

**Andrew Barr MLA**  
**Chief Minister**



Member for Kurrajong

Treasurer

Minister for Economic Development

Minister for Tourism and Major Events

10 NOV 2017

Ms Mary Cavar  
Assistant Commissioner  
Productivity Commission  
Melbourne Office  
Level 12  
530 Collins Street  
MELBOURNE VIC 3000

Dear Ms Cavar

The ACT Government is pleased to forward its submission to the Productivity Commission's (Commission) Draft Report on Horizontal Fiscal Equalisation (HFE) (Draft Report), dated October 2017.

The attached submission provides responses to all major findings and recommendations outlined in the Draft Report. It also responds to a number of information requests sought by the Commission.

The ACT supports many of the findings; however, it does not support the key recommendation that the Commonwealth Treasurer revise the objective of HFE from providing States and Territories (States) with the fiscal capacity to deliver the same level of services to providing States with the fiscal capacity to deliver a reasonable level of services. If implemented, the outcome of such a redefinition would be partial, rather than full, fiscal equalisation. The ACT considers that the Draft Report has not provided a clear policy rationale for this proposal.

I note the Commission is scheduled to release its Final Report on HFE to the Commonwealth Government in January 2018.

I again wish the Commission the very best in its endeavours in this critical area of national public policy.

Yours sincerely

Andrew Barr MLA

Chief Minister

**AUSTRALIAN CAPITAL TERRITORY LEGISLATIVE ASSEMBLY**

London Circuit, Canberra ACT 2601, Australia GPO Box 1020, Canberra ACT 2601, Australia  
Phone +61 2 6205 0011 Fax +61 2 6205 0157 Email barr@act.gov.au



@ABarrMLA



AndrewBarrMLA



andrewbarr



**ACT**  
Government

# **ACT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HORIZONTAL FISCAL EQUALISATION**

ACT GOVERNMENT  
SUBMISSION

NOVEMBER 2017

**THIS PAGE LEFT BLANK INTENTIONALLY**

# CONTENTS

1	Commentary.....	5
2	Summary.....	11
3	ACT Responses to the Productivity Commission's Findings, Recommendations and Information Requests .....	15
3.1	Objective of HFE.....	15
3.2	HFE and Equalisation .....	19
3.3	HFE and State Policies .....	22
3.4	HFE and State Budgets .....	29
3.5	HFE and Migration .....	32
3.6	Methodological changes to the current system of HFE .....	33
3.7	Alternative approaches to HFE .....	40
3.8	Institutional Reforms .....	48
4	Attachments .....	57

**THIS PAGE LEFT BLANK INTENTIONALLY**

## Commentary

The ACT welcomes the Productivity Commission's (Commission) *Draft Report on Horizontal Fiscal Equalisation* (HFE) (Draft Report) as a positive contribution to the national debate on Australia's system of HFE and the distribution of the Goods and Services Tax (GST). There are many pleasing aspects and others that cause concern.

Conceptually, the ACT concurs with 11 of the 17 findings while disagreeing with the other six to different degrees. Similarly, with regard to the Draft Report's recommendations, the ACT agrees with four of the six and disagrees with the remaining two.

- The recommendation to revise the equalisation objective from one that gives States and Territories ('States') the capacity to provide services to the same standard, to one that gives them the capacity to provide services to a reasonable standard equates to partial equalisation and is rejected outright by the ACT.

Otherwise, the ACT's view is that the Commission has correctly identified the fundamental issues and underlying strengths and weaknesses which underpin the unique nature of the Australian system of HFE.

It has done so by accurately documenting and accounting for the major changes over time that have occurred in this dynamic field of Commonwealth-State relations and importantly, correctly characterised the underlying federal financial relations framework which operates under the auspices of the *Intergovernmental Agreement on Federal Financial Relations* (IGA-FFR).

### ACT Support for Findings – HFE Principles

The findings clearly demonstrate that the current HFE formula to equalise States' revenue raising and service delivery capacities is not detrimental to national productivity. Similarly, the findings do not provide systemic evidence that Australia's approach to HFE is creating disincentives for reform, including reforms to enhance revenue raising capacities or drive efficiencies in spending. Rather, the findings suggest that while the potential for such disincentives might exist, this does not have a substantive impact on State government policy setting.

The ACT particularly welcomes several of the other findings which align with its long standing views expressed in submissions to the various reviews and inquiries conducted into the HFE system over the last decade namely:

- The basic premise of HFE - fiscal equity across the Commonwealth - has broad support across the nation.
  - The ACT would take this further - HFE as practised should be seen as a national asset that other federations might envy.

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

- Confirms no significant distortions to economic growth or net migration:
  - In effect, the report concludes the Commonwealth Grants Commission (CGC) formula does not restrict the appropriate movement of capital and labour across State borders to more productive regions during times of high labour demand.
- Identifies the ongoing need for a re-examination of the different underlying and structural characteristics of different revenue bases, noting energy and resources in particular, including the treatment of parties which restrict the development of energy resources:
  - These matters are already under investigation as part of the CGC's *2020 Methodology Review of GST Revenue Sharing Relativities* (2020 Review).
- Reinforces the ongoing need to revisit the HFE formula of rolling three year averages and the associated lag impact:
  - Again, under examination already as part of the 2020 Review.

Interestingly, the Draft Report also addresses a discrepancy in the actual Terms of Reference (ToR) provided to the Commission:

- The findings confirm that the present HFE formula, in its stated aim of comprehensively equalising States' fiscal capacities, does not place too great a reliance on broad indicators. Rather, the focus is on specific indicators which recognise States' different circumstances, the opposite to the concern apparently underlying this point in the ToR.

Many of these findings have been raised by the ACT in the past and have already been flagged for further consideration in the 2020 Review.

Ultimately, the Draft Report also did not come out in favour of adopting a number of contentious alternative methodologies proposed by some parties to the inquiry. While broad in nature, they are commonly offered up by some as a genuine way forward, but have been effectively dismissed in past reviews and again in this report, namely:

- Relativity floors; discounting mining assessments; application of broad indicators to revenue and expense assessments; equal per capita (EPC) distribution; EPC with 'top-up' funding; adoption of benchmark costs; treating Indigenous disadvantage differently; adoption of overseas models; removal of cost equalisation; and actual per capita (gap) distribution.

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

The ACT takes particular comfort from the report's emphasis on removing any perceived disincentives for development and taxation of mineral and energy resources and for State tax reform, with the latter of particular interest to this jurisdiction. However, the flexibility to address these concerns is already present in the current system – as can be seen from proposals and other work now being undertaken by the CGC as part of its five year rolling methodology review.

The fact that these issues are under consideration in the course of the 2020 Review should not and must not be construed as somehow reflecting a weakness in the current HFE system. Indeed, the normal cycle of review was interrupted by the *2012 GST Distribution Review* followed by an eighteen month restricted *2015 Methodology Review of GST Revenue Sharing Relativities* which one could argue has prevented earlier and timely consideration of some of the issues as they developed.

The real underlying story, in the ACT's view, is one of a system that is clearly flexible in character and which, via the administration of a professional independent body in the form of the CGC, has engendered a framework that has proven responsive to changing economic circumstances in its many forms including past extraordinary circumstances.

Indeed, from an ACT perspective, a system that has successfully overseen the two territories transitioning into the federation as fully independent financial members, despite very significant challenges in their revenue raising capacities and service delivery needs, has proven its flexibility and ability to accommodate extreme outliers to the mainstream States. The common basis for integration rested on the notion of providing each with the same fiscal capacity of the collective.

Importantly, the ACT also welcomes the Draft Report's focus on addressing a number of underlying myths that have been allowed to persist and become entrenched in the national discussion in more recent times, to the detriment of the credibility of the system and to public understanding of its objectives and operation.

In particular, the ACT notes the commentary contained in the footnote on page 33:

- *"Note that a relativity refers to a State's share of the total GST pool relative to its share of the national population. Discussions of HFE frequently (and erroneously) refer to a relativity as the share of GST 'returned' to a State compared to the amount that was 'collected' or 'generated' by, or in, that State; however, this is not a component of the GST distribution, and in many cases is not measurable".*



## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

This confirms that the amount of GST raised in a State in a financial year is not currently measurable as it is a national tax without borders. Any attempt to rationalise both what is raised and returned to any one particular jurisdiction is therefore factually incorrect. In our view this clarification should be given more prominence in the final report.

The Draft Report also clearly highlights administrative shortcomings in the supporting governance and protocol guidelines underpinning the system which has exacerbated the lack of understanding of the system endemic in the national debate.

The ACT would also welcome further comment in the Commission's final report on these shortcomings including specific recommendations on how they can be addressed in a tangible manner, building on the earlier recommendations outlined in the *GST Distribution Review Report* (2012) by Messrs Greiner, Brumby and Carter.

### ACT Disagreement with Findings - HFE Objective

The ACT disagrees with the key finding which portrays the current system as generating an excessive level of equalisation when compared to other OECD countries, and with a seemingly excessive and layered complexity such that few parties understand the basis of the system. While concluding that Australia's HFE system results in a high degree of equalisation compared to other countries, it then contends that the system goes too far, creating significant weaknesses. The Draft Report does not provide evidence in support of this conclusion. The purported need to revise the current objective for HFE - one of providing States with the fiscal capacity to provide the *same level of service* to one premised on *a reasonable level of service* is illogical. There is no clear rationale offered or suggested for a move that would see the objective of HFE moving to partial equalisation. In particular, no argument has been offered to support a proposition that any likely alternative outcome would be in the best interests of the nine jurisdictions comprising the federation.

This finding appears to be motivated by a perception that HFE as currently practised is under significant strain and must be changed because one particular jurisdiction's share of GST has fallen to an extreme low. In effect, what the proposed revised objective of HFE implies is a redistribution of funds from the less wealthy jurisdictions to the wealthiest jurisdiction in the nation, and moreover a jurisdiction which is likely to continue to hold that position by a considerable margin for the foreseeable future.

Although the Commission appears to have considered this proposed change as a short term fix to an immediate problem, it represents a fundamental change to the equalisation system which would, in practice, entrench a specially advantaged position for one jurisdiction, allowing it to build up over time the capacity to provide higher and higher levels of service and lower and lower levels of taxation to its residents compared with all other jurisdictions. The consequences of this situation for the integrity and credibility of federal financial relations in the longer term need to be carefully considered by the Commission.

### ACT Disagreement with Findings – Simplification

The Draft Report finding in favour of simplifying the HFE process is not new and is one the current Commonwealth Grants Commission has prioritised as an objective of the 2020 Review of GST methodology.

It has been an objective for many years but, given the zero sum nature of the GST distribution, States and Territories themselves have often sought greater complexity in order to capture their special circumstances. Hence, simpler is not necessarily better. That said, the system has in many respects been simplified in recent years in any case, for example in the reduction of assessment categories which occurred at the time of the 2010 Methodology Review.

### ACT Support for Findings – Other

The final key point the ACT has taken from the report is the contention that ultimately, greater benefits will only come from more fundamental reforms to Australia's federal financial relations, in particular to spending and revenue raising responsibilities and accountabilities. The ACT remains committed to reform discussions along these lines and has been an active participant in previous reviews which have had that objective, most recently the Federation White Paper process of 2014 to 2016.

Unfortunately in one sense, the national policy debate has now switched to the much narrower issue of GST sharing arrangements as a means of deflecting national debate on the wider reform objectives.

### A Way Forward

It is apparent to the ACT from reported public comments of State and Territory leaders that a significant majority do not support the key finding in the draft report which, if implemented, would change the current objective of HFE.

Given this broadly shared view, it is incumbent on the Commission to re-evaluate this key finding. In that context, the ACT contends there are a number of initiatives outlined in the recently released CGC paper titled CGC Position Paper CGC 2017-21 titled "The Principle of HFE and its Implementation" which should be reviewed by the Commission.

Two key proposals from the CGC offer an effective means of addressing the concerns which appear to have motivated the recommendation for change to the objective of HFE:

- Allowing States to retain at least half of any additional revenues generated through a change in mineral royalty rates.

## **ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE**

- Changing the length of the assessment period from three to one or two years in order to improve the contemporaneity of the HFE system.

At a broader level, however, by its very nature, the GST pool itself should not be used by the Commonwealth as a vehicle to address the special fiscal circumstances faced by WA. There are a number of levers open to the Commonwealth to assist that state as it transitions from an unprecedented boom to a more sustained position of relative advantage.

The Commonwealth, for its part, could revisit the distribution of revenues from offshore petroleum (oil and gas) royalty revenue with a view to increasing the shares received by the States and Territories which have facilitated these developments.

As expressed by some parties to the review and in response to the Commission's main findings, it also remains open to the Commonwealth to continue to provide top-up funding to WA in the form of infrastructure grants or similar if the Commonwealth believes such assistance is warranted. This would be similar in intent to the structural assistance grants afforded to South Australia (SA), and Victoria (VIC) in recent times or New South Wales (NSW) in the past for industry restructure.

Finally, the Commission can elevate its findings and recommendations for improving the institutional arrangements underpinning Australia's HFE system in its final report, which would be of immense benefit to the national debate.

## Summary

The objective and consequential definition of HFE remains clear to the ACT and is reflected in the ACT's responses in this submission. It can be summarised in the statement that the GST should be distributed in accordance with the 'principle of HFE' as clearly understood and accepted by all governments when they signed the IGA-FFR.

- The Draft Report does not present a compelling case for diluting the present emphasis on fully equalising the fiscal capacities of States. The Report itself acknowledges that HFE as it stands has had little or no adverse impact on economic growth and productivity.

The proposed redefinition of the objective of HFE to provide States with the fiscal capacity to provide a 'reasonable' level of services rather than the 'same' level of services has been given no substantive justification other than to reduce the redistribution of GST to favour a particular jurisdiction. Therefore, the ACT stands by the position that HFE must seek to deliver as close as it can to 'full', not 'partial', equalisation and that to give States the same fiscal capacity is not an undeliverable ideal. Equalisation to the level of the second strongest State as an alternative to the current HFE system would exacerbate differences in fiscal capacity between the States and thus be likely to increase disparities in the provision of State government services. This cannot be justified as a pathway to reform.

That said, the ACT is currently investigating possible adjustments to the supporting principles underpinning HFE, with the most notable relating to the policy neutrality principle along with all other jurisdictions as part of the 2020 Review program, including:

- Limiting the extent to which discretionary changes in tax or royalty rates by States affect their GST share, by ensuring States retain at least half of the own source revenue effects of such a change.
- Ensuring that assessments do not unduly penalise or reward States which, in similar circumstances, adopt very different policies towards potential mineral and energy developments (for example, coal seam gas production).
- For revenue assessments generally, aiming to minimise, to the extent practicable, tax reform disincentives arising from the effects on tax bases (elasticity effects) of tax policy choices.

The other key area where the ACT considers that change is warranted relates to the application of the contemporaneity principle and whether the size or currency of the three year assessment window should be changed - should it comprise one, two or three years, and should it be moved forward to include the year immediately preceding the application year. Unlike the Draft Report which favours retaining the system of lagged indicators, the ACT contends there is scope for an alternative approach, which was highlighted in its earlier submission.

## **ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE**

These adjustments have already been flagged by the CGC for consideration. The ACT's goal for the 2020 CGC review is to have these matters adequately addressed while at the same time recognising they will go some way to addressing a number of the perceived weaknesses of the current system including the so called outlier situations, as the system has done in the past.

Finally, the ACT considers that advance calls for the Commission to address a possible transitional timeframe that gives all states and territories time to adjust to any departure from the existing definition of HFE – embodying a winner/loser guarantee mentality – is premature.

A summary of the ACT's responses to the key findings, recommendations and information requests is given in the following tables and addressed in the accompanying chapters.

