an average level of fiscal capacity is considered to be the strongest alternative.

PC DRAFT FINDING 2.1

While it has a number of strengths, there are also several deficiencies with the objective of Australia's horizontal fiscal equalisation (HFE) system. In particular, equalisation is always to the fiscally strongest State; it provides for limited consideration of efficiency; and it results in a complex system.

The primary objective of the system may be better refocused to provide the States with the fiscal capacity to allow them to supply services and the associated infrastructure of a reasonable standard.

This objective should be pursued to the greatest extent possible, provided that:

- it does not unduly influence the States' own policies and choices beyond providing them with fiscal capacity
- it does not unduly hinder efficient movement of capital and people between States
- the process for determining the distribution of funds is transparent and based on reliable evidence.

The PC has sought the views of participants on what level of HFE would be considered reasonable and has put forward a range of possible options.

From New South Wales' perspective, any new approach to the distribution of GST revenues must comply with the principles of fairness, efficiency, simplicity, accountability and stability.

Any approach to defining reasonable HFE must address these criteria and the concerns about the current system raised by the PC and look beyond the specific circumstances of today to be sustainable over the longer term. Any new HFE model should also be consistent with a longer-term objective of moving to an EPC distribution of GST grants.

The PC has outlined a number of possible methodological approaches to achieving reasonable equalisation, including equalisation to the average fiscal capacity of states and equalisation to the second strongest state.

New South Wales believes that none of the "reasonable standard" options proposed in the draft report meet these all of these objectives for HFE.

However, if equal per capita distribution of GST is not adopted in the short-term, a revised objective for HFE which provides the states with the fiscal capacity to allow them to deliver services and associated infrastructure of a "reasonable standard" is a positive step forward if it adopts equalising to the average fiscal capacity of all states.

Equalisation to the average ensures that all states are provided the fiscal capacity of at least the average state. Under this approach, states with above average fiscal capacity retain this advantage relative to the average state and fiscally weaker states can deliver services not appreciably different from the national average standard of services.

Modelling by NSW Treasury (Appendix A) suggests equalisation to the average state would still allow the fiscally weakest state capacity in 2017-18 the capacity to deliver at least 96 per cent of the national average standard of services. This variation in service delivery capacity represents a modest and reasonable departure from the standard currently delivered by HFE.

A further benefit of the average state model is that the disincentive effects of the current system are reduced. This provides states with a greater incentive to undertake tax and other productivity enhancing reforms. As the PC noted in its draft report, equalisation to less than the strongest state would be expected to produce commensurately smaller disincentive effects on efficiency than current arrangements.[7] Modelling by NSW Treasury shows that equalisation to the average state would be expected to produce the least disincentives for states pursuing major economic reforms.

However, equalising to the average fiscal capacity does not address the flaws of the HFE methodology. Complementary reforms are also needed to address the complexity of the HFE methodology itself, and this will require far-reaching, effective reforms to existing governance arrangements (discussed in Chapter 4).

Equalising to the average state – impact on perverse incentives

The average model is the best model that reduces the fiscal penalty faced by fiscally stronger states from pursing economic and fiscal reforms.

The average state model most reduces the size of any possible economic efficiency impacts of equalisation, by moving closer to an EPC distribution of GST in comparison to other proposed models.

The average state model also increases incentives for fiscally strong states to improve their fiscal capacity. This will result in greater economic development and activity nationally, with some economic benefits being captured, in part, by the Commonwealth's broad tax bases.

Equalisation to the second strongest state has significant disadvantages compared to the average state model:

[7] PC Draft Report, p. 187

- Where the fiscal circumstances of the strongest and second strongest states are very similar, the outcome for all jurisdictions is unchanged from current outcomes.
- The model introduces considerable volatility into the level of equalisation provided to fiscally weaker states based on the relative fiscal circumstances of the strongest and second strongest states. Setting the degree of equalisation as the average fiscal capacity of all states will reduce volatility of the equalisation standard.
- The perverse incentive effects on state behaviour are greater, particularly for the second and third fiscally strongest states with a consequential impact on productivity and economic growth.
- The second strongest state is forced to deliver a lower standard of services than fiscally weaker states.

Further analysis on equalisation to the average fiscal capacity of states, and to the second strongest state, can be found in Appendices A and B.

2.2 Transition

Precise transitional arrangements will be difficult for states to agree, given the zero sum nature of HFE reform. This will require the PC to show strong leadership in providing guidance for governments on the most appropriate transition path to effect HFE reform.

New South Wales considers that the most appropriate transition path towards equalisation to the average fiscal capacity of all states would either require Commonwealth transition funding or a staged implementation approach towards the new model over a five year period aligned with the next review period from 2020 to 2025.

3. Institutional reform

Key points

- Poor credibility and a lack of transparency and widespread confidence and acceptance of HFE outcomes are a direct consequence of poor institutional arrangements and practices, alongside the absence of robust oversight mechanisms.
- Good public sector governance separates policy setting from regulatory or other administrative functions. Good governance also requires that policy-setting functions remain strictly within the domain of elected representatives. More broadly, good governance also requires open and transparent decision-making processes underpinned by robust accountability frameworks. The CGC does not meet current thresholds for good public sector governance.
- Separating the responsibility for *implementing* HFE from the responsibility for setting its objective, is therefore fundamental to improving public acceptance of HFE and the credibility of the CGC.
- No other field of public administration concentrates such extensive decision making – leading to an annual distribution of more than $60 billion – in one institution.
- The outcome is that the CGC pays too much attention to the equalisation task, ignoring the outcomes of equalisation and the impact it has on state citizens.
- The CGC should be accountable to all state jurisdictions. This would give better practical recognition of the fiscal importance of CGC decision making directly upon states. Ultimately, the Commonwealth Treasurer will still have to be the decision maker, because the CGC and GST revenues are subject to Commonwealth legislation. But this should at a minimum be on the basis of advice from state representatives.
- The history of the GST as the states' tax, and federal financial relations more broadly, highlight the need for the states to have an equal role in holding the CGC to account for its decisions, alongside the Commonwealth. Institutional reforms proposed by the PC do not adequately recognise this.
- To address these weaknesses, New South Wales recommends that the Board of Treasurers, or a new state-led body, could be responsible for recommending to the Commonwealth Treasurer the definition of HFE, terms of reference for the CGC and the nomination of CGC Commissioners.
- Simplification of existing HFE methodologies requires an external accountability mechanism to oversight the CGC to be successful.

