



Australian Government
Productivity Commission

Horizontal Fiscal Equalisation

Productivity Commission
Draft Report
Overview & Draft Recommendations

October 2017

This is a draft report prepared for further public consultation and input. The Commission will finalise its report after these processes have taken place.

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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

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.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

Opportunity for further comment

You are invited to examine this draft report and comment on it by written submission to the Productivity Commission by Friday 10 November 2017 and/or by attending a public hearing. Further information on how to provide a submission is included on the inquiry website: <http://www.pc.gov.au/inquiries/current/horizontal-fiscal-equalisation>

The final report will be prepared after further submissions have been received and public hearings have been held, and will be submitted to the Australian Government in January 2018.

Public hearing dates and venues

Location	Date	Venue
Perth	14 & 15 November 2017	Four Points by Sheraton 707 Wellington Street, Perth
Melbourne	17 November 2017	Productivity Commission 530 Collins Street, Melbourne
Sydney	22 November 2017	Sydney Masonic Centre 66 Goulburn Street, Sydney

Public hearings may be held in other locations if needed, and you may also participate via teleconference. Please visit the inquiry website to register your interest in participating in a public hearing.

Commissioners

For the purposes of this inquiry and draft report, in accordance with section 40 of the *Productivity Commission Act 1998* (Cwlth) the powers of the Productivity Commission have been exercised by:

Karen Chester

Deputy Chair

Jonathan Coppel

Commissioner

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The full report is available from www.pc.gov.au

OVERVIEW

Key points

- The basic premise of HFE — fiscal equity in the Australian federation — has broad support.
- While the specific practice of HFE has always been debated, it is now under significant strain as Western Australia's share of the GST has fallen to an extreme low.
- The practice of HFE has evolved over time, and now embodies an undeliverable ideal: to give States the same fiscal capacity. In other words, all States are brought up to the fiscal capacity of the fiscally strongest State (currently, as assessed by the CGC, Western Australia).
- Notwithstanding anomalies, the current system of HFE has good points.
 - It achieves an almost complete degree of 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.
- And HFE does not result in significant distortions to interstate migration or economic growth.
- But the pure may be the enemy of the good: the current HFE system struggles with extreme circumstances, and this is corroding confidence in the system.
 - Equalising comprehensively and to the fiscally strongest State means that the redistribution task is too great for any jurisdiction to bear; and is volatile at times of significant cyclical and structural change.
 - There is scope for it to discourage desirable mineral and energy resources policies (royalties and development) and State policy for major tax reform (a costly first-mover disadvantage).
 - The system is beyond comprehension by the public, and poorly understood by most within government — lending itself to a myriad of myths and confused accountability.
- The Australian Government should articulate a revised objective for HFE. While equity should remain at the heart of HFE, it should aim to provide States with the fiscal capacity to provide a reasonable level of services.
 - Equalisation should no longer be to the highest state, but instead the average or the second highest State — still providing States a high level of fiscal capacity, but not distorted by the extreme swings of one State.
 - By contrast, relativity floors or discounts for particular revenue streams do not resolve HFE's deficiencies and must prove arbitrary, and likely have unintended consequences.
- Any material change to HFE in the current extreme environment will lead to significant redistributions of the GST. Timing and careful transition are paramount, especially to ensure the fiscally weaker States are not significantly disadvantaged.
- The Commonwealth Treasurer should ask the CGC to recommend relativities consistent with a revised objective. The CGC should also be directed to pursue significant simplification of its assessment process, even if it results in slightly less — or less precise — equalisation.
- The CGC should play a prominent public communication and education role — a much needed objective voice to inform the public dialogue about HFE.
- Reforming 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 accountabilities.

Overview

The Productivity Commission has been asked to undertake an inquiry into Australia's system of horizontal fiscal equalisation (HFE) as the basis for the distribution of GST revenue to the States and Territories (hereafter States). The Productivity Commission is to consider the influence the current system of HFE has on:

- 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, and
- the States' abilities to prepare and deliver annual budgets.

Moreover, the inquiry poses the questions of whether the current system of HFE is in the best interests of national productivity and whether there may be preferable alternatives.

Much of the debate about HFE in Australia stems from confusion and disagreement about its objective. Clear specification of objectives is important for policy issues where there are trade-offs, and a clear objective is essential for assessing the effectiveness of the system, now, and for any future changes.

With that in mind, the Productivity Commission has assessed the current HFE system and any proposed alternatives against an objective for HFE that takes account of equity, efficiency and simplicity. Our approach is focused on the Australian community as a whole, and is not framed solely in the interests of any individual State (as required under the *Productivity Commission Act 1998* (Cwlth)).

What has motivated this inquiry?

