



Australian Government  
Productivity Commission

# Horizontal Fiscal Equalisation

Productivity Commission  
Inquiry Report  
*Overview & Recommendations*

No. 88, 15 May 2018

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The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

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# Contents

<b>Key points</b>	<b>2</b>
<b>Overview</b>	<b>3</b>
The Commission's task and approach	5
What is HFE and why does it exist?	6
Our assessment of the current HFE system	10
A revised objective and better governance for HFE	18
Are there alternative approaches?	21
A proposed way forward	32
<b>Findings and recommendations</b>	<b>37</b>

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## OVERVIEW

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## Key points

- The basic premise of Horizontal Fiscal Equalisation — fiscal equality in the Australian federation — has broad support from all levels of government.
- The current practice of HFE seeks to give all States the same fiscal capacity to deliver public services. To do this, all States are brought up to the fiscal capacity of the fiscally strongest State (currently, as assessed by the Commonwealth Grants Commission, Western Australia).
- This approach to HFE is under intense scrutiny at present as Western Australia's share of the GST has fallen to a record low. Even so, the current system of HFE has strengths.
  - It compensates States for their structural disadvantages and achieves an almost complete degree of fiscal equalisation — unique among OECD countries.
  - The independent and expert CGC is well placed to recommend GST relativities. It has well-established processes that involve consultation and regular methodology reviews.
- But the current approach also has significant weaknesses. Reform and development opportunities are likely being missed at the expense of community wellbeing over time.
  - There is much scope for the system to discourage State policy for major tax reform and desirable mineral and energy policies (royalties and development).
  - Full fiscal equalisation does not systematically allow States to retain the dividends of their policy efforts. This raises concerns about the fairness of equalisation outcomes and corrodes public confidence in the system.
  - The system is very poorly understood by the public and indeed by most within government — lending itself to a myriad of myths and confused accountability.
- While equity should remain at the heart of HFE, there is a need for a better balance between equity and efficiency.
  - The Commonwealth Government should set a revised objective for HFE to provide States with the fiscal capacity to deliver a **reasonable standard** of services. Changing the objective is an essential precursor to further improvements to the HFE system.
- Governance reforms are also needed. This includes the CGC playing a more prominent communication role to inform the public discourse on HFE.
- The CGC should be directed (without delay) to pursue more simple and policy-neutral assessments, and increase its materiality thresholds, in line with achieving a reasonable standard of equalisation. Other 'in-system' changes proposed by others, such as mining discounts, do not resolve HFE's deficiencies and pose too much of a risk to fiscal equality.
- In-system and governance changes will improve HFE but can only go so far. Additional efficiency gains are only in prospect from an alternative equalisation benchmark, which many would regard as a fairer outcome.
  - Amongst a number of options designed to equalise to a **reasonable standard**, equalisation to the average of all States (rather than to the strongest State) is judged to provide a better balance between fiscal equality, fairness and efficiency.
- Changing the benchmark in the current fiscal environment will lead to a material redistribution of the GST. This change is likely to prove manageable for all States if phased. Transition should be funded by the beneficiary States and by hastening slowly, such that no State sees a reduction in its GST from one year to the next of more than 2 per cent of its overall revenue.
- The transition paths outlined in this report would soften any year-on-year impact, to less than 1 per cent of State revenue.
- Improving HFE will deliver benefits to the Australian community. But ultimately, greater benefits will only come from more fundamental reforms to Australia's federal financial relations: namely, to spending and revenue raising responsibilities and ensuing accountabilities.

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# Overview

Australia's system of horizontal fiscal equalisation (HFE) transfers GST between the States and Territories (hereafter States) with the aim of equalising States' fiscal capacities to deliver public services. HFE has often been a point of contention with the States, as each has vied for a larger share of the funding pool.

There is nothing new about these arguments between the States. This has been going on since 1933. (Peter Costello 2006)

But this contention has elevated markedly in recent times as the extent of redistribution has risen to an unprecedented high — embodied in Western Australia's share of the GST falling to a record low (figure 1). This 'new low' has been anticipated since 2011, but arguably was not at the time the GST distribution deal was struck more than a decade earlier in 1999.

A key factor behind this has been the recent mining investment and construction boom, which had a particularly strong and lasting impact on Western Australia's fiscal capacity. Although the mining boom is fading and Western Australia's economy (and revenue-raising capacity) has significantly weakened, it still remains the fiscally strongest State — as assessed by the Commonwealth Grants Commission (CGC) — and is expected to remain so for much of the foreseeable future.

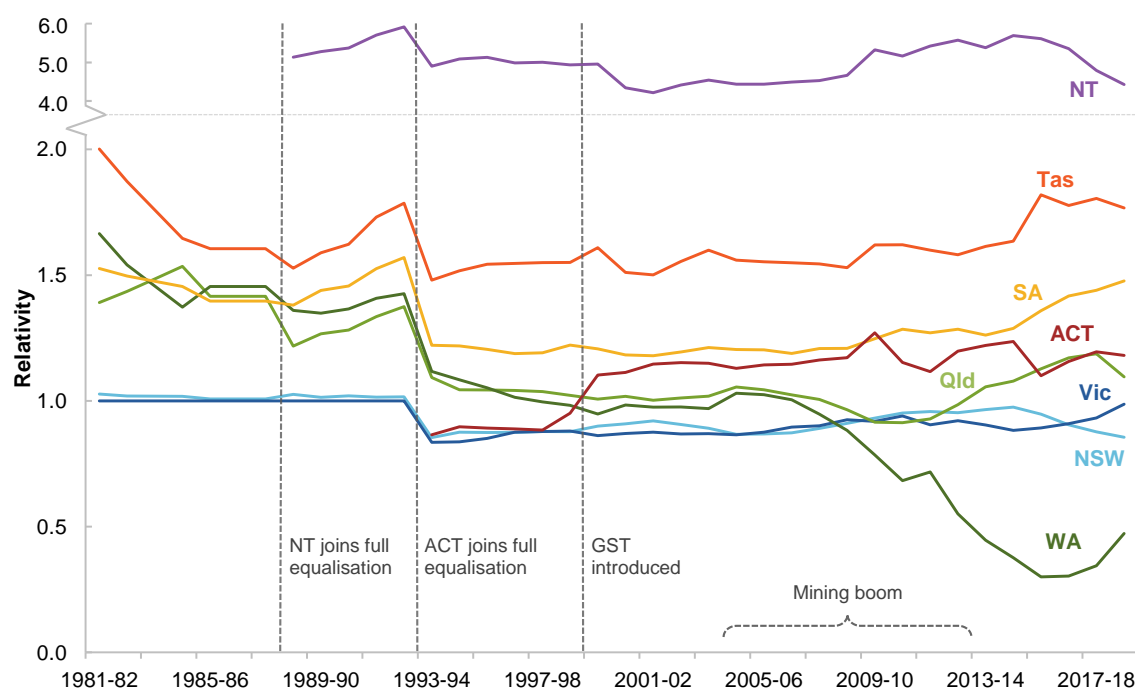
Since its inception, the way any State views the operation of HFE at any point in time is largely subject to Miles' law — 'where you stand depends on where you sit'.

Many in Western Australia have expressed extreme dissatisfaction with that State's low share of the GST. This discontent reflects perceptions about fairness and the extent of equalisation away from Western Australia, although some of this is driven by the misconception that States are 'entitled' to their population share of the GST revenue pool.

Some participants have also argued that the HFE system impedes economic growth by acting as a disincentive for State Governments to reform their tax system or to develop particular industries or projects, or by cross-subsidising States that ban mineral or energy extraction. Some of these concerns have become heightened in recent times due to the mining boom and debate about the domestic availability of natural gas.

Other parties, particularly from the smaller and fiscally weaker States, have spoken out against many of these views, emphasising HFE's role in promoting fiscal equality across the Australian federation, especially given the inherent disadvantages some States face in raising revenue or delivering services.

Figure 1 Divergence in State per capita GST relativities



Views about Australia’s HFE system are strongly held but some of these are underpinned by misconceptions or are encumbered by a dearth of evidence on the effects of the system on the Australian economy and community. Over the years there have been numerous calls for substantial change to HFE, including in several major independent reviews — such as the review of Commonwealth-State Funding in 2002 (Garnaut and FitzGerald 2002b), the GST Distribution Review in 2012 (Brumby, Carter and Greiner 2012a), and the National Commission of Audit in 2014 (NCOA 2014). And while there have been modest improvements to the system, deficiencies remain.

It is against this backdrop that the Commission has been asked to undertake an inquiry into Australia’s system of HFE. The inquiry provides an opportunity to examine whether there are sustainable ways to address long-running concerns about the HFE system. And while the outcomes for Western Australia have exposed weaknesses in the HFE system, the Commission’s recommendations in this report are not designed to ‘repair’ the current fiscal circumstances of any single State. The proposed changes are aimed at improving the HFE system for the benefit of the Australian community as a whole.



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## The Commission's task and approach

The terms of reference for this inquiry essentially task the Productivity Commission to ask and answer two broad questions. The first is how the current HFE system impacts on the Australian community, economy and State Governments, specifically with respect to:

- productivity, efficiency and economic growth, including the movement of capital and labour across State borders
- the incentives for the States to undertake fiscal (expenditure and revenue) reforms that improve the operation of their own jurisdictions
- States' abilities to prepare and deliver annual budgets.

The second is whether there are preferable alternatives to the current system of HFE.

With that in mind, the Commission has assessed the current HFE system and proposed alternatives against a framework built on the criteria of equity, efficiency, and transparency and accountability. The Commission's framework has evolved from that used in the draft report and takes a broad interpretation of equity for HFE — one that incorporates both fiscal equality and fairness (or reward for policy effort) in the distribution of the GST (box 1). Balancing fiscal equality and fairness through this broader equity lens means that States' fiscal capacities do not necessarily have to be equal.

### Box 1      **'Fairness' — a broader interpretation of equity for HFE**

The basic premise of HFE — fiscal equality in the Australian federation — has broad support. Even so, views on 'equity', 'equality' and 'fairness' of the system differ. The current HFE objective presents equity as full equalisation of fiscal capacities between States. Many participants agreed with this, while others saw equity as equal *treatment* of States — with the GST distributed equally per capita, regardless of State demographics or circumstances. Yet others viewed equity as equality of *opportunity* — where funding compensates States for unequal starting points, but also allows them to reap some fiscal benefits from their policy efforts.

The notion of 'fairness' of the HFE system was also raised. Although interpretations differ, it was often viewed as reward for hard work or skill — or keeping a share of the financial benefits of that work. The dilemma in designing an HFE system is that it is not easy to distinguish between fiscal gains that reflect a State Government's policy effort from those that are merely 'the luck of the draw'. In many cases, it will be a combination of the two. For instance, although some States are endowed with an abundance of valuable natural resources, such as minerals, they must exert some effort in facilitating extraction and development of their resources, such as licensing and approvals. Such effort can be considerable, especially for contentious mining activities.

The Commission considers it important to take account of concerns about fairness, especially where such concerns relate to disincentives for good policy (efficiency). And thus, our assessment of how the HFE system achieves equity takes account of whether it can address inherent advantages and disadvantages in the fiscal capacities of the States (fiscal equality) *and* reflect some fiscal reward for effort and policy reform (fairness).

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The Commission's framework also acknowledges that it is not possible to completely avoid adverse efficiency effects arising from any system of HFE. This is because systems of redistribution, such as HFE, are based on measures of fiscal capacities that can be influenced by governments, and thus adverse incentive effects are, in principle, inescapable. The key goal is to ensure that the HFE system does not *unduly* discourage efficiency-enhancing reforms, productivity improvements, or growth.

In carrying out our assessment, the Commission has constructed a set of 'cameos' to illustrate the efficiency effects of the system. This was done by looking at how potential State policy changes can impact on States' GST shares and the influence this might have on States' incentives. Since the draft report, the Commission has developed additional cameos to test these ideas further. Work has also been undertaken to assess the relative efficiency effects of alternative equalisation benchmarks. Finally, the Commission has developed a set of principles to guide the transition to any new equalisation approach and has assessed what the transitional impacts might be. The latter benefited from further (post draft report) consultation with the Commonwealth and the States, to inform projections of State relativities and the GST pool for the transition period.

## What is HFE and why does it exist?

HFE involves the transfer of funds to or between States to offset differences in revenue-raising capacities and/or the use and costs of providing services and infrastructure.

The primary rationale for HFE is fiscal equality, or the equal treatment of equals — as people in different regions might expect to be treated under a unitary government. This is an unrealistic expectation in a federation, where the States have significant policy autonomy. So in practice HFE seeks equal fiscal treatment of jurisdictions, not interpersonal equity.