3.1 CGC decision making and accountability

The CGC exercises a quasi-judicial role in defining and interpreting the principle of HFE, determining its application, the scope and extent of equalisation, and assessing whether current or proposed methodological approaches are consistent with the principle and objectives of HFE.

The CGC is not well placed to exercise such functions. The CGC cannot independently approach such questions, given its considerable involvement in the design and administration of the HFE system. CGC Commissioners and the Secretariat have mutually dependent roles.[8] Under the current model, CGC Commissioners consider advice provided by the Secretariat but are also intimately involved in the day to day direction of Secretariat operations.

Confidence in any interpretations reached on the objective of HFE is best served by a decision-making process that approaches this task at an arms-length basis, separate to the decision-making body that both designs and administers the HFE process.

A related concern is the relatively modest consultation the CGC undertakes with the states. As Western Australia noted in its post-draft submission:

> *This [consultation] is characterised by formal meetings between the CGC and all states, but with a CGC staff predominantly informing states what work they have decided to conduct, with limited opportunities for that work to be shaped by state knowledge or insights. The CGC is also engaging private consultants with minimal state consultation on the scope of the work. (WA Government, Post-draft Submission, pp. 40-41.)*

This is despite the fact that methodological changes can significantly alter distribution outcomes for states and can often be based on judgment, reliance on partial and incomplete data and arguably conceptually flawed analysis by the CGC. States must have a greater role in HFE to ensure that the process delivers credible and conceptually sound outcomes.

Unilateral decision making by the CGC – 2020 Methodology Review

In the recent position paper for the 2020 Methodology Review, the CGC stated a focus of the Review will be to ensure each state retains after equalisation, in those

[8] CGC 2017-2021 Corporate Plan, p. 2

categories in which it dominates, at least half of the own-source revenue effects of discretionary policy changes it makes.

This approach will lead to own-source revenues being arbitrarily excluded from the HFE process. It also exacerbates the perverse incentives of HFE and risks further costs to economic efficiency and productivity.

Despite the significant implications this approach will have on the GST distribution of all states, as far as NSW is aware, no state has been consulted on this recommendation to which we strongly object.

Good public sector governance separates policy setting from regulatory or other administrative functions. Good governance also requires policy-setting functions to remain strictly within the domain of elected representatives. More broadly, good governance also requires open and transparent decision-making processes underpinned by robust accountability frameworks. The CGC does not meet current thresholds for good public sector governance.

No other field of public administration concentrates such extensive decision making in one institution, with the CGC responsible for the annual distribution of more than $60 billion annually.

An aspect that also makes the CGC unique, in comparison to other public sector bodies, relates to the absence of external accountability mechanisms. This includes the absence of performance audits and judicial scrutiny. This represents an area for further consideration by the PC.

The CGC requires a strong and effective governance framework to ensure it is held accountable to those directly affected by its decisions. The CGC must be responsible to states who oversee its decision making.

Poor credibility and a lack of transparency and widespread confidence and acceptance of HFE outcomes are a direct consequence of poor institutional arrangements and practices, alongside the absence of robust oversight mechanisms.

3.2 Board of Treasurers

New South Wales recommends that the Board of Treasurers, representing all states, could be responsible for recommending to the Commonwealth Treasurer the definition of HFE, the terms of reference for updates and methodology reviews, and nominations for CGC Commissioners. CGC Commissioners would be responsible for overseeing the implementation of the terms of reference by the CGC Secretariat.

New South Wales does not consider that shifting the locus of accountability for HFE to the states – so that those most affected by CGC decision making have a clear, well-defined oversight role – represents a "radical change" that is "not required to allay most of the concerns raised by participants", as suggested by the PC.[9]

Providing the Board of Treasurers with these responsibilities could address key problems associated with current CGC decision-making processes and institutional arrangements while delivering the following benefits:

- *Accountability* – elected representatives drawn from across states would assume responsibility for recommending to the Commonwealth Treasurer the definition of HFE and assessing the trade-offs to be made between competing principles for equity, efficiency and simplicity.
- *Separation of functions* – policy and implementation functions would be separated with the CGC wholly focussed on implementing and applying the principle of HFE within parameters determined by elected representatives and centred on methodological approaches designed to give best effect to policy intent.
- *Process stability* – stable and certain methodological approaches resulting from a greater degree of scrutiny and a greater onus placed upon the CGC to justify changes to existing approaches based on well-founded evidence and demonstrated benefits. In turn, this would eliminate quasi-judicial decision making and ad hoc methodological changes unilaterally decided by the CGC.
- *Simplicity* – the Board of Treasurers could foster a continued focus on simplicity and simplification of existing methodologies by exposing CGC methodologies to external scrutiny and a continued commitment to simplified HFE that achieves a less precise degree of equalisation.

Integrating the newly established Board of Treasurers with existing institutional arrangements offers a much needed solution that would substantially strengthen and enhance existing governance arrangements. At the same time, it would also generate a greater sense of joint ownership across state governments.

Indeed, providing state Treasurers with real and meaningful input into the HFE process reflects the importance of political engagement in defining the HFE objective. As Shah notes:

> *"…ultimately, it is the fundamental role of the executive and legislative institutions to evaluate efficiency and equity tradeoffs and mediate conflicting interests of various stakeholders to develop a national consensus and a durable national*

[9] PC Draft Report, p. 199

> *compact on the desirability and the standard of equalization that is politically acceptable and fiscally affordable*."[10]

Further, the PC's draft recommendations for repairing HFE to achieve a trade-off between equity, efficiency and simplicity necessarily introduces significantly greater reliance on judgment and subjectivity to CGC decision making. This will compound existing problems. It also risks further undermining the legitimacy, and level of public confidence, in current approaches to HFE and its outcomes across states unless governance arrangements are reformed.

The following table sets out proposed roles and responsibilities for a reformed governance framework that conforms to principles of good public sector governance. This proposed model also leverages the newly established Board of Treasurers and, thus, offers an appropriate mechanism by which states can hold the CGC to account.