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

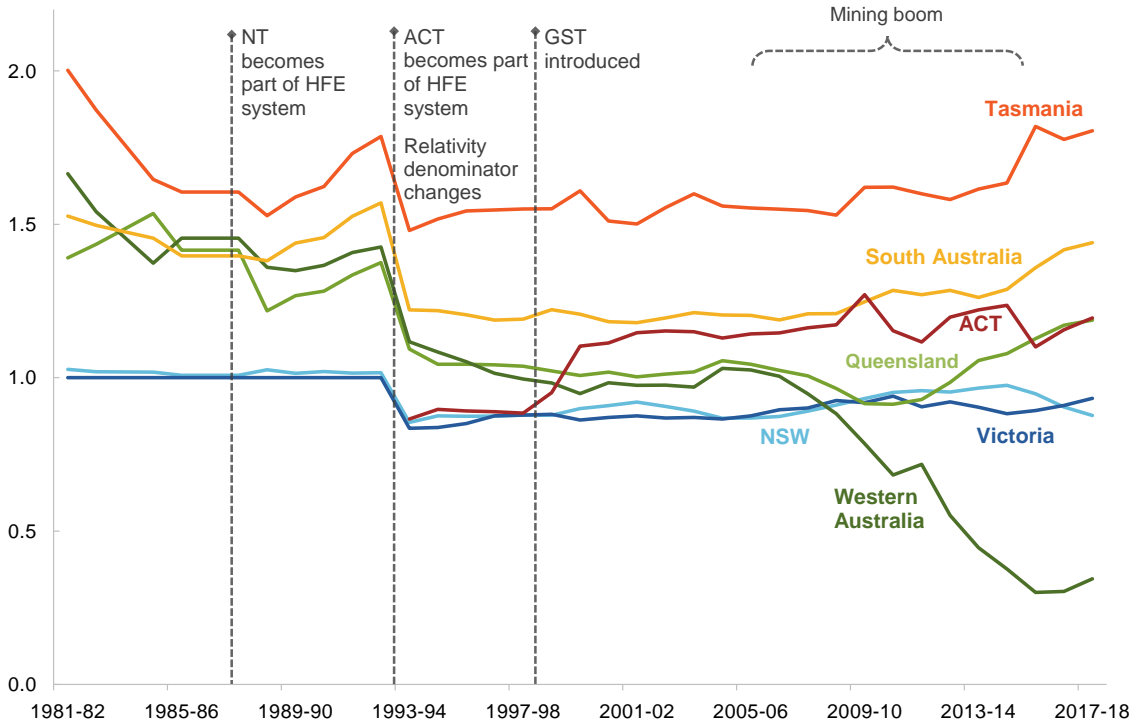
The distribution of the GST has frequently been a point of contention among States, as each State has vied for a larger share of the GST pool. But this friction has increased markedly in recent times as Western Australia's share of the GST has fallen to an unprecedented low (figure 1). This 'new low' has been anticipated since 2011, but arguably not at the time the GST distribution deal was struck in 1999.

A key factor behind this has been the recent mining boom, which had a particularly strong impact on Western Australia's revenue-raising capacity. This saw Western Australia's

relativity start falling from the middle of last decade. The mining boom is fading and Western Australia’s economy (and revenue-raising capacity) has significantly weakened. However, Western Australia’s share of the GST pool remains historically low, due to the lags involved in the equalisation process.

Many parties have expressed extreme dissatisfaction with Western Australia’s low share of the GST. This discontent reflects perceptions about fairness and the extent of equalisation away from Western Australia. There are also concerns about the non-contemporaneity of the distribution — specifically, that it may exacerbate economic cycles instead of smoothing them. Since 2014-15, the Australian Government has provided over \$1.2 billion in infrastructure funding to Western Australia, which has been quarantined from the HFE process, to effectively maintain Western Australia’s relativity at 2014-15 levels.

Figure 1 State per capita relativities^a



^a The Northern Territory is not shown. Its relativities fluctuated between a minimum of 4.02 and a maximum of 5.91 between 1988-89 and 2017-18.

Source: CGC (2017a).

Some parties have also argued that the HFE system impedes economic growth by acting as a disincentive for State governments to develop particular industries or projects, or by subsidising States that ban mineral or energy extraction. Others have spoken out against these views and emphasise HFE’s role in promoting equity across the Australian federation, given the inherent disadvantages some States face in raising revenue or delivering services.

What is HFE and why does it exist?

HFE is a common feature across federations. It 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 equity, or the equal treatment of equals — as 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 for the equal fiscal treatment of jurisdictions. This equity basis for HFE is largely undisputed even in the current debate.

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. The relevance of these other rationales for HFE is more contested.

The Australian federation 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 — 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).

There is no Constitutional reference to HFE, nor is it explicitly defined in current legislation or in any formal agreement between the Commonwealth and States. The principle of HFE has evolved over time, primarily as a result of the work of the Commonwealth Grants Commission (CGC) (box 1). It also evolved from partial to full and comprehensive equalisation by the late 1970s/early 1980s. Australia is unique among federations in almost completely eliminating disparities in fiscal capacity between States.

HFE also forms the basis of how financial assistance grants are distributed among local governments. These grants are distributed on the principle that '... each local governing body in the State is able to function, by reasonable effort, at a standard not lower than the average standard of other local government bodies in the State'.