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

### Summary of the ACT's Response to the Commission's Draft Findings

Srl No	Finding No	Area	ACT's Position	Comments
1	Finding 2.1	Objective of HFE	Part disagree	Disagreement on the level of equalization, there is no ground for reasonable equalization.
2	Finding 3.1	HFE and Equalisation	Part disagree	The ACT considers degree of HFE achieved in Australia to be a positive, not deficiency.
3	Finding 8.1	HFE and Equalisation	Part disagree	The ACT does not consider that the HFE system in Australia totally eliminates fiscal disparity among States
4	Finding 4.1	HFE and State Policies	Agree	-
5	Finding 4.2	HFE and State Policies	Agree	-
6	Finding 4.3	HFE and State Policies	Agree	-
7	Finding 5.1	HFE and State Budgets	Part disagree	Disagreement that reduction of the lag in assessment will lead to disputes and potential for unintended consequences.
8	Finding 5.2	HFE and State Budgets	Agree	-
9	Finding 6.1	HFE and Migration	Agree	-
10	Finding 7.1	Methodological changes to the current system of HFE	Agree	With the caveat that the ACT supports the CGC proposal of discounting 50% of any royalty increases in mining from equalisation.
11	Finding 7.2	Methodological changes to the current system of HFE	Agree	-
12	Finding 7.3	Methodological changes to the current system of HFE	Agree	-
13	Finding 7.4	Methodological changes to the current system of HFE	Part disagree	Disagreement since the ACT does not consider that the current approach of using internal standards incentivises technical inefficiency in service delivery. It also considers gaming potential on the expenditure side to be low.
14	Finding 8.2	Alternative approaches to HFE	Agree	-
15	Finding 8.3	Alternative approaches to HFE	Agree	-
16	Finding 8.4	Alternative approaches to HFE	Agree	-
17	Finding 8.5	Alternative approaches to HFE	Part disagree	Disagreement on PC's proposal on the level of fiscal equalisation

### Summary of the ACT's Response to the Commission's Draft Recommendations (all draft ones)

Srl No	Recommendation No	Area	ACT's Position	Comments
1	Recommendation 2.1	Objective of HFE	Part disagree	Disagreement on the objective of HFE being reasonable or good enough equalisation.
2	Recommendation 7.1	Methodological changes to the current system of HFE	Part disagree	Disagreement on the objective of HFE being reasonable or good enough equalisation.
3	Recommendation 7.2	Methodological changes to the current system of HFE	Agree	The ACT proposes to <b>extend</b> the recommendation to the quarantining of infrastructure payments from full equalisation.
4	Recommendation 9.1	Institutional Reforms	Agree	The ACT requests the Commission to split the recommendation to three separate ones as they warrant individual attention.
5	Recommendation 9.2	Institutional Reforms	Agree	-
6	Recommendation 9.3	Institutional Reforms	Agree	-

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

### Summary of the ACT's Response to the Commission's Information Requests

Srl No	Request for	Area	ACT's Response	Comments
1	Scenarios for cameos	HFE and State Policies	Suggestion given	-
2	Views on simple cost benchmark for expense equalisation	Methodological changes to the current system of HFE	Views shared	-
3	Information and views on changes to methodology	Methodological changes to the current system of HFE	Views shared	The ACT does not support the revised objective of HFE but is open to exploration of simplification options.
4	Views on quarantining of Commonwealth payments	Methodological changes to the current system of HFE -	Views shared	-
5	Views on levels of fiscal equalisation	Alternative approaches to HFE	Idea rejected	The ACT emphatically rejects any option purporting reasonable equalisation.
6	Views on transition to new approach	Alternative approaches to HFE	Views shared	-

## ACT Responses to the Productivity Commission's Findings, Recommendations and Information Requests

### 1.1 Objective of HFE

#### 1.1.1 The Productivity Commission's Perspective

The draft Report states that the primary rationale for HFE is fiscal equity, with the current objective as interpreted by the CGC to equalise States' fiscal capacity to the *same* standard. It notes that in practice this involves raising States' fiscal capacity to that of the strongest State (currently Western Australia).

The report goes on to claim that the current objective and practice of HFE are problematic, on four grounds:

- the size of the task, and potential volatility of the standard at times of major cyclical and structural change;
- the failure to substantively consider efficiency effects;
- the complexity of the system; and
- the lack of Commonwealth Government leadership in the interpretation and practice of HFE.

The report proposes equalisation of States' fiscal capacity to a lesser standard of "reasonable" rather than "same". It states that this would provide greater flexibility than the current approach, by allowing for:

- consideration of broader objectives, particularly efficiency, as well as the risk associated with complexity and poor data; and
- recognition of States' different circumstances, and particularly whether the strongest State provides the best benchmark.



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.

DRAFT RECOMMENDATION 2.1

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.

## ACT Response

The grounds for the Commission's proposed change to equalisation to the level of the second strongest State, or alternatively to the average of all States, are not clearly stated or justified.

Although there is a contention that the current approach is deficient because of its failure to substantively consider efficiency effects, the Commission has established elsewhere in the report that the economic efficiency impacts of the HFE system are small, if not negligible. The ACT agrees with that view, as the available evidence clearly establishes that there is, at worst, a minor negative impact and, at best, a minor positive impact of HFE on economic efficiency.

However, the Commission has also highlighted in Chapter 4 the potential for adverse economic efficiency impacts *at the margin*, in relation to State decision-making about tax reform and mineral development. The ACT supports that view and hence has advocated for the adoption of elasticity adjustments in relation to tax reform, and for a more equitable approach to State decisions on mineral and energy development and taxation. These changes can be comfortably accommodated within the present equalisation framework, and it is our contention that that is the most efficient and fairest way of dealing with these issues.

It is true that the current approach is complex, but the Commission does not make clear why that is intrinsically a problem. The proposal to equalise to a different standard does not, of itself, alter the complexity of the system. In isolation, that change would not require the CGC to do anything other than maintain what it already does and simply alter the final calculation of GST requirements, with those results representing just the final stage in a long and complex process of data collection and analysis. Further, the ACT considers that the level of complexity is appropriate given the complexity of the task of achieving fiscal equity (whether to the same or a reasonable standard).

Although it can fairly be asserted that there has been, in recent times, a lack of Commonwealth leadership in promoting the benefits of the equalisation system and raising understanding of how it operates, that in itself does not invalidate the system. Stronger leadership and advocacy of the equalisation system is what is required to address that problem. Further to such a move, the ACT supports the Commission's recommendations that:

- the Commonwealth Government should clearly articulate the objective of HFE;
- the objective should be established through a process led by the Commonwealth in consultation with the States and reflected in the IGA-FFR; and
- the objective should be reflected both in the relevant legislation and in the terms of reference for CGC Updates and Reviews.

Indeed, these recommendations are in line with those of Chapter 4 of the Final Report of the GST Distribution Review of 2011-12, for which the ACT has strongly advocated since they were first made.

This leaves what appears to be the main thrust of the Commission's recommendation to alter the equity objective to the achievement of a reasonable rather than same standard of equalisation among States. The key driver is what might be called the "outlier problem" and the associated heavy task of redistribution required of the GST.

It appears that a major concern of the Commission is the degree to which WA has been, in recent years, a very substantial outlier in its capacity compared with other States. This has seen a concomitant increase in the size of the redistribution task as a proportion of the GST revenue pool. This is illustrated by charts such as Figure 2.2, showing the large increase in the standard deviation of assessed revenue per capita over the period of the mining boom.

The ACT notes that although WA has become an outlier in its overall fiscal capacity compared to other States due to the enormous growth in its revenue raising capacity over the last decade or so, it is not accurate to analyse the situation from the revenue perspective only. Ultimately, State expenses also play a significant role in the equalisation process. It is critical to note that WA also has higher than average expenses in comparison to other States, offsetting some of its higher than average revenue-raising capacity. Of course, the Northern Territory (NT) has the highest per capita expenses among all States but the combined picture of per capita revenue-raising capacity and per capita expenses does not make WA as much of an outlier as it is purported to be, if it is solely the State's revenue-raising capacity which is taken into account.

It is true that the fiscal strength of the WA economy relative to those of other States in recent times is unprecedented. The mining boom generated a huge expansion (around sevenfold) in the royalty revenues earned by the State government, as well as an extremely high rate of population growth. These factors created both great opportunities and strong spending pressures for the State government. Further complications arose from the volatility of world commodity prices, particularly iron ore, creating major challenges in budgetary management for the State.

However, these challenges were not created by the GST distribution system. The key problem caused by this system was its pro-cyclical impact, the result of the lagged method of changes to States' circumstances being reflected in their GST entitlements sometime after those changes had actually occurred. Thus, instead of offsetting both the rise in iron ore prices and their subsequent fall, the system reinforced those trends and made them far worse. However, the Commission's report gives insufficient attention to this issue and has made no recommendation on improving the contemporaneity of the system. By contrast, the ACT addressed this in its initial submission to the inquiry, and considers that the Commission should re-examine this and other proposals to improve the contemporaneity of the system before producing its final report.

Consideration should also be given to the longer term outlook for the equalisation task. The situation of WA in recent years, and for the foreseeable future, comprises both cyclical and structural elements. Although the mining boom has passed, WA has undergone a fundamental change in relative position among the States, and there is every reason to believe that it will continue to be the fiscally strongest State by a wide margin. WA's own Budget documents support that view, with their estimated GST relativity rising only to around 0.62 by 2020-21, with the appearance of a plateau somewhere between 0.6 and 0.7 (see **Attachment A: Outlook for WA's Relativity**). The question for the longer term then is whether such a relativity constitutes too great an outlier and imposes too great a redistribution burden on the equalisation system. There does not seem to be strong evidence for these propositions.

The long-term maintenance of equalisation to a standard below that of the strongest State would leave WA with substantial unequalised capacity, building up over time, and giving it a far stronger capacity to deliver better services and/or lower taxes for its residents than those of other States. It is questionable whether that is a desirable outcome, or whether the resources of the Federation should be allocated to achieve a more equitable result.

As it currently stands (based on 2017-18 data), equalisation to the level of the second strongest State would mean a 15% reduction in the level of equalisation, while equalisation to the average would mean a 32% reduction in the level of equalisation. Those numbers would be felt directly in lower standards of service for residents of the fiscally weaker States. Therefore, the ACT contends that “good enough” is not good enough, and that equalisation to the same standard should be maintained.

## 1.2 HFE and Equalisation

### 1.2.1 The Productivity Commission's Perspective

Chapter 8 of the Commission's Draft Report performs a comparative analysis of Australia's system of HFE against the HFE systems of other countries with both federal and unitary central governments. The Commission compares HFE systems across countries on the type of equalisation (cost equalisation vs revenue equalisation), the mechanism of equalisation (horizontal equalisation, or transfers between sub-national governments, vs vertical equalisation, or transfers from the national government to sub-national governments) and the extent to which sub-national governments are equalised.

The Draft Report finds that in comparison to other countries, Australia's HFE system is balanced between cost and revenue equalisation and is heavily reliant on vertical transfers from the Commonwealth Government to the State governments. The Draft Report's findings conclude that Australia's HFE system results in a high degree of equalisation compared to other countries.

#### DRAFT FINDING 3.1

Australia achieves a high degree of horizontal fiscal equalisation and to a much greater extent than other countries.

#### DRAFT FINDING 8.1

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.

## ACT Response

### Level of Equalisation

The ACT notes the Commission's finding that Australia's system of HFE achieves a greater level of equalisation than comparable schemes in other countries. The ACT broadly supports the findings of the Commission in this area, but differs from the Commission both in its interpretation of these findings and some specific elements of the findings.

In its Draft Report, the Commission identifies Australia's high level of equalisation as a potential weakness in Australia's HFE system, arguing that the high level of equalisation from Australia's HFE system can place excessive burdens on individual States in circumstances where one or more States have much higher fiscal strength than the remaining States, such as is the case at present with WA. The Commission notes in its Draft Report:

*"Equalisation is taken too far: equalising comprehensively and to the fiscally strongest State means that when there is an outlier, the redistribution task is considerable and the standard being equalised to is potentially volatile"*

- Draft Report on Horizontal Fiscal Equalisation, Productivity Commission, 2017, p. 16.

The ACT does acknowledge that in extreme circumstances, the comprehensive equalisation of Australia's HFE system can pose a significant burden on individual States. At the same time, the ACT considers that the problems with extreme outliers can be addressed through adjustments to the current HFE system to improve contemporaneity. Further, it is the ACT's view that addressing such concerns does not require a restructure of the HFE system to reduce the overall level of equalisation. Contrary to the position of the Commission, the ACT considers the high degree of equalisation achieved in Australia to be a positive feature of its HFE system, not a deficiency. Full equalisation maximises the achievement of fiscal equity and ensures that all State governments have the capacity to provide an equal quantity of services of equal quality to any other jurisdiction. As noted in the ACT's previous submission:

*"Despite shortcomings such as a high degree of complexity, the Australia system has become the model for an ideal equalisation system. The basic approach is sound, complete, feasible, and reasonably transparent...the unique benchmark against which all equalisation mechanisms have to be compared in terms of their vulnerability to manipulation and perverse incentives."*

*Equity and Efficiency Aspects of Interagency Transfers in a Multigovernment Framework, Spahn, 2007, p. 93.*

By definition, any proposed movement from full equalisation to partial equalisation necessitates that weaker States reduce their level of services, or alternatively increase their own-source taxes, so that greater fiscal transfers can be given to the fiscally stronger States (i.e. the States with the greatest capacity to provide their citizens with services).

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

This inherently compromises the fundamental objective of fiscal equity. It is the view of the ACT that the Commission's Draft Report has not provided a convincing rationale for why the fiscally weakest States should be made worse off for the benefit of the fiscally strongest. Further elaboration on this point can be found in section 3.7.

Further to this, the ACT disagrees with the Commission's assessment that Australia's HFE system totally eliminates disparities in fiscal capacity between the States. As the Commission itself notes in its Draft Report, the Commonwealth Government routinely quarantines a portion of payments it makes to the States from the equalisation process in its Terms of Reference to the CGC:

*"In 2013-14, approximately 3 per cent (\$1.6 billion) of Commonwealth payments for specific purposes were quarantined (by the Commonwealth Treasurer) based on terms of reference requirements"*

- *Draft Report on Horizontal Fiscal Equalisation, Productivity Commission, 2017, p. 79.*

Further, the CGC's equalisation process itself, due to either choice by the CGC or as a consequence of a lack of data availability, incorporates methodologies that reduce the number of factors that influence the distribution of GST and therefore the level of equalisation. Examples of such methodologies include the use of materiality thresholds, the discounting of revenues and expenditures and the exclusion of revenue sources such as gambling from differential assessments. All of these factors necessarily mean that the level of equalisation in Australia's HFE system is not complete, as not all revenues and expenses are accounted for in the CGC's calculation of the State GST relativities. Therefore, Australia's HFE system as it currently operates cannot totally eliminate disparities in fiscal capacity between the States.

### How Funds are Actually Used

Box 3.4 of the Draft Report (p.90) notes that some participants to the Commission's inquiry have interpreted low actual to assessed expense ratios for some States in some categories as GST revenue "not being used by States in a way that improves services or State structural disadvantage". Great care needs to be taken in drawing such conclusions, as highlighted by the CGC in one of its recent research papers (*What States Do*) associated with the 2020 Methodology Review:

*"Differences between actual and assessed expenses can be due to: State policies; efficiency with which the service is provided; disabilities not assessed (either because they could not be reliably measured or because they were not material); lack of reliability of the data; discounting applied to some influences when there was uncertainty surrounding the results."*

Low actual to assessed ratios may in some cases reflect more efficient use of funds by a State, rather than a lower standard of service.

In other cases there are significant differences in State policies which make comparison of actual expenses questionable. For example, in relation to the low level of actual spending for services to communities in Tasmania, the State provided very limited subsidies for water and electricity to its consumers. This may reflect better and more economically efficient policy than States with higher actual expenses.

Moreover, States having a low actual to assessed expense ratio in one category may have a much higher ratio in some other category, indicating legitimate State policy choice. In the case of Tasmania, its actual to assessed expense ratio for services to industry was 151.0 in the 2017 Update, which may indicate a deliberate decision to spend more funds in that sector. Alternatively, it may reflect differences between States in the accuracy of classification and reporting of expenditure data. Thus, the ACT contends that it is not accurate to look at actual to assessed ratios in a selective manner to arrive at generalised conclusions about a State's service level.

### 1.3 HFE and State Policies

#### 1.3.1 The Productivity Commission's Perspective

Chapter 4 of the Commission's Draft Report considers the views presented in the submissions it had received and undertakes a numerical analysis of the impact of Australia's HFE system on State economic and taxation policy. Section 4.1 considers HFE's impact on State taxation policy as a result of reforms in State tax policy causing changes to either the national average tax rate for a given tax base or to the value of the underlying tax base. Section 4.2 considers HFE's impact on efficiency in State service delivery and possible incentive effects with regard to pursuing economic development and addressing structural disadvantage. Section 4.3 considers possible incentive effects created by HFE with regard to mineral and energy resource development.

On the basis of the Commission's literature review and analysis, the Draft Report finds that Australia's system of HFE generally does not disincentivise State tax reform, though disincentives may exist for first movers on tax reform or in circumstances of uncertainty on the CGC's treatment of tax reform. Likewise, the Commission finds that Australia's HFE system does not incentivise nor disincentivise State policies for addressing structural disadvantage. The Commission did however find that while there is no direct evidence of HFE influencing State policy with regard to mineral and energy resource development, the potential incentive effects are significant and should be addressed. The Commission requests suggestions for further modelling exercises ("cameos") that may assist its understanding of possible incentive effects of Australia's HFE system on State tax reforms.

DRAFT FINDING 4.1

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.

INFORMATION REQUEST

*What further 'cameos' would usefully illustrate how particular State reforms can influence GST shares?*

**ACT Response**

The ACT agrees with the Commission's contention that States considering tax reforms would generally not be deterred by the impacts of such reforms on the distribution of the GST. Likewise, the ACT also agrees that there are nevertheless some circumstances in which the distribution of the GST may be materially affected by State tax reforms and in such circumstances, States may be disincentivised from participating in reform.