There is also an efficiency aspect to HFE. The theory argues that, in the absence of HFE, people could move interstate solely due to differences in States' abilities to offer lower taxes or a greater level of services, instead of underlying economic drivers like employment opportunities. HFE is sometimes also seen as a mechanism to insure against adverse economic shocks, by acting to offset lower revenues in a single jurisdiction. The relevance of these other rationales for HFE is more contested.

HFE is one part of a broader system of federal financial relations in Australia, which is characterised by both *horizontal* and *vertical* fiscal inequities (gaps). The latter refers to the fact that the Commonwealth Government raises revenues in excess of its spending responsibilities, while State Governments have insufficient revenue from their own sources to finance their spending responsibilities. For the States, some of this 'gap' is of their own volition, due to how they choose to use their tax bases. The distribution of GST revenues in Australia aims to correct both for the imbalance in taxing and spending powers between the Commonwealth and the States (vertical), and between the States (horizontal).

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## The current practice of HFE in Australia

The HFE system has evolved over time, primarily as a result of the work of the CGC. The objective has also evolved from partial to full and comprehensive equalisation by the early 1980s. Since the introduction of the GST in 2000, there has been limited input from the Commonwealth Government, which has provided only implicit approval of GST relativities and developments in the HFE methodology through yearly updates and the five-yearly methodology review terms of reference (box 2). Australia is recognised internationally as unique in almost completely eliminating disparities in fiscal capacity between States.

Presently, the CGC recommends a distribution of GST revenue according to the following:

State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

The CGC also applies a set of four supporting principles to guide its methodology. These are: reflect what States collectively do (rather than what they could or should do), policy neutrality (avoid individual State policy decisions directly affecting their GST shares), practicality and contemporaneity. These supporting principles, however, are generally subsidiary to the primary objective of achieving full and comprehensive equalisation.

The process used by the CGC to calculate the GST relativities is complex and comprehensive. It covers all State general government activities across seven revenue categories plus Commonwealth payments and 13 expense categories (plus net borrowing). The CGC's 2015 methodology review comprised two volumes that totalled over 800 pages.

This comprehensive scope does not mean that all activities are differentially assessed (that is, have 'disabilities' that reflect a State's structural disadvantages applied to them) or that HFE achieves perfect equalisation. Some disabilities cannot be reliably measured or have an immaterial impact and are either discounted or assessed on an equal per capita (EPC) basis. Due to this, in 2016-17, nearly 40 per cent of revenues, and about 20 per cent of expenditures were assessed on an EPC basis, or near EPC basis.

Conceptually, the CGC's formula does the following (figure 2):

1. States with relatively low fiscal capacities are raised to the average (pre-GST) fiscal capacity of all States
2. all States are then raised to the capacity of the fiscally strongest State (currently Western Australia)
3. any remaining revenue from the GST pool is distributed to all States on an EPC basis.

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## Box 2      The evolution of HFE in Australia

Horizontal fiscal equalisation has a long history in Australia. Upon federating, the six colonies of Australia ceded the right to impose and collect customs and excise duties (the dominant source of public revenue at the time) in favour of the Commonwealth. This created a vertical fiscal imbalance (VFI) and led to various general revenue-sharing schemes with the States. In addition, special grants were made to the fiscally weaker States — Western Australia, Tasmania and South Australia — largely on an ad hoc basis.

In 1933, following the threat of Western Australia's secession, the Commonwealth Grants Commission (CGC) was established to make recommendations on these special grants. This was done on the basis of making it possible for a claimant State 'by reasonable effort to function at a standard not appreciably below that of other States'. The CGC also imposed a 'penalty for claimancy' until 1945.

During the Second World War, the Commonwealth assumed sole responsibility for collecting income tax. This significantly exacerbated VFI and necessitated a greater level of general revenue sharing with the States. In the postwar period, specific purpose payments also became more important as a means of providing financial assistance and influencing the delivery of services and infrastructure within States. In contrast, the significance of horizontal equalisation achieved by way of special grants recommended by the CGC gradually declined. South Australia, Western Australia, Tasmania and Queensland entered and withdrew from claimancy at various times between 1960 and 1975.

A major change occurred in the mid to late 1970s. Financial assistance grants (to address VFI) were replaced by income tax sharing arrangements, and the Premiers' Conference of April 1977 decided that revenue under this arrangement was to be distributed on the basis of relativities based on equalisation principles. This meant that the same funding source was being used to address vertical and horizontal fiscal imbalance, and the CGC's recommendations affected the finances of all States, not just the claimant States. By 1985, the allocation to the States had become a zero-sum game, albeit initially from a much smaller pool of grants than today (\$10 billion in 1985-86, or about \$28 billion in current dollars).

The full equalisation principle, as embodied in the *States (Personal Income Tax Sharing) Amendment Act 1978* (Cwlth), referred to '... standards not appreciably different from the standards of government services provided by the other States'. Since then, there have been further revisions by the CGC to the equalisation principle, which now refers to States being able to function at the 'same standard'. Essentially, the CGC has been recommending relativities based on full equalisation since 1981.

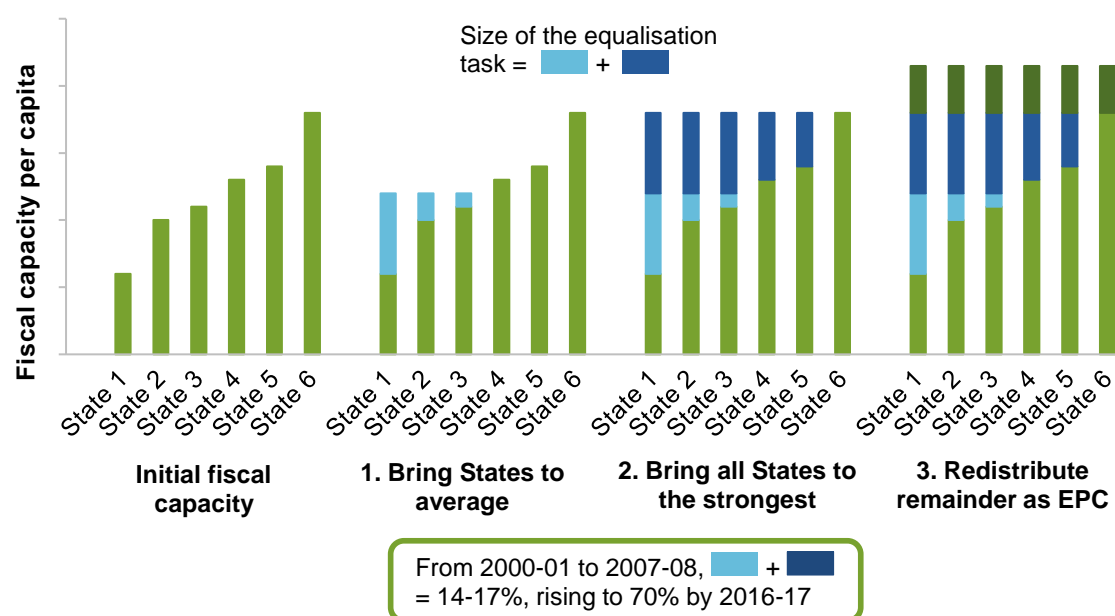
Another significant change occurred with the introduction of the GST in 2000. The GST replaced financial assistance grants and various state taxes, and the GST pool was to be returned to the States according to the principle of HFE. It meant that the Commonwealth no longer had any substantive role in determining the total level of general revenue grants to the States:

... [T]he terms were agreed between the States. This is a very important point. Now, New South Wales will come in here and say it needs more money. That is an argument it is having with Queensland and Western Australia. Not an argument with me. (Peter Costello 2006)

After these equalisation steps, all States are provided with the fiscal capacity to provide the national average level of services. And due to a vertical fiscal imbalance (VFI) between the State and Commonwealth Governments, even the fiscally strongest State requires an EPC component 'top up' (step three) to be able to provide the average level of services.

The size of the equalisation task — that is, the share of the GST pool required to bring all States up to the fiscal capacity of the strongest State — fluctuated between 14 per cent and 17 per cent of GST revenue from 2000-01 to 2007-08, before rising to 70 per cent of the pool in 2016-17 and falling to just over 50 per cent in 2018-19. This equalisation task reflects the increased disparity in the fiscal capacities of the States during this period (as also revealed in the unprecedented dispersion in GST relativities).

Figure 2 **Schema of the conceptual stages of the HFE process**



Another way to think about the size of the equalisation task is to first distribute the GST on an EPC basis and then redistribute — from States with above-average fiscal capacity to those with below-average fiscal capacity — to achieve equalisation. This measure of the equalisation task has increased from about 8 per cent to 12-13 per cent, and back down to 10-11 per cent, over the same period (figure 3).

Some of the key factors affecting the redistribution of the GST (away from a per capita distribution) are mining, remoteness and regional costs, and Indigenous status (figure 4).

Figure 3 **Share of GST pool not distributed on a per capita basis**

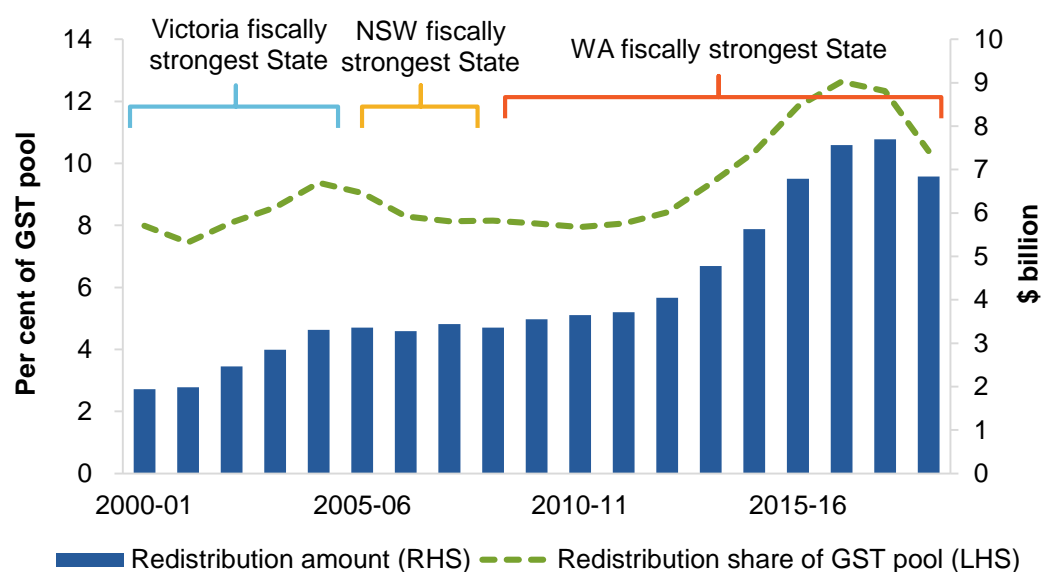


Figure 4 **GST redistribution from equal per capita, 2018-19**



## Our assessment of the current HFE system

### How does HFE affect State budget management?

GST payments provide most States with a substantial share of their overall revenue (table 1). As a result, HFE has considerable scope to influence States' budget outcomes and management.

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**Table 1 GST payments and State budgets, 2017-18**

	<i>NSW</i>	<i>Vic</i>	<i>Qld</i>	<i>WA</i>	<i>SA</i>	<i>Tas</i>	<i>ACT</i>	<i>NT</i>
Total grants revenue (\$b)	31.59	30.22	27.95	9.04	10.74	3.69	2.24	4.26
Total revenue (\$b)	79.84	64.39	56.46	28.19	19.17	5.93	5.42	5.88
GST payments (\$b)	17.51	14.99	14.85	2.26	6.28	2.38	1.24	2.89
% total grants revenue	55	50	53	25	58	64	55	68
% total revenue	22	23	26	8	33	40	23	49

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Several features of Australia's HFE system promote predictable and stable GST payments. This stability is primarily achieved by applying a three-year moving average to relativity calculations, plus a two-year data lag (to ensure robust data are available). A consequence of this emphasis on stability is that equalisation is less contemporaneous.

Less contemporaneous equalisation can exacerbate the budget cycle where State fiscal situations change abruptly — as happened to Western Australia during the mining boom. In this instance, the three-year assessment period and two-year lag in the system resulted in declining GST relativities coinciding with falls in royalty revenue, thereby intensifying the effects of the economic cycle on Western Australia's budget (box 3).