Box 1 **The evolution of HFE in Australia**

Horizontal fiscal equalisation has a very 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, and following the threat of Western Australia's succession, 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, via financial assistance grants. 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 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 — that is, full equalisation. 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 initially 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', but 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)

The practice of HFE in Australia

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; policy neutrality; practicality; and contemporaneity. These supporting principles, however, are subsidiary to the primary objective of achieving full and comprehensive equalisation.

The actual formula 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 doesn't mean that all activities are differentially assessed (that is, have 'disabilities' applied to them) or that HFE achieves perfect equalisation. Some disabilities cannot be reliably measured, may be discounted or have an immaterial impact.

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

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

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. Another way to think about the size of the equalisation task is the share of the GST pool that is distributed away from an EPC distribution. This has increased from about 8 per cent to 12-13 per cent over the same period (figure 3).

Some of the key factors affecting the redistribution of GST revenue (away from an EPC distribution) are mining production, remoteness and regional costs, and Indigenous status (figure 4).

Figure 2 Schema of the conceptual stages of the HFE process

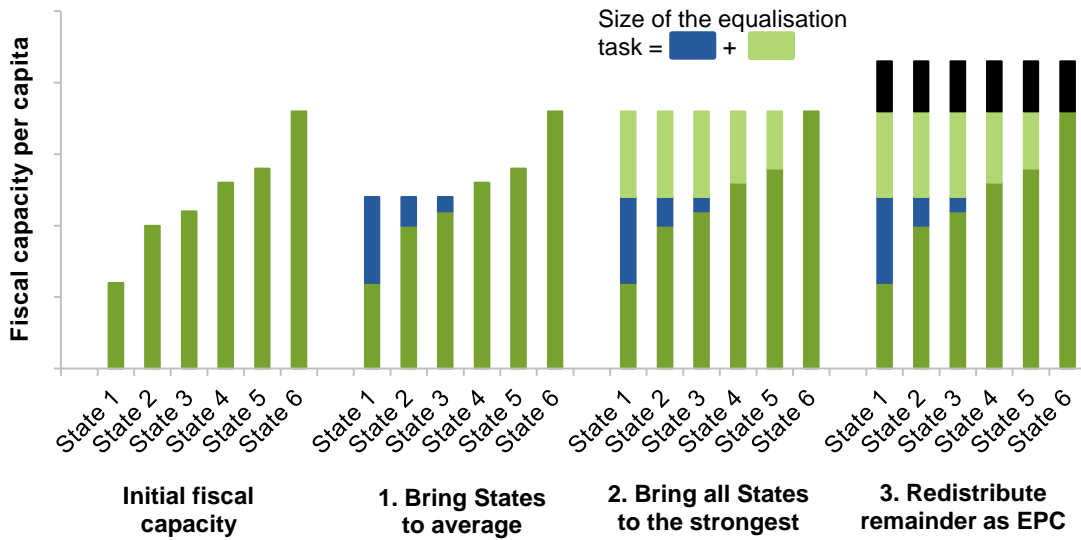


Figure 3 Share of GST pool redistributed away from equal per capita

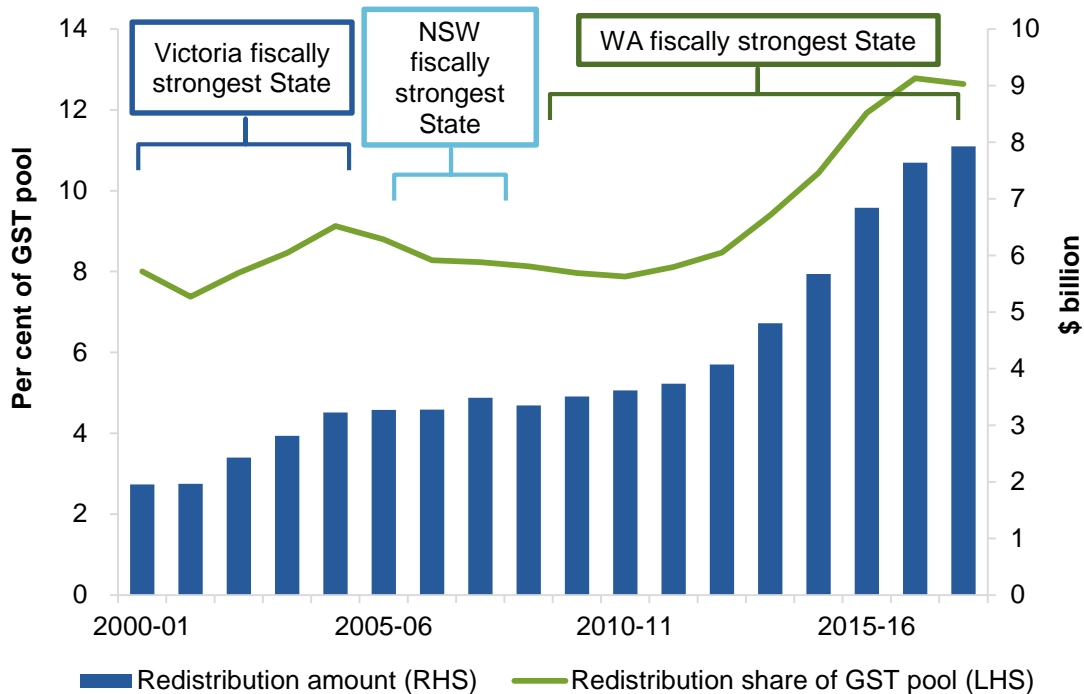
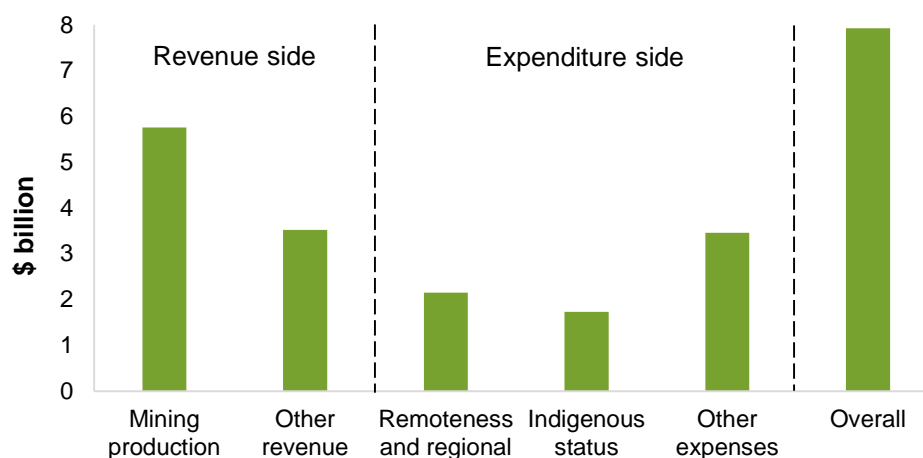