The ACT reiterates the distinction between first order and second order GST distribution effects as presented in the ACT's initial submission. As defined in the ACT's initial submission, first order GST distribution effects are impacts to a State's assessed fiscal capacity from a change in State taxation or economic policy that do not result from changes in an underlying cost or revenue base. Conversely, second order GST distribution effects are impacts to a State's assessed fiscal capacity that do result from changes to an underlying cost or revenue base.

As presented in the ACT's initial submission, the 2012 GST Distribution Review found that, in regards to first order effects, while there may be theoretical incentives and disincentives posed by such effects, there is no definitive evidence of HFE directly exerting influence on State economic and taxation reform decisions in practice (Greiner, Brumby and Carter, 2012.). This position largely corroborates the Commission's findings in the Draft Report:

*"The current system creates perverse theoretical incentives in some instances, but there is little evidence that they have any effect in the real world. In particular, there is no evidence that HFE acts as a material disincentive to State tax reform."*

- GST Distribution Review Final Report, Greiner, Brumby and Carter, 2012, p. 140.

The ACT reiterates its position on incentives created by Australia's HFE system expressed in its initial submission that second order effects are of greater concern and should be addressed.



As stated in the ACT's initial submission, States are incentivised to avoid taxing bases with low levels of elasticity in favour of taxing bases with high levels of elasticity in the absence of an adjustment to factor in the impact of tax policy on the size of underlying tax bases. The ACT notes that the Commission's Draft Report alludes to the ACT's position:

*"There have been several attempts to calculate the impact that a change in State tax rates would have on a State's GST payments (box 4.3). Past research has found that the effects due to changes in average tax rates are mostly small, with the elasticity effects being larger. These findings are generally consistent with the Productivity Commission's estimates of small average-rate effects for most selected tax types (table 4.1; appendix C)."*

- *Draft Report on Horizontal Fiscal Equalisation, Productivity Commission, 2017, p. 95.*

The ACT reaffirms its support for a reinstatement of elasticity adjustments to account for the impact of tax reform on underlying tax bases as stated in the ACT's initial submission. The ACT also notes that the CGC appears notionally interested in reinstating such adjustments as part of the 2020 Review, having commissioned a consultancy with the Australian National University's Tax and Transfer Policy Institute on the impact of tax elasticity on State revenue bases. The ACT recommends that the Commission consult with the CGC on this matter.

### DRAFT FINDING 4.2

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.

### 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.

## ACT Response

The ACT supports the Commission's above findings. As referenced in the ACT's initial submission, the ACT acknowledges the potential for Australia's HFE system to create disincentives for States pursuing economic development, however the ACT considers that these incentive effects are likely to be small and therefore not a substantial influence on State policy decisions.

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

This is on the basis that the quantum of possible GST redistribution from adjustments to the HFE system to account for second order effects of State policies that improve economic growth is quite small and thus not likely to cause a substantial shift in the distribution of the GST:

*"Although business development expenses are currently assessed equal per capita by the CGC, the relatively small size of this expenditure category suggests that even a substantial differential assessment of need between States would not have a significant effect on the overall distribution of the GST."*

- *Submission to the Productivity Commission Inquiry into Horizontal Fiscal Equalisation, ACT Government, 2017, p. 31.*

The ACT also maintains that impacts of a given State policy proposal on the GST distribution is only one possible consideration when State policymakers design and implement new policies. Other factors, such as community benefits of economic growth and social justice are likely to outweigh GST distribution effects when deciding whether to implement a given proposed policy.

Further, the ACT's position on HFE's incentive effects on addressing structural disadvantage is also consistent with the Commission's finding that there is limited scope for such factors to have a significant influence on State policy decisions:

*"There is no compelling evidence that Australia's HFE system is likely to systematically bias States towards providing services in a particular way, or towards particular policies aimed at growing their economies or addressing structural disadvantages."*

- *Draft Report on Horizontal Fiscal Equalisation, Productivity Commission, 2017, p. 106.*

The ACT notes that the Commission's basis for their finding is that effects on the GST distribution of any given State policy is only one possible consideration during the policy making process and therefore State policy behaviour cannot be conclusively linked to Australia's HFE system. This rationale aligns very closely with the ACT's position.

With regard to the incentive effects of Australia's HFE system on State royalty policies, the ACT noted in its response to the CGC Staff Discussion Paper CGC 2017-02-S, titled *"The Principle of HFE and its Implementation"*, that under the current assessment approach, States that are dominant producers of particular mineral and energy resources are incentivised through Australia's HFE system to lower their royalty rates on these resources, or avoid raising them, if they were otherwise considering changes to their royalty regimes.

This position is supported by ACT modelling (refer to **Attachment B**) done in response to a proposed methodology change in CGC Commission Position Paper CGC 2017-21, titled *"The Principle of HFE and its Implementation"*.

The CGC has proposed to discount additional revenue generated through changes in tax rates by 50 per cent, so to reduce the possibility of disincentive effects arising from the redistribution of additional revenues through the GST distribution:

*“For the 2020 Review, the Commission considers that its methods should ensure each State retains, after equalisation, at least half of the own-source revenue effects of the discretionary policy changes that it makes. This will ensure that for any discretionary rate change, no more than half of the changed revenue will be affected by the equalisation process, thereby removing the potential for cases to arise where the equalisation effects outweigh the effects of discretionary policy change.”*

- *CGC Commission Position Paper CGC 2017-21, The Principle of HFE and its Implementation, CGC, 2017, p. 26.*

The ACT modelled the impact on the GST distribution if the State with the greatest share of the national tax base and the State with the lowest share of the national tax base increased their royalty rates by one percentage point for coal and gold. In the case of coal, the State with the greatest share of the national tax base is Queensland (57.07 per cent) and the State with the lowest share (that still has production) is Tasmania (0.09 per cent). In the case of gold, the State with the greatest share is Western Australia (69.57 per cent) and the State with the lowest share is Tasmania (0.54 per cent).

For context, coal is the second greatest source of mining royalties, with total coal royalties generated by the States in 2013-14 amounting to \$3.213 billion, and gold is the third greatest source, with total gold royalties generated by the States in 2013-14 amounting to \$326 million (2015 Review, CGC, 2015, p. 108.).

The ACT's modelling shows that if Queensland increased its effective coal royalty rate by one percentage point from 8.021 per cent to 9.021 per cent, it would see a reduction in its GST distribution from coal royalties of \$84.7 million, from -\$1.1915 billion to -\$1.276 billion. This amounts to a per capita loss of GST of \$17.14, offsetting a gross revenue gain of \$46.28 per capita, giving a net gain of \$29.14 per capita, or about 63% of the gross revenue.

Conversely, the ACT estimates that if Tasmania increased its effective coal royalty rate by one percentage point from 9.45 per cent to 10.45 per cent, Tasmania would gain an additional \$7,000 in GST; from \$65.307 million to \$65.315 million. This amounts to a per capita increase of GST of \$0.01.

This modelling shows that in regard to coal royalties, there is a moderate disincentive for dominant producers of coal to increase their coal royalties and no notable incentive or disincentive effects for non-dominant producers to increase their coal royalties arising from the HFE system.

ACT modelling also shows that if Western Australia increased its effective gold royalty rate by one percentage point from 2.566 per cent to 3.566 per cent, it would see a reduction in its GST distribution of \$51.9 million; from -\$191.18 million to -\$243.07 million.

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

This amounts to a per capita loss in GST of \$19.35, offsetting a gross revenue gain of \$32.96 per capita, giving a net gain of \$13.61 per capita, or about 41% of the gross revenue.

Further, if Tasmania increased its effective gold royalty rate by one percentage point from 2.326 per cent to 3.326 per cent, the ACT estimates that Tasmania would gain \$11,000 in GST; from \$5.121 million to \$5.132 million. This amounts to a per capita gain in GST of \$0.02.

This modelling shows that in regard to gold royalties, there is a substantial disincentive for dominant producers of gold to increase their gold royalties and no notable incentive or disincentive effects for non-dominant producers to increase their gold royalties arising from the HFE system.

However, it should be noted that a one percentage point increase represents a far greater proportional increase in the royalty rate for gold than for coal given the much lower starting effective royalty rate on gold. Thus, the per capita difference for the modelled increase in the effective gold royalty rates is higher than that for coal. Given the much smaller total production value of gold compared with coal, an increase in royalty rates of the same proportion for the two minerals would produce a much larger change in the GST distribution from the increase for coal than that for gold.

The modelled royalty rate changes show that any State that unilaterally increases its effective royalty rates on coal or gold would retain sufficient revenues from the increase to be substantially better off, net of the GST distribution effects. However, for minerals where a State is a monopoly producer, as is the case with Western Australia's production of iron ore and nickel, the GST distribution effect is such as to leave the State with a net revenue gain equal only to its share of the national population.

On the basis of the above modelling, the ACT supports the Commission's position that dominant producers of mineral and energy resources can be faced with incentives to lower or avoid raising their resource royalty rates. This incentive is particularly strong where a State is a monopoly producer of a mineral. However, a monopoly position only applies to iron ore and nickel, for which Western Australia is effectively the sole producer. The incentive effects for coal and gold, both of which have dominant but not monopoly producers, could also be considered significant. However, the effect for gold in absolute terms is small compared with that for coal, as shown by the above modelling. In the future, it is possible that other resources such as coal seam gas and lithium may exhibit incentive effects of comparable magnitude to those for iron ore, coal and gold.

Given these considerations, the ACT supports the CGC's proposal to discount additional revenue generated through changes in tax rates by 50 per cent, noting that this change is specifically intended to deal with changes in mineral royalty rates and that in practice it will only impact a few mineral categories.

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

The ACT considers that further modelling should be done on the influence of changes in mineral royalty rates on the GST distribution as a cameo exercise for the Commission's final report.

The ACT also draws particular attention to the issue of policy neutrality in relation to mineral and energy resources for which some States have banned exploration and extraction such as coal seam gas. As noted by the Commission, the CGC currently assesses States that have banned exploration and extraction of a given resource as having no capacity to generate revenues from the resource. The ACT agrees with the Commission's position on this issue that this treatment distorts State incentives as policy decisions to restrict resource development are not treated equally with policy decisions to facilitate resource development:

*"This treatment may distort States' incentives because policy decisions to restrict extraction are not treated symmetrically with policy decisions to facilitate extraction (for example, a State with 10 per cent of the population that allows extraction of a specific mineral would see most of the revenue equalised away to other States, whereas if it were to ban extraction it would effectively receive a share of other States' royalties from that mineral)."*

- *Draft Report on Horizontal Fiscal Equalisation, Productivity Commission, 2017, p. 112.*

In the ACT's view, this methodology is a clear violation of the CGC's supporting principle of policy neutrality and should be addressed.

As expressed by the ACT in its response to CGC 2017-02-S, an assessment of potential capacity would represent an ideal solution to this issue. However, as noted in the Commission's Draft Report, the ACT considers that such an assessment would be impractical. The ACT also notes the Commission's observation that such an approach is not utilised in any other HFE system:

*"In any case, participants argued that an assessment based on potential production would be unworkable, given incomplete data and the control States have over exploration activity (CCIWA, sub. 11, p. 6). The Productivity Commission is not aware of any other country that uses such an approach as part of fiscal equalisation."*

- *Draft Report on Horizontal Fiscal Equalisation, Productivity Commission, 2017, p. 112.*

On the basis of practical considerations, the ACT's position is that mineral and energy resources that are the subject of moratoriums or bans in at least one State should be assessed on an equal-per-capita basis in order to eliminate any possible incentive effects and ensure consistency with the principle of policy neutrality. While the ACT notes that this itself creates possible incentive effects as noted by the Commission, the ACT considers that imperfect solutions are an unavoidable operational reality of Australia's HFE system.

Related to this issue, the ACT also supports the Commission's finding that the inclusion of incentives to promote mineral and energy resource exploration and extraction would breach the principle of policy neutrality and compromise State autonomy, representing a dilution of the equity objective of HFE.

## 1.4 HFE and State Budgets

### 1.4.1 The Productivity Commission's Perspective

The Productivity Commission discusses the impact of HFE on State budget management from the perspective that States get a very significant share of their overall revenue from GST payments, which are an outcome of the implementation of the HFE system.

The Commission argues that the current process of GST distribution “blurs accountability for State budget outcomes”. It uses analysis of GST payments and requirements (Figure 5.2) as affected by the three-year assessment period and two-year lag built into the HFE process, to contend that such an assessment period and lag limits the responsiveness of GST payments to changes in State budget positions, which can accentuate the fiscal impact of economic cycles and economic shocks.

At the same time, the Commission further contends that, while the three-year assessment period has a benefit in terms of reducing the volatility of GST payments, available options to reduce the two-year lag would increase volatility and complexity and has the potential for unintended consequences.

#### 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.

#### DRAFT FINDING 5.2

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.

## ACT Response

While the ACT agrees with most of the Commission's findings above, we contend that a key problem that needs redress in the HFE system has been overlooked.

The ACT considers that the lagged assessment approach is a major cause of the weakening in support for the HFE system in recent years, in particular through its adverse impact on Western Australia's budgetary position. The result of this lagging is that, as the PC has pointed out, the HFE system operated in recent years to exacerbate rather than mitigate the cyclical impact of the economic shocks faced by WA. Changing the objective of HFE will not solve this problem. Instead of changing the objective itself, as the Commission is currently proposing, making the assessment process more contemporaneous would better align the GST allocation with States' own source revenue positions in the application year, maximising the ability of the system to counter the effect of major cyclical changes.

This was the reason for the ACT's proposal in its submission for improving contemporaneity by reducing the lag, recommending replacement of the earliest assessment year with estimates for the current year, i.e. the year before the application year (see **Attachment C** for a schematic representation of the ACT's contemporaneity proposal). The ACT agrees with the Commission that its suggested approach would produce more volatility in GST payments to States than the current approach, but it would also help to offset major fluctuations in State own-source revenue, thereby providing a much-needed element of stability to *overall State revenue*. This effect would apply principally to the larger States and to large fluctuations in own source revenue, enabling situations such as that of WA during the mining boom to be better addressed. However, we agree with the Commission that offsetting cyclical factors is not, and should not be, a primary objective of HFE.

The ACT disagrees that making the HFE system more contemporaneous as we have proposed would increase disputes or increase the probability of unintended consequences, given that actual data would be available for the first half of the current year prior to finalisation of an Update and there would be minimal reliance on State estimates. In its contemporaneity proposal, the ACT has recommended that the CGC source estimates of the current year (i.e. the last assessment year) either from independent parties or develop the capability themselves, to avoid the errors which would arise due to differences in forecasting methods across States.

The ACT notes but disagrees with two other Commission contentions expressed in the draft report. While in general it is true that forecast and projection approaches can produce incorrect relativities when States' economic circumstances change, the ACT's contemporaneity proposal envisages using six months of current year data for forecast purposes, thus significantly reducing the scope for error in the forecasting.

In this context, States like Tasmania and Western Australia have already contended that they are able to forecast their relativities/GST payments one year ahead of the budget year with reasonable accuracy, comparable with taxation revenue forecasts for the budget year. Since a forecast at least one year in advance is likely to have more assumptions and variability built in, it is reasonable to assume that a forecast which includes six months of actual data from the current year will be more accurate.

In fact, keeping in mind that State revenue data is much more volatile than expense data, and mining revenue and stamp duty conveyance revenue are among the two most volatile revenue streams within revenue assessment, the ACT's analysis<sup>1</sup> available in **Attachment D** shows that the models Queensland and Western Australia Treasuries use for estimating stamp-duty revenue and mining revenue (respectively) predict the total revenues for their States from those streams to within  $\pm 5$  per cent of the actual expenses on 4 out of 5 occasions. Hence, if the CGC can study those models and base their forecasting algorithm off such models, forecasting for two of the most volatile revenue streams can be performed well. Once the two most (notoriously) volatile pieces of the assessment are deemed feasible from the perspective of using forecasted data, the ACT does not consider that there is a major challenge in predicting relativities fairly accurately using such data.

The Commission contends, reasonably, that when relativities are calculated using forecasts or projections, it would likely need correction and hence potentially large retrospective adjustments to payments when actual data for the assessment year is available. However, the ACT's view is that retrospective adjustments would not be required where forecasts are being used, as we have proposed, only for the second half of the latest assessment year (the current year). This approach would be no different from the way the CGC calculates a relativity for a particular assessment year and then updates that relativity in the next year's Update due to more updated data being available for that assessment year, without making any correction to the relativity used for that assessment year in the previous Update. As mentioned in the report itself (p. 125):

*"In the 2017-18 update, data revisions changed GST payments substantially for some States, with a \$181 per capita reduction for the Northern Territory and a \$94 per capita reduction for Western Australia."*

The ACT notes there were no corrections to the NT's and WA's relativities for 2016 because of the above significant data changes. Hence, analogously, the ACT contends that the use of forecasts based on six months' actuals in our contemporaneity proposal does not necessitate any retrospective corrections.