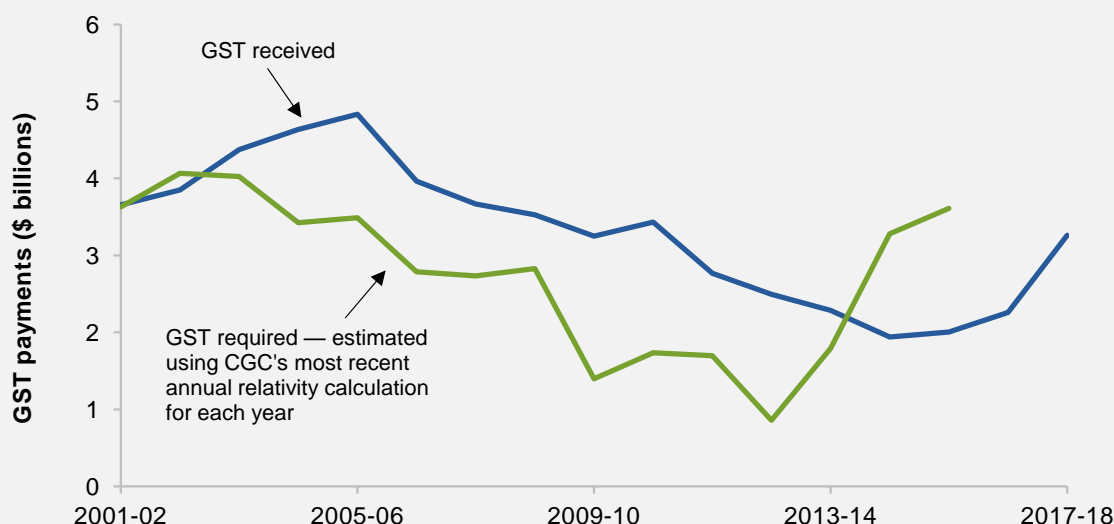
That said, Western Australia still remains the fiscally strongest State — its mining royalties are about three and a half times higher now than they were before the mining boom. Indeed, the higher level of mining production in Western Australia is expected to continue for the foreseeable future, indicating a more enduring change, rather than a transitory change, in its revenue fortunes. This is an important factor when it comes to assessing the case for change. It strongly suggests that ad hoc top-ups are not an enduring solution.

Western Australia's experience has been unprecedented, exacerbated by earlier budget decisions of the WA Government. For States with less extreme changes in fiscal capacity, limited contemporaneity has been less problematic, and indeed most other States prefer an emphasis on stability (particularly as GST payments are on average less volatile than other State revenue sources).

Trying to increase the contemporaneity of the assessment could introduce additional complexity and volatility. The most effective response to a lack of contemporaneity lies with the States themselves. States have a range of methods, including borrowing and saving, by which they can manage gaps between their GST needs and actual payments, as they already use for other sources of budget volatility.

### Box 3 Western Australia's fiscal position

The mining construction boom has driven large shifts in Western Australia's fiscal capacity. Its revenue-raising capacity increased by about 90 per cent from 2007-08 to its peak in 2013-14. Royalty income alone over this period increased from about \$1.7 billion to about \$6 billion, but declined in the following years. The three-year assessment period and two-year lag have complicated budget management by slowing the change in Western Australia's relative to these changes in its fiscal capacity.



In practice this meant that while Western Australia's royalties were increasing, it received larger GST payments than it would have received under a fully contemporaneous HFE system. The CGC has estimated that growth in iron ore royalties resulted in Western Australia retaining an extra \$7 billion in the six years to 2015-16. Similarly, as Western Australia's royalty income has declined, it has received lower GST payments than its assessed needs. This has contributed to a deteriorating fiscal position.

However, the lower GST payments were forecast by the WA State Treasury. The 2011-12 budget projected a fall in WA's relativity from 0.72 to 0.33 by 2014-15. But the WA Government had expectations of HFE reform (following the 2012 GST Review). The then WA Treasurer stated in his 2011-12 budget speech:

What we reasonably anticipate is that in 2013-14 the CGC will have brought in a new GST system. We expect it will produce a floor of about 75 per cent of our population share of the GST. Therefore we expect extra revenue of \$1.8 billion in 2013-14 and \$2.5 billion in 2014-15. These amounts will allow for reduced borrowings and will be used to progressively reduce existing debt to less than \$18 billion while maintaining strong infrastructure investment ... If that change does not occur in that year, the State Government will then have no choice but to wind back infrastructure investment to decrease debt. (Porter 2011, p. 3)

This suggests the State was on a higher course of spending than would be the case if there were no expectation of a floor. A recent inquiry into WA Government expenditure (Langoulant 2018) reached a similar conclusion, stating that 'if the warnings Treasury provided that the policy settings of the day would cause major difficulties in the future had been heeded, it is highly likely that the State's current budget and debt positions would have been mitigated, and in a material manner' (p. 55). Several inquiry participants made similar points.



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## Does HFE affect State incentives for reform?

The CGC's methods for calculating GST shares to the States are intended to be policy neutral — that is, GST shares should not be affected by an individual State's policy decisions. But because average State policy is determined by what States collectively do, there is some inevitable tension with the principle of policy neutrality.

The CGC calculates GST shares by reference to average policy. On the revenue side, this means calculating how much tax a State could raise if it applied the national average tax rate. GST is then used to balance out differences between States with stronger or weaker tax bases (revenue disabilities). On the expenditure side, calculations tend to be more complex but in essence the CGC calculates how much it would cost to provide a service if every State spent in line with the national average. States' assessed expenses are then adjusted up or down depending on structural factors (expenditure disabilities) that bear on the use and/or cost of providing services, such as the age profile or level of dispersion of their population.

The tension between what States do and policy neutrality is inherent to *any* system of HFE, in that any increase in a State's fiscal capacity relative to others will see it receive less in equalisation payments. In practice, most of the concerns about potential incentives for inefficient policy outcomes are on the revenue side, with some very large potential effects in relation to major State tax reform and the taxation of minerals and energy.

### There can be disincentives for State tax reform

When a State changes its tax *rate* or tax *base*, this policy change can lead to a change in that State's share of the GST — by virtue of how the GST formula works. The direction and size of the effect is not straightforward and depends on where the State sits relative to the average.

In general, where a State changes its tax rate, the subsequent effect on the GST distribution will be small (except for the case of mining royalties). It will be larger for the larger States, as they have a bigger impact on the national average tax rate.

However, policy changes that affect the base — for example, approving new mining activity or increasing stamp duty compliance — can have a significant effect on the GST distribution. This is because changes to the base mean changes to assessed revenue raising capacity (vis-à-vis other States). For example, if a State like Victoria (with 25 per cent of Australia's population), increased its tax base and therefore increased tax revenue by \$100, it would see \$75 (\$100 less its population share) of the additional revenue redistributed to other States.

The potential to lose GST payments could discourage States from pursuing efficiency-enhancing reforms that are in the national interest. States could also be discouraged from pursuing reforms due to uncertainty about how the CGC will assess their revenues. These concerns would be significant in the event of a State undertaking major reforms to its tax mix. These incentive effects are illustrated by way of cameos in box 4.

## Box 4 Impact on GST payments of hypothetical reform ‘cameos’

The Commission has analysed three reform ‘cameos’ to illustrate how GST payments can be affected by changes in State policy. The cameos are hypothetical and show the GST impact for a single year for each State if it was to undertake the reform while the other States made no change. The impacts highlight how sensitive GST shares can be to individual State policies.

In the first cameo, a State unilaterally cuts its rate of stamp duty on property in half. The lost revenue is replaced by introducing a new broad-based land tax that applies to all residential land. While the direct impact is revenue neutral, any State that does this would likely end up losing GST payments, with New South Wales, Victoria and Queensland potentially losing about \$1 billion — and Queensland and the ACT facing the biggest per-capita losses.

In the second cameo, a State unilaterally abolishes its insurance taxes. Any State that does this would lose because spending on insurance (and consequently the measured tax base) would increase and because the State would still be assessed as having the capacity to raise revenue through insurance taxes. The GST impacts are lower than the first cameo since the insurance tax base is small relative to other tax bases.

In the third cameo, a State unilaterally introduces a new congestion tax in its capital city. This raises revenue equivalent to \$200 per capita, which is then hypothecated to public transport. The GST impacts are also modest in this case, though in practice there would be considerable uncertainty about how the CGC might treat the new tax and hypothecated spending.

### Impacts on GST payments, unilateral reform, 2016-17

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Baseline annual relativity	0.84	1.01	1.03	0.57	1.53	1.72	1.21	4.19

#### Cameo 1: Stamp duty halved with revenue replaced by new land tax

##### Lower-bound

Change in GST payments (\$m)	-337	-351	-308	-131	-83	-24	-33	-10
Change in GST payments (\$pc)	-43	-56	-63	-51	-48	-45	-82	-39
New GST relativity	0.82	0.99	1.00	0.55	1.51	1.70	1.18	4.17

##### Upper-bound

Change in GST payments (\$m)	-1 281	-1 178	-982	-366	-250	-79	-115	-32
Change in GST payments (\$pc)	-164	-189	-201	-143	-146	-152	-283	-132
New GST relativity	0.77	0.93	0.95	0.52	1.47	1.66	1.10	4.13

#### Cameo 2: Insurance taxes abolished

Loss in own-source revenue (\$m)	1 985	1 218	828	661	479	104	20	43
GST (\$m)	-16	-87	-61	-37	-30	-8	-4	-3
GST (\$pc)	-2	-14	-12	-14	-17	-15	-9	-11
New GST relativity	0.84	1.01	1.03	0.57	1.52	1.71	1.21	4.18

#### Cameo 3: New congestion tax introduced and hypothecated to public transport

Congestion tax revenue (\$m)	1 560	1 249	977	514	343	104	81	49
Change in GST payments (\$m)	73	19	-36	2	-3	-2	0	0
Change in GST payments (\$pc)	9	3	-7	1	-2	-3	-1	-2
New GST relativity	0.84	1.01	1.03	0.57	1.53	1.72	1.21	4.19

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Where the tax reform involves modifying existing taxes (cameos 1 and 2), there can be a distinct first-mover disadvantage. In the somewhat unlikely case of multilateral reform (by all States), there would still be effects on the GST distribution, but of a smaller magnitude. If a State were to unilaterally abolish a tax (cameo 2) it would lose GST because it would still be assessed as having the capacity to raise revenue in that area (and the tax base would increase due to the removal of the tax and the consequential increase in demand). In the case of a new tax (cameo 3), the results are more ambiguous, and sometimes multilateral reform can have bigger GST effects.

There is no doubt that policy reform disincentives exist, and no-one disputes the principle. To some extent, the presence of such policy disincentives is an inescapable consequence of pursuing full fiscal equalisation — whereby the tax bases of fiscally stronger States are ‘shared’ (through equalisation) with fiscally weaker States. Whether such effects actually influence policy decisions is naturally harder to discern, given closed-door decision making.

There is widespread disagreement on the occurrence and magnitude of disincentive effects and, unsurprisingly, conclusive evidence is scarce. Some inquiry participants argued that the GST effects of tax reform have no influence at all on State behaviour; others suggested that the effects can be pervasive and accumulate over time. Some States also said that they do not even consider the GST consequences of their tax changes, even when contemplating major reforms, such as replacing stamp duties with land tax. This implies that important policy decisions are being taken without consideration of the total fiscal impacts on the State. As noted by one participant to this inquiry, ‘it would appear to us quite reasonable that any state Treasury would consider and model the impact on GST receipts of any tax reform — it would be negligent not to’.

Overall, while there is limited direct evidence, absence of evidence is not equivalent to evidence of absence. Indeed, decisions not to pursue reforms are impossible to directly observe when there are strong first-mover disincentives for policy reform. The potential for large impacts on GST (as illustrated in cameo 1) — combined with VFI and an arguably limited range of efficient State revenue sources — means that States may not even consider major reforms, even where the benefits to the community would be considerable.

### Mining poses particularly large problems for policy neutrality

The potential for HFE to distort State policy is pronounced for mineral and energy resources, as these are very unevenly distributed across States. For example, over 98 per cent of all iron ore production is in Western Australia. In such extreme situations, Western Australia’s policy *is* average State policy — and thus the mining assessment is not policy-neutral because that State’s own choices directly influence the level of GST payments it receives. If Western Australia raised royalties on iron ore, it would lose close to 90 per cent of the additional revenues to other States.

Due to these outsized effects, some have argued that States have an incentive to under-tax mineral rents or extract rents through other means — an example pointed to by participants

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was Western Australia abandoning its proposal to raise royalty rates on gold. Several participants also strongly criticised the HFE system as a major disincentive to States developing their mineral and energy resources. Any State that developed contentious mining activity would bear the full social and political cost of the development, but only retain its population share of the royalties (due to the tax base effects discussed earlier). And there are perennial concerns that the equalisation process does not fully account for industry development expenses, though this inquiry has not been presented with new or convincing evidence that changes are required.

Similarly, several participants argued that the HFE system effectively rewards States for restricting resource extraction. For example, New South Wales and Victoria, which have restricted coal-seam gas exploration, benefit from the equalisation of Queensland's gas royalties — because where a State has restricted resource extraction it is assessed as having zero capacity to raise royalty revenue. Essentially, policy decisions to *restrict* extraction are not treated symmetrically with policy decisions to *facilitate* extraction. This is often contrasted with the assessment of gambling revenue, which has no effect on the GST distribution because each State is assumed to have the same per capita capacity to raise revenue from gambling.

