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Dear Ms K Chester 11.1.2018

Productivity Commission

PO Locked Bag 2,Collins St East

Melbourne Vic 8003

Dear Ms Chester, REFORMING HFE IN THE GST DISTRIBUTION

The Federal Treasurer is to be complimented for nominating HFE as the focus for the Inquiries he instigated for the PC by mid-May 2018 and the CGC by Feb.2020, into the GST Distribution system, now considered at the highest levels to be broken.

I believe the Australian system is broken because of its complexity and use of HFM (M = Maximisation of Services/Revenue instead of Equalisation).

I have addressed these two supposed causes in my enclosed paper of 10.1.2018.

My suggestions probably need or deserve wider consideration, but for a short time, these are being confined to the PC and CGC who naturally, must both be engaged in any major system changes.

Being 93 years old or young as preferred, and as time is precious, I await your comment with interest.

Yours sincerely,

John P McAuley

Copy to Secretary, CGC

REFORMING HFE IN THE GST DISTRIBUTION : ATTACHMENT

MAIN POINTS

1.HFE is nowhere defined, is variously applied. Central purpose is Equity.

2.OECD:HFE aims for typical citizen to equitably access public Services. In the 1940-50's Revenue-raising began to be equalised as well.

3. HFE IN AUST.: CGC equalises Services & Revenue at levels of States with (highest) Maximum levels,ie CGC uses HFM, not HFE, thereby expanding subsidies.

4. OTHER RESERVATIONS: 1. CGC introduces complex immeasureable concepts, eg effort/fiscal capacity.2.Subsidies are difficult to disentangle from other Cw. payts.

5.SHARING HIGH/LOW S/R AMOUNTS: Causes & rationale for sharing may be obscure, eg high cost may be due to greed or need. Resolve this by use of the State agg. balanced (current non-capital) Budget.

6. CGC's PROCEDURAL COMPLEXITY: Threshold has been passed; now imperative to simplify by confining equalising only to items common to all States, with their all-State aggregates equal to approx. 50% of totals for Services and Revenue respectively (at present CGC equalises 60% of Revenue).

7. PROCEDURE RECOMMENDED: Refer to the four steps outlined on page 2.

EFFECTS ON GST ADJUSTMENTS FOR A STATE WITH HIGH/LOW S/R

Services(S) Cost	Revenue(R)	Net Effect
High(above ave) = Donor	Low(below ave) = Recipient	
High	Low, offsetting	Nil * (* Subject to High/Low Relativities)
Low	High, offsetting	Nil * " " "
Ave	Ave	Nil
High	High, accentuating	+, Donor
Low	Low, accentuating	-, Recipient

JPMcA 10.1.18

REFORMING HFE IN THE GST DISTRIBUTION

1. HFE DISCRIPTION: Horizontal Fiscal Equalisation (HFE) is a concept and is nowhere defined with authority. Accordingly, its implementation within Federations is diverse, often highly controversial, with probably no two countries being identical in its application. The procedure used by the Cwlth. Grants Com. (CGC) in Australia is unique. The Inter- Gov. Agreement Implementation (GST) Act 2000 requires the principles of HFE be implemented but the Act does not define the concept. Despite the diversity and absence of preciseness, the purpose of HFE is clear and denoted by Equalisation, ie equity amongst given states/provinces. This may be coupled with objectives of efficiency and stability, but as to which items should be equalised and how measured, these are left to practical procedures and circumstances, within the stated objective of promoting equity.

2. OECD: The closest source of an acceptable definition is represented by the descriptions given by the OECD (ref. 1) where it stated that "The objective of equalisation is to provide every citizen (wherever domiciled) with an average level of public services at comparable rates". Two points are to be noted: 1. provision of Services, and 2. at the Average cost level. The OECD report further explains that additional to Services, equalisation of Revenue-raising was commenced to be included in some countries, only from the 1940-50's. The OECD warned that this inclusion of Revenue might warp industry location decisions, especially of public & private infrastructure and in poorer states, and could reduce constructive tax and development effort.