Further, in line with the ACT's position that a key problem in the current HFE system is its lack of contemporaneity, the ACT is open to other proposals which improve contemporaneity. A possible option that can be considered is a move to a one-year assessment period from the current three-year assessment period.

It is expected that the relativities calculated using a one-year assessment period would be much more volatile than relativities calculated using a three-year assessment period.

---

<sup>1</sup> The ACT compared the projections of annual revenue available in State Mid-year Budget Review statements with the actual expenses available in State Annual Financial Statements for the years 2011-12 to 2015-16. Details are available in Attachment C of the current submission and the complete contemporaneity proposal is available in Attachment E in the ACT's previous submission.



However, the ACT's analysis, shown in **Attachment E**, comparing the volatility of State relativities determined using a one-year assessment period with the volatility of State relativities determined using a three-year assessment period shows only a slight increase in volatility between the two approaches (with the coefficient of variation being used as a measure of volatility) e.g. the coefficient of variation for NSW increases from 3.6% to 6.1% when the assessment period changes from three years to one year, which is not a substantial increase in volatility.

The ACT agrees with the Commission's finding on the relative volatility of GST payments, vis-a-vis other sources of State government revenue. As posited in the ACT's previous submission, the ACT has significant difficulty in predicting GST relativities (and hence, GST payments) due to the many factors that affect a small State's revenue and expense assessments. Most significant of such factors are circumstances in large States like NSW, Victoria and Western Australia, which are beyond a small State's control.

## 1.5 HFE and Migration

### 1.5.1 The Productivity Commission's Perspective

Chapter 6 of the Draft Report analyses the efficiency of Australia's HFE system and its impact on the migration of labour. The analysis in this chapter is predicated on literature review of academic research and the submissions provided to the Commission.

The Commission found that there is limited to no capacity for Australia's HFE system to influence net migration flows through its impact on the net fiscal benefits offered by each State. This finding is on the basis that the quantum of GST that is redistributed between the States is small relative to total government revenue in each State. Therefore, the distribution of the GST is unlikely to have a substantial impact on net migration flows.

#### DRAFT FINDING 6.1

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.

### ACT Response

The ACT supports the Commission's finding that the redistribution of the GST under Australia's HFE system is small in magnitude relative to total government revenue for most States. From an ACT perspective, in the 2017-18 financial year, the ACT is projected to receive \$202 million more than its population share of the GST pool. This is compared to a projected total ACT Government revenue of \$5.341 billion. This means that the ACT's expected revenue from the GST redistribution amounts to only 3.78 per cent of the ACT Government's projected total revenue.

Moreover, the ACT notes that, as per the CGC's *2017 Update of GST Revenue Sharing Relativities*, only approximately \$7.928 billion out of \$62.74 billion, or 12.64 per cent of the total GST pool in 2017-18 is expected to be redistributed from an equal-per-capita distribution.

The ACT notes however that this may not necessarily hold for States with extreme GST relativities. For example, Western Australia is expecting to receive \$2.229 billion in GST in 2017-18 compared to an equal per capita share of \$6.742 billion; a redistribution of \$4.514 billion, or 15.86 per cent of Western Australia's projected total government revenue in 2017-18.

Despite this caveat, the ACT is supportive of the Commission's finding that Australia's HFE system does not have a material impact on net migration flows. As the Commission notes, labour moves between locations for a multitude of reasons, most of which are not directly related to net fiscal benefits. Thus, changes in net fiscal benefits arising from the redistribution of the GST are unlikely to have any substantive influence on labour mobility and thereby economic efficiency. The ACT notes that this position is consistent with the ACT's initial submission, which contended that there is no conclusive evidence to suggest that Australia's HFE system generates economic inefficiencies through distorting net migration flows.

## 1.6 Methodological changes to the current system of HFE

### 1.6.1 The Productivity Commission's Perspective

The Commission discusses various options for improving the current system of HFE in chapter 7 of the draft report. The various options considered are:

- Changes to the mining assessment through either removing mining from the HFE process altogether or using a discount factor in the mining assessment;
- Introduction of a relativity floor;
- Introduction of a broad indicators approach for assessing fiscal capacity;
- Using external benchmarks for expense equalisation; and
- Different treatment of indigenous disadvantage

The Commission further explores whether there is consistency and existence of clear guidelines regarding the quarantining of Commonwealth payments.

As a result of their analysis, the Commission comes up with four findings and two recommendations related to the methodological changes required to the current system of HFE.

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.

DRAFT FINDING 7.2

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.

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.

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.

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.

INFORMATION REQUEST

*Further views are sought on the potential to apply a simple cost benchmark approach to the expenditure assessment.*

## **ACT Response**

The ACT's perspectives on each of the proposals/findings from the Commission are as follows:

### Changes to Mining Revenue Assessment

The ACT agrees with the Commission's finding that removing mining from the HFE process, or the use of a discount factor within the mining assessment, is inequitable. As mining revenue constitutes what is known as a source-based difference in State capacities, removal or discounting of mineral revenue would also be economically inefficient. At the same time, the ACT agrees that policy neutrality is a significant concern in the mining assessment, but one that applies in the context of decisions at the margin (e.g.: whether or not to increase or decrease a royalty rate) and only in relation to a few minerals with large production values. Hence, the ACT supports the CGC's proposal (in the 2020 Methodology Review) of allowing a State to retain at least 50 per cent of its revenue from increased mining royalties, post equalisation, for mineral resources where the State is a dominant producer.

A particular attraction of the CGC's proposal lies in the fact that, while it deals effectively with the policy neutrality issue, its impact in practice would be limited to only a few minerals. For most minerals, royalty increases by large producer States (e.g. NSW for coal) would not result in a loss of more than 50% of the gross revenue gain, implying that the CGC's proposal would not even come into play. However, Western Australia, due to its dominant position in iron ore production, is currently able to retain only its population share of about 11 per cent in the case of any royalty increase, severely disincentivising any such decision from them. The CGC's proposal would go a long way in eliminating such disincentives and enhancing policy neutrality in the revenue assessments for iron ore, gold and nickel.

Similarly, on the issue of bans on mineral exploration, the ACT supports an EPC assessment of minerals where bans have been imposed by some States. As mentioned earlier, this is again from a policy neutrality perspective since the treatment of States imposing bans on exploration as having zero production capability for the purpose of revenue assessment acts as an incentive for States banning such activity.

The ACT's support for both of the above propositions is strictly due to their impact on removing any policy disincentives from the mining assessment. As a general proposition, the ACT believes that all mining revenue should be equalised.

### Introduction of a Relativity Floor

The ACT concurs with the Commission's finding. The ACT considers any relativity floor to be inequitable since it necessarily implies, assuming it comes into play, that more GST would be made available to the strongest State, at the expense of those with lesser fiscal capacity. Moreover, setting of any relativity floor would be highly judgemental since there is no objective way to determine what the relativity floor should be. Last but not least, imposition of a relativity floor would make the HFE process suboptimal from both an efficiency and an equity viewpoint because it creates a different treatment of any State which is subject to the benefit of the floor coming into play. Thus, a relativity floor proposition fails on multiple counts.

### Use of Broad Indicators for Simplicity

The ACT agrees with the Commission's finding. Although broad indicators could offer major benefits in simplicity, it is likely that their use would cause a very significant dilution in equalisation and result in major inequities in the GST distribution across States. This concern is particularly relevant to the ACT because of the dominant role played by the Commonwealth government in the Territory, which has a marked impact on the ACT's revenue raising capacity, as well as on its expenditure needs.

The assumption underlying the broad indicators approach is that high-level economic indicators such as Gross State Product (GSP) and Gross Disposable Income (GDI) are a good measure of States' fiscal capacity. However, although such measures give a good impression of States' overall economic strength, they are not necessarily an accurate reflection of the fiscal capacity of State governments.

For example, in the context of using Gross State Product (GSP) or Gross Disposable income (GDI) as an indicator of the ACT's fiscal capacity, compensation that Commonwealth government employees receive form a significant proportion of the total. However, considering the legal restrictions imposed by the Australian Constitution, the ACT cannot impose payroll tax or land tax on the Commonwealth for the compensation paid to its employees or the land that it holds in the ACT. Thus, a significant proportion of the GSP/GDI figures for the ACT does **not** lead to any major revenue accrual for it and use of such broad indicators would be likely to lead to a gross overestimation of the ACT's revenue raising capacity.

Further, even keeping aside the peculiarities of the ACT as the national capital and seat of federal government, an indicator like GSP can at best act as an indicator of the revenue raising capability of a State. It does not take into account any of the possible cost and use disabilities that may lead to higher expenses for a State (e.g. high indigenous population, remoteness, high wage costs etc). The ACT has seen no discussion of broad indicators which could apply to expense assessments, which are already substantially more complex and diverse than the revenue assessments. As fiscal capacity is effectively a measure of expense needs net of revenue capacity, it is amply clear that GSP, by its very nature, cannot be a reliable measure of a State's fiscal capacity.

The counter-intuitiveness of using broad indicators is well demonstrated through the negative relativities that the ACT and the NT purportedly would have, if GSP or GDI was used as an indicator for distribution of GST, as the Commission's analysis shows (p.153). The ACT notes that even in the international sphere, broad indicators are considered as an inadequate barometer for measuring a State's revenue-raising capacity.

The situation of the ACT in relation to broad indicators is a microcosm of the impact of such an approach on a larger scale.

The inability of State governments to access the broader tax bases available to the Commonwealth (personal and corporate income tax, excise tax and consumption taxes) means that they cannot "get around" the problem of misalignment of their fiscal capacity with their broader economic bases. This means that broad indicators could only be a workable alternative to the CGC's current approach to assessing fiscal capacity if fundamental reforms of the Federation were undertaken, in terms of both taxation powers and expenditure responsibilities.

### External Benchmarks for Expense Equalisation

The ACT agrees in principle that externally defined benchmarks for service delivery could encourage greater efficiency and reduce potential for gaming of the system. However, the ACT does not consider that the current approach of internal standards incentivises technical inefficiency in service delivery, nor does it consider gaming potential on the expenditure side to be of major concern. In fact, the CGC's current expense assessment methodology rewards efficiency insofar as States get to keep the benefits of providing services efficiently (i.e. their actual expenses are less than their assessed expenses). The Commission's contention that reform of the system's underlying objective and approach would address the potential for disincentives and gaming at the margin is questionable, since problems at the margin are best addressed by adjustments at the margin, and not by change to the underlying base of the system.

The ACT considers that, while there is merit in exploring benchmark approaches to costing or pricing of services, there is no simple way of doing this. A possible option for the use of external standards is in assessment categories where needs-based funding from the Commonwealth plays a key role, such as Health and Education. To some extent the CGC already does that in these assessments, by adopting elements of the Commonwealth funding models in the way it assesses need (whether by explicit direction in ToR, or through its own internal considerations). This approach could be taken further, as suggested below, with associated benefits in reducing the complexity and potential for inconsistency in the current assessment methods used for these major categories of expenditure.

This approach would imply replacement of standards based on the average of what States do with an external, nationally established benchmark (in Health, the National Efficient Price and associated Diagnosis Related Group (DRG) weightings; in Education, the Schooling Resource Standard). Under a single national model, these benchmarks would in effect represent what States do, with a constraint that services are delivered efficiently.

However, the ACT notes that both National Efficient Price and Schooling Resource Standard involve considerable complexity in design and the collection of large amounts of data to support their calculation. Moreover, there would need to be a separate benchmark for each significant category of service provided by State governments. Last but not the least, usage of such external benchmarks would introduce inconsistency in how different State expenditures and revenues are assessed and would also require the development of national models for areas where none currently exists.

The ACT notes expenditure assessments are not simply a matter of establishing an average or efficient cost per service. They also require determination of usage rates by different population groups. This would still be required whether an internally determined average or an externally defined benchmark is used for the cost of services.

### Different Treatment of Indigenous Disadvantage

The ACT agrees with the Commission's contentions on this point. The ACT considers that change to the funding of needs relating to indigeneity has to be addressed in a strategic fashion through fundamental reform to roles and responsibilities. Until that time, it is imperative that the status quo is maintained and indigeneity continues as a significant disability so that States with a high proportion of indigenous people continue to receive GST for their higher than average expenses.

### Simplification, Aggregation and 'Good Enough' Equalisation

While the ACT supports the CGC exploring measures that could deliver significant simplification, it notes that aggregating assessments implies or necessitates moving to broader indicators of capacity. It contends that otherwise greater aggregation would just be presentational and would **not** lead to genuine simplification. Moreover, as stated in Finding 7.3, a move to broader indicators is likely to have significant costs in terms of loss of accuracy and diluted equalisation - in that regard it appears to contradict the Commission's recommendation 7.1. Aggregation of assessment categories was also applied in previous CGC reviews and led to the increased use of EPC assessments, thus reducing the scope and accuracy of equalisation.

The ACT does not support an objective of 'good enough' equalisation, however, assuming that this is intended to have the same meaning as 'reasonable' equalisation. If so, then such an approach is not acceptable as it detracts fundamentally from the core equity principle of HFE. If, on the other hand, 'good enough' refers to broader and more aggregated approaches at the assessment category level, then the concerns expressed above apply, especially that such changes could move substantially towards less precise equalisation in affected assessment categories.

### INFORMATION REQUEST

*The Commission seeks further information and views on changes to methodology, both within the current approach to HFE and in any alternative approach, that would deliver significant improvements in simplicity, reduce some of the distortionary effects of the current system, and still deliver a degree of equalisation consistent with the Commission's revised objective of HFE.*

---

### ACT Response

The ACT does not support the Commission's revised objective of HFE, nor does it consider the current approach to HFE creates any significant distortionary effects.

We support the proposal that the CGC be asked to explore simplification options, such as the use of broad indicators, but consider that such approaches entail significant risk to achievement of the fundamental equity objective of HFE. The ACT's stance on this matter has already been covered at length in the response above.

### 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.

---

### INFORMATION REQUEST

*The Commission seeks further views on the principles that should apply with respect to considering which (if any) Commonwealth payments should be quarantined by the Commonwealth Treasurer, and hence would not affect the distribution of GST revenue.*

---

### ACT Response

The ACT agrees with the above recommendation and proposes that it be extended, as described below.

Broadly, the recommendation is consistent with the ACT's views on Commonwealth funding and its quarantining through ToR, as expressed in its previous submission. However, apart from quarantining by the Commonwealth Treasurer, another aspect to be considered is the quarantining of payments associated with infrastructure funding in general and national network roads and rail in particular.



As described in detail in the ACT's previous submission (and also in the ACT's response to the CGC Staff Paper on "Principles of HFE and Its Implementation", related to the 2020 Methodology Review), the exclusion of 50% of national network funding from equalisation is based on an estimate of assumed benefits to other States and the Commonwealth. However, the 50% is an arbitrary figure applied by the CGC to all such projects, with no attempt made to quantify the actual distribution of benefits across jurisdictions.

Moreover, the CGC found (2015 Review) that there was no relationship between State shares of the National Network Roads payments and any of the State based drivers of road investment over the period 2006 to 2013. This means that equalisation is critical to correcting the maldistribution of these funds and hence the above recommendation should be extended to include the CGC's approach to quarantining of infrastructure payments from equalisation.

### 1.7 Alternative approaches to HFE

#### 1.7.1 The Productivity Commission's Perspective

The draft report recognises that fiscal equalisation is practised widely among OECD countries, while claiming that Australia has the most comprehensive scheme of any. It acknowledges that Australia's approach embodies many of the lessons from overseas experience, including elements such as:

- avoiding the use of a narrow representative tax base;
- using moving averages to reduce volatility;
- avoiding tied equalisation payments;
- taking account of broader conditional transfers; and
- having an independent grants agency.

At the same time, the Commission considers that the Australian system could be improved by:

- avoiding high "equalisation tax rates";
- ensuring political buy-in for changes to equalisation arrangements; and
- building societal understanding and consensus.

However, it has also concluded that no alternative approaches provide an unambiguous improvement on the current HFE system. In particular, the report rejects an equal per capita (EPC) approach as "inimical to the equity principle underpinning HFE". It also states that an EPC with top-up funding model should only be considered as part of broader reform of Commonwealth-State financial relations. Therefore, the Commission has proposed an adaptation of the current approach to HFE involving equalisation to a lesser standard.

DRAFT FINDING 8.2

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.

DRAFT FINDING 8.3

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.

DRAFT FINDING 8.4

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.

DRAFT FINDING 8.5

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.

## ACT Response

### International Comparisons

As the report states, the GST payments from the Commonwealth to the States play the dual role of vertical and horizontal equalisation. This arguably gives rise to some misunderstanding about the nature and purpose of the GST distribution and there may be merit in considering a more explicit identification of these two components of the system. Such an approach would align more closely with that of overseas countries which have separate payment streams for vertical and horizontal equalisation.

The Commission's assertion that "Australia is unique among OECD countries with federal governments in totally eliminating disparities in the fiscal capacity of sub-central governments" is an overstatement. The ACT notes that the Commission contradicts its previous statement elsewhere in the report (p.88) commenting "even in Australia's case however, equalisation is not perfect, as acknowledged by the CGC".