Figure 4 **GST redistribution from equal per capita, 2017-18**



How does HFE affect State budget management?

GST payments provide 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.

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)	31.86	29.82	27.63	9.22	10.66	3.68	2.18	4.26
Total revenue (\$b)	79.89	63.41	55.87	28.46	19.15	5.87	5.34	6.23
GST payments (\$b)	17.68	14.83	14.96	2.35	6.36	2.40	1.23	2.92
% total grants revenue	55	50	54	26	60	65	57	69
% total revenue	22	23	27	8	33	41	23	47

Source: State budget papers (2017); CGC (2017).

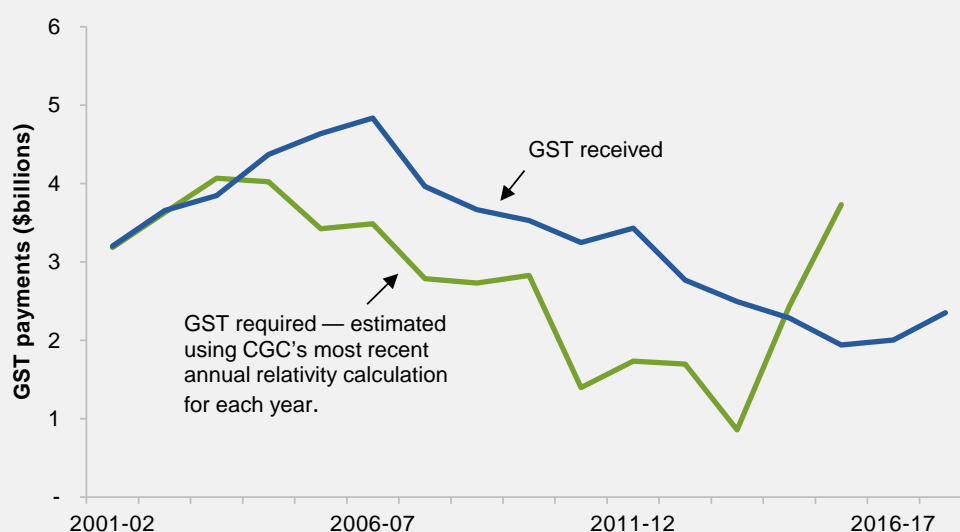
Several features of Australia's HFE system promote predictable and stable GST payments. This stability is primarily achieved by applying a three-year moving average to relativity calculations (which has been in place since 2010; prior to that a five-year average was used). A consequence of this emphasis 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 exacerbating the effects of the economic cycle on Western Australia's budget (box 2).

Box 2 Western Australia's fiscal position

The mining boom has driven large shifts in Western Australia's revenue raising capacity. From 2000-01 to 2013-14, the WA Government's annual royalty income increased from \$0.7 billion to \$6 billion. In the following years, however, this income declined substantially to \$4.1 billion in 2015-16 and \$5.3 billion in 2016-17, according to the most recent budget papers.

The three-year assessment period and two-year lag have meant that Western Australia's relativity has been slow to respond to changes in the State's fiscal capacity. While Western Australia's royalties were increasing, it received larger payments than it would have received under a fully contemporaneous HFE system. In fact, 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.



More recently, as Western Australia's royalty income has declined, it has received lower GST payments. This situation has contributed to a deteriorating fiscal position. However, Western Australia's falling GST shares were predicted. For example, in its 2011-12 budget, the State projected a fall in its relativity from 0.72 to 0.33 by 2014-15 (its actual relativity for that year was 0.38). However, the WA Government based its spending decisions on the assumption that a 0.75 GST relativity floor would be introduced.