3. HFE IN AUSTRALIA: The OECD states that "the driving force for equalisation is equity" and the report gives every indication that equity is represented by the average (arithmetic mean). The CGC on the other hand departs from this standard. Equity in the CGC's procedure is represented by the standard set by the State which has the Highest, not Average level of Service. Thus "The current operational definition of HFE that the CGC has adopted is that each State should ...have the fiscal capacity to provide services and associated infrastructure at the same standard if each made the same effort to raise revenue from its own resources at the (assumed) same level of efficiency" (ref.2). The CGC would contend that "same standard" implies this could include a standard different from the average, ie includes the all-state Highest, which it uses, thereby obliging itself to introduce Revenue-raising into HFE at levels commensurate with financing equalised Services at the Highest, not average cost levels. I suggest the CGC's procedure in this respect would be a unique world-first. Even if another precedent exists somewhere, disadvantages from using the Highest standard seem to be predominant. I suggest the CGC's procedure is best described not as HFE, but more aptly as HFM (M=Maximisation, not Equalisation). The effect of using HFM instead of HFE is to inflate the + and - levels of adjustments, ie the subsidies to the recipient States and required to be paid by the donors, in the annual GST distributions.

4. OTHER RESERVATIONS: Equalisation of Revenue-raising at "the same, equivalent "effort" as described by CGC in ref.2, is more complex and difficult to measure acceptably. The CGC endeavours to overcome this by its bold assumptions that "Fiscal Capacity (FC) is measured (more easily) by reference to net financial assets per capita" (NFApc), and that FC and NFApc are equal provided there is equality in the same/average levels of Services & Revenue. State Fiscal Capacity however is notoriously difficult to

measure because it depends on unpredictable policy decisions, community attitudes, Cwlth. interventions, natural resources, CSG exploration & development, native titles, poker machines & other gambling facilities etc. Moreover, calculations of subsidies made by the CGC are difficult to disentangle from other payments by the Cwlth., namely General Revenue Assistance, Payments for Specific Purposes, and Agreements covering Health, Education, Housing etc.

5. SHARING OF HIGH/LOW REVENUE-raising/SERVICES-cost: Reasons for relatively high or low amounts may not always be readily evident. These could be due to size/dispersion of population, economies of scale, superstructure support, education/skill of workforce, and so on. This difficulty obscures whether an extreme cost of a Service is due to "greed" or "need", and thus leads to a query whether a high amount is necessarily a rational basis for sharing with other States. This dilemma would be resolved on the basis now recommended of targeting that, for the all-State aggregate of (common) Services expenses to be shared in the given year, is approx. equal to the all-State aggregate Revenue-raised to be shared. This means accepting as a norm for the particular year, a balanced, aggregate State current (non-capital) Budget. This would represent an (implied) inducement for a State, given the Revenue expected to be available, to restrain expenditure on Services so as to result in a balanced Budget.

6. PROCEDURAL COMPLEXITY: Simplicity has now become paramount, given that it takes 800 pages and 3 volumes for the CGC's annual results to be presented, so that comprehension and capacity for revisions are jeopardised. It is noted that the CGC omits from its equalising procedure, approx. 40% of all-State revenue. It is recommended that (1) equalising be now confined only to those Services and Revenue items common to virtually all States; and (2) that these common items be so selected that their all-State aggregates represent approx. 50% of current Expenditure & Revenue respectively, with negligible balance in this Budget. The 50% rate is tentative, would be variable yearly, and flexible to the aim of reasonably acceptable GST adjustments for recipient and donor States. Confining revenue to common items should solve the broken system of which WA complains.

7. PROCEDURE RECOMMENDED: 1. For each year, CGC to select the principal, items common to all States, of current expenditure on Services cost, and current (non-capital) Revenue raised, such that the all-State aggregates for common Services and Revenue are equal in balance to one another, and in each case, to approx. 50% of the State total. 2. The Aust. Population is divided into each of the two aggregates from (1), to arrive at the average per capita amounts. 3. For each State, the differences for Services and Revenue are obtained between the State's average per capita and the Aust. average. 4. The net between these plus or minus differences when multiplied by the respective State population, represent the amounts which each State has to pay to, or is due to receive from the GST pool. Overall, these pluses and minuses should approx. cancel to 0: refer Attachment.

Source 1.Fiscal Equalisation in OECD Countries, OECD Working Paper 4 of 2007

2 CGC Review 2015

John P McAuley 10.1.2018