Board of Treasurers

- Make recommendations to the Commonwealth Treasurer on the definition of HFE and terms of reference for methodology reviews and regular updates
- Consider recommendations from the Commissioners to adopt new methodological approaches or change existing methodologies
- Nominate Commissioners for appointment by the Commonwealth Treasurer
- Oversee ongoing simplification of the HFE methodology

CGC Commissioners

- Oversee and direct the day to day operations of the CGC
- Consider and make recommendations on new methodological approaches, or updates to existing approaches
- Consider and make recommendations on the scope and extent of the equalisation task (that is, which government activities should be subject to HFE)
- Consider and make decisions on different data sets and on data adjustments

[10] Shah (2017), *Horizontal Fiscal Equalization in Australia: Peering Inside the Black Box*, p. 29

- Review and assess critiques and challenges to assessments and methodological approaches
- Conduct consultation with state governments on methodological approaches (including annual updates and five yearly reviews)

CGC Secretariat

- Implement approved methodologies and conduct assessments
- Identify relevant data, and make approved data adjustments
- Propose new methodological approaches, or updates to existing approaches

Commonwealth Treasurer

- Approve recommendations on relativities
- Appoint Commissioners based on recommendations from the Board of Treasurers

3.3 Commonwealth leadership

The PC identifies a need for the Commonwealth to assume an active leadership role for HFE to deliver needed reforms to improve governance and accountability.[11] This includes:

- articulating a revised objective for HFE
- asking the CGC to recommend relativities consistent with the HFE objective
- directing the CGC to pursue significant simplification of the assessment process.[12]

This draft finding forms part of a suite of broader reforms the PC posits as a means to address current problems associated with the current institutional design.

Both singularly, and collectively, these draft findings and recommendations fall short of addressing the current, fundamental accountability deficit and are inadequate.

[11] PC Draft Report, p. 23

[12] PC Draft Report, p. 22

The unequal relationship between the Commonwealth and states is the core problem with Australia's fiscal federalism, and is a function of extreme levels of VFI. The proposed PC reforms would only increase this unequal relationship, further elevating and entrenching the role of the Commonwealth to the detriment of states.

Widespread public confidence in the CGC and in HFE distributed outcomes would also be damaged.

The long-term sustainability of HFE and credibility of the CGC is intimately linked to separating responsibility for setting and defining the principle of HFE and its objective from its implementation. This draft finding by the PC[13] is consistent with long standing and widely accepted principles of good public sector governance. New South Wales supports this conclusion which forms the basis of our recommended approach.

A recommendation by the PC that only addresses the role of the Commonwealth will lead to a one-sided outcome unacceptable to states. This shortfall will not be addressed by other draft recommendations proposed by the PC to address institutional arrangements.

The CGC and the states – accountability over the GST

The GST is first and foremost the states' tax.

The GST was introduced based on a good faith bargain between the Commonwealth and states. In a wide-reaching reform intended to benefit national economic efficiency and secure a sustainable, growing revenue source to states, an array of inefficient state taxes were abolished. In exchange, the Commonwealth agreed to raise GST revenues on the behalf of states due to a constitutional prohibition on states levying excise taxes.

Whilst the recent intergovernmental bargain struck in 1999 and accompanying the introduction of the GST goes in part to justifying a role for states over the distribution of GST between states, longer historical underpinnings are also relevant.

Accountability in the Australian Federation authored by Analytic Outcomes and commissioned by the PC clearly demonstrates how the introduction of the GST is the result of a complex evolution of Australia's model of fiscal federalism extending back to the establishment of the uniform income tax regime in 1942.

The uniform income tax regime relied upon the Commonwealth agreeing to compensate states for the loss of income tax revenue in the form of tax

[13] PC Draft Report, p. 22

reimbursement grants. In the late 1950s, this compensation assumed a new outward form in the nature of financial assistance grants. In 1976, these financial assistance grants became tax sharing arrangements which, in turn, reverted into financial assistance before finally assuming their current form as GST revenue distributions.[14]

Today, the GST meets a gap in state's fiscal capacity that was removed with the implementation of the uniform tax system.

The GST is now widely viewed as the key mechanism through which HFE is now realised in Australia. However, it is more correct and accurate to acknowledge that every state has an entitlement to the GST, as compensation for the loss of state's income tax raising revenue.

Every dollar of GST raised and redistributed for the purpose of equalisation means there is one less dollar available to replace states own-source revenue capacity that was displaced by the uniform income tax regime.

On this basis, an explicit, clearly defined role for states that properly reflects this longstanding bargain and defining feature of Australia's fiscal federalism is needed. This role must allow states, through the Board of Treasurers, to exercise real and meaningful oversight powers over the CGC, and to hold it accountable for its decisions.

3.4 Simplification

PC DRAFT RECOMMENDATION 7.1

The Commonwealth Government should direct the CGC, through the terms of reference it receives, to consider approaches to assessment that deliver significant simplification and 'good enough' equalisation outcomes. The use of more highly aggregated assessments should receive detailed consideration as part of the current CGC process.

In the absence of perfect information, the true equalising distribution of GST grants is unknown. This means it is impossible to determine whether a methodological change to HFE results in a more precise level of equalisation. Simplification of the CGC's methodology therefore does not necessarily result in less HFE.

[14] Analytical Outcomes, *Accountability in the Australian Federation,* p. 27

Simplification of existing CGC methodologies requires a credible and effective external accountability mechanism. The PC itself finds that the CGC, without external impetus, will not embrace a shift towards simplification of its existing methodologies.[15]

This conclusion is demonstrated by the 2010 Methodological Review which had simplification of its methodology as one of its key goals. The Review led to a reduction in the total number of assessment categories while sub-assessment categories increased, thus undoing any headline gains in simplification and resulting in no meaningful reduction in complexity.

Further mechanisms, to complement the Board of Treasurers, should be adopted to hardwire simplification into CGC methodologies.

A simplification panel

A one-off reduction in complexity of existing HFE methodologies could be realised through the appointment of an ad hoc or one off panel to review existing methodological approaches. This represents a genuine opportunity for governments (alongside the CGC) to step back and holistically assess the degree of complexity, and in turn, the level of precision needed to achieve a reasonable equalisation outcome.

An independent panel of experts could be appointed to interrogate proposed methodological approaches and CGC decision making to make recommendations to the Board of Treasurers on measures to simplify CGC methodologies. The panel would be issued terms of reference focusing on balancing the principles of equity and efficiency with simplicity. An international expert in fiscal equalisation could be appointed to lead this simplification exercise.

This approach would deliver an immediate benefit in terms of reduced complexity. Implementing this recommendation would require careful consideration of processes to be followed. However, terms of reference focused on simplification, and the appointment of a select panel of experts by the Board of Treasurers, offers a beneficial approach to re-evaluate existing assessment methodologies to take into account equity, efficiency and incentive effects, simplicity, data reliability and stability of outcomes.