In sum, there is a large potential for the HFE system to discourage efficient taxation and extraction of (some) minerals. Indeed, the mining assessment has always thrown up problems, due to the dominance of select minerals and particular States, and has been subject to significant change in methodology over the years. Over time, the disincentives for major tax reform and the efficient taxation of minerals could have a material cumulative impact on the economy and wellbeing.

### Efficiency concerns about expenditure-side equalisation are less prevalent

When the CGC assesses State expenditure needs, it considers the *cost* of providing a service and the levels of service *use*. These are equivalent to the rate and base effects on the tax side, and lead to similar incentive effects. Where a State reduces or increases its average costs, it has very little impact on the GST distribution, and as such, the current HFE system is unlikely to materially distort State incentives to provide public services cost effectively.

However, where a State addresses its structural disadvantage and therefore affects the use of its services and infrastructure, its GST share would move in line with the structural change, meaning the State would only receive its population share of the fiscal benefits. This could create disincentives for States to address their structural disadvantages, particularly if they would incur high costs to do so. More generally, there are long-running concerns that HFE leads to grant dependency in the smaller States and a failure to pursue economic development. Again, these in-principle incentive effects are hard to substantiate with direct evidence.

A related concern is that the HFE process redistributes significant funds due to Indigeneity, but that some States are not spending that money on Indigenous services nor delivering better

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outcomes. Such concerns are often accompanied by the suggestion to take Indigeneity out of HFE. However, Indigeneity is a genuine and significant driver of jurisdictional spending, and absent some fundamental reform to Commonwealth-State roles and responsibilities — and thus accountabilities (discussed later) — it remains open to question what taking Indigeneity out of HFE would achieve.

Overall, the potential for HFE to distort State policy is much lower on the expenditure side than it is on the revenue side. The greater driver of expenditure effort is accountability for the way funds are allocated. Such accountability is systematically absent due to VFI and blurred funding responsibilities in many areas.

### **Does HFE affect interstate migration?**

There are longstanding academic debates about the effect of HFE on interstate migration and thus productivity and economic growth. Some researchers contend that HFE improves economic efficiency by reducing incentives for labour and capital to move because of different levels of taxes and services between States. Others argue that HFE can harm economic growth by dulling the incentives for labour and capital to move where they would be most productive.

In practice, it is hard to demonstrate that Australia's HFE system has had a material influence on migration. People move interstate for a range of reasons (often for work or family), though the evidence shows they do not respond to the full extent of work opportunities available in other States. Fiscal differences by jurisdiction are unlikely to play a significant role. And the magnitude of fiscal redistribution that arises from HFE is small relative to total government revenue (just over 1 per cent). Either way, HFE is unlikely to have a significant effect on interstate fiscal differences, and hence on incentives to relocate.

### **In summary, how is the current system performing?**

Our overall assessment is that the current HFE system is functioning reasonably well in regard to:

- *a high degree of fiscal equality*: the principle of fiscal equalisation is strongly supported and Australia's HFE system achieves a high degree of equalisation. It enables all States to provide the average national level of services and mostly adjusts for material structural disadvantages that are out of States' control
- *an independent process*: the CGC, as an expert agency independent from governments, is well placed to conduct the HFE distribution process. It has well-established processes that involve consultation and regular methodology reviews. This helps to remove some (although not all) of the political melee around the distribution of GST
- *stability for State budgets*: HFE responds reasonably well to State circumstances and supports budget stability, with predictability of GST payments for (most) States.

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However, there are deficiencies in a number of areas, which have become particularly pronounced recently. These include:

- *the system is not policy neutral*: the potential for States to lose significant GST payments in some instances can deter them from the politically difficult task of improving the efficiency of their tax mixes or expanding their tax bases. Distortions are particularly pronounced for major tax reform exercises and in relation to mineral and energy resources (including royalty policies and restrictions on extraction)
- *too little weight is afforded to the importance of fairly rewarding effort*: the current HFE system does not systematically provide for States to retain a reasonable share of the fiscal dividends of their policy efforts without them being ‘equalised away’ through lower GST payments. This can result in outcomes considered to be ‘unfair’
- *lack of transparency and accountability*: the complexity of the HFE system has increased over time. And while this may not be a problem in itself — indeed, there are many aspects of public policy that are highly complex — it can lead to misinformation and undermine accountability for decisions and public confidence in the system. There are also concerns from some State Governments and others that the CGC at times makes judgments about policy matters that should be the domain of elected governments.

## **A revised objective and better governance for HFE**

### **The need for a revised objective**

To some degree, the problems with HFE arise because the objective is almost singularly focused on achieving full equalisation of fiscal capacities. In doing so, it does not afford a meaningful trade-off (if any) between equity, efficiency, transparency and accountability. Although efficiency is partially considered by way of the supporting principle of policy neutrality, it has typically (until recently with respect to the mining assessment) taken a ‘back seat’ to fiscal equality.

In striving for full fiscal equalisation, it is likely that opportunities are being missed to achieve broader equity outcomes (that incorporate fairness by rewarding States for their policy efforts) and to improve efficiency for the benefit of the Australian community.

A revision to the objective of HFE would be in the best interests of national productivity and wellbeing, and is an essential precursor to achieving other improvements to the HFE system. The primary objective of the HFE system should be to provide the States with the fiscal capacity to supply services and associated infrastructure of a reasonable (rather than the same) standard. A similar objective has been adopted in several other countries, including Canada, where equalisation is intended to achieve ‘reasonably comparable’ levels of public services at reasonably comparable levels of taxation across provinces.

Like the current approach to HFE, this proposed objective puts fiscal equality at the heart of HFE. However, the revised objective acknowledges the trade-off between full and

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comprehensive equalisation on the one hand, and fairness and efficiency on the other. It is also more flexible than the way the HFE objective is currently framed and would give the Treasurer greater scope (via the terms of reference) to direct the CGC to achieve less equalisation where this can deliver greater fairness and efficiency.

The Commonwealth Government should take on a greater leadership role in specifying the objective. The Treasurer should present the revised objective to the Council on Federal Financial Relations (the COAG council that oversees the financial relationship between the Commonwealth and the States, including the Intergovernmental Agreement on Federal Financial Relations). The objective should then be reflected in the terms of reference issued by the Treasurer to the CGC.

### **What governance reforms are needed?**

Reforms to improve governance and accountability are needed, especially with the revision of the HFE objective to allow scope for a better balance between efficiency and equity.

There is a dearth of public (and even government) understanding of how HFE works, and this is compounded by the lack of a strong neutral voice in public discussion. The CGC should take on a stronger communication role to facilitate a more informed public discourse on HFE, much like the RBA and Parliamentary Budget Office do today.

The CGC should also engage better with the States, by building on its extensive consultation practices to provide, when requested by a State, provisional ‘draft rulings’ on the possible GST implications of a change in State policy (for example, a major tax reform). This would help to reduce some of the fiscal uncertainty that States face when considering reforms, and provide greater transparency about the CGC’s deliberations on such decisions.

A strengthened decision-making framework will also be necessary for the CGC to make better-informed decisions and for the States and the public to understand the CGC’s judgments. The Commonwealth Treasury (drawing upon its community-wide perspective) should provide input to the CGC’s consultation processes, including by making public submissions. The Treasurer should also nominate specific areas of focus for the CGC in the terms of reference for the five yearly methodology reviews.

There is also scope to improve accountability, by the CGC systematically making the data provided by the States publicly available. This will create greater transparency of how HFE is applied in practice and make the system less of a ‘black box’. There are also broader national interest benefits (for example, to researchers) from making data available. It will ultimately improve government decision making and the efficiency of service delivery. And it will help to hold States accountable for their own policies and spending.

Accountability is already blurred by the patchwork of payments from the Commonwealth to the States. While the general principles applied to Commonwealth payments in the HFE formula appear sound and internally consistent with the CGC’s overall approach to HFE,

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they may not always be consistent with governments' other, more direct, objectives for those payments. Perhaps as a result of this, there has been a growing tendency to quarantine some Commonwealth payments purely on political grounds.

The ability of the Commonwealth Treasurer to quarantine payments from HFE would benefit from stricter, principled guidelines. This would ensure that quarantining does not compromise the objective of HFE and undermine the efficacy of the equalisation process. These guidelines should be determined in consultation with the States, and should seek a balance between enhancing accountability and transparency, while not unduly affecting the ability of the Commonwealth Treasurer to quarantine payments in exceptional circumstances (where quarantining is in the national interest).

The Commission's recommended governance changes to improve transparency and accountability are readily implementable and should commence promptly.

More broadly, there is clearly a need for an holistic assessment of how different kinds of payments interact with each other. The tapestry of payments is symptomatic of broader problems with federal financial relations, the roots of which lie in the very high degree of VFI and the unclear delineation of responsibilities for service provision across governments. Ultimately, reform to HFE will only go part of the way to improving the outcomes from Australia's federal financial arrangements.

There is a need and an appetite to renew endeavours to reform federal financial relations in the broad. This process should be led by the Council on Federal Financial Relations with input from, and prioritisation by, the recently formed Board of Treasurers. Such broader reform to federal financial relations was universally supported by participants to this inquiry, albeit none were able to clearly articulate just what this would look like.

In the first instance, governments should assess how Commonwealth payments to the States — both general revenue assistance and payments for specific purposes — interact with each other. Governments should also work to a better-delineated division of responsibilities. In particular, responsibilities and accountabilities for Indigenous policy — an area where there continues to be little improvement despite significant expenditure — should be given priority. Where responsibilities remain 'hybrid' in nature, as will inevitably be the case in some instances — especially where there is an intersection of national and State priorities and where State or local delivery of services may be more efficient (such as for transport) — then stronger up front 'belts and braces' are needed for governments to be held accountable to the community for the funding and provision of public services. Following this, and ultimately informed by the allocation of funding responsibilities and accountabilities, options to meaningfully address VFI in Australia should be considered and advanced.



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## Are there alternative approaches?

The Productivity Commission has been asked to consider whether there are preferable alternatives to the present approach to equalising States' fiscal capacities.

The Commission's proposed revised objective — equalisation to a reasonable standard — strongly suggests that alternatives to the present system are needed.

The Commission's consideration of alternative approaches covers two broad types.

- The first involves 'in system' changes to the way fiscal capacities are assessed, to achieve greater efficiency (policy neutrality), and transparency and accountability in the system.
- The second involves use of alternative equalisation benchmarks, which could more holistically address some of the problems identified and achieve broader efficiency and fairness benefits.

Both approaches, and the specific options within them, variously trade off equity, efficiency, and transparency and accountability. The trade-off between equity and efficiency is an inescapable consequence of HFE and of any move away from a 'precise' equalisation approach to a reasonable standard that injects greater fairness and efficiency into the system.

To be 'preferable' to current arrangements, alternative approaches would need to address the concerns identified above and still provide States with the fiscal capacity to deliver a reasonable standard of services to their communities (in line with the Productivity Commission's proposed objective for HFE).

### Better 'in system' ways to assess State fiscal capacities

The Commission considered several ways of assessing States' fiscal capacities. These included, discounts for individual revenue categories, targeted discounts for specific policy decisions, and the use of broad indicators and category level indicators to assess State revenue raising capacities and expenditure needs.

At first pass, some of these options appear to offer prospective benefits, such as broad indicators and targeted discounts, but on balance are not workable or pose too great of a risk to fiscal equality (they may not achieve a 'reasonable' level of equalisation).

Use of simpler and more policy-neutral category-level indicators hold the most promise but can only go so far in addressing the problems with the HFE system.

Discounts for mining or other revenue categories are hard to justify

Discounting entire revenue categories, such as mining revenue or stamp duty, could be used to address policy non-neutrality concerns. This approach would guarantee that a State retains

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at least the discounted proportion of the change in revenue (as the discounted revenue would essentially be quarantined from equalisation).

A common proposal among inquiry participants was to impose discounts of 25 per cent or 50 per cent to the mining revenue assessment. Canada applies a 50 per cent discount to mining revenues in its equalisation formula (although Canada's HFE approach is not full equalisation to begin with). Applying a mining discount would deliver significant benefits to Western Australia, and to a lesser extent, Queensland and the Northern Territory.

Proponents of this option argue that applying a discount would reflect the lack of policy neutrality inherent in the current mining assessment. However, a discount does not sit well with the main fiscal equality objective of HFE. Mining revenue, in particular, is a prime example of a source-based advantage — one a State benefits from by virtue of where its borders happen to be drawn — and should *prima facie* be included in the equalisation process. Further, there is a possibility that introduction of such a discount would herald calls for other carve outs. The proposal of a discount points to a legitimate problem in the HFE process, but provides a less than robust solution.