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 around 75 per cent of our population share of the GST. (Porter 2011, p. 3)

Several inquiry participants have argued Western Australia's poor fiscal predicament is as much a product of the State's own poor fiscal management. In per capita terms, the State's total nominal expenses increased by 94 per cent, compared with 80 per cent for the rest of Australia from 2000 to 2015, and it went from being the second lowest paying State government to the second highest. While the WA Government's increased fiscal capacity likely played a role, market-driven forces (for example, competing with the mining sector and the need to attract workers to more regional locations) were also a significant driver.

Source: WA Government (2016); CGC (2015d); ABS (Cat. no. 5512.0).

However, Western Australia's experience has been an unprecedented outlier, 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 other States

preferred an emphasis on stability. Trying to increase the contemporaneity of the assessment could introduce additional complexity and volatility.

Does HFE affect State incentives for reform?

The CGC calculates GST shares by reference to average State policy. On the revenue side, this means calculating how much tax a State could have raised had it applied the national average tax rate. GST is then used to balance out differences between States with stronger or weaker tax bases.

Calculations tend to be more complex on the expenditure side, 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 are then adjusted up or down depending on structural factors (‘disabilities’) that bear on the use and/or cost of providing government services, such as the age profile of their populations or their level of population dispersion.

These methods 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 tension with the principle of policy neutrality. Most of the concerns about potential incentives for inefficient policy outcomes are on the revenue side, with some unique outcomes in relation to 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.

However, policy changes that affect the base — for example, approving new mining activity or increasing payroll tax compliance — can have a very 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 the 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 case of a State undertaking major reforms to its tax mix. These incentive effects are illustrated by way of cameos in box 3.

Where the tax reform involves modifying existing taxes (first cameo), there is a distinct first-mover disadvantage. In the (unlikely) case of multilateral reforms (by all States), there would still be effects on the GST distribution, but of a smaller magnitude. In the case of a new tax (second cameo), the results are more ambiguous, and sometimes multilateral reforms can have bigger effects.

Box 3 Impact on GST payments of hypothetical reform ‘cameos’

The Commission has analysed two reform ‘cameos’ to illustrate how GST payments can be affected by changes in State policy. The cameos are hypothetical and show the GST impact only for a single year. Yet they 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 and Victoria potentially losing up to \$1 billion, and Queensland and the ACT facing the biggest per-capita losses.

In the second 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 impact on GST payments is a lot smaller in this cameo, 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, 2015-16

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Baseline annual relativity	0.84	0.93	1.14	0.60	1.44	1.83	1.20	4.28
Cameo 1: Stamp duty halved with revenue replaced by new land tax								
<i>Lower-bound</i>								
Change in GST payments (\$m)	-317	-319	-302	-159	-83	-22	-30	-12
Change in GST payments (\$pc)	-41	-53	-63	-61	-49	-43	-76	-47
New GST relativity	0.82	0.91	1.11	0.57	1.42	1.81	1.17	4.26
<i>Upper-bound</i>								
Change in GST payments (\$m)	-1233	-1125	-920	-472	-250	-74	-103	-39
Change in GST payments (\$pc)	-161	-188	-191	-181	-147	-143	-263	-161
New GST relativity	0.77	0.85	1.06	0.52	1.38	1.77	1.09	4.21
Cameo 2: New congestion tax introduced and hypothecated to public transport								
Congestion tax revenue (\$m)	1534	1200	962	521	341	103	79	49
Change in GST payments (\$m)	69	6	-36	3	-3	-2	0	0
Change in GST payments (\$pc)	9	1	-7	1	-2	-3	-1	-2
New GST relativity	0.84	0.93	1.14	0.60	1.44	1.83	1.20	4.28

Source: Appendix C.

Whether such GST effects — or uncertainty about their occurrence or magnitude — actually influence policy decisions is harder to discern. 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. The 2012 GST Distribution Review found that ‘the current system creates perverse theoretical incentives in some instances, but there is little evidence that they have any effect in the real world’.

However, absence of evidence is not equivalent to evidence of absence. Such disincentives to desirable policies, as presented in the cameos (box 3), when viewed cumulatively over time, could be at significant cost to the Australian economy.

Mining poses particularly large problems for policy neutrality

Mineral and energy resources 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 the mining assessment is not policy neutral because the State’s own choices directly influence the level of GST payments Western Australia receives. The WA Government has estimated that if it raised royalties on iron ore, it would lose about 88 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. Several participants 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 political cost of the development, but only retain its population share of the royalties. 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 banned coal-seam gas exploration — will benefit from the equalisation of Queensland’s gas royalties. 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 is treated as entirely a product of policy, and therefore has no effect on the GST distribution.

The potential for HFE to distort State policy is therefore pronounced for mineral and energy resources. While there is no direct evidence that GST effects have influenced specific policy decisions, the incentive effects are large and have the potential to undermine State policy neutrality over time. Yet there is no obvious and workable alternative for equalising mining revenue in a way that would not affect policy incentives. The current lack of policy neutrality may be an inevitable consequence of pursuing full and comprehensive equalisation with the data available.