No system of equalisation can totally eliminate disparities in fiscal capacity, for many reasons, including lack of sufficient data of the required quality to support such an attempt. It is true that the Australian system attempts, as far as is reasonably possible, to achieve full equalisation, through taking an approach which is both comprehensive and practical. It is consistent in principle with schemes of other countries and, as Figure 8.1 indicates, not an extreme outlier but situated within a broad spectrum of equalisation schemes. The ACT's view is that Australia's equalisation system is a benchmark against which those of other countries can be assessed.

The draft report notes that OECD experience suggests that, particularly where cost equalisation arrangements apply, an independent agency leaves less room for political bargaining and allows equalisation to occur as a technical exercise. It also states that a balance is needed between an independent agency and political ownership. The ACT agrees with that view, as acknowledged by the Commission, and has been a consistent advocate of measures to improve the governance and accountability of the HFE process.

### Improvements to the Current System

#### *Equalisation Tax Rates*

Avoidance of so-called "high equalisation tax rates" is supported by the Commission as a desirable improvement for the Australian system, on the basis that they create incentives for States not to increase their fiscal base or pursue growth strategies. It sees this as a particular risk where minimum capacity arrangements apply. On the other hand, introduction of a relativity floor would remove any equalisation of capacity which would otherwise have taken a State below that floor. The ACT agrees that floor or ceiling arrangements are an inefficient mechanism which should not be introduced to the Australian system.

The equalisation tax rate obviously depends both on the level of equalisation sought and on the degree of disparity in the underlying fiscal circumstances of States – a higher equalisation standard and/or greater disparity in circumstances will generate a higher equalisation "tax rate". However, simply adopting equalisation to a lesser standard cannot guarantee low equalisation taxes – this will depend on how the individual jurisdictions are distributed across the spectrum of capacity. Ultimately, low equalisation taxes could only be ensured by convergence of the economic circumstances of States.

Clearly, a very high level of dependence of sub-national governments on the central government (vertical fiscal imbalance) is undesirable, and may generate perverse incentives. However, within some such broad constraint, vertical imbalance is not intrinsically bad and reflects, at least in part, more efficient arrangements for setting tax rates and collecting taxes than would be afforded by a more decentralised approach.

### *Representative Tax Base*

The report rejects the use of a narrow representative tax base to estimate States' revenue raising capacity, endorsing inclusion of all major sub-central government taxes in the assessment to reduce strategic behaviour. The ACT supports this view and notes that this is, in effect, an argument against the use of broad indicators. Our views on this issue are set out in more detail in the response to the Commission's proposals for methodological changes to the current system (Chapter 7).

### *Standardised Costs*

Similarly, in relation to expenditure needs, the report sees a need to standardise approaches to costs per service to reduce incentives for sub-central governments to overspend and operate inefficiently. However, it sees the CGC's approach as effectively managing that risk, in particular through the averaging method, which amounts to using an internally-determined set of standard costs per service. The ACT supports this view.

### *Use of Tied Payments*

The report notes the significance of tied payments (Specific Purpose Payments, National Partnership Payments) in the equalisation of the fiscal capacity of the States, given that many of these payments are allocated according to need. These payments are appropriately considered by the CGC as part of the equalisation process. The Commission also takes the view that tied or conditional transfers limit the autonomy of sub-national governments and are generally not the best way to achieve desired outcomes. The ACT broadly supports this view, with further commentary below on the "three stage process" approach, which could provide a more flexible way of dealing with the issue than the current rigid separation of tied and untied payments.

### *Societal Consensus*

The report echoes the view of Shah<sup>2</sup> that achieving societal consensus on the standard of equalisation is at the heart of fiscal equalisation arrangements. In reality, however, Australia's system of fiscal equalisation is a little known or understood aspect of the operation of the Federation which is operated by the CGC through a highly technical process. Achieving an informed understanding of the issues presents a significant challenge, but that is not a reason for continuing the current approach of an absence of involvement from Commonwealth Treasury and a very low profile from the CGC. The ACT supports a much stronger role of both organisations in promoting understanding of the system and dispelling common myths.

### Alternative Approaches to GST Distribution

The report canvasses a number of alternative approaches to distributing GST revenue, namely:

- equal per capita (EPC) or a variant with top-up funding;
- actual per capita (APC);
- equalising to a level less than that of the strongest State; and
- a three-stage process for grant allocation with the Commonwealth the principal agency funding the vertical fiscal gap.

### *Equal per Capita Distribution*

Some States have claimed that an EPC distribution can be considered partially equalising because more GST per capita is raised in the fiscally stronger States, which assumes acceptance of the fundamental proposition that the GST is "owned" by the State in which it is paid. However, direct data on how much GST is actually paid in each State is not available. Proxy measures, such as household final consumption expenditure (HFCE), must be used to estimate the GST actually raised in each jurisdiction (see **Attachment F: Estimation of GST Paid in States using HFCE**).

The ACT's analysis clearly illustrates that if any proxy measure such as HFCE for determining GST paid in a State was applied, an EPC distribution could **not** be considered as even partially equalising. This arises as fiscally stronger States like Victoria and Western Australia have a higher share of the national population in comparison to their share of national expenditure and hence will draw GST share from the fiscally weaker States, the NT and the ACT, due to the latter's lower shares of national population in comparison to their share of national expenditure.

The ACT agrees with the Commission's contention that an EPC approach to distributing GST is totally inconsistent with the equity objective of HFE. A population share approach to distributing GST does not recognise any of the structural factors leading to fiscal inequity among States and does nothing in terms of addressing such fiscal inequity.

---

<sup>2</sup> Shah, A. 2012, 'Lessons from Worldwide Practices of Intergovernmental Fiscal Transfers'.

*Equal per Capita Distribution with Top-up Funding*

The variant of EPC distribution with top-up funding from the Commonwealth would, on the ACT's calculations, have required an additional \$8 billion from the Commonwealth in 2017-18 to achieve full equalisation (see **Attachment G: Funding Requirement to Support an EPC Distribution of GST with Additional Assistance to Fiscally Weaker States**). This would impose a very large additional burden on the Commonwealth Budget and hence on all taxpayers across the nation, involving offsetting welfare losses through an increase in the overall tax burden, higher debt or cuts to other Commonwealth services, depending on how the Commonwealth decides to fund the extra expenditure. It also leaves the stronger States with "under-equalised" fiscal capacity.

Our conclusion is that an EPC with top-up approach could only be viable in the context of substantive reform of federal financial relations. In our response to Chapter 9 (Scope for Reform) we have suggested a mechanism for achieving this outcome.

*Actual Per Capita Distribution*

An actual per capita (APC) assessment assumes that each State's actual revenue raised and expenses incurred accurately reflect its capacity. However, an APC distribution would clearly be influenced by policy decisions of individual States.

Putting aside the possibility of false reporting (over-reporting of expenditure and under-reporting of revenue) to gain an advantage, a State making an explicit policy decision to increase expenditure per capita relative to other States would recoup all but its population share in GST and a State making an explicit policy decision to reduce revenue per capita relative to other States would similarly recoup all but its population share in GST. However, if all States tended to make the same type of policy moves, they could largely cancel each other out.

The CGC has suggested (CGC 2017-03-S, paragraph 26) that the closeness of the equalisation and APC distributions suggests disabilities rather than policy differences are the biggest contributor to differences in what States do. However, it is quite possible that this would change if the system moved to an APC method. The underlying incentives would change – at least to some degree rewarding particular policy choices compared with the current system, which tries to ensure that States do not benefit from specific policy choices. This is a weakness of taking a purely static, 'snapshot' kind of approach to the analysis.

The ACT agrees with the Commission's contention that an actual per capita (APC) approach has the risk of rewarding inefficiency and hence, is not a suitable alternative to current arrangements.

At the same time, the ACT notes that certain revenue assessments in mining, due to the heavily skewed nature of some revenues emanating from specific States, almost become equivalent to an APC assessment. We have proposed (see above) a means of dealing with adverse policy incentives arising from very unequal distribution of tax bases.

*Equalising to a Lesser Level than Strongest State*

The ACT has set out its position in relation to equalisation to a standard below that of the strongest State in the response to Chapter 2 (Objective of HFE). We are asking the Commission to consider the longer term implications of such an approach, which in our view would involve a substantial misallocation of the Federation's resources to the advantage of one State. The proposition that equalisation **for all other States** should be to a "reasonable" or "good enough" standard is not acceptable.

*Three-Stage Process with Commonwealth Funding the Gap*

The three-stage grant allocation approach proposed by Warren<sup>3</sup> has considerable merit in terms of improving clarity and accountability within the federal financial relations framework. In particular, the separation of payments for vertical and fiscal equalisation could help to reduce misunderstandings about the nature and purpose of the current funding mechanisms.

One implication of the proposal would be to break the current automatic payment of all GST revenue to the States in a single untied payment and to open the way for additional or restructured payments to be funded from the Commonwealth's consolidated revenue. Thus, it offers a constructive way out of the current zero-sum game of the GST distribution.

The ACT's view is that the Stage 2 (horizontal equalisation) component should involve full, not partial HFE. Moreover, negotiation across all governments may not be realistic in terms of achieving a final, agreed approach, and the concept of COAG assuming a more central role is not a practical option. We continue to support the strong, central role of the CGC in recommending equalisation allocations to the Commonwealth Government, with the final decision resting with the Commonwealth Treasurer.

The Stage 3 concept is worth further consideration in light of recent developments, particularly in relation to the new arrangements for provision of housing and homelessness funding from the Commonwealth to the States. The new National Housing and Homelessness Agreement (NHHA) represents a further extension of a trend of greater Commonwealth control and intervention in major areas of State expenditure responsibility, increasingly through incorporation of requirements in Commonwealth legislation.

The ACT's view is that a far preferable approach would be to strengthen cooperative arrangements between the Commonwealth and States to achieve shared objectives, through mechanisms such as the previous COAG Reform Council. Legislative approaches including detailed performance requirements of States are far too inflexible a mechanism and entail dictation by the Commonwealth to the States rather than cooperation. We note that the Commission, in its recent Five-Yearly Productivity Review (*Shifting the Dial*, p.23) has identified intergovernmental relations as being in need of renewal, stating that "seeking reform primarily through control of payments should be least preferred".

---

<sup>3</sup> Warren, N. Submission no.38 to this Inquiry.

Further flexibility to accommodate the difficulties of States with large resource endowments could be explored by the Commonwealth, for example it could revisit the distribution of revenues from offshore petroleum (oil and gas) royalty revenue with a view to increasing the shares received by the States and Territories which have facilitated these developments. The significance of these developments appears to be increasing with major new gas fields such as Gorgon, Wheatstone and Ichthys coming into production.

---

### INFORMATION REQUEST

*The Commission seeks participant views on what level of fiscal capacity would be consistent with enabling States to provide a 'reasonable' level of services? For example, this could be the average fiscal capacity, the average of the 'donor' States, or the fiscal capacity of the second strongest State.*

---

### ACT Response

The ACT does not support the adoption of an equalisation objective of a 'reasonable' level of services. It implies a significant dilution of equalisation and potentially creates a substantial difficulty in defining the meaning of 'reasonable'. It is assumed that the Commission considers that equalisation to one of the levels indicated above would meet the standard of 'reasonable' equalisation.

If so, then the method of determining it would be essentially the same as that currently employed by the CGC, which is an internal, data-driven approach culminating in a ranking of the fiscal strength of States. In this scenario no further information is required.

If, on the other hand, the Commission does not consider that 'reasonable' can be defined in purely quantitative terms using the CGC's existing assessment approaches, then it implies moving to an alternative standard of equalisation which involves some kind of external standard and/or the application of expert judgement. No guidance has been given by the Commission to clarify its view on this issue. In any case, the ACT does not support the adoption of an external standards approach to assessing equalisation requirements of States.



INFORMATION REQUEST

*The Commission seeks participant views on managing transition to any new approach, and the most amenable process for considering the transition path. For example, could it be considered via the CGC's 2020 methodology review?*

---

**ACT Response**

The ACT considers that it is premature to address the issue of transition paths at this stage, with the direction and magnitude of possible change to the HFE system not yet resolved. However, should major change to the current system be agreed, the CGC should be asked to advise on the best mechanism and timeframe for transition to any new approach to HFE which might be adopted. This requires thorough consideration and could not be sensibly implemented earlier than the 2020 Methodology Review i.e.: in the 2020-21 financial year. The CGC could be given supplementary terms of reference for the 2020 Review to address this issue.

## 1.8 Institutional Reforms

### 1.8.1 The Productivity Commission's Perspective

The Commission's analysis leading to Draft Recommendation 9.1 calls on the CGC to play a prominent public communication and education role – a much needed objective voice to inform the public dialogue about HFE. It concludes:

- There is scope to improve the governance of the HFE system. In particular, the CGC should provide an independent and objective voice to inform the public dialogue on HFE.
- It should also engage in a process with State Treasurers to provide the States with 'draft rulings' on how a proposed policy change would affect their GST payments.

#### 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.

## ACT Response

The ACT considers improving the institutional arrangements underpinning Australia's HFE system should be given a more predominant status in the Commission's final report.

In general terms, the ACT considers there is greater scope for the CGC and the Commonwealth to defend the application of the HFE framework, which both administer under legislation; the former as an independent body. In particular, these bodies could do more to address issues as they arise in the public arena by factually correcting much of the myths underpinning the national debate that has had a destabilising flow-on effect, making it even more difficult for parties working within the framework to manage their effort.

Consequently, the ACT requests that the Commission consider splitting this recommendation into three separate key recommendations for the final report. All three warrant specific attention.

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

The ACT strongly agrees with this recommendation.

As stated, the CGC is encouraged to strengthen its educative role in public forums and the national debate. This would not involve defending the policy of HFE, which is the domain of governments, rather how it is implemented in the current settings.

The ACT, does however, reject the contention in the report on which this recommendation has been formed, namely:

*"This confusion appears to stem from the absence of a strong neutral public voice to communicate the mechanics of the system and how it is meeting the policy objective, which, as noted in chapter 2, has not been clearly defined by the Commonwealth Government". (P199).*

As already discussed elsewhere, it is very clear how HFE is defined and practised. That is not the problem.

Indeed, the Commission has the opportunity to make this a key focus of their response to the ToR, one that would be a welcome contribution to the ongoing debate on the acceptability and implementation of the HFE system in Australia.

The ACT also agrees with the Commission in rejecting the changes to HFE governance structures suggested by some parties which entail a shift away from an independent agency reporting to the Commonwealth Government. Rather, the ACT has consistently advocated for the implementation of the 2012 GST Distribution Review recommendations in this area, which would assist substantially in promoting informed public debate and understanding.

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

The 2012 recommendations were designed to improve governance arrangements for the HFE system, reflecting an urgent need for the States and the Commonwealth to act as joint stewards of the system, rather than competitors or critics.

The Commission's final recommendations should be broadened not only to identify the educative role of the CGC but also better incorporate the role of the Commonwealth itself, which should provide strategic guidance to the CGC and the States on HFE matters.

The Commonwealth taking up such a role does not compromise the independence of the CGC. For its part, the CGC has a valid role in defending or indeed explaining the system. Stronger involvement of both parties would add greater clarity in the national debate, and diminish the difficulty of individual States, particularly those classified as a 'receiver', to enter the debate.

Indeed, the Commonwealth has ceased to become an active participant in many of the CGC/State deliberations and no longer submits submissions or papers to the CGC Reviews, Updates, or other independent inquiries.

Regardless, most jurisdictions have consistently agreed there is merit in the CGC and Commonwealth taking on a much wider proactive educational role in developing an understanding of HFE and thereby also dispelling the many myths and 'black box' commentary which has unjustifiably gone unanswered for a long period.

- Both parties should be more active in busting many of the myths surrounding the GST debate that commonly play out in the national media. The most basic and substantial example of an error perpetuated in the national debate is that of a GST relativity for a State being a certain number of cents that the State gets back from every dollar of GST that it contributes.

This is in spite of the fact that the CGC has reiterated multiple times in its reports that such an interpretation of a relativity is fundamentally incorrect. Quoting from the Commission's report on HFE which, ironically, is only touched upon as a footnote (p.33):

- *Note that a relativity refers to a State's share of the total GST pool relative to its share of the national population. Discussions of HFE frequently (and erroneously) refer to a relativity as the share of GST 'returned' to a State compared to the amount that was 'collected' or 'generated' by, or in, that State; however, this is not a component of the GST distribution, and in many cases is not measurable.*

From a practitioner's perspective the commonly asserted black box tag is demeaning of the high quality of work undertaken in this field by all State and Territory governments. It should also be noted, HFE is not the sole domain of Treasuries, as commonly stated publically. Rather, it is one requiring a whole-of-government approach to any CGC task as a major focus is the cost and use drivers underpinning State service delivery.