### Targeted discounts for future policy changes

A more targeted approach would be to directly link the amount of GST a State retains after HFE to a specific policy decision that is expected to have a large impact on that State's GST payment. Such an approach would apply discounts to prospective policy changes and would therefore provide policy neutrality at a lower cost to fiscal equality than would discounts to entire revenue categories.

As part of its 2020 methodology review, the CGC has put forward an option for a State undertaking a tax or royalty rate change to retain at least 50 per cent of the additional revenue after equalisation. The CGC did not articulate a rationale for this proportion of retained revenue and in principle it could be higher or lower. The CGC's decision on the level is subject to consultation with the States and finalisation of the 2020 review. Unlike previous CGC-initiated changes to the mining assessment, this change represents a significant methodology change and departure from full equalisation.

The Commission's analysis of this proposal shows that in practice, and for the foreseeable future, it would apply only to Western Australia, and only to iron ore, nickel and gold (as these are the only instances where more than 50 per cent of the additional revenue could be 'equalised away' by HFE). As such, it would have no impact on State policy disincentives for other types of tax changes (such as replacing stamp duty with land tax). And it does not offer a systematic way of addressing policy non-neutrality arising from States expanding their tax bases.

Leaving the discount in place indefinitely for a given policy decision may not be desirable, and may have unintended consequences, for fiscal equality. Any revenue sources (such as minerals) that provide States with a material fiscal advantage should, in principle, be

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included within HFE. Further, over time, multiple discounts would increase the complexity of the HFE system and reduce its transparency.

### A broad indicator could achieve policy neutrality but remains elusive in practice

Another approach to achieving greater simplicity and policy neutrality is to use a single broad indicator (such as gross state product or household disposable income) to assess each State's fiscal capacity. Such an approach, in principle, offers a simple, transparent and genuinely policy-neutral measure of fiscal capacity — to the extent that changes in an individual State's taxes have very little influence on the broad indicator and thus would not influence the amount of GST the State receives. This approach has been used for some transfers in the United States but is otherwise not commonly used in equalisation schemes overseas.

But there are also a number of genuine concerns with a single broad indicator, including whether the indicator meaningfully reflects fiscal circumstances within States. A broad indicator would have significant costs in terms of material loss of accuracy, and may not achieve a 'reasonable' level of equalisation. The broader the indicator that is used, the more such risks may arise. And in practice, finding a single indicator that provides a reasonable reflection of States' fiscal capacities remains elusive and arguably does not exist.

### Simpler and more policy-neutral category level indicators could improve efficiency

A better approach involves the use of simpler and more policy-neutral indicators at the revenue and expenditure category level. This offers a way of achieving simplicity (and hence transparency) in the system as well as improving efficiency, without unduly risking fiscal equity in the way that a single broad indicator does. This could be done in several ways, including using more general measures of tax bases (and removing adjustments and carve outs for tax free thresholds and exemptions), or by using a single measure for each revenue or expenditure category (rather than separate measures for each sub-category).

Greater use of simpler and policy-neutral indicators at the category level would more directly link GST shares to each State's underlying capacity to raise taxes or provide services. Thus, it is less prone to influence from an individual State's policy choices and designs, and therefore would have efficiency benefits.

During the time of this inquiry, the Commission has identified and assessed one prospective candidate. Use of a more policy-neutral measure of the underlying stamp duty tax base would mean that GST payments are less susceptible to change as a result of tax reforms to replace stamp duty with land tax (box 5). In this example, each of the alternative indicators would achieve better policy neutrality, but come at the potential cost of less accurately reflecting States' abilities to raise revenue. The key challenge in selecting an indicator is thus striking a balance between these two factors.

Ideally, the indicators should be beyond the direct influence of State policy (thus achieving policy neutrality), while also ensuring States are provided with the fiscal capacity to deliver a reasonable standard of services.

#### Box 5 Improving the policy neutrality of the stamp duty assessment

The CGC currently uses the total value of property transferred (adjusted for tax exemptions and progressive tax rates) to assess a State's ability to raise revenue from stamp duties on property — a tax base that, while reflecting 'what States do', can be highly sensitive to changes in policy. This can create strong disincentives to replace stamp duty with a more efficient broad-based land tax (box 4).

These undesirable GST impacts could be reduced if a more policy-neutral measure of the tax base was used in the CGC's assessment — one that is less sensitive to changes in State tax rates or other policy settings. Specifically, if the total value of the dwelling stock was used instead, reform disincentives could be reduced by up to 63 per cent. And if the unimproved value of land was used, disincentives could be eliminated — this is because the same indicator is used to estimate the GST distribution due to the new land tax, and because the size of the underlying tax base is not expected to change as a result of the tax reform.

#### Stamp duty halved with revenue replaced by new land tax, unilateral reform, 2016-17

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
<b>Change in GST payments (\$m)</b>								
<i>Current approach</i>								
GST, lower bound (\$m)	-337	-351	-308	-131	-83	-24	-33	-10
GST, upper bound (\$m)	-1 281	-1 178	-982	-366	-250	-79	-115	-32
<i>Value of dwelling stock<sup>a</sup></i>								
GST, lower bound (\$m)	-404	-340	-329	-169	-105	-27	-33	-10
GST, upper bound (\$m)	-523	-449	-398	-215	-133	-35	-43	-13
<i>Unimproved value of land</i>								
GST (\$m)	0	0	0	0	0	0	0	0

<sup>a</sup> The lower and upper bound calculations are based on estimates of the elasticity of the value of average house prices to a one percentage point change in stamp duty rates (-0.20 and -0.26 respectively).

Both of these alternative indicators trade-off accuracy in reflecting States' abilities to raise revenue with policy neutrality. Using the unimproved value of land performs better in terms of reducing disincentives to reform, but using the total value of the dwelling stock may better reflect States' underlying abilities to raise property tax (as it reflects the value of structures and improvements).

Further exploration of the application of simpler and more policy-neutral indicators (beginning with the prospective candidate identified by the Commission) is ideal fodder for the CGC's five-yearly methodology reviews. However, the CGC is unlikely to pursue and implement such an approach absent of direction to do so and while the HFE objective remains focused on achieving full equalisation. The HFE objective needs to be revised (as discussed above) to pave the way for a better balance between equity and efficiency in the CGC's assessments. The CGC also needs to be explicitly directed, via the terms of reference it receives from the Treasurer, to examine simpler and more policy-neutral indicators. This

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should also include direction to adopt significant increases in materiality thresholds (to determine which revenues and expenditures are incorporated into the equalisation process), which would assist in determining and applying the indicators. For example, if the materiality threshold was to be quadrupled (as recommended in the 2012 GST Distribution Review) then insurance taxes and some expenditure disabilities would be removed from the assessment.

These changes have merit regardless of any changes to the equalisation benchmark itself, but would need to be implemented alongside the change to the HFE objective and governance reforms proposed above.

But without a benchmark change to give substance to ‘reasonable’ equalisation, it has to be acknowledged that these options are limited. Although they offer potential benefits, they do not resolve some of the other material problems of the system. In particular, there does not appear to be any obvious policy-neutral indicators, or any other workable methodology changes, that could be applied to the mining revenue assessment. Thus, without more fundamental changes to HFE, the largest source of policy non-neutrality — both now and into the foreseeable future — would remain untouched.

Further, use of more policy-neutral indicators cannot completely remove the scope for State policy changes (such as tax design and development approvals) to influence the size of tax bases — and thus GST payments — especially over the long term. These effects are inherent to equalisation itself and in many cases can only be reduced significantly by reducing the extent of equalisation.

## **Is there a preferred alternative benchmark for equalisation?**

Changing the equalisation benchmark would be a simple way to help address the main policy non-neutrality issues that arise for mining, and more broadly, that relate to State’s developing their tax bases. But as with substantial ‘in system’ changes to the way fiscal capacities are assessed, it is a judgment as to what level of equalisation best balances fiscal equality, on the one hand, and efficiency and fairness, on the other.

The Commission has considered a range of alternative equalisation benchmarks, drawing on practices used overseas or proposed in submissions. Each approach is targeted at achieving less than full equalisation of State fiscal capacities.

### **An equal per capita approach to distributing GST**

Under an EPC approach, each State would receive a share of the total pool of GST revenue equal to its share of the national population. Participants proposing the adoption of an EPC allocation argued that it would be a ‘fairer’ system of distributing GST revenues.

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In the current environment, an EPC distribution would see more GST revenue flow to New South Wales, Victoria and Western Australia, and less to the remaining States, with the Northern Territory experiencing the largest reduction in per capita terms.

An EPC approach would be extremely simple and policy-neutral. It would have no adverse effect on States' incentives to pursue increased prosperity (and revenue) or improved efficiency in providing services, as it is determined solely by State populations. However, an EPC approach is inimical to the fundamental fiscal equality objective of HFE. It takes no account of State differences in revenue-raising capacities nor does it recognise that some States face higher costs in providing services to their communities. It is therefore an unviable option.

### An equal per capita approach with 'top-up' funding

An extension of the EPC approach is to distribute the GST pool on an EPC basis but supplement these funds with 'top-up' funding from the Commonwealth to the fiscally weaker States. Such funding might, for example, be provided at a level that ensures no State is worse off than under current arrangements (or that all States are able to provide a minimum level of services). Had it been applied for 2018-19, Queensland, South Australia, Tasmania, the ACT and the Northern Territory would have required top-up funding.

The National Commission of Audit in 2014 considered and recommended a model in which the GST was distributed to the States on an EPC basis, with the Commonwealth providing top-up funding to the fiscally weaker States (with the amounts to be determined by the CGC). Importantly though, this recommendation was not designed to be adopted on its own. It was intended to be implemented as part of a broader suite of recommendations to reform federal financial relations, including to address VFI and to clarify roles and responsibilities between the States and the Commonwealth.

The key benefit of this approach is that it would break out of the zero-sum game. It would also highlight the scale of the transfers required to address horizontal fiscal inequity (the top-up component), which may improve transparency and accountability in the federation. The OECD has found that systems that mix both horizontal and vertical equalisation are less transparent and accountable because they blur responsibility between financing and funding.

Further, by making the big States' GST grants contingent only on their population, this model would have no adverse effect on their incentives to increase revenue or pursue improved efficiency in providing services. But, this model is reliant on additional funding from the Commonwealth Government, which has its own opportunity costs and is unlikely to be forthcoming in the current environment. Given the 'cost' of this approach, it should only be considered in the context of broader reform to federal financial relations that generate compensating benefits.

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## Relativity floors

A further commonly suggested change to HFE is to introduce a relativity floor. A State whose relativity fell below the floor would be lifted up to that floor. This could be achieved using funds from the GST pool (meaning it would come at the expense of the other States) or some external funding source. The additional infrastructure payments the Commonwealth has made to Western Australia are effectively already providing a *de facto* floor.

An HFE system with a relativity floor would result in partial equalisation for all States when one State's underlying relativity goes below this boundary, but full equalisation at other times. The most common proposal was for a relativity floor of 0.7, but there were also suggestions for hybrid approaches and the gradual introduction of a relativity floor over coming years. While Western Australia's relativity is forecast to increase over the next few years, it remains likely that a relativity floor of 0.7 would 'bite' in the future.

The concept of a floor has some initial attraction. It acknowledges that the current system works in a satisfactory way *on average*, and when jurisdictions are similar, but is seen to produce 'unfair' outcomes in circumstances where there are large disparities in the fiscal fortunes of States. At the margin, a floor may provide greater incentives to States to pursue further development. An *explicit* floor would also be more transparent than the *implicit* floor that has emerged through the additional infrastructure payments to Western Australia.

However, the introduction of a relativity floor is unlikely to provide a solution to the efficiency concerns identified earlier. It would only address policy non-neutrality for the State(s) for which the floor binds (Western Australia for the foreseeable future) and this depends on the level at which the floor is set. And adding a floor today creates a variant to the system that can be further varied — with inevitable pressure for funding beyond the GST pool. A floor is targeting a symptom, and ultimately, prevention is better than cure.

## Benchmarks that deliver a reasonable standard of services

An alternative approach is to lift States up to some agreed reasonable standard of fiscal capacity — but not as far as to the level of the fiscally strongest State, as presently occurs — and then distribute the balance of the GST equally per capita. In principle, this approach could be used to bring States up to *any* level of fiscal capacity less than that of the strongest State.

The Productivity Commission has assessed five alternative equalisation benchmarks, including those raised in the draft report and some others that were raised by participants:

- equalising to the fiscal capacity of the second strongest State (ESSS)
- equalising to the average of the fiscally strongest (donor) States
- equalising to the average of all States (ETA)
- full equalisation for only the small States

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- 90 per cent full equalisation (as mooted by the CGC).

The equalisation task under each of these approaches is shown in figure 5 for the past 17 years (to demonstrate what would have transpired) and over the forward estimates.

Changing the benchmark makes way for further consideration of efficiency issues. It offers a simple way to lessen the disincentives for significant State tax reform or mining development and royalties — and is consistent with the revised objective of HFE. However, this approach on its own is unlikely to deliver significant improvements to simplicity.