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. 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 in practice.

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 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 roles and responsibilities (and thus accountabilities, discussed later), it remains open to question what taking Indigeneity out of HFE would achieve.

In sum, the potential for HFE to distort State policy is much lower on the expenditure side than it is on the revenue side.

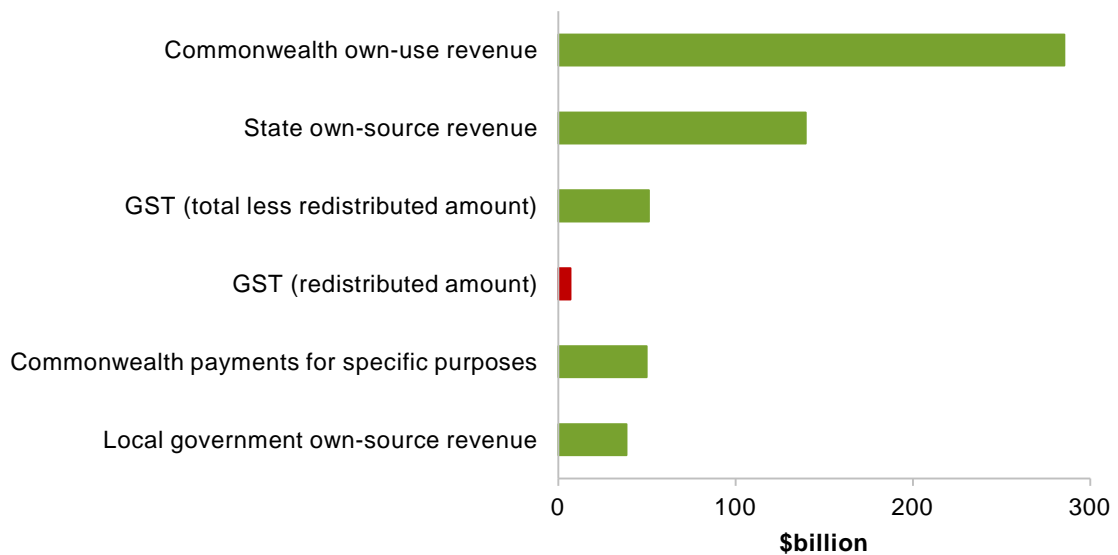
Does HFE affect productivity and economic growth?

There are longstanding academic debates about the effect of HFE on 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 tell whether Australia's HFE system has helped or hindered productivity and growth. People move interstate for a range of reasons — often for work or family — though the evidence shows that 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. The magnitude of fiscal redistribution that arises from HFE is small relative to total government revenue (just over 1 per cent) (figure 5). HFE is thus unlikely to have a significant effect on interstate fiscal differences either way — and hence on incentives to relocate.

The main concerns for productivity and growth over time would arise from HFE discouraging major State revenue and development reforms, as discussed above.

Figure 5 **The relative size of the GST redistribution, 2015-16**



Attempts to quantify the efficiency impacts of HFE have not proved compelling. Some modelling exercises find that HFE improves economic efficiency, whereas others find that it detracts from it. But the effects are relatively small, and the results of these models are largely driven by the assumptions fed into them. For these reasons, the Productivity Commission has not pursued its own general equilibrium modelling of HFE.

In summary, how is the current system performing?

The Productivity Commission's overall assessment in this Draft Report is that the current HFE system is functioning reasonably well in regard to:

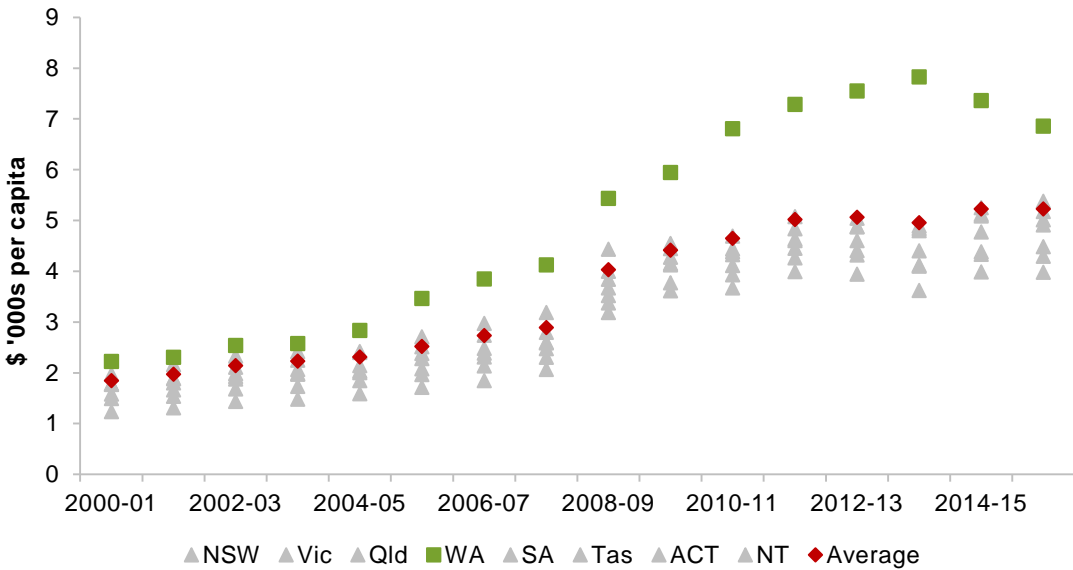
- *equity*: the principle of fiscal equalisation is strongly supported and Australia's HFE system achieves an almost complete degree of equalisation — this is unique among OECD countries with federal governments
- *an independent and transparent process*: the CGC, as an expert agency independent from governments, is well placed to conduct the HFE distribution process. It has well-established processes that involve consultation and regular methodology reviews
- *stability*: HFE results in reasonably stable GST payments and a level of predictability for (most) States regarding budget outcomes.