It is also important that subsequent changes to the HFE methodology do not undermine any move to simplify the CGC methodology over time. A standing simplification panel, responsible for evaluating the case for new complexity to the system, could also be integrated into the CGC's 2020 review and subsequent reviews.

[15] PC Draft Report, p. 154

3.5 Public communications and education

DRAFT RECOMMENDATION 9.1

The CGC — through its Chairperson and Commission members — should provide a strong neutral voice in the public discussion on the HFE system.

The CGC should also enhance its formal interactions with the State and Commonwealth Governments. In particular, it could provide draft rulings to State Governments on the potential HFE implications of a policy change.

The PC has found that the CGC could better engage with governments and assume a greater role on public communications as an independent, objective voice on HFE.

New South Wales welcomes this draft finding and can agree scope exists for the CGC to assume some public role to improve public understanding of HFE. However, on balance, this is a modest recommendation that fails to address the poor governance arrangements and accountability deficit that currently exists.

3.6 Draft rulings

A draft ruling mechanism will not reduce fiscal uncertainty for states seeking to change state policy. The need for this recommendation is a direct consequence of poor governance arrangements that characterise CGC decision making, but the recommendation is poorly targeted. It will not address fundamental issues associated with the accountability deficit.

New South Wales does not support the introduction of a draft ruling mechanism. Better designed and more carefully framed solutions will address issues associated with the accountability gap.

The proposed mechanism fails to appreciate that the ATO and its rulings deal with a taxation system based on static law, with interpretation and application of that system through court and tribunal decisions. These act as a fetter and check on the discretion the ATO may exercise in formulating public and private rulings. These rulings are also binding, meaning there is no scope for a future change. Where a ruling or advice is not legally binding, the ATO can provide administratively binding advice. This means ATO rulings are highly credible – binding both upon applicants (or a class of applicants) and the ATO itself.

In comparison, CGC methodologies are highly changeable, responding to complex changes in what states do, the application of policy neutrality and the treatment of data within a zero-sum game designed to achieve full equalisation.

A further key difference overlooked by the PC is that the ATO, unlike the CGC, does not make its decisions in a vacuum. An extensive set of arrangements and institutional frameworks are in place that impose a high level of scrutiny on ATO decision making and, in turn, means the ATO is held to a high accountability standard. These include:

- judicial review under the *Administrative Decisions (Judicial Review) Act 1977*
- administrative review by the Administrative Appeals Tribunal
- the Inspector-General of Taxation.

This is in addition to government-wide accountability measures associated with the Ombudsman, the Australian National Audit Office and the Office of the Australian Information Commissioner.

3.7 Data availability

PC DRAFT RECOMMENDATION 9.2

The CGC should make the data provided by the States publicly available on its website, along with the CGC's calculations on these data. Where there are risks identified with this approach, mitigating steps should be identified and taken.

New South Wales agrees with this recommendation and the greater transparency it should provide as long as suitable steps are taken to preserve confidentiality where necessary.

4. Further issues

Key points

- Mining revenues should continue to be fully assessed – the principle of HFE requires symmetrical treatment to deliver equity.
- Indigenous outcomes are not improved under HFE. Greater transparency and better outcomes would result from addressing acute Indigenous disadvantage outside HFE and through broader, coordinated approaches to federal financial relations.
- Commonwealth payments that are already distributed amongst states on a differential basis should not be subject to equalisation.
- The current three year assessment period with a two year lag strikes an appropriate balance between contemporaneity and budget stability.
- The introduction of externally defined benchmarks would involve daunting practical difficulties and substantially greater scope for dispute.
- The use of broad indicators would potentially simplify the HFE process significantly and this approach is worthy of further exploration.

4.1 Mining assessment

PC DRAFT FINDING 4.3

The potential for HFE to distort State policy is pronounced for mineral and energy resources. While there is no direct evidence that GST effects have influenced specific policy decisions, the incentive effects are large and have the potential to undermine state policy neutrality over time.

However, making adjustments to the HFE system specifically to add incentives for resource exploration policies that are deemed to be desirable would be an intentional breach of policy neutrality and state autonomy; be a source of additional complexity; and come at the expense of equity.

PC DRAFT FINDING 7.1

Removing mining from the HFE process, or the use of a discount factor within the mining assessment, is inequitable and not justified. However, there is a need to consider potential improvements in the assessment method in light of problems with policy neutrality.

New South Wales supports continued full inclusion of all mining revenues within the HFE methodology.

The CGC assessment of mining royalties has been contentious since the inception of the all state reviews by the CGC in the late 1970s. However following the mining boom, the importance of royalties within the CGC assessments has increased significantly resulting in a large redistribution of GST revenues between the states. In this context, the methodology adopted by the CGC for assessing state revenue raising capacity from mining royalties has become even more critical.

Given the concentration of specific minerals in particular states (see Table 4.1), any assessment of mining revenues needs to balance the potential for changes in state policies to impact GST relativities and the need to accurately assess the revenue raising capacity of the states. Over time, balancing these two competing objectives has seen a number of changes to the methodology chosen by the CGC.

Table 4.1 – Distribution of revenue base for specific minerals – 2015-16[16]

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Resource	*%*	*%*	*%*	*%*	*%*	*%*	*%*	*%*	*%*
Iron Ore	0.0	0.0	0.0	98.5	1.1	0.4	0.0	0.0	100.0
Coal	38.3	1.3	59.3	0.9	0.1	0.0	0.0	0.0	100.0
Gold	13.5	2.1	6.6	71.3	3.3	0.1	0.0	3.2	100.0
Copper	18.3	0.0	28.1	18.9	33.9	0.8	0.0	0.0	100.0
Bauxite	0.0	0.0	45.7	37.9	0.0	0.0	0.0	16.4	100.0
Nickel	0.0	0.0	0.4	99.6	0.0	0.0	0.0	0.0	100.0
Oil and Gas and Other	6.1	8.4	29.7	20.2	18.2	2.8	0.0	14.7	100.0

To minimise the impact of state policy on the assessment of revenue raising capacity, the share of the revenue base attributed to individual states needs to be kept as low as possible. Achieving this outcome favours aggregated assessments of revenue raising capacity where the concentration of one particular mineral in one state will have a lesser

[16] CGC online assessment system

impact. An example of such an approach would be to assess the revenue raising capacity from mining royalties for each state as one assessment.