Importantly, from a policy neutrality (and efficiency) perspective, States that are above the relevant equalisation benchmark (such as the strongest State in the case of ESSS) have less of a disincentive to initiate policy effort (such as tax reform or controversial development activity) than States that are below the benchmark. This is because States above the benchmark only receive their EPC share of the residual GST pool (they are not ‘equalised’ as they are already above the equalisation benchmark). In other words, each State’s GST grant is largely invariant to its own policy choices (box 6).

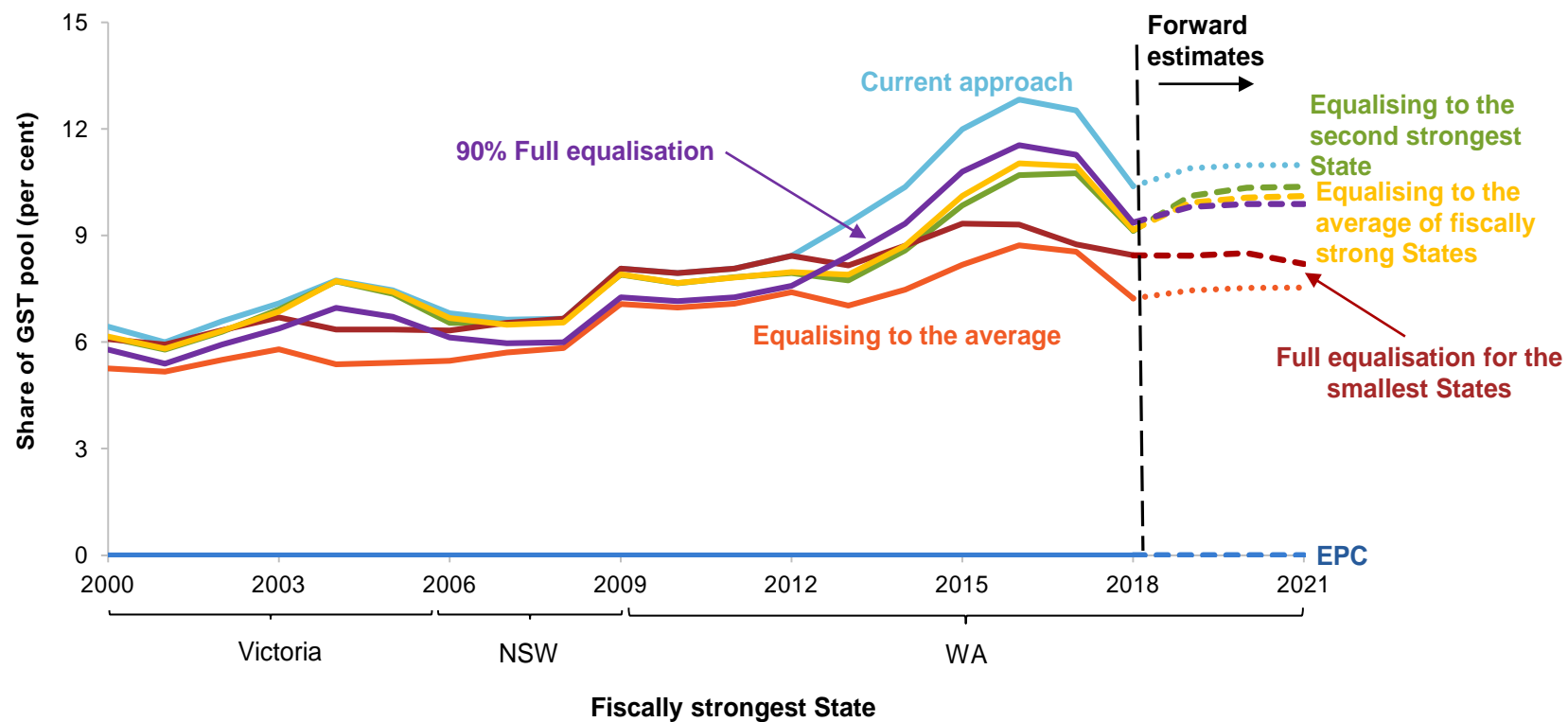
### **Which benchmark provides a better balance between equity and efficiency?**

None of these benchmarks is unambiguously superior and there is no ‘right’ balance. Each has advantages and disadvantages that are difficult to comprehensively identify, let alone quantify. The preferred option is the one with the greatest potential benefits (in terms of greater fairness and increased policy neutrality) relative to the potential costs (less fiscal equality).

Equalising to the average of the fiscally strong States and equalising to the second strongest State have the smallest fiscal equality impacts (table 2), but do not significantly reduce disincentives for reform other than for the fiscally strongest State, and perhaps the second strongest State (depending on the relative fiscal capacities of the strongest States). They also raise other potential problems. In particular, because the benchmark would be determined based on the fiscal capacity of only a few States, equalisation could continue to be driven by fiscal outliers, should the strongest and second strongest States attain a significantly stronger fiscal capacity than the other States.



Figure 5 The equalisation task under alternative benchmarks<sup>a</sup>



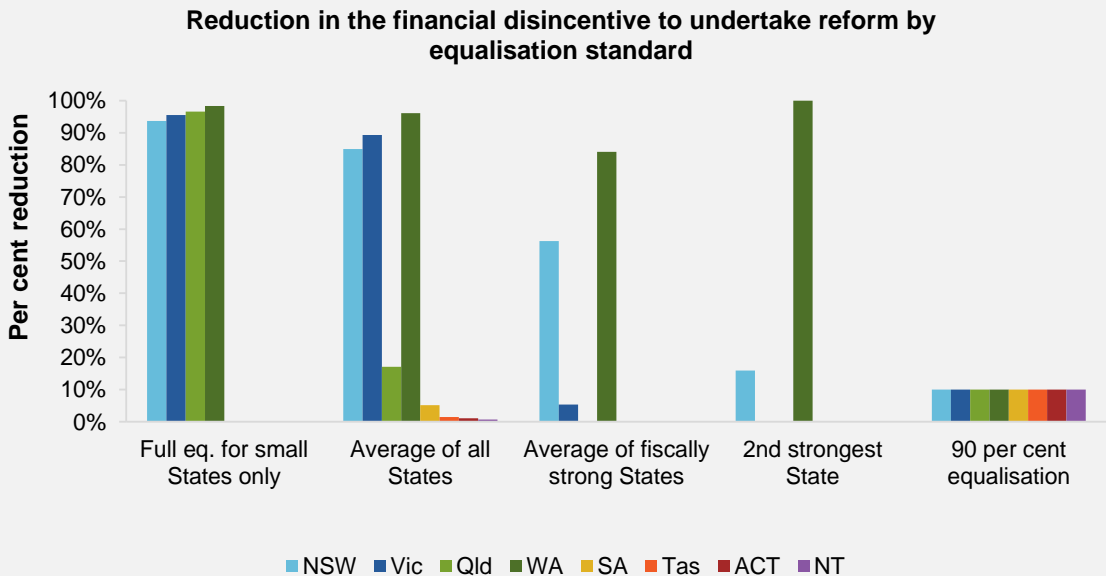
<sup>a</sup> The pool includes Health Care Grants in estimates made before 2009. Dashed sections denote projections.

By contrast, although ETA has the largest fiscal equality impacts, it also offers the greatest scope for efficiency and fairness gains, as it mutes policy non-neutrality for a larger number of States, allowing more (albeit the large) States to retain a greater portion of the benefits of policy effort, including major tax reform. The Commission’s analysis suggests that disincentives would be reduced for New South Wales, Victoria and Western Australia by between 85 and 96 per cent.

Box 6

How do alternative equalisation benchmarks influence State reform incentives?

A general ‘in principle’ illustration of how alternative equalisation benchmarks could affect policy reform disincentives is to examine what happens when one State loses \$100 per capita of GST revenue. This loss could be from any reform that resulted in that State losing GST revenue — for example, due to a policy that encouraged the expansion of one of its tax bases — while all other States gain an equal per capita amount such that the total amount of GST distributed remains constant. Examining whether a State loses more or less than the original \$100 under each of the equalisation benchmarks provides an indication of how the alternative benchmarks affect disincentives. Compared to the current system (where disincentives are fully present for all States), the alternative equalisation benchmarks mute disincentives to varying degrees, with full equalisation for only the small States providing the greatest muting of disincentives for the large States, and 90 per cent equalisation providing the least muting of disincentives for the large States.



These generalised findings apply to the stamp duty and land tax reform cameo in box 4 — the analysis shows that ESSS would remove disincentives for this reform for the strongest State (currently Western Australia) and reduce them for the second strongest State (currently New South Wales). Under ETA, disincentives are substantially reduced for Western Australia, New South Wales and Victoria and by a small amount for Queensland. For the remaining States (South Australia, Tasmania, the ACT and the Northern Territory) disincentives are slightly reduced.

Under immediate implementation to ETA, with no transition, the reduction in GST payments would not (in 2018-19) have exceeded 2.5 per cent of total revenue for any State, and all States would have been able to meet at least 97 per cent of their assessed expenditure needs.

More generally, States can choose (as they already do) to prioritise and adjust the way they spend their GST payments to ensure that key services continue to be funded. There are instances where States choose to fund services to a higher or lower degree than the CGC assesses they need to in order to provide the national average level of services.

To the extent that there are major adverse budgetary impacts on States of a sudden move to ETA, a carefully designed transition can help to alleviate the impacts (discussed below).

**Table 2 Fiscal impacts of immediate implementation (no transition) of the alternative equalisation benchmarks**

Changes in GST payments relative to the current benchmark, 2018-19

<i>Change in GST payments</i>	<i>NSW</i>	<i>Vic</i>	<i>Qld</i>	<i>WA</i>	<i>SA</i>	<i>Tas</i>	<i>ACT</i>	<i>NT</i>
<b>90 per cent full equalisation</b>								
\$ million	302	20	-128	362	-219	-106	-20	-211
\$ per capita	38	3	-26	138	-126	-202	-48	-856
% of total revenue	0.4	0.0	-0.2	1.2	-1.1	-1.8	-0.4	-3.9
<b>Equalisation to the average of the fiscally strong States</b>								
\$ million	-823	-666	-515	2 303	-178	-54	-43	-25
\$ per capita	-102	-102	-102	879	-102	-102	-102	-102
% of total revenue	-1.0	-1.0	-0.9	7.8	-0.9	-0.9	-0.8	-0.5
<b>Equalisation to the second strongest State</b>								
\$ million	-842	-681	-526	2 357	-182	-55	-44	-26
\$ per capita	-105	-105	-105	899	-105	-105	-105	-105
% of total revenue	-1.0	-1.0	-0.9	8.0	-0.9	-0.9	-0.8	-0.5
<b>Full equalisation for the smallest States</b>								
\$ million	1 009	-1 427	-2 524	2 961	0	0	0	0
\$ per capita	126	-220	-506	1 129	0	0	0	0
% of total revenue	1.2	-2.1	-4.5	10.0	0.0	0.0	0.0	0.0
<b>Equalisation to the average</b>								
\$ million	833	-1 570	-1 368	2 903	-474	-143	-114	-67
\$ per capita	104	-242	-273	1 108	-273	-273	-273	-273
% of total revenue	1.0	-2.3	-2.4	9.8	-2.5	-2.4	-2.0	-1.2
<b>Total GST payments under current system</b>								
	<i>NSW</i>	<i>Vic</i>	<i>Qld</i>	<i>WA</i>	<i>SA</i>	<i>Tas</i>	<i>ACT</i>	<i>NT</i>
\$ million	18 030	16 830	14 447	3 255	6 751	2 434	1 298	2 755
\$ per capita	2 246	2 591	2 878	1 242	3 879	4 640	3 100	11 181

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Full equalisation for only the smallest States — another alternative benchmark — has the potential to deliver similar efficiency benefits as ETA. But it runs into the problem of whether the larger States should be eligible for full equalisation. For example, under this option, Queensland would not be equalised as it is a large State. Thus, any fiscal equalisation required to account for the fiscal cost of economic shocks in Queensland — for example, from a natural disaster — could require top-up funding. As with an EPC with top-up funding approach, this funding would likely always be hostage to Commonwealth fiscal vicissitudes.

The Commission has judged that, on balance, ETA is a preferable alternative to the current benchmark. ETA is expected to provide the best balance between equity and efficiency compared to the current approach and the alternative benchmarks considered. It would also be a more stable basis for deriving GST relativities. This is because the benchmark is determined using the fiscal capacities of all States, rather than only one State (as presently occurs) or a few States (as is the case under most of the other alternatives). It is thus the least susceptible to fiscal outliers.

## **A proposed way forward**

The Productivity Commission has identified a package of changes that are expected to improve the equity, efficiency, and transparency and accountability of the HFE system (table 3).