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

- *equalisation is taken too far*: equalising comprehensively and to the fiscally strongest State means that when there is an outlier, the redistribution task is considerable and the standard being equalised to is potentially volatile (figure 6)
- *policy neutrality*: the current HFE system struggles with State circumstances that differ markedly from the other jurisdictions. The potential for HFE to distort State policy is pronounced for major tax reform exercises (especially first-movers) or in relation to mineral and energy resources (including royalty policies and restrictions on extraction)
- *simplicity and comprehensibility*: the CGC’s drive for full and precise equalisation has meant that there has been an increase in system complexity over time. This has led to the system being poorly understood by the public, and even by many within government.

In terms of overall national efficiency and growth, Australia’s HFE system has typically been found to have little direct effect. However, the current redistribution is historically high, which may be elevating any efficiency effects.

Figure 6 WA is an outlier due to its assessed revenue capacity



A need for a revised objective

Overall, the current HFE system goes too far in the pursuit of equalisation and much beyond what other federations do. Arguably it also goes beyond what a unitary government would do, which is providing a level of services to all residents that is relatively consistent from one year to the next, and which is likely closer to the average across the nation. In contrast,

equalising to the strongest State — particularly when the strongest State is so much stronger — has meant equalising to a benchmark that is relatively volatile.

This volatility, combined with little consideration of efficiency, a complex and misunderstood system and an absence of government accountability, is currently undermining the otherwise strong social consensus for HFE. The subjective notion of ‘what is fair’ means trying to find the age old balance between fair inequality and unfair equality. This is compounded by the reality that when the States agreed to give up some of their own-source revenues in exchange for the GST, distributed on the basis of HFE, it is doubtful any anticipated the extreme outcomes we are observing today.

The Productivity Commission considers that a revision to the objective of HFE would be in the best interests of national productivity and wellbeing.

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

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

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

Like the current approach to HFE, the Productivity Commission’s proposed objective puts equity at the heart of HFE. However, our revised objective for HFE acknowledges that there is a trade-off between full and comprehensive equalisation on the one hand, and efficiency and simplicity on the other hand.

Moreover, the Commonwealth Government should take on a greater leadership role in specifying the objective, and reflecting it in the terms of reference it issues to the CGC for its yearly updates and five-yearly methodology reviews. While the Commonwealth Government can do this unilaterally, the Productivity Commission anticipates this would be pursued through a collaborative process with the States to create an environment of mutual accountability.

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 — would be the appropriate body through which to consult with the States. This body could also provide input to the Treasurer on the appropriate benchmark to which the States should be equalised.

Are there preferable alternatives?

The Productivity Commission has considered alternative approaches to the current HFE arrangements. Some involve making adjustments to the current methodology, while other options involve more fundamental change.

Each approach variously trades off equity, efficiency and simplicity — the trade-off between equity and efficiency is inescapable — and has its advantages and disadvantages. To be ‘preferable’ to current arrangements, alternative approaches would need to meet the Productivity Commission’s objective for HFE and address some of the concerns identified in the assessment above.

Adjustments to current methodology

A persistent criticism of the current HFE system and its underlying methodology is that it does not deal well with extreme circumstances. This often leads to views that there is a need to move to a system involving — in the words of the 2012 GST Distribution Review — either less equalisation, or less precise equalisation.

Approaches that lessen policy neutrality concerns

The CGC’s supporting principle of ‘what States do’ can come into conflict with the principle of policy neutrality. Also, the very significant level of detail that underpins the CGC’s assessments creates complexity and even perhaps a false sense of precision (GST relativities are calculated to five decimal places).

One approach is to adopt a much simpler assessment based on ‘broad indicators’. For example, assessments of revenue capacity or expenditure needs could be based on a broad macroeconomic indicator such as gross state product or household disposable income. This approach has been used for some transfers in the United States but is otherwise not commonly found in equalisation schemes overseas. A further, less drastic option is a move to more highly aggregated assessments, but drawing in the first instance on the current approach used by the CGC.

A key benefit of the broad indicators approach is greater simplicity and transparency. Most importantly, the use of broad indicators provides for a genuinely policy-neutral measure of fiscal capacity. In this way, the use of broad indicators should avoid most of the incentive effects discussed earlier. But there are also a number of genuine concerns with broad indicators — namely about the quality of the available data and whether these indicators accurately reflect particular circumstances within States. The Productivity Commission’s own calculations also throw up some complications for this approach.