The one-assessment approach has been criticised as not reflecting 'what states do' as royalty rates vary considerably from commodity to commodity (see Table 4.2). In the 2015 Review, the CGC placed a high priority on this factor when it chose to adopt a mineral-by-mineral approach to the assessment of mining royalties. Since that time, the CGC has expressed some reservations with the potential for their current assessment methodology to result in too great an impact from state policy decisions on GST relativities.

Table 4.2 –Average royalty rates – 2015-16[17]

Mineral	Average Royalty Rate (%)
Iron Ore	7.3
Coal	7.2
Gold	2.8
Copper	3.5
Bauxite	9.8
Nickel	2.1
Oil and Gas*	10
Other*	5.5

* As at 2013-14

For the 2010 CGC Review, the CGC chose to balance the competing objectives of 'policy neutrality' and the need to reflect 'what states do' by adopting a two-category approach to mining royalties. In essence, the CGC observed that mining royalty rates for specific minerals fell naturally into either a high and low category reflecting the nature of the mineral deposit. New South Wales believes that the 2010 methodology represents a more sensible balancing of the CGCs competing objectives.

Western Australia claims it is disadvantaged by the CGC assessment of mining royalties. In essence, Western Australia argues that an accident of history (namely, the geology of the state and the drawing of state boundaries) should result in the state being able to levy lower than average tax rates or provide a higher standard of public services on a permanent basis.

[17] CGC online assessment system

Based on the CGC working papers for the 2015 Review, New South Wales has attempted to recalculate assessed mining revenues for each state based on both a global approach (or one-category approach) as well as a two-category approach and compare these with the outcome of the current mineral-by-mineral approach.

Our calculations indicate that the current CGC approach results in the most favourable outcome for Western Australia and that any move towards a more policy neutral assessment of mining royalties would see Western Australia's share of GST reduced. In addition, the changes in assessed revenues and therefore GST grants for Western Australia by adopting each different approach would be marginal (see Table 4.3).

Our modelling also shows similar results for 2013-14.

Table 4.3 – Assessed revenue from mining royalties – 2015-16, $m

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Assessment	$m	$m	$m	$m	$m	$m	$m	$m	$m
One category	1,163	88	1,916	4,788	374	39	0	125	8,493
Two category	1,184	82	2,030	4,756	290	38	0	112	8,493
Mineral-by-mineral	1,179	103	2,010	4,754	257	36	0	155	8,493

Given that Western Australia already receives the most favourable assessment status from the CGC, we do not believe discounting of the mining royalties assessment is necessary. Any such discount would unfairly privilege those citizens located in an individual state (where that state is the dominant producer for a particular resource) only because of the historical good fortune associated with its resource endowments.

The principle of HFE as currently applied by the CGC, and as recommended by the PC, requires symmetry of treatment to deliver equitable outcomes. Upside benefits (such as mining revenues) must be treated consistently with downside costs (for example disabilities such as remoteness) under HFE.

An EPC distribution would eliminate such questions.

Analysis by the PC regarding the incentive effects of HFE on setting efficient royalties merits further consideration, including possible responses. However, New South Wales does not agree with arguments by Western Australia that the CGC inadequately recognises its expenditures on economic development. The PC has already noted arguments in support of this position as part of its draft report, including that:

- remoteness and other mining-related factors are assessed in service delivery costs
- the private sector has undertaken the bulk of investment in mining infrastructure
- the nature of the underlying resource and global commodity prices are the primary driver of mining activities globally.

Finally, from an economic efficiency perspective, a greater degree of equalisation towards Western Australia to provide greater recognition of such costs may, at the margin, create perverse incentives for over-investment by government that, at the same time, may also displace private capital.

Accordingly, amendments to the mining assessment to alter the balance between equity and efficiency and uphold the principle of policy neutrality appear unachievable, unjustified and risky. New South Wales supports the retention of existing approaches to the assessment of mining revenues.

4.2 Indigeneity

New South Wales has already highlighted the long-standing and historically entrenched levels of disadvantage facing Indigenous communities located in particular in the Northern Territory. The perpetuation of such levels of disadvantage demonstrates that HFE is ill-adapted to address acute economic and social disadvantage.

HFE does poorly at addressing and improving Indigenous outcomes. This is a nationally important and critical priority. Effective, long-lasting and rapid action is needed that would direct Commonwealth funding specifically for this purpose. Such a change would drive greater transparency and is consistent with the Commonwealth's constitutional responsibilities towards the Northern Territory, as well as the acute level of fiscal dependence of the Northern Territory on the Commonwealth.

The Commonwealth should not engage in cost shifting by handing off its responsibilities for the development of the Northern Territory onto the states. As long as the Northern Territory remains a territory, the Commonwealth should continue to meet its constitutional obligations to assist the Northern Territory on its development path.

Delivering enduring solutions to address acute Indigenous disadvantage depends on stable and secure Commonwealth funding allocated specifically for this purpose. On this basis, the Northern Territory and Commonwealth governments alike may be held to a higher level of account. The PC itself acknowledges this, arguing that responsibilities and accountability for Indigenous policy be given close attention as significant expenditure to date has resulted in little improvement.[18] There is no compelling reason why such a change should be contingent on broader financial relations reform.

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[18] PC Draft Report, p. 191

4.3 Commonwealth payments

PC DRAFT RECOMMENDATION 7.2

The Commonwealth needs to develop clear guidelines detailing the basis on which Commonwealth payments are to be quarantined from HFE by the Commonwealth Treasurer, so that they do not unnecessarily erode the efficacy of the CGC's relativities.

The guidelines should be based on the principle that quarantining of payments ought to occur only in exceptional circumstances.

Generally, the CGC takes into account Commonwealth tied payments as part of states' revenues with a view to equalising fiscal capacity between states.

The lack of consistent and transparent guidelines can cause significant budget uncertainty and funding problems for states if they are unaware of the CGC's treatment of a particular tied grant. For example, uncertainty around the degree to which a tied grant for a transport infrastructure project will be equalised can lead to significant budget shortfalls and delays in the construction of major infrastructure.

Equalisation of tied grants also leads to the substitution of tied versus untied funding and overrides negotiated agreements, effectively reducing the fiscal autonomy of those states that work with the Commonwealth to further national priorities and initiatives.

In circumstances where tied grants include differential funding based on specific disabilities, that funding will be redistributed under HFE unless the disabilities are exactly the same in both situations. That is extremely unlikely and raises the unanswerable question of which set of disabilities is correct.