Most of these improvements are highly desirable (and should be the source of few, if any, serious objections) and can be pursued now. First, there needs to be clear articulation of a revised objective for HFE. This is an essential precursor to implementing the Commission's proposed improvements to the way State fiscal capacities are assessed (namely, the use of simpler and more policy-neutral indicators and increases in materiality thresholds). Changes to HFE governance would be complementary to these changes and would help to establish the balance between equity and efficiency in practice, as well as increase accountability in the system.

Additional benefits, but more controversy, will come from also adjusting the equalisation benchmark to ETA. This would help to address some of the broader equity and efficiency problems of the HFE system, particularly with respect to policy distortions for mining and disincentives faced by some States to develop their tax bases.

## **Hastening slowly in the transition to the new equalisation benchmark**

Any changes to the equalisation benchmark in the current fiscal environment will result in a smaller amount of GST redistributed away from EPC, and commensurately a material redistribution of GST payments to Western Australia and in some cases New South Wales at the expense of the other States. Any changes therefore need to be timed and implemented

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carefully over a transition period, to give States sufficient time to adjust, and in particular, to avoid materially disadvantaging the fiscally weaker States.

Transition to ETA could be implemented in a number of ways, but any approach should be guided by a clear set of principles to help ensure that the transition:

- *is manageable for State budgets* — States should be able to manage their budgets during the current forward estimates period and plan for changes over the longer term. There is no hard and fast rule on what is manageable but as a rule of thumb, States could be expected to manage a reduction in their GST payments (relative to what they expected to receive) of about 2 per cent of their total revenue from one year to the next
- *is fiscally sustainable for all Governments* — the most sustainable approach is for the transition to be funded through the GST pool, rather than from sources outside the pool, such as other Commonwealth payments. Any funding outside the pool should only be contemplated as part of an agreement on broader federal financial reform, and even then it should be time limited and have clear limits set around its magnitude
- *delivers the benefits of reform in a timely manner* — although a lengthy transition path would benefit some States, there are potential costs involved from deferring full implementation of the new benchmark. The transition needs to strike a balance between assisting States to manage a change in their GST and capturing the benefits of reform.

Regardless of the transition approach taken there is inevitable uncertainty in the potential future impacts. The Commission has adopted a simple, illustrative analysis to assess two possible transition paths to ETA, both beginning in 2019-20 — a four year transition and an eight year transition. The effect of the transition is to gradually spread the GST impacts of the change to ETA over these years, giving States time to adjust (figure 6).

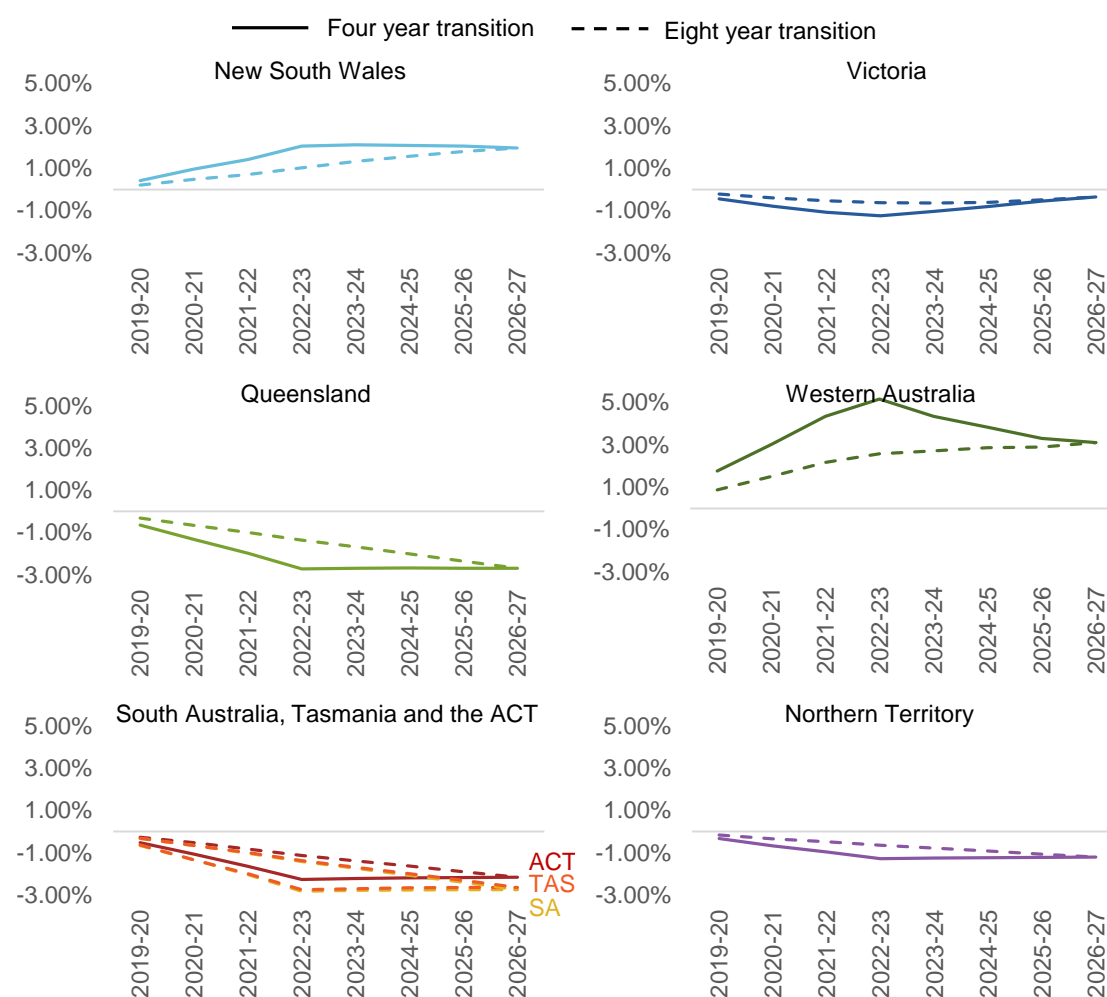
The key assumptions underpinning the transition analysis were informed by consultation with the Commonwealth and State Treasuries. The Commission's 'best estimate' uses Commonwealth Treasury MYEFO projections for growth in State populations and growth in the GST pool, and an average of the GST relativity forecasts provided by contributing State Treasuries.

Based on the analysis, it is judged that transition to ETA would be manageable over either a four or eight year timeframe. The Commission's 'best estimate' (and alternative scenarios that take into account different GST relativities) show that between any two years, the amount by which any State will need to adjust its budget is less than 1 per cent of its total State revenue (figure 7).

However, there are a large number of factors that could affect GST payments and State revenues that are not captured in this analysis. Economic variables do not always evolve as expected and it is difficult to project how fiscal capacities will develop over time. Further, States may encounter unforeseen or exceptional events — for example, a large shock to a single State, such as a natural disaster, could result in its relative fiscal capacity being much

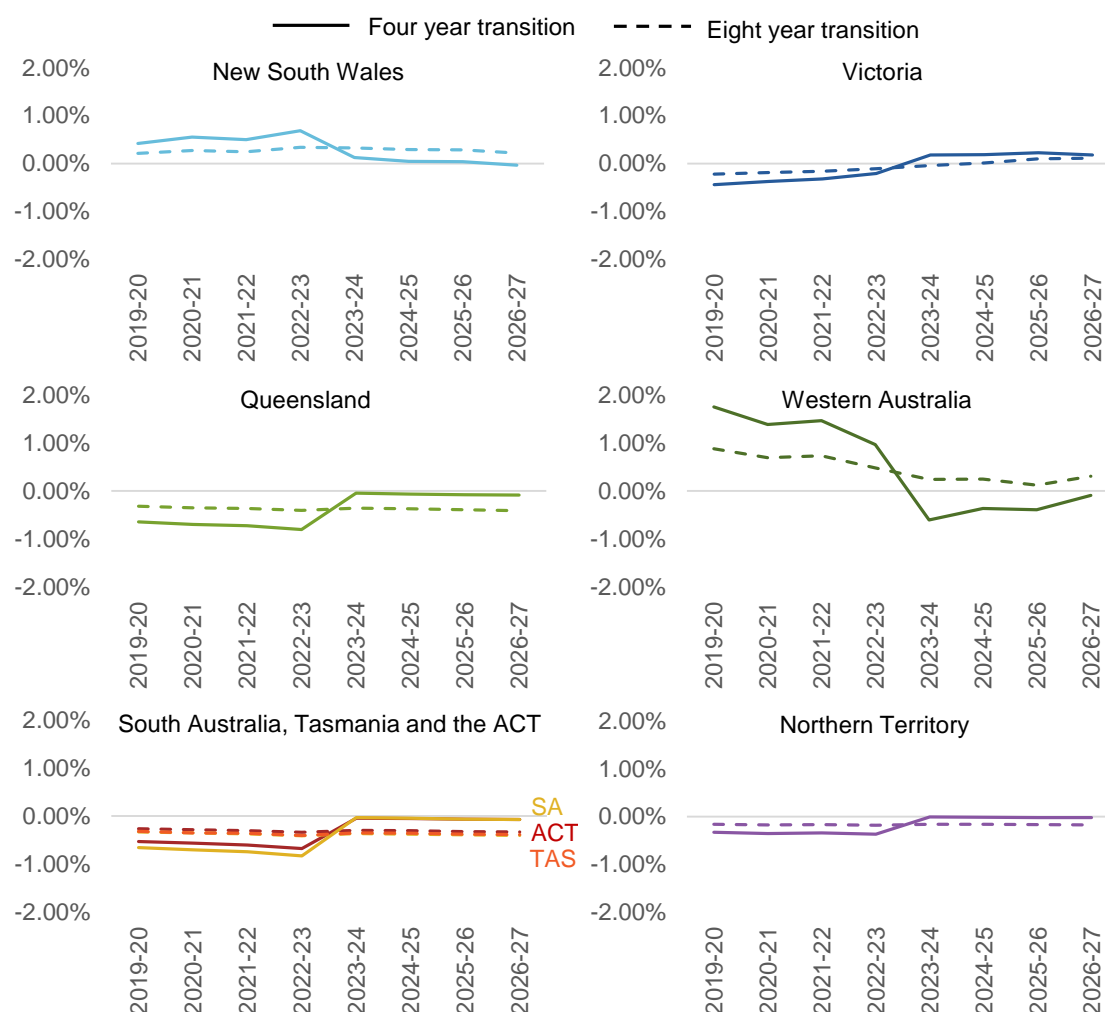
lower than currently expected. Such events could make the transition to ETA less (or indeed more, in the case of a positive shock) manageable than projected.

**Figure 6 Two transition paths to ETA: phasing GST impacts over time**  
Change in GST payments (relative to the current benchmark) as a share of State revenue, best estimate scenario, 2019-20 to 2026-27



An eight year transition path gives States considerable time to adjust and provides latitude to deal with unexpected changes in States' fiscal capacities, although it would delay the potential benefits of the change compared to a four year transition. That said, the costs of delay would be largely borne by the State(s) that stand to benefit the most: Western Australia and to a lesser extent New South Wales. These States (especially Western Australia as the initial primary beneficiary) could essentially 'fund' the transition to ETA by a transition path that 'hastens slowly'. An eight year transition would also significantly reduce the potential need for funding to be provided to States from outside the GST pool.

**Figure 7 Transitioning to ETA: the year-on-year impacts on State budgets are likely to prove manageable**  
 Year-on-year change (incremental change from previous year) in GST payments (relative to the current benchmark) as a share of State revenue, best estimate scenario, 2019-20 to 2026-27



A longer transition path also provides a greater window for the States and the Commonwealth to substantively revisit broader reforms to federal financial relations, which could potentially alleviate any residual ongoing fiscal impacts on the States from the new benchmark. Indeed, during this inquiry all States were united on one single policy endeavour — the need for substantive reform to federal financial relations. The Productivity Commission views such policy endeavour as timely, benefitting from the input of the newly formed Board of Treasurers, with the prospect of larger ongoing economic benefits for all Australians.