Again, the Commission call for a more public role for the CGC is fully endorsed by the ACT, noting as the Commission reports, that the scope of the public role must be clearly defined as being to inform, not advocate – much like the Parliamentary Budget Office and the Reserve Bank of Australia Governor today.

The ACT would suggest the Commission add into its final report specific examples of how this role could be implemented.

***2. The CGC should also enhance its formal interactions with the State and Commonwealth Governments.***

Similarly, the ACT welcomes and fully supports the Commission recommendation for the CGC to improve interactions with Government representatives. This should be presented as a key recommendation in the Commission's final report.

This engagement should be widened by including higher level interaction with governments more broadly outside of the various Treasuries. This could be delivered in many forms:

- Briefing sessions for State and Commonwealth parliamentarians at key points of a major inquiry via the existing Workplace Discussions inherent in any methodology work program.
- Appearance before the *Council on Federal Financial Relations* in relation to periodic updates on work-in-progress on 5-yearly reviews (the 2020 Methodology Review currently) and on the release of Annual Updates in the intervening years.
- Annual appearance by the Chairman and Commissioners before an appropriate Senate Estimates Committee to allow Senators the opportunity to clarify any difficulties in relation to recommendations.

As noted, most of the above suggestions relate to a re-instatement of a number of practices previously followed by the CGC in past Reviews. One key consideration for their demise of late is the fact the CGC has been subjected to the same efficiency measures as all Commonwealth agencies over a number of years, which has led to a progressive reduction in the underlying budget available to the CGC hence, reductions also in staff numbers.

A recommendation calling on the Commonwealth to review this legacy issue would be welcomed by the ACT:

- The CGC should be financed at a 'deemed appropriate level' to the satisfaction of all parties, and not simply as determined by the Commonwealth as is the present case.

***3. The CGC should also enhance its formal interactions with the State and Commonwealth Governments by providing draft rulings to State Governments on the potential HFE implications of a policy change.***

The ACT agrees with this recommendation and encourages the Commission to expand on it in the final report, with the one proviso that the concept of a draft ruling be changed to one of informed advice only e.g.: to provide advice on the effect of a State policy change on existing assessment methods via interpretations by CGC staff (as distinct from the Commission itself).

Consistent with the previous statements, the ACT has also sought greater upfront engagement by the CGC in an advisory capacity for national policy deliberations. The Territory has long held the view the CGC could play a much more proactive role in facilitating policy analysis in collaboration with central agency officials tasked with implementing national reform in the major areas of State service delivery.

There have been numerous past occasions on which the views of the CGC would have added to the deliberations had they been sought in advance on options under discussion in the various intergovernmental policy forums:

- Commission observations and in some instances ongoing analysis of the options under investigation for their impact on the equalisation framework and consequential redistribution impacts from a GST perspective.

On many occasions where individual States have undertaken their own analysis and offered views to their respective governments it simply has led to significant discrepancies in advice and hence, confusion all round.

An excellent precedent was set for the initial Health Care Agreement when CGC officers were invited to join the Health Task Force in Treasury – this was very successful but unfortunately was not replicated for the reforms that followed, particularly in the Education sector and to some extent with NDIS.

A more proactive CGC in the national reform space at the invitation of the Commonwealth and States would be a very positive development. Whether that intervention is in the form of draft advice or takes the form of direct participation in deliberations, such as membership of specific task forces, could be agreed on a case by case basis, but it is important that a mechanism be established in the first instance.

Equally, this scenario could be played out for any individual or collective new State policy issue as it surfaces, such as the recent example of the South Australian bank tax proposal.

**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.

The Commission's analysis leading to Draft Recommendation 9.2 acknowledges while the Commission is of the view that GST funding should not be tied, there are other opportunities available to improve accountability. One opportunity to improve accountability in the HFE system specifically is through increased disclosure of data used in the CGC's calculations:

- GST payments should continue to be provided on an untied basis. That said, there is scope to improve government accountability in the HFE system through the CGC making the data provided by the States (as well as its calculations using these data) publicly available.

**ACT Response**

The ACT agrees with this recommendation.

There is a strong national interest case – beyond that pertaining solely to the HFE system – for releasing the States' HFE data.

Indeed, the ACT Treasury regularly tests the opportunities of using the CGC data collection to look further into ACT Directorate financials for related information which may strengthen the ACT Government's position in future policy negotiations with the Commonwealth. It also facilitates the joint understanding of the nature and cost of ACT Government services and the ACT's relative position to other States and the NT.

Consequently, the ACT contends that, apart from very limited data that is considered commercial-in-confidence, the rest of the data that States share with the CGC to enable various assessments ultimately contribute to standard sources of publicly available information, e.g. the ABS and GFS data. The ACT does not envisage any major challenges in sharing such data publicly.

The CGC's underlying assessment simulation model (the CGC's assessment system on line - ASOL) is a key source document available to Treasuries and it is understood is currently made available by the CGC to outside parties, but only following agreement of all States. Wider public access to this system could be considered:

- At the same time, the CGC's assessments are complex and, while transparency in sharing those should help, there are risks that parties unfamiliar with the CGC's assessments may misinterpret some elements in the process and further contribute to the myths already circulating in public media.

The ACT considers it critical that all possible risks should be thought through and mitigating steps identified **before** any such steps of making the assessments publicly available are considered. It should not be done post facto. An appropriate protocol between all parties should be agreed in advance and be included in the suggested toolkit discussed earlier.

### DRAFT RECOMMENDATION 9.3

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 to address Indigenous disadvantage should be a priority in this regard.

The Commission's analysis leading to Recommendation 9.3 suggests accountability in the broader federal financial system is, unsurprisingly, elusive due to the vertical fiscal gap, the patchwork of payments from the Commonwealth to the States and the many shared service delivery responsibilities:

- The States' high reliance on Commonwealth payments makes it imperative that the whole system works effectively. Yet, the system is complex and appears to have been given little holistic consideration.
- There is only so much an improved HFE system can deliver in isolation. The greatest benefits potentially come from broader reform to Australia's federal financial relations. Governments should develop a process to work towards this as a longer-term goal.
- This process should assess how Commonwealth payments to the States — both general revenue assistance and payments for specific purposes — interact with each other; and
- It should also include consideration of a practical division of responsibilities between the States and the Commonwealth, and accompanying accountability and performance arrangements.

### ACT Response

The ACT agrees with the above recommendation.

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

As posited in the ACT's previous submission, significant scope for reform exists in the sphere of federal financial relations:

- The submission canvassed an option of expenditure equalisation being replaced by national needs-based funding, as currently exemplified by the needs-based models used to allocate Commonwealth payments for hospitals and schools. In any case, explicit consideration of the interaction of these payments with general revenue assistance (principally the GST) would be worthwhile.

The ACT also noted that there was substantive examination of options for reform of federal financial relations through the Commission of Audit and Federation Reform White Paper processes during the 2014-16 period, which the Commonwealth abandoned before they could be completed.

As correctly alluded to in the Commission report, there would need to be a willingness at the political level in both the Commonwealth and the States to revive such processes if longer term reform of federal financial relations is to be seriously considered.

However, that does not appear to be on the agenda at any level of government. Rather, a strong centralist approach to public policy appears to be well underway, with the current VFI settings not expected to change in the foreseeable future:

- All parties will need to accept this reality. Nothing is on the drawing boards that will alter this setting.
- In doing so it must also be accepted that this requires the continuation of a sophisticated but transparent HFE system to ensure basic equity across the nation.

In the ACT's view, such a system is in place which is flexible enough to absorb shocks and current discontent. HFE as practised should be seen as a national asset:

- Other countries envy it.
- Parties should resist calls to dismantle it.

Rather, the joint task of parties should be characterised as one of fostering full ownership of the HFE principle, supported by excellent governance arrangements to ensure it is pursued in an open and transparent way:

- The collective challenge going forward.

Other objectives such as State tax reform, national competition reform and income tax sharing proposals will remain dormant until the Commonwealth provides an environment conducive to stimulating a desire for reform.



There also rests the problem for the foreseeable future - there is an issue about the long-term sustainability of government budgets in Australia:

- Loan Council nominations indicate that currently the Commonwealth is running a much larger deficit than the States when considered in relation to the division of expenditure responsibilities between the levels of government:
  - The Commonwealth has 77.5% of the total deficit compared with 55% of the expenditure responsibilities.

However, in the longer term States may face greater sustainability problems particularly because of the growth rate of health expenditure and the inefficiency of many State taxes:

- From a States' perspective the real challenge lies not in the short to medium fiscal settings but more in the longer term outlook when policies such as the NDIS and demand-driven health funding really kick in with an ageing population:
  - That is the focal challenge for all parties.

For its part, the ACT is on the public record as supporting a view that there remains an urgent need for reinvigorating discussion on roles and responsibilities in parallel with significant broadening of the tax reform agenda in the country. The ACT would also expect, and will continue to argue for, any tax reform to place a greater focus on the totality of State and Commonwealth taxation, including income tax, and specifically to design a more efficient suite of taxes thereby reducing reliance on existing less efficient taxes. The ACT has commenced its own tax reform agenda with these design objectives.

## Attachments

1. Attachment A – Outlook for Western Australia's relativity
2. Attachment B – Modelling of GST impact of an increase in royalty rates for gold and coal
3. Attachment C - Schematics Explaining the ACT's Contemporaneity Proposal
4. Attachment D – Comparison of forecasts made in the Mid-year Review with the Final Budget Outcome for States
5. Attachment E - Comparison of volatility of relativities between one and three-year assessment periods (using coefficient of variation)
6. Attachment F - Estimation of GST paid in States using Household Final Consumption Expenditure (HFCE)
7. Attachment G - Funding requirement to support an EPC distribution of GST with additional assistance to fiscally weaker States

**THIS PAGE LEFT BLANK INTENTIONALLY**

# OUTLOOK FOR WA'S RELATIVITY

The following analysis deals with the outlook for Western Australia's GST relativity over the next few years, in light of the proposals for change to the GST Distribution system canvassed in the Productivity Commission's Draft Report on Horizontal Fiscal Equalisation.

Key sources of information are the CGC reports and WA State Budget documents.

The two key drivers of relativity for WA focused on in this analysis are iron ore royalties and population growth.

The 2018 Update, which will apply for the 2018-19 financial year, will drop out the assessment year 2013-14 and bring in the latest assessment year 2016-17.

2013-14 represented the peak of the boom for WA's mining royalty revenue (\$5.45 billion), with an average iron ore price of \$137 per ton in 2013 and sales of over \$70 billion for 2013-14. At the same time, the State was experiencing population growth of around 3% per annum - reported in the 2015 Review as 3.1% for 2011-12, 3.7% for 2012-13 and 2.8% for 2013-14.

The individual assessment year relativity numbers for WA in this period were:

Assessment Year	2013-14	2014-15	2015-16
Relativity	0.085	0.350	0.598

The unprecedented low figure for 2013-14 pushed WA's relativity down from 0.37627 to 0.29999 in the 2015 Review. Because of the continuing effect of 2013-14 in the relativities, WA's relativity remained very low in the ensuing period: 0.30330 in the 2016 Update and 0.34434 in the 2017 Update.

Iron ore royalty income to WA over this period has been as follows (including estimates for the forward years):

Year	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Royalty Income (\$m)	5,450	4,023	3,600	4,706	4,584	4,174	3,908	4,091

While the 2016-17 royalty figure is considerably lower than the 2013-14 figure, it is still higher than the (actual/estimated) returns in any of the other years. Over the forward estimates period to 2020-21, iron ore sales are expected to be quite steady at the 800 million tonne mark, which is a record high.

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

While population growth for WA has been as follows:

Year	2013-14	2014-15	2015-16	2016-17	2017-18
Pop'n growth	3.3%	2.0%	0.0%	0.8%	1.4%

Although the dropping out of the 2013-14 assessment year will clearly produce an increase in WA's relativity in the 2018 Update, it will be constrained by the very weak population growth over the three assessment years for that Update (2014-15 to 2016-17). Moreover, the continued high production volumes of iron ore will keep WA's royalty revenues strong.

These factors point to a continuing strong resource-based economy which will continue to be the strongest State from an equalisation point of view and a very substantial outlier. This conclusion is supported by the WA Budget estimates of GST relativity:

Year	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Relativity (actual/est)	0.29999	0.30330	0.34434	0.438	0.556	0.617

These numbers also indicate that WA will not return any time soon to a "normal" level of relativity after which a floor could be put in place, given that the lowest suggested floor canvassed in media reports and stakeholder submissions appears to be 0.70.

Modelling of GST impact of an increase in royalty rates for gold and coal

Coal Mining Royalties (Tasmania Rate Change)  
2015 Review Figures (13-14) 2017 Update Population (17-18)

State	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	National
Population (m)	7.91	6.238	4.942	2.682	1.732	0.522	0.404	0.246	24.676
Effective Royalty Rate (per cent)	8.026	8.049	8.021	8.519	6.062	9.450	0	0	8.025
Revenue Base (\$m)	16,373	479	22,872	264	53	34	0	0	40,075
Percentage of Revenue Base (per cent)	40.9	1.2	57.1	0.7	0.1	0.1	0	0	
Estimated Actual Revenue (\$m)	1,314	39	1,835	22	3	3	0	0	3,216
National Average Royalty Rate	8.025								
Assessed Revenue (\$m)	1,314	38	1,836	21	4	3	0	0	3,216
Assessed Revenue Per Capita (\$)	166.12	6.16	371.43	7.90	2.46	5.23	0	0	130.34
National Average Assessed Revenue Per Capita (\$)	130.34								
Difference in Assessed Revenue Per Capita (\$)	-35.78	124.18	-241.09	122.44	127.88	125.11	130.34	130.34	
GST Redistribution (\$m)	-283	775	-1,191	328	221	65	53	32	
Net Position (\$m)	1,031	813	643	351	225	69	53	32	
Change in Effective Royalty Rate (per cent)						1			
New Effective Royalty Rate (per cent)	8.026	8.049	8.823	8.519	6.062	10.450	0	0	
Estimated New Actual Revenue (\$m)	1,314	39	1,835	22	3	4	0	0	3,217
New National Average Royalty Rate (per cent)	8.026								
New Assessed Revenue (\$m)	1,314	38	1,836	21	4	3	0	0	3,217
New Assessed Revenue Per Capita (\$)	166.14	6.16	371.47	7.90	2.46	5.23	0	0	
New National Average Assessed Revenue Per Capita (\$)	130.35								
Difference in New Assessed Revenue Per Capita (\$)	-35.79	124.19	241.11	122.45	127.90	125.12	130.35	130.35	
New GST Redistribution (\$m)	-283	775	-1,192	328	222	65	53	32	
New Net Position (\$m)	1,031	813	643	351	225	69	53	32	
Change in GST Distribution (\$m)	0	0	0	0	0	0	0	0	
Change in Net Position (\$m)	0	0	0	0	0	0	0	0	
Change in GST Distribution Per Capita (\$)	0	0.01	-0.03	0.01	0.01	0.01	0.01	0.01	
Change in Net Position Per Capita (\$)	0	0.01	-0.03	0.01	0.01	0.66	0.01	0.01	

Data Source (for all tables): The CGC’s 2015 Review report or, in the case of population, the 2017 Update report.

**ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE**

Coal Mining Royalties (Queensland Rate Change)

2015 Review Figures (13-14) 2017 Update Population (17-18)

State	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	National
Population (m)	7.91	6.238	4.942	2.682	1.732	0.522	0.404	0.246	24.676
Effective Royalty Rate (per cent)	8.026	8.049	8.021	8.519	6.062	9.450	0	0	8.025
Revenue Base (\$m)	16,373	479	22,872	264	53	34	0	0	40,075
Percentage of Revenue Base (per cent)	40.9	1.2	57.1	0.7	0.1	0.1	0	0	
Estimated Actual Revenue (\$m)	1,314	39	1,835	22	3	3	0	0	3,216
National Average Royalty Rate	8.025								
Assessed Revenue (\$m)	1,314	38	1,836	21	4	3	0	0	3,216
Assessed Revenue Per Capita (\$)	166.12	6.16	371.43	7.90	2.46	5.23	0	0	130.34
National Average Assessed Revenue Per Capita (\$)	130.34								
Difference in Assessed Revenue Per Capita (\$)	-35.78	124.18	-241.09	122.44	127.88	125.11	130.34	130.34	
GST Redistribution (\$m)	-283	775	-1,191	328	221	65	53	32	
Net Position (\$m)	1,031	813	643	351	225	69	53	32	
Change in Effective Royalty Rate (per cent)			1						
New Effective Royalty Rate (per cent)	8.026	8.049	9.021	8.519	6.062	9.450	0	0	
Estimated New Actual Revenue (\$m)	1,314	39	2,063	22	3	3	0	0	3,445
New National Average Royalty Rate (per cent)	8.596								
New Assessed Revenue (\$m)	1,407	41	1,966	23	5	3	0	0	3,445
New Assessed Revenue Per Capita (\$)	177.93	6.60	397.84	8.46	2.63	5.60	0	0	
New National Average Assessed Revenue Per Capita (\$)	139.61								
Difference in New Assessed Revenue Per Capita (\$)	-38.33	133.01	-258.23	131.15	136.98	134.01	139.61	139.61	
New GST Redistribution (\$m)	-303	830	-1,276	352	237	70	56	34	
New Net Position (\$m)	1,011	868	787	374	240	73	56	34	
Change in GST Distribution (\$m)	-20	55	-85	23	16	5	4	2	
Change in Net Position (\$m)	-20	55	144	23	16	5	4	2	
Change in GST Distribution Per Capita (\$)	-2.54	8.83	-17.14	8.71	9.09	8.90	9.27	9.27	
Change in Net Position Per Capita (\$)	-2.54	8.83	29.14	8.71	9.09	8.90	9.27	9.27	

# **ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE**

Gold Mining Royalties (Western Australia Rate Change)  
2015 Review Figures (13-14) 2017 Update Population (17-18)

State	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	National
Population (m)	7.91	6.238	4.942	2.682	1.732	0.522	0.404	0.246	24.676
Effective Royalty Rate (per cent)	2.556	2.581	2.558	2.566	2.529	2.362	0	2.586	
Revenue Base (\$m)	1,454	240	1,287	8,841	464	69	0	353	40,075
Percentage of Revenue Base (per cent)	11.4	1.9	10.1	69.6	3.7	0.5	0	2.8	
Estimated Actual Revenue (\$m)	37	6	33	227	12	2	0	9	326
National Average Royalty Rate	2.563								
Assessed Revenue (\$m)	37	6	33	227	12	2	0	9	326
Assessed Revenue Per Capita (\$)	4.71	0.99	6.67	84.48	6.87	3.39	0	36.77	13.20
National Average Assessed Revenue Per Capita (\$)	13.20								
Difference in Assessed Revenue Per Capita (\$)	8.49	12.21	6.52	-71.28	6.33	9.81	13.20	-23.58	
GST Redistribution (\$m)	67	76	32	-191	11	5	5	-6	
Net Position (\$m)	104	82	65	36	23	7	5	3	
Change in Effective Royalty Rate (per cent)				1					
New Effective Royalty Rate (per cent)	2.556	2.581	2.558	3.566	2.529	2.362	0	2.586	
Estimated New Actual Revenue (\$m)	37	6	33	315	12	2	0	9	326
New National Average Royalty Rate (per cent)	3.258								
New Assessed Revenue (\$m)	47	8	42	288	15	2	0	12	414
New Assessed Revenue Per Capita (\$)	5.99	1.25	8.49	107.41	8.73	4.31	0	46.76	
New National Average Assessed Revenue Per Capita (\$)	16.78								
Difference in New Assessed Revenue Per Capita (\$)	10.79	15.53	8.30	-90.63	8.05	12.47	16.78	-29.98	
New GST Redistribution (\$m)	85	97	9	-52	3	1	1	2	
New Net Position (\$m)	123	103	74	72	26	8	7	2	
Change in GST Distribution (\$m)	18	21	9	-52	3	1	1	-2	
Change in Net Position (\$m)	18	21	9	37	3	1	1	-2	
Change in GST Distribution Per Capita (\$)	2.30	3.32	1.77	-19.35	1.72	2.66	3.58	-6.40	
Change in Net Position Per Capita (\$)	2.30	3.32	1.77	13.61	1.72	2.66	3.58	-6.40	



## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

Gold Mining Royalties (Tasmania Rate Change)

2015 Review Figures (13-14) 2017 Update Population (17-18)

State	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	National
Population (m)	7.91	6.238	4.942	2.682	1.732	0.522	0.404	0.246	24.676
Effective Royalty Rate (per cent)	2.556	2.581	2.558	2.566	2.529	2.362	0	2.586	
Revenue Base (\$m)	1,454	240	1,287	8,841	464	69	0	353	40,075
Percentage of Revenue Base (per cent)	11.4	1.9	10.1	69.6	3.7	0.5	0	2.8	
Estimated Actual Revenue (\$m)	37	6	33	227	12	2	0	9	326
National Average Royalty Rate	2.563								
Assessed Revenue (\$m)	37	6	33	227	12	2	0	9	326
Assessed Revenue Per Capita (\$)	4.71	0.99	6.67	84.48	6.87	3.39	0	36.77	13.20
National Average Assessed Revenue Per Capita (\$)	13.20								
Difference in Assessed Revenue Per Capita (\$)	8.49	12.21	6.52	-71.28	6.33	9.81	13.20	-23.58	
GST Redistribution (\$m)	67	76	32	-191	11	5	5	-6	
Net Position (\$m)	104	82	65	36	23	7	5	3	
Change in Effective Royalty Rate (per cent)						1			
New Effective Royalty Rate (per cent)	2.556	2.581	2.558	2.566	2.529	3.362	0	2.586	
Estimated New Actual Revenue (\$m)	37	6	33	227	12	2	0	9	326
New National Average Royalty Rate (per cent)	2.568								
New Assessed Revenue (\$m)	37	6	33	227	12	2	0	9	326
New Assessed Revenue Per Capita (\$)	4.72	0.99	6.69	84.66	6.88	3.39	0	36.85	
New National Average Assessed Revenue Per Capita (\$)	13.23								
Difference in New Assessed Revenue Per Capita (\$)	8.51	12.24	6.54	-71.43	6.35	9.83	13.23	-23.63	
New GST Redistribution (\$m)	67	76	32	-192	11	5	5	-6	
New Net Position (\$m)	104	83	65	35	23	7	5	3	
Change in GST Distribution (\$m)	0	0	0	0	0	0	0	0	
Change in Net Position (\$m)	0	0	0	0	0	1	0	0	
Change in GST Distribution Per Capita (\$)	0.02	0.03	0.01	-0.15	0.01	0.02	0.03	-0.05	
Change in Net Position Per Capita (\$)	0.02	0.03	0.01	0.15	0.01	1.34	0.03	-0.05	

### Summary

- The above four models calculate the estimated impact on the GST distribution of an increase of one percentage point to the effective royalty rates of coal and gold for Queensland, Western Australia and Tasmania.
  - States chosen are the most and least dominant (which still has production) for the mineral concerned.
- The model works by first calculating the effective royalty rate of each jurisdiction based on the revenue base (as per the 2015 Review; 2013-14 figures) and estimated per-state revenue, which was calculated based on the total revenue generated for each mineral type (2015 Review, 2013-14 figures) indexed by the proportion of production of coal and gold that occurs in each State (2013-14 Review, 2013-14 figures).

## **ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE**

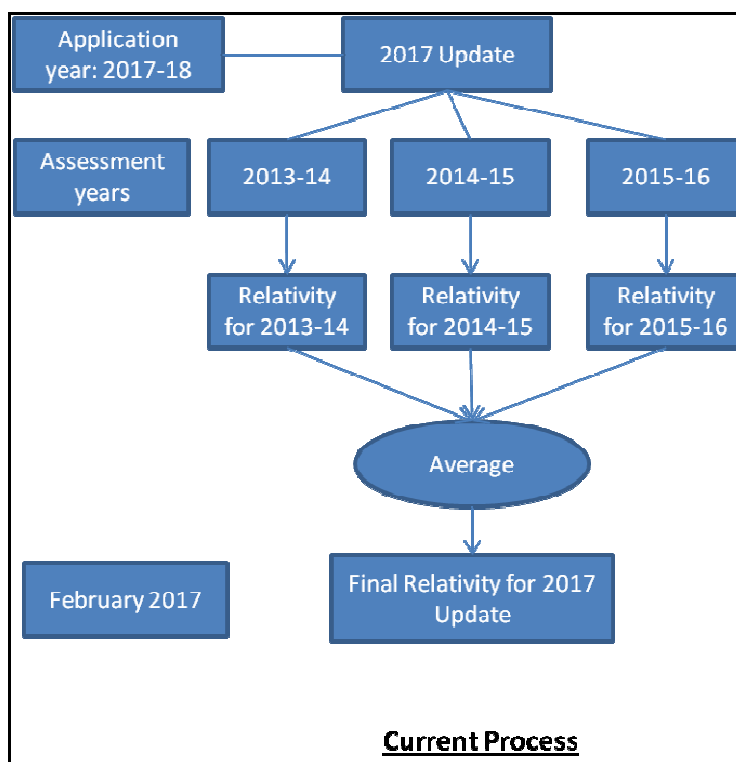
- From this, a national average effective royalty rate is calculated, which is multiplied by the revenue base of each jurisdiction to calculate each State's estimated assessed revenue.
- Per capita calculations are then performed for the estimated assessed revenue of each jurisdiction as well as a national average per capita assessed revenue.
- The amount of GST redistribution is therefore calculated by taking the difference between each State's per capita figure and the national average per capita figure and multiplying this difference by each State's population.
- A net financial position (actual revenue plus the GST redistribution) is likewise calculated for each State.
- An additional one percentage point is then added to the relevant jurisdiction's effective royalty and new estimated actual revenues are generated based on this change.
- The process detailed above is then repeated for the new effective royalty rates and the net effects of the change on the GST distribution and State net financial positions are calculated from the difference between the new figures and the originals.

### Schematics Explaining the ACT's Contemporaneity Proposal

The short descriptions and schematics shown below use the CGC's 2017 Update of GST Relativities to show the implications of the ACT's contemporaneity proposal and possible other options like using the latest assessment year only, for calculation of relativities.

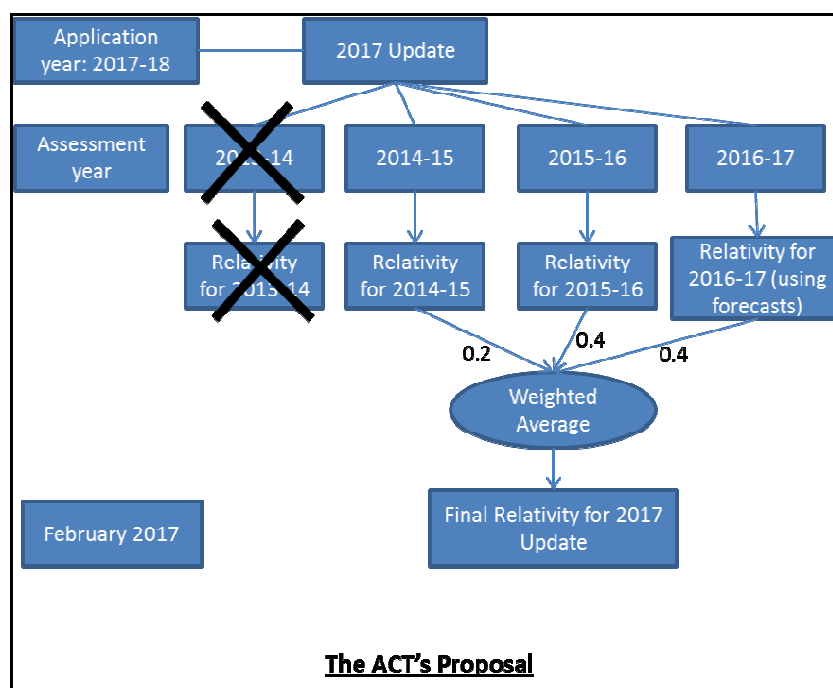
#### The Current Process

- The application year for the 2017 Update is financial year 2017-18.
- Three assessment years were considered – 2013-14, 2014-15 and 2015-16.
- Relativities were calculated for each assessment year and the final relativity was an average of the three.
- The CGC published the final relativity for the 2017 Update in February 2017.



Diagrammatic Representation of the Current Process

### The ACT's Proposal



Diagrammatic representation of the ACT's contemporaneity proposal

### Key Aspects of the ACT's Proposal

- Compared to the current process, the assessment year furthest from the application year (2013-14) is replaced by the year preceding the application year (2016-17), which will make the assessment more contemporaneous.
  - It implies that forecasts have to be used for the last assessment year, i.e. 2016-17.
  - While data reliability can be an issue in such a case, especially for revenues, the ACT's analysis shows that States like Queensland (QLD) and Western Australia (WA) have models in place which can predict stamp duty conveyance revenues and mining revenues, the two most volatile streams of revenues, fairly accurately (see **Attachment D**). The ACT encourages the Commission to examine their models and draw inferences on how such models can be leveraged to implement the ACT's contemporaneity proposal.
  - Expense categories are not highly volatile by nature. Hence, they are not considered as an impediment in implementing our proposal.
- Further improvement in contemporaneity will also be derived from the fact that the relativity calculated for the earliest year shall now have the lowest weighting of 20 per cent while the two other years would have weightings of 40 per cent each. This is an assumption premised on the following logic:
  - The latest year has the benefit of being the most contemporaneous to the application year, though the use of forecasts hinders on the data reliability principle.
  - The middle year is less contemporaneous to the application year, in comparison to the latest year, but has the advantage of having reliable data.

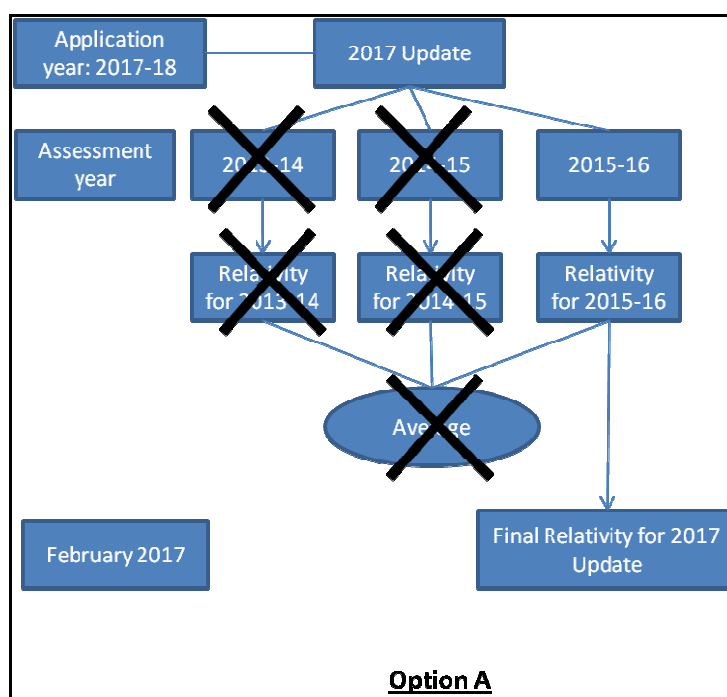
## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

- Hence, on balance, the weightings of the middle year and the latest year have been proposed to be the same; 40 per cent each
- The ACT's proposal does not envisage any correction mechanism since any variations between the estimates used for assessment and the final outcomes for revenue and expense categories (which would be determined later in the year) are expected to be totally random in nature. Benefits and losses that States would derive due to such differences are expected to cancel out to some extent, over time.
- The ACT considers that our proposal strikes a balance between the contemporaneity and data reliability issues. We consider our proposal addresses many of the challenges in the current assessment process regarding contemporaneity and would appreciate the Commission's support in implementing it. At the same time, we consider the proposal to be a refinement of the current system and the ACT does not envisage it to be a radical new way for calculating relativities.
- Some of the issues that a State like WA has on GST distribution are ultimately resultant from the impact of contemporaneity. While our proposal will not eliminate such issues, we expect that its implementation will mitigate quite a few of such issues.

### Other Options

Option A – Using a single assessment year, the most recent

- Only the most recent assessment year (2015-16) is considered. In comparison to the current process, the two earlier assessment years are removed from the calculation.
- The 2017 Update report and final relativities for the States are still published in February 2017.