New South Wales recommends the following guidelines for the treatment of tied grants:

- grants that include differential calculations (such as those relating to health and education) should not be subject to equalisation
- national partnership agreements (including infrastructure grants) that are negotiated on a bilateral basis should not be equalised
- Commonwealth own purpose payments should not be equalised.

4.4 Contemporaneity

> **PC DRAFT FINDING 5.1**
>
> Features of Australia's HFE system detract from its contemporaneity. While this works to smooth out changes in GST payments, it can exacerbate the fiscal impact of economic cycles when States experience large economic shocks. Such a situation has occurred in Western Australia in recent years.
>
> However, offsetting cyclical factors is not the primary objective of HFE, and alternative approaches do not offer unequivocal improvements. Reducing the length of the assessment period would have mixed impacts across States, and reducing the lag due to delayed data availability would introduce additional scope for dispute, volatility and the potential for unintended consequences.

The PC has correctly identified how HFE can impact state budget management.

At different times in the economic cycle and in different budgetary circumstances, reducing or increasing contemporaneity may attenuate or exacerbate states' revenue volatility.

A move away from the current assessment timeframe is only justified where there is clear evidence that a change away from the current approach will deliver clear benefits. These benefits are not clearly or compellingly identified as a result of the PC's analysis and, as such, New South Wales does not consider there to be sufficient evidence supporting changes to address contemporaneity.

Similarly, the introduction of projections or forecasts to reduce the lag, whilst technically feasible would also introduce a new and undesirable source of uncertainty, volatility and complexity due to the need to make continued corrections as well as a potential for gaming behaviours. Such outcomes must be avoided.

4.5 Broad indicators and cost benchmarks

> **PC DRAFT FINDING 7.3**
>
> The introduction of a broad indicators approach for assessing fiscal capacity could potentially deliver benefits in terms of simplicity, but would also have significant costs in terms of loss of accuracy, and may not achieve a 'reasonable' level of equalisation. The broader the indicators that are used, the more such risks may arise.

New South Wales agrees that the use of broad indicators would potentially simplify the HFE process significantly and considers this to be an approach worth further exploration. The results of a broad indicator approach would need to be carefully considered.

PC DRAFT FINDING 7.4

The use of externally defined benchmarks for efficient service delivery within the HFE process would encourage greater efficiency and reduce the potential for gaming the system. However, it faces daunting practical difficulties and involves a high degree of scope for dispute.

New South Wales agrees that the introduction of externally defined benchmarks would involve daunting practical difficulties and a high degree of scope for dispute, and does not support their introduction.

While New South Wales believes that the current HFE system does not place sufficient emphasis on efficiency, it is not clear that the adoption of external benchmarks would improve this situation.

Determining benchmarks would be arbitrary and subject to dispute, and measuring any benchmarks would add further layers of complexity to an already complex process. The aim of the PC review should be to reduce complexity rather than increase it.

APPENDIX A – Equalisation to the average state

Under equalisation to the average state, fiscally weaker states receive top up funding from within the GST pool to bring them up to the fiscal capacity of the average of all states, rather than the fiscal capacity of the strongest state. The remainder of the GST pool is distributed on an EPC basis.

Analysis

Equalisation to the average state ensures that fiscally weaker states are able to deliver a reasonable standard of services but not, in the absence of imposing higher than average tax rates, a national average standard of services.

If equalisation to the average state had been applied in 2017-2018, fiscally weaker states would be placed in the position to deliver a standard of services of around three per cent less than the national average, without them imposing higher than national average tax rates.

For example, although the ACT would be the most adversely impacted by a switch to the average state model in 2017-18, it would still receive sufficient GST revenues to deliver 96.4 per cent of its assessed expenditure requirements.

Table A.1 – Impact of equalisation to the average state (2017-18)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Average state HFE ($m)	17,570	13,857	13,375	5,956	5,803	2,235	1,100	2,842
Current HFE ($m)	17,680	14,829	14,963	2,354	6,360	2,403	1,230	2,921
Change difference								
($m)	-110	-972	-1,588	3,602	-557	-168	-130	-79
($ per capita)	-14	-156	-321	1,343	-321	-321	-321	-321
Share of assessed expenditure in 2015-16 (%)	**-0.2%**	**-1.8%**	**-3.3%**	**13.4%**	**-3.3%**	**-3.1%**	**-3.6%**	**-1.7%**

When comparing the various alternative models for HFE (other than an EPC distribution), equalisation to the average state also minimises the impact of state policy decisions on the distribution of GST revenues. This is because a greater portion of the GST pool is distributed on an EPC basis compared to alternative models.

Evaluation against assessment criteria (compared to status quo)

Criterion	Assessment
Equity	**No change**. Allows the fiscally weakest states to still deliver services of a reasonable standard.
Efficiency	**Improved.** The marginal effects of tax or expenditure reforms on the distribution of GST for donor states are significantly reduced.
Simplicity	**Worse**. The model relies on the same CGC methodology, and adds an additional complication by equalising to the average fiscal capacity of all states. This makes it difficult to explain the operation of the HFE system, as the system moves states to a defined fiscal capacity, rather than a defined service level.
Accountability	**No change.** The model relies on the same institutional architecture.
Stability	**Improved.** Equalisation to the average state results in less volatile GST outcomes for individual states.

APPENDIX B – Equalisation to the second strongest state

Equalisation to the second strongest state would mean fiscally weaker states receive top up funding within the GST pool to bring them up to the fiscal capacity of the second strongest state (currently NSW). The remainder of the GST pool is then distributed on an EPC basis.

Analysis

Equalisation to the second strongest state ensures fiscally weaker states are able to deliver a reasonable standard of services but not, in the absence of imposing higher than average tax rates, a national average standard of services. It also means that the strongest state benefits from less equalisation, and is provided additional fiscal capacity to provide a greater standard of services compared to all other states.

If equalisation to the second strongest state had been applied in 2017-18, fiscally weaker states would be placed in a position to deliver a standard of services around 1.5 per cent less than the national average, without them imposing higher than national average tax rates.