On balance, a broad indicators approach, while potentially delivering benefits in terms of simplicity, would have significant costs in terms of material loss of accuracy, and may not

achieve a ‘reasonable’ level of equalisation. The broader the indicators that are used, the more such risks may arise. A more intermediate approach, involving application of broad indicators to the various revenue and expenditure categories, would appear to be a less extreme approach with greater probability of balancing accuracy and simplicity.

There is merit in further exploring whether broad indicators may prove more fruitful at the revenue and expenditure category levels. This is ideal fodder for the CGC’s five-yearly methodology reviews. However, the CGC is unlikely to pursue such simplification absent of direction to do so and while it remains singularly focused on achieving full equalisation.

The Productivity Commission also explored whether the equalisation methodology could make greater use of efficient or ‘model state’ standards, for example, based on notions of efficient service delivery and optimal taxation policy. But the Commission is not drawn to such ‘external’ standards, as they would invite a significant degree of complexity and subjective judgment.

Discounting mining

A common proposal among inquiry participants has been to impose discounts of 25 per cent or 50 per cent on the mining revenue assessment. Canada applies a 50 per cent discount to mining revenues in its revenue 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, Queensland and the Northern Territory.

Proponents of this option argue that applying a discount would reflect the uncertainty and lack of policy neutrality inherent in the current mining assessment. There is some merit in this argument. 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 reviews. Moreover, the CGC already applies discounts to select assessments where data quality is patchy, where uncertainty exists regarding fiscal capacity, or where the CGC’s view is that a methodology requires further development (in 2015 these discounts resulted in a total redistribution of \$503 million relative to a case where no discounting was applied).

The Productivity Commission is not attracted to this option. A discount does not sit well with the main equity objective of HFE. Mining revenue 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.

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 already providing a de-facto floor.

An HFE system with a relativity floor would result in partial equalisation where a State's underlying relativity goes below this boundary, but full equalisation at other times. The most common proposal is for a relativity floor of 0.7, but there were also suggestions of a staged or gradual introduction of a relativity floor over coming years. While Western Australia's relativity is forecast to increase over the next few years, it is nonetheless 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 has difficulty with extreme circumstances. At the margin, a floor may also provide greater incentives to States to pursue further development. Furthermore, an *explicit* floor would be more transparent than the *implicit* floor that has emerged through the additional payments to Western Australia. However, the introduction of a relativity floor is unlikely to provide a holistic fix to the various complexity and efficiency concerns identified earlier, and may even increase uncertainty and unpredictability. A floor is targeting a symptom, and ultimately, prevention is better than cure.

More fundamental changes to how GST revenue is distributed

The alternative approaches considered offer a departure from the CGC's full equalisation principles, and draw on practices used overseas or proposed in submissions.

Equal per capita

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 a change to an EPC allocation argued that it would be a 'fairer' system of distributing GST revenues.

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.

An EPC approach would be extremely simple, and would have no adverse effect on States' incentives to pursue increased prosperity (and revenue) or improved efficiency in providing services. However, an EPC approach would fail to meet the core equity objective of HFE, and is therefore not a viable option.

Equalisation to less than the fiscally strongest State

This approach involves first lifting States up to some agreed level of fiscal capacity (a standard the Productivity Commission views as ‘reasonable’) — but not bringing them up to the level of the fiscally strongest State as presently occurs — and distributing the balance of the GST pool on an EPC basis.

In principle, and subject to views on what is considered a reasonable standard of fiscal capacity, this approach could be used to bring States up to *any* level of fiscal capacity less than that of the fiscally strongest State. For example, this could be the average fiscal capacity, the average of the ‘donor’ States, or the fiscal capacity of the second strongest State. It could also be based on the efficient or model state standard discussed above.

This equalisation approach avoids the full equalisation that occurs under the current system, and addresses the volatility introduced in the case of an extreme outlier State. For example, in a world of equalising to the average, the low for Western Australia’s relativity (during the period 2000–2017) becomes 0.87 as opposed to 0.30.

This approach would also make way for consideration of efficiency issues where material — for example, it should lessen the disincentives for significant State tax reform or mining development and royalties — and it would be consistent with the Productivity Commission’s revised objective of HFE. However, this approach on its own is unlikely to deliver significant improvements to simplicity.

Equal per capita with ‘top-up’ funding

This approach would see the entire GST pool distributed to the States on an EPC basis, but with the Commonwealth Government providing ‘top-up’ funding to the fiscally weaker States to ensure that no State was worse off than under current arrangements.

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 distribution of that additional equalisation grant from the Commonwealth being determined by the CGC). This recommendation was part of a broader suite of recommendations to reform federal financial relations.

Were this approach applied for 2017-18, Queensland, South Australia, Tasmania, the ACT and the Northern Territory would require top-up funding. But realistically, advocates of such a model typically have Queensland as an EPC-only recipient (being a State whose relativity fluctuates around 1