Data Comparison between Budget Review and Final Budget Outcome for States

		2011-12 (\$ amounts in \$mn)				2012-13 (\$ amounts in \$mn)				2013-14 (\$ amounts in \$mn)				2014-15 (\$ amounts in \$mn)				2015-16 (\$ amounts in \$mn)			
State/Territory	Revenue/Expense Head	Budget Rvw	FBO	Variation	Variation %	Budget Rvw	FBO	Variation	Variation %	Budget Rvw	FBO	Variation	Variation %	Budget Rvw	FBO	Variation	Variation %	Budget Rvw	FBO	Variation	Variation %
ACT	Mining revenues	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
	Payroll tax revenues	311.348	316	4.652	1%	329.7	320.0	-9.68	-3%	334.8	330.0	-4.847	-1%	358.9	358.0	-0.908	0%	422.3	422.0	-0.25	0%
	Land tax revenues	114.996	115	0.004	0%	66.5	71.0	4.512	7%	75.8	79.0	3.222	4%	89.1	98.0	8.935	10%	94.1	101.0	6.931	7%
	Stamp duty conveyance revenues	274.81	320	45.19	16%	266.4	310.0	43.561	16%	232.2	291.0	58.822	25%	226.4	273.0	46.572	21%	276.2	331.0	54.82	20%
	Commonwealth payments	1535.207	1605	69.793	5%	1603.3	1713.0	109.721	7%	1781.6	1840.0	58.393	3%	1920.4	1992.0	71.594	4%	1886.0	1886.0	-0.002	0%
NSW	Mining revenues	1768	1464	-304	-17%	1378.0	1318.0	-60	-4%	1440.0	1338.0	-102	-7%	1350.0	1254.0	-96	-7%	1302.0	1189.0	-113	-9%
	Payroll tax revenues	6623	6721	98	1%	7059.0	6946.0	-113	-2%	7164.0	7083.0	-81	-1%	7454.0	7461.0	7	0%	7854.0	7924.0	70	1%
	Land tax revenues	2482	2350	-132	-5%	2438.0	2333.0	-105	-4%	2525.0	2335.0	-190	-8%	2497.0	2467.0	-30	-1%	2764.0	2747.0	-17	-1%
	Stamp duty conveyance revenues	5221	5338	117	2%	6189.0	5269.0	-920	-15%	6884.0	6765.0	-119	-2%	7290.0	8093.0	803	11%	8704.0	9581.0	877	10%
	Commonwealth payments	26887	26043	-844	-3%	24578.0	24466.0	-112	0%	25885.0	27306.0	1421	5%	27483.0	28067.0	584	2%	28769.0	29172.0	403	1%
NT	Mining revenues	162.3	145.764	-16.536	-10%	117.7	112.0	-5.671	-5%	113.3	154.4	41.058	36%	164.1	162.3	-1.812	-1%	167.7	196.3	28.619	17%
	Payroll tax revenues	164	171.447	7.447	5%	191.0	205.5	14.46	8%	215.0	250.2	35.162	16%	259.0	268.7	9.706	4%	283.0	289.6	6.59	2%
	Land tax revenues	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
	Stamp duty conveyance revenues	78	93.192	15.192	19%	131.0	128.4	-2.589	-2%	130.0	144.6	14.583	11%	150.0	265.1	115.143	77%	138.0	136.0	-1.984	-1%
	Commonwealth payments	3790.959	3985.489	194.53	5%	3846.3	3779.2	-67.184	-2%	3850.3	3891.3	40.97	1%	4275.0	4394.1	119.025	3%	4594.4	4682.6	88.247	2%
QLD	Mining revenues	3257	2795	-462	-14%	2426.0	2139.0	-287	-12%	2686.0	2378.0	-308	-11%	2506.0	2058.0	-448	-18%	2350.0	2122.0	-228	-10%
	Payroll tax revenues	3492	3462	-30	-1%	3715.0	3751.0	36	1%	3976.0	3914.0	-62	-2%	3955.0	3782.0	-173	-4%	3795.0	3712.0	-83	-2%
	Land tax revenues	1047	1013	-34	-3%	1012.0	990.0	-22	-2%	980.0	986.0	6	1%	995.0	977.0	-18	-2%	996.0	1010.0	14	1%
	Stamp duty conveyance revenues	1960	2023	63	3%	1968.0	1887.0	-81	-4%	2320.0	2403.0	83	4%	2883.0	3082.0	199	7%	3117.0	3005.0	-112	-4%
	Commonwealth payments	21898	22749	851	4%	18506.0	18295.0	-211	-1%	20330.0	21755.0	1425	7%	23037.0	23594.0	557	2%	24869.0	23740.0	-1129	-5%
SA	Mining revenues	195.75	203.69	7.94	4%	204.6	171.9	-32.7	-16%	281.8	312.3	30.5	11%	293.1	238.5	-54.6	-19%	248.7	201.4	-47.3	-19%
	Payroll tax revenues	1039	1010	-29	-3%	1105	1077	-28	-3%	1139	1079	-60	-5%	1147	1096	-51	-4%	1139	1111	-28	-2%
	Land tax revenues	601	588	-13	-2%	576	562	-14	-2%	572	565	-7	-1%	564	559	-5	-1%	581	570	-11	-2%
	Stamp duty conveyance revenues	817	764	-53	-6%	807	894	87	11%	936	874	-62	-7%	1002	1026	24	2%	1023	1007	-16	-2%
	Commonwealth payments	7622	7636	14	0%	6865	6655	-210	-3%	6806	6731	-75	-1%	7190	7210	20	0%	8095	7995	-100	-1%
TAS	Mining revenues	50	54	4	8%	41	29	-12	-29%	34.6	36	1.4	4%	29	27	-2	-7%	28	15	-13	-46%
	Payroll tax revenues	302.4	304	1.6	1%	305.7	275	-30.7	-10%	298.6	300	1.4	0%	310.1	312	1.9	1%	321.5	325	3.5	1%
	Land tax revenues	90	88	-2	-2%	89.8	89	-0.8	-1%	86.6	86	-0.6	-1%	90.7	83	-7.7	-8%	90.4	97	6.6	7%
	Stamp duty conveyance revenues	137.5	136	-1.5	-1%	131.5	139	7.5	6%	153.6	154	0.4	0%	174.1	193	18.9	11%	194.4	216	21.6	11%
	Commonwealth payments	2895.3	3016	120.7	4%	2861.7	2937	75.3	3%	2881.5	2976	94.5	3%	3071.7	3133	61.3	2%	3477.4	3510	32.6	1%
WA	Mining revenues	4579	4343	-236	-5%	4366	4425	59	1%	6089	6025	-64	-1%	4368	4603	235	5%	3788	4126	338	9%
	Payroll tax revenues	3032	3096	64	2%	3584	3476	-108	-3%	3730	3566	-164	-4%	3737	3602	-135	-4%	3697	3502	-195	-5%
	Land tax revenues	549	552	3	1%	569	568	-1	0%	662	661	-1	0%	750	744	-6	-1%	949	948	-1	0%
	Stamp duty conveyance revenues	1291	1362	71	5%	1624	1870	246	15%	2047	1969	-78	-4%	1882	1699	-183	-10%	1546	1756	210	14%
	Commonwealth payments	8599	8633	34	0%	7693	7781	88	1%	7583	7498	-85	-1%	7533	7810	277	4%	6748	7038	290	4%
VIC	Mining revenues	45.7	65.6	19.9	44%	46.3	45.1	-1.2	-3%	47.5	52.4	4.9	10%	51.4	44.3	-7.1	-14%	51.2	49	-2.2	-4%
	Payroll tax revenues	4659.8	4695.8	36	1%	4868.5	4750.9	-117.6	-2%	4910	4949.1	39.1	1%	5148.4	5135	-13.4	0%	5394.2	5365	-29.2	-1%
	Land tax revenues	1360.1	1401.4	41.3	3%	1587.3	1589.2	1.9	0%	1566.4	1658.7	92.3	6%	1750.9	1753	2.1	0%	1740.6	1771	30.4	2%
	Stamp duty conveyance revenues	3650.6	3307	-343.6	-9%	3162	3276.1	114.1	4%	3908.6	4167.5	258.9	7%	4472	4938	466	10%	5418	5839	421	8%
	Commonwealth payments	19728.3	19818.4	90.1	0%	19113.4	19155.9	42.5	0%	20539	22440.6	1901.6	9%	21448.3	21010.3	-438	-2%	22343.6	22309	-34.6	0%

Data Source: All data used in the above analysis has been sourced from the individual States’ budget-review/mid-year and annual financial statements, for the financial years 2011-12 to 2015-16, as published by the respective State Treasuries.

**Summary**

- The above table compares the predictions that State Treasuries made in their budget-review/mid-year financial statement for a particular stream of revenue, and compares the per cent variation of that prediction with the actual results for that revenue stream, available in the annual financial statements for the State.
- The per cent variation is shaded in green colour if the variation of prediction from the actual is within  $\pm 5$  per cent and shaded red if it is greater than 5%.
- The revenue streams chosen are the ones assessed in determining the GST distribution, e.g. mining revenues, payroll tax revenues, stanp duty conveyance revenues etc.
- The objective of this exercise was to check if at least certain States are forecasting their revenues quite accurately, so that the CGC can study their models and develop their own expertise in using six months of revenue data available for a State to predict the annual revenues for that State from that stream. It would enable the CGC to use forecasted revenues for the final assessment year, in order to implement the ACT’s contemporaneity proposal.
- Results show that the models used by treasuries in Queensland and Western Australia for predicting stamp duty conveyance revenue and minin revenue (respectively) are fairly accurate and the CGC can study those models to develop their own versions of revenue forecasting algorithm.



Comparison of Volatility of Relativities between One-Year and Three-Year Assessment Periods

Report	Application Year	Assessment Year	Relativities based on One Year Assessment Proposal								Actual Relativities based on Three Year Average							
			NSW	Vic	Qld	WA	SA	Tas	ACT	NT	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
2017 Update	2017-18	2015-16	0.83554	0.93168	1.13841	0.59823	1.43817	1.82883	1.19706	4.27876	0.87672	0.93239	1.18769	0.34434	1.43997	1.80477	1.19496	4.66024
2016 Update	2016-17	2014-15	0.86858	0.97824	1.12638	0.41091	1.41994	1.74379	1.19064	4.57894	0.90464	0.90967	1.17109	0.30330	1.41695	1.77693	1.15648	5.28450
2015 Review	2015-16	2013-14	0.925	0.864	1.27	0.154	1.463	1.837	1.116	5.045	0.94700	0.89300	1.12800	0.30000	1.35900	1.81900	1.10000	5.57100
2014 Update	2014-15	2012-13	0.94695	0.86552	1.14452	0.32681	1.3407	1.69799	1.2117	5.84984	0.97500	0.88282	1.07876	0.37627	1.28803	1.63485	1.23600	5.66061
2013 Update	2013-14	2011-12	0.99000	0.90500	1.05300	0.35500	1.21400	1.78900	1.29900	5.47000	0.96600	0.90400	1.05600	0.44600	1.26200	1.61500	1.22100	5.31400
2012 Update	2012-13	2010-11	0.96960	0.89179	1.12229	0.29564	1.30324	1.48680	1.22499	5.66206	0.95340	0.92135	0.98506	0.55135	1.28491	1.58105	1.18508	5.52844
2011 Update	2011-12	2009-10	0.97819	0.89986	0.98295	0.62637	1.22545	1.53796	1.07965	5.23021	0.95776	0.90476	0.92861	0.71729	1.27070	1.59942	1.11647	5.35708
2010 Review	2010-11	2008-09	0.98635	0.96242	0.82893	0.65148	1.28743	1.65959	1.20206	5.26913	0.95205	0.93995	0.91322	0.68298	1.28497	1.62091	1.15295	5.07383
		Standard Deviation	0.05759	0.04206	0.13132	0.17997	0.09575	0.13011	0.06700	0.53009	0.03343	0.01931	0.10552	0.16681	0.07002	0.10022	0.04788	0.32060
		Variance	0.00332	0.00177	0.01724	0.03239	0.00917	0.01693	0.00449	0.28100	0.00112	0.00037	0.01113	0.02783	0.00490	0.01004	0.00229	0.10278

Coefficient of variation	6.1%	4.6%	12.1%	42.1%	7.2%	7.7%	5.6%	10.2%	3.6%	2.1%	10.0%	35.9%	5.3%	6.0%	4.1%	6.0%
--------------------------	------	------	-------	-------	------	------	------	-------	------	------	-------	-------	------	------	------	------

Data Source: Review and Update reports from the Commonwealth Grants Commission, 2010 to 2017.  
Attachment/Chapter: Calculation of GST Relativities

Summary

- The above table compares the volatility of State relativities if a one-year assessment period would have been used for determining relativities instead of a three-year assessment period. Coefficient of variation, calculated by dividing sample standard deviation by the sample mean, is used as the measure of volatility.
- Relativities based on a one-year assessment period are determined by considering the relativity of the final assessment year relevant to that Update or Review. E.g. the final assessment year for the 2017 Update was 2015-16. Hence, in the case of a one-year assessment period, the relativity that the CGC calculated for each State for 2015-16, using that year’s data, became the relativity for that State in the 2017 Update.
- Relativities for three-year assessment period are the actual relativities used by the CGC to recommend GST distribution for the next financial year.
- A comparison of the coefficient of variation of each State’s relativity between the one-year and three-year assessment periods shows that there isn’t much variation between the two.
  - E.g. for NSW, the coefficient of variation of relativities calculated using one-year assessment period is 6.1% while it is 3.6% for relativities calculated using a three-year assessment period. These two values do not differ by much. In fact the highest difference is for WA, which is about 6.2%, again, not a large figure.



**Estimation of GST paid in States using household final consumption expenditure**

State	Expenditure <sup>1</sup> (\$m)	% of National Expenditure	% of National Population <sup>2</sup>
ACT	16,446	1.75%	1.64%
NSW	316,821	33.67%	32.05%
NT	10,466	1.11%	1.02%
QLD	182,808	19.43%	20.08%
SA	61,553	6.54%	7.12%
TAS	17,749	1.89%	2.16%
VIC	232,990	24.76%	25.03%
WA	102,158	10.86%	10.89%
<b>Total</b>	<b>940,991</b>	<b>100%</b>	<b>100%</b>

**Notes**

1. Household final consumption expenditure data sourced from ABS 5220.0, Australian National Accounts: State Accounts, 2015-16
2. Population numbers as on 31 Dec 2015, sourced from Commonwealth budget.

**Summary**

- This table shows the relationship between GST raised in a State and EPC distribution of GST, assuming that the former can be measured using State Household Final Consumption Expenditure (HFCE) as a proxy.
- National expenditure is the sum of all States' HFCE.
- Taking the example of the NT and Victoria, it is observed that the NT raises 1.11% of total GST (as measured using HFCE data) while Victoria raises 24.76% of all GST. At the same time, the NT's and Victoria's populations are 1.02% and 25.03% of Australia's respectively. Thus, if GST was to be distributed EPC, it would mean that the NT would get less GST than it raised, while Victoria would get more GST than it raised.
- This completely negates the argument of partial equalisation since a fiscally stronger State like Victoria would get more GST than it raised while a fiscally weaker State like the NT would get less GST than it raised, equivalent to GST being moved from the NT to Victoria.

**THIS PAGE LEFT BLANK INTENTIONALLY**

**Funding Requirement to Support an EPC Distribution of GST with  
Additional Assistance to Fiscally Weaker States**

GST Pool 2017-18 (\$m)                      62,340  
EPC Component (\$pc)                      2,526.34

State	Assessed Need	Difference vs WA (\$pc)	Population 2017-18 (m)	Funds Distributed EPC (\$m)	Initial Total Grant (\$m)	Budgeted GST Allocation (\$m)	Shortfall (\$m)	Total Top-up Funding (\$m)	Total GST and Top-up Funding (\$m)
NSW	2,002	569	7.91	19,983	19,983	17,554.08	-	-	19,983
VIC	2,232	799	6.238	15,759	15,759	14,765.36	-	-	15,759
QLD	2,727	1,294	4.942	12,485	12,485	14,870.69	2,385.51	2,385.51	14,871
WA	1,433	0	2.682	6,776	6,776	2,327.32	-	-	6,776
SA	3,446	2,013	1.732	4,376	4,376	6,302.60	1,926.97	1,926.97	6,303
TAS	4,382	2,949	0.522	1,319	1,539	2,387.37	847.99	1,068.62	2,387
ACT	2,868	1,435	0.404	1,021	1,021	1,224.62	203.97	203.97	1,225
NT	10,251	8,818	0.246	621	2,169	2,907.97	738.74	2,286.49	2,908
<b>Total</b>	<b>NA</b>	<b>NA</b>	<b>24.676</b>	<b>62,340</b>	<b>64,108</b>	<b>62,340</b>	<b>6,103</b>	<b>7,872</b>	<b>70,212</b>

Sources: 2017 Update Report, Table S3-1-8, Assessed budgets summary, 2015-16 (\$ per capita)  
2017 Update Report, Table S1-1, Estimated resident populations and projections by State, at 31 December (persons)

## ACT GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT ON HFE

### Summary

- This table shows the top-up finding that would be required based on the EPC distribution of GST with top-up for the 'recipient' States.
- First, the entire GST is distributed EPC.
- Next, it is checked whether the EPC component of GST is enough to offset the difference in assessed needs with the strongest State, WA, available in the 3<sup>rd</sup> column.
  - If the EPC component is enough to offset the difference, top-up funding is not required, at this stage of proposal.
  - If the EPC component is not enough to offset the difference, then a top-up funding is provided.
  - Barring Tasmania and the Northern Territory, no other State gets any top-up funding at this stage since their difference in assessed need with WA on a per capita basis is less than the EPC component.
- The initial grant is calculated as a sum of GST distributed EPC and top-up funding provided (if any).
- This initial grant is then compared with the budgetary allocation of GST done using the full equalisation method, to check if any of the States are falling short of untied funds emanating from GST.
- If there is a shortfall, further top-up funds are provided and at this stage, QLD, SA and ACT get top-up funding, in addition to further top-up funding provided to Tasmania and the NT. The total top-up funding provided under this scheme comes to \$7.9 billion.

**THIS PAGE LEFT BLANK INTENTIONALLY**



Chief Minister, Treasury and Economic  
Development Directorate

November 2017