Table A.2 – Impact of equalisation to the second strongest state (2017-18)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Second strongest state HFE ($m)	16,513	13,909	14,234	5,598	6,104	2,158	1,170	2,885
Current HFE ($m)	17,680	14,829	14,963	2,354	6,360	2,403	1,230	2,921
Change difference								
$m	-1,167	-920	-729	3,244	-256	-77	-60	-36
$ per capita	-147	-147	-147	1,210	-147	-147	-147	-147
Share of assessed expenditure in 2015-16 (%)	**-1.6%**	**-1.7%**	**-1.5%**	**12.1%**	**-1.5%**	**-1.4%**	**-1.6%**	**-0.8%**

Reducing the equalisation objective to the second strongest state confers an arbitrary advantage on the fiscally strongest state at any point in time. Importantly, equalisation to the second strongest states will result in the same outcomes as the CGC's current methodology where the second strongest and strongest states have similar fiscal capacities.

From an efficiency perspective, the perverse incentives created by the HFE methodology are diluted, but to a lesser extent than a model that equalises to the average state. A new perverse incentive is also introduced as the second strongest state has incentives to reduce its fiscal capacity, especially where the fiscal capacity of the second and third state are close (as has been the case for New South Wales and Victoria in the past).

Evaluation against assessment criteria (compared to status quo)

Criterion	Assessment
Equity	**Worse.** While still allowing fiscally weaker states to deliver services to a reasonable standard, it confers an arbitrary advantage on the strongest state and unfairly privileges those residents to the detriment of citizens across all other states.
Efficiency	**No change**. While compared with current HFE the incentives to pursue tax and expenditure reforms are improved, a new perverse incentive would be introduced for the second strongest state to game HFE.
Simplicity	**Worse**. The model relies on the same CGC methodology, and adds an additional complication by equalising to the second strongest state. This makes it difficult to explain the operation of the HFE system, as the system moves states to a defined fiscal capacity, rather than a defined service level.
Accountability	**No change**. The model relies on the same institutional architecture.
Stability	**Worse.** The equalisation to the second strongest state will result in increased volatility as the level of GST grants will be sensitive to both the fiscal circumstance of the second strongest state and the relative fiscal circumstances of the strongest and second strongest states.

APPENDIX C – Summary of New South Wales position

No.	PC Draft findings and recommendations	New South Wales position
Objective of HFE		
2.1F	While it has a number of strengths, there are also several deficiencies with the objective of Australia's horizontal fiscal equalisation (HFE) system. In particular, equalisation is always to the fiscally strongest State; it provides for limited consideration of efficiency; and it results in a complex system. The primary objective of the system may be better refocused to provide the States with the fiscal capacity to allow them to supply services and the associated infrastructure of a reasonable standard. This objective should be pursued to the greatest extent possible, provided that: • it does not unduly influence the States' own policies and choices beyond providing them with fiscal capacity • it does not unduly hinder efficient movement of capital and people between States • the process for determining the distribution of funds is transparent and based on reliable evidence.	**Strongly agree.** HFE reform is required to ensure states are not penalised for undertaking sound, fiscally responsible reform to drive economic growth, increased efficiency and productivity. Redefining the objective of HFE to achieve equalisation to a reasonable standard is a positive step towards a more balanced and appropriate distribution of the GST. Moving to a reasonable standard will also remove the false sense of precision that defines the CGC's current approach to HFE.
2.1R	The Commonwealth Government should clearly articulate the objective of HFE. This objective should aim for reasonable rather than full equalisation (as envisaged in draft finding 2.1). The objective should be established through a process led by the Commonwealth and involving consultation with the States, and should be reflected in the Intergovernmental Agreement on Federal Financial Relations. The objective should also be reflected in the terms of reference which the Commonwealth Government issues for the yearly update and five-yearly methodology review. The Commonwealth Grants Commission Act 1973 (Cwlth) should also be updated to reflect the adopted objective.	**Agree.** However, the states should have a leading role in recommending an articulated objective of HFE to the Commonwealth. This will better reflect the important role of the GST for states' budgets. The Board of Treasurers could provide an appropriate forum to lead this work.
HFE and equalisation		
3.1F	Australia achieves a high degree of horizontal fiscal equalisation and to a much greater extent than other countries.	**Agree.**

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8.1F	Fiscal equalisation to address disparities in the fiscal capacity of sub-central governments is common among OECD countries. But other countries' approaches to fiscal equalisation are inextricably linked to their unique institutional frameworks — this limits those schemes' applicability to Australia. Despite this, overseas experience provides lessons that can inform the elements of our system in order to better meet the objectives of our fiscal equalisation scheme. Australia is the only OECD country with a federal government that totally eliminates disparities in fiscal capacity between sub-central governments.	**Agree.**
HFE and state policies		
4.1F	For the most part, States considering tax reforms would generally not be deterred by the effects on GST redistribution. However, there are circumstances where the GST effects can be material — such as for a State undertaking large-scale tax reform — and act as a significant disincentive to States implementing efficient tax policy. These disincentives are likely to be exacerbated where the State is a first mover on reform or where there is uncertainty about how significant tax changes will be assessed by the CGC.	**Agree.** New South Wales has long argued that the HFE system creates disincentives for reform. HFE should not act to penalise states for pursuing good economic reforms. New South Wales also agrees that absence of evidence is not equivalent to evidence of absence, and considers the PC has adopted an appropriate methodological approach in this regard.
4.2F	Changes in State service delivery policies can impact on GST payments, but the impacts are mostly trivial. HFE is unlikely to discourage — nor encourage — States from pursuing growth strategies or addressing their structural disadvantages given the broader and more significant benefits of doing so to the community.	**Disagree.** New South Wales outlined in its first submission that expenditure assessments dull incentives for fiscally weaker states to reduce the cost of servicing disadvantaged communities.
4.3F	The potential for HFE to distort State policy is pronounced for mineral and energy resources. While there is no direct	**Agree.**