**Table 3 A package of changes to improve the HFE system**

<i>Problem to be addressed</i>	<i>Proposed change</i>	<i>Main benefits of change</i>
<b>Revising the objective for HFE</b> — <i>refining the objective to allow for the HFE system to provide a better balance between fiscal equality and efficiency</i>		
A narrow interpretation of equity — fiscal equality is pursued above all else, at the expense of fairness and efficiency.	Reframe the objective of HFE to enable a 'reasonable standard' of services (rec. 6.1).	Provide a better balance of HFE objectives — fiscal equality, fairness and efficiency.
Leadership by the C'wlth Government on the objective is missing.	Clear articulation by the C'wlth Government of the objective (rec. 6.1).	Condition community and State expectations and improve confidence in the system.
<b>Improving governance arrangements</b> — <i>enhancing transparency and accountability through more robust decision-making frameworks and stronger communication</i>		
The system is not well understood by the public — myths and confused accountability.	The CGC should provide a strong neutral voice in the public debate (rec. 6.2).	Less misunderstanding and greater confidence in the system.
Uncertainty for States with respect to how tax changes will be assessed by the CGC.	Provisional and time limited 'draft rulings' on the implications of a policy change (rec. 6.3).	Better enable States to assess the implications of a policy change for their GST payments.
The approach to Treasurer quarantining C'wlth payments is ad hoc and undermines the objective of fiscal equalisation.	Develop guidelines for quarantining by the Treasurer (rec. 6.4).	Improve predictability and transparency, and the integrity of the HFE system.
The CGC at times makes policy judgments on trade-offs between equity and efficiency that are not transparent or well understood by the States.	The C'wlth Treasury should provide submissions to the CGC's processes, and the C'wlth Treasurer should nominate areas of focus in the terms of reference (rec. 6.5).	Better inform decisions from the perspective of the broader Australian community.
Limited access to data and calculations of revenue and expenditure assessments.	Make the data and calculations from the CGC publicly available (rec. 6.6).	Greater accountability and replicability.
<b>Improving the way fiscal capacities are assessed</b> — <i>'in-system' changes to correct for some of the equity and efficiency problems with the HFE system</i>		
The HFE system is not policy-neutral, with disincentives for some major State tax reforms and economic development.	Simpler and more policy-neutral revenue and expenditure assessments. Increases in materiality thresholds (rec. 7.1).	Directly target some efficiency problems and simplify the system. Allow States to retain more from their policy effort. Increased public confidence.
<b>Moving to a better equalisation benchmark</b> — <i>additional equity and efficiency benefits could be captured by changing the equalisation benchmark</i>		
States do not systematically receive reward for policy effort — distortions are pronounced for mineral and energy resources.	Equalise to the average (pre-GST) fiscal capacity of the States (rec. 8.1). Phase in the new benchmark over a number of years.	Reduce major policy disincentives for some States. Improve fairness. Time for States to adjust.
<b>Broader reform to federal financial relations</b> — <i>greater gains are likely through broader reform to federal financial relations</i>		
Accountability is blurred, particularly for Indigenous outcomes. There is a complex web of C'wlth payments and VFI remains high.	Assess how C'wlth payments interact and develop a clear division of responsibilities, followed by consideration of options to reduce VFI (rec 9.1).	Improved accountability and transparency. Greater State autonomy. Paves the way for broader reform to VFI.



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# Findings and recommendations

*States refers to States and Territories in the following findings and recommendations.*

## Australian and international equalisation

### FINDING 2.1

Australia achieves a high degree of horizontal fiscal equalisation and to a much greater extent than other countries. It is the only OECD country with a federal government that seeks to fully eliminate disparities in fiscal capacity between sub-national governments.

## HFE and State policies

### FINDING 3.1

Most State tax reforms would have limited impacts on the GST distribution. 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 for States to implement 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.

### FINDING 3.2

Changes in State service delivery policies can impact on GST payments, but the impacts are mostly trivial. HFE is unlikely to directly discourage — nor encourage — States from improving the efficiency of service delivery or addressing their structural disadvantages, given the broader and more significant benefits of doing so to the community. Accountability for policy outcomes — which is lacking — is a much greater driver of expenditure choices.

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#### FINDING 3.3

The potential for HFE to distort State policy is pronounced for mineral and energy resources. While there is limited direct evidence that GST effects have influenced specific policy decisions, the incentive effects for some States are palpable and have the potential to undermine State policy neutrality.

However, making adjustments to the HFE system specifically to add incentives (rather than remove disincentives) for desirable resource exploration policies, or to singularly remedy disincentives for mining taxation, would not advance policy neutrality, would be a source of additional complexity, and come at the expense of fiscal equality.

## HFE and State budgets

#### FINDING 4.1

Features of Australia's HFE system can exacerbate the fiscal impact of economic cycles when States experience large economic shocks. Such a situation recently occurred in Western Australia.

However, offsetting cyclical influences on State budgets is not the primary objective of HFE, and options to improve contemporaneity do not offer unequivocal improvements.

- Reducing the length of the assessment period would have mixed impacts across States, and may ultimately have little effect on State budget fluctuations.
- The two-year data availability lag cannot be substantially reduced without introducing additional scope for volatility and dispute.

The most effective response to a lack of contemporaneity lies with the States themselves, and with the necessity for State Treasuries to factor the assessment period and GST lag into their budget management processes (which most do).

#### FINDING 4.2

Volatile State revenues can contribute to uncertainty in budgeting processes. Compared with other sources of State Government revenue, GST payments are relatively stable and in some cases may offset volatility from other revenue sources.

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## HFE and interstate migration

### FINDING 5.1

Taken together, the available evidence suggests that fiscal factors (including those related to HFE) are unlikely to play a major part in interstate migration decisions. Other factors, such as differences in work opportunities between States and personal reasons, are bigger drivers of interstate migration.

## The case for change to the current approach

### FINDING 6.1

While Australia's HFE system has a number of strengths, it also has several deficiencies. In particular, it can provide disincentives for desirable tax and resource development policies, and, to the extent that States do not reap much of the rewards of their own policy efforts, can detract from fairness.

Many of these concerns are due to the pursuit, above all else, of comprehensive equalisation of fiscal capacities. It is likely that opportunities are being missed to more fairly reward States for their policy efforts, and to improve efficiency and enhance the wellbeing of the Australian community over time.

## A revised objective for HFE

### RECOMMENDATION 6.1

The objective of the HFE system should be refocused to provide the States with the fiscal capacity to provide services and associated infrastructure of a reasonable (rather than the same) standard.

The Commonwealth Government should set this revised objective of HFE.

- The Treasurer should present the revised objective to the Council on Federal Financial Relations.
- Following this, the Treasurer should reissue the terms of reference to the CGC for the 2020 methodology review to reflect the new objective.

The terms of reference for all future relativity updates and five-yearly methodology reviews should reflect this revised objective.

The Intergovernmental Agreement on Federal Financial Relations and the *Commonwealth Grants Commission Act 1973* (Cwlth) should also be amended to reflect the revised objective.

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## Governance changes to improve transparency and accountability

### RECOMMENDATION 6.2

The CGC — through its Chairperson and Commission members — should provide a strong neutral voice, to facilitate a better informed public discourse on the HFE system.

### RECOMMENDATION 6.3

The CGC should strengthen its formal interactions with the State and Commonwealth Governments. In particular, when requested by a State Government, it should provide provisional ‘draft rulings’ on the HFE implications of a policy change.

### RECOMMENDATION 6.4

The Commonwealth Government, in consultation with the States, should 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 and compromise the objective of HFE).

The guidelines should strike a balance between enhancing accountability and transparency, while not unduly affecting the Treasurer’s ability to quarantine payments in exceptional circumstances that are in the national interest.

### RECOMMENDATION 6.5

The Commonwealth Government should strengthen the CGC’s decision-making framework. In particular:

- the Commonwealth Treasury should provide input, including public submissions, to the CGC’s five-yearly methodology review process, drawing upon its community-wide perspective
- the Commonwealth Treasurer should nominate specific areas of focus for the CGC in the terms of reference for the five-yearly methodology reviews, following (as is currently the case) consultation with the States.

### RECOMMENDATION 6.6

The CGC should immediately and systematically make the data provided by the States publicly available on its website, along with the CGC’s calculations on these data.

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## **‘In system’ changes to better assess States’ fiscal capacities**

### **FINDING 7.1**

The use of externally defined benchmark costs in the HFE system to assess State expenditure on service delivery would encourage greater efficiency, but faces daunting practical difficulties and a high degree of scope for dispute.

### **FINDING 7.2**

Using a single broad indicator to assess States’ fiscal capacities offers considerable potential to improve policy neutrality and simplify the HFE system. However, a single indicator that accurately reflects the underlying revenue-raising capacities and expenditure needs of each State remains elusive and arguably does not exist.

### **FINDING 7.3**

The use of more policy-neutral revenue and expenditure indicators, along with significantly higher materiality thresholds, offers considerable scope to secure greater efficiency and simplify the HFE system (and therefore improve transparency and accountability), while also achieving a high degree of fiscal equality in overall State fiscal capacities.

The Commission has identified one prospective candidate — in the stamp duty tax base. But there is only limited scope to secure greater policy neutrality through this approach where it matters most — in the mining assessment.

### **FINDING 7.4**

Discounting mining (or other revenue categories) in the HFE process — or removing it entirely — is not justified and would come at a high cost to fiscal equality.

### **FINDING 7.5**

The CGC’s proposal to discount revenues such that a State retains at least 50 per cent of the own-source revenue impacts of a tax or royalty rate change (net of GST payments) is an incomplete approach to mitigate policy non-neutrality in HFE. It would only address policy influence on average tax rates, not on tax bases, and only for Western Australia for the foreseeable future.

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#### RECOMMENDATION 7.1

The Commonwealth Treasurer should direct the CGC (in accordance with the refocused HFE objective) to:

- examine simpler and more aggregated revenue and expenditure assessments that use more policy-neutral indicators, consistent with achieving a reasonable standard of services
- adopt significant increases in materiality thresholds, which would assist in determining and applying more policy-neutral category level indicators.

This initial direction should be embedded in revised terms of reference for the CGC's 2020 methodology review.

### Alternative equalisation benchmarks

#### FINDING 8.1

An equal per capita approach to the distribution of GST revenue is incapable of providing States with the fiscal capacities to deliver a reasonable standard of services. It is thus inimical to the fiscal equality rationale underpinning HFE.

#### FINDING 8.2

An equal per capita with top-up funding approach for distributing GST revenue could provide all States with the fiscal capacity to deliver a reasonable standard of services, depending on the level of top-up funding. While this would meet the fiscal equality rationale underpinning HFE, the top-up funding would always be subject to the vagaries of the Commonwealth budget. It should only be considered in the context of broader reform to federal financial relations that generate compensating benefits.

#### FINDING 8.3

The introduction of a relativity floor would blunt the equalisation task and introduce greater incentives for policy effort for the beneficiary State(s) — Western Australia for the foreseeable future. But a floor represents a band-aid solution, as it is not well targeted to broader efficiency and fairness problems.

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#### FINDING 8.4

No alternative benchmark for equalisation is unambiguously superior to any other. All have costs and benefits that are difficult to comprehensively identify, let alone quantify. Determining which alternative benchmark is most likely to provide the greatest net benefit — the right balance — involves judgment about whether the benefits of greater policy neutrality (efficiency) and reward for policy effort and risk taking (fairness) outweigh the fiscal equality impacts.

Overall, equalising to the average (pre-GST) fiscal capacity of all States is judged to provide a better balance than the current benchmark and is thus a preferred alternative.

- It offers the greatest incentives for some States (but not all) to undertake efficiency-enhancing tax reform and broadly reduces policy non-neutrality with respect to the mining revenue assessment.
- It is less susceptible to fiscal outliers and therefore provides a more stable basis for deriving GST relativities.

The impacts on fiscal equality are expected to be modest and manageable, especially when implemented through a carefully designed transition.

#### RECOMMENDATION 8.1

The Commonwealth Government should transition Australia's system of HFE towards equalisation to the average (pre-GST) fiscal capacity of all States, with the remaining GST revenue distributed on a per capita basis.

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## Transition to an alternative equalisation benchmark

### FINDING 9.1

There are many ways a new equalisation benchmark could be phased in. The most effective transition approach is one that:

- enables States to manage their budgets during the current forward estimates period and plan for changes over the longer term
- is fiscally sustainable for all governments, in that it is funded through the GST pool (in effect, by the States that benefit from the change) and not from outside the pool
- delivers the benefits of the new benchmark in a timely manner.

Either a four year or eight year transition path to ETA is judged to be manageable for the States. A four year transition would deliver the benefits of reform more quickly, but an eight year transition provides greater latitude to deal with unexpected changes in the future fiscal circumstances of the States. By delaying the full implementation of ETA, both approaches are effectively funded from within the GST pool by the States that stand to benefit the most.

An eight year transition would also provide more time for State and Commonwealth Governments to negotiate broader reforms to federal financial relations, which could potentially alleviate any residual ongoing adverse fiscal impacts on States from the new benchmark.

## Broader reform to federal financial relations

### RECOMMENDATION 9.1

Improvements to the HFE system can only go so far.

The Commonwealth and State Governments, through the Council on Federal Financial Relations and recently formed Board of Treasurers, should work towards meaningful reform to federal financial relations.

In the first instance, the process should:

- assess how Commonwealth payments to the States — both general revenue assistance and payments for specific purposes — interact with each other, given the significant reforms to payments for specific purposes that have occurred in recent years
- develop a better-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.

Following this, options to address the vertical fiscal imbalance should be considered and advanced.