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	evidence that GST effects have influenced specific policy decisions, the incentive effects are large and have the potential to undermine State policy neutrality over time. However, making adjustments to the HFE system specifically to add incentives for resource exploration policies that are deemed to be desirable would be an intentional breach of policy neutrality and State autonomy; be a source of additional complexity; and come at the expense of equity.	
HFE and state budgets		
5.1F	Features of Australia's HFE system detract from its contemporaneity. While this works to smooth out changes in GST payments, it can exacerbate the fiscal impact of economic cycles when States experience large economic shocks. Such a situation has occurred in Western Australia in recent years. However, offsetting cyclical factors is not the primary objective of HFE, and alternative approaches do not offer unequivocal improvements. Reducing the length of the assessment period would have mixed impacts across States, and reducing the lag due to delayed data availability would introduce additional scope for dispute, volatility and the potential for unintended consequences.	**Agree.** New South Wales considers that the current three year assessment period with a two year lag strikes an appropriate balance between contemporaneity and budget stability.
5.2F	GST payments are less volatile than other major sources of State government revenue. While some States have reported difficulty forecasting GST payments, others consider GST payments to be no less unpredictable than other sources of revenue.	**Agree.**
HFE and migration		
6.1F	The redistribution that arises from Australia's system of HFE is small in magnitude relative to total government revenue for most States. As such, the GST distribution and net fiscal benefits are unlikely to be a significant driver of interstate movement of people.	**Agree.**
Methodological changes to the current system of HFE		
7.1F	Removing mining from the HFE process, or the use of a discount factor within the mining assessment, is inequitable and not justified. However, there is a need to consider	**Agree.** The PC should provide greater guidance on what potential

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	potential improvements in the assessment method in light of problems with policy neutrality.	improvements should be pursued to address policy neutrality concerns.
7.2F	The introduction of a minimum relativity floor would blunt extreme equalisation outcomes and might theoretically introduce greater incentives for States to pursue development opportunities. But a floor will likely prove a band-aid solution as it does not address the identified deficiencies of HFE, and may even introduce greater uncertainty and unpredictability into the HFE system.	**Agree.**
7.3F	The introduction of a broad indicators approach for assessing fiscal capacity could potentially deliver benefits in terms of simplicity, but would also have significant costs in terms of loss of accuracy, and may not achieve a 'reasonable' level of equalisation. The broader the indicators that are used, the more such risks may arise.	**Disagree.** New South Wales considers that the use of broad indicators (and associated risks) merits further consideration.
7.1R	The Commonwealth Government should direct the CGC, through the terms of reference it receives, to consider approaches to assessment that deliver significant simplification and 'good enough' equalisation outcomes. The use of more highly aggregated assessments should receive detailed consideration as part of the current CGC process.	**Agree.** However, it is important for states to have a role in this process. It is also important that robust governance arrangements are in place to ensure that simplicity is achieved and maintained over time. A simplification panel provides governments (and the CGC) an opportunity to step back and holistically assess the degree of complexity, and in turn, the level of precision needed to achieve a reasonable equalisation outcome.
7.4F	The use of externally defined benchmarks for efficient service delivery within the HFE process would encourage greater efficiency and reduce the potential for gaming the system. However, it faces daunting practical difficulties and involves a high degree of scope for dispute.	**Agree.**
7.2R	The Commonwealth needs to develop clear guidelines detailing the basis on which Commonwealth payments are to be quarantined from HFE by the Commonwealth Treasurer,	**Agree.** New South Wales considers that Commonwealth payments should

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	so that they do not unnecessarily erode the efficacy of the CGC's relativities. The guidelines should be based on the principle that quarantining of payments ought to occur only in exceptional circumstances.	be excluded from equalisation where they are distributed on a differential (needs) basis. This will retain the policy intent of the distribution of funds under tied grants, and support good enough equalisation outcomes more broadly.
Alternative approaches to HFE		
8.2F	An equal per capita approach to distributing GST revenue is incapable of equalising the fiscal capacities of States. This approach is thus inimical to achieving the core equity rationale underpinning horizontal fiscal equalisation.	**Strongly disagree.** An EPC model is the best way to achieve outcomes that are efficient, equitable, simple, transparent and predictable. It can also be easily replicated. Perverse incentives also are eliminated and unintended consequences avoided.
8.3F	An equal per capita with top-up funding approach would provide all States with the fiscal capacity to deliver a similar level of services. While this would meet the equity rationale underpinning horizontal fiscal equalisation, the top-up funding would always be hostage to fiscal constraints faced by the Commonwealth Government and, thus, this approach poses uncertainty for the fiscally weaker States. Such an approach should only be meaningfully considered as part of a broader reform of Commonwealth–State financial relations.	**Agree.**
8.4F	An actual per capita approach (which is similar to the current system except that it uses actual revenue and expenses rather than assessed revenue and expenses) would provide all States with the fiscal capacity to deliver a similar standard of services and, in doing so, would meet the equity rationale that underpins horizontal fiscal equalisation. However, this approach has significant risks for adverse efficiency effects (less incentive to contain costs and pursue efficient service provision) — and on those grounds is an unacceptable alternative to current arrangements.	**Agree.**

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8.5F	Equalisation can be designed to provide a spectrum of fiscal equalisation outcomes — for example, from equalising to the average fiscal capacity across the States up to equalising to that of the strongest State. The extent to which this approach would meet the equity rationale underpinning horizontal fiscal equalisation therefore depends on the level of equalisation this approach is intended to deliver.	**Agree.** The extent of equalisation is an important question that requires significant engagement by the states. The Board of Treasurers is the most appropriate forum to decide this question.
Institutional reforms		
9.1R	The CGC — through its Chairperson and Commission members — should provide a strong neutral voice in the public discussion on the HFE system. The CGC should also enhance its formal interactions with the State and Commonwealth Governments. In particular, it could provide draft rulings to State Governments on the potential HFE implications of a policy change.	**Agree.** However, on balance, this is a modest recommendation that fails to address the poor governance arrangements and accountability deficit that currently exists. The PC must consider the decision-making processes of the CGC, and its contribution to the existing flaws of the HFE system.
9.2R	The CGC should make the data provided by the States publicly available on its website, along with the CGC's calculations on these data. Where there are risks identified with this approach, mitigating steps should be identified and taken.	**Agree.**
9.3R	The Commonwealth and State Governments, through the Council on Federal Financial Relations, should develop a process that would work towards a longer term goal of reform to federal financial relations. In the first instance, it should assess how Commonwealth payments to the States — both general revenue assistance and payments for specific purposes — interact with each other today, given the significant reforms to payments for specific purposes that have occurred in recent years. The process should also work to a well-delineated division of responsibilities between the States and the Commonwealth, and establish clear lines and forms of accountability. Policies	**Agree.** A new approach to fiscal federalism is needed that better reflects the equal, sovereign role of states and the services they provide to improve the wellbeing of all Australians. New South Wales urges the PC to build on the conclusions it reached in its *Shifting the Dial* report, as part of the final HFE report, to lay out a path for fundamental reform

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	to address Indigenous disadvantage should be a priority in this regard.	to HFE and fiscal federalism more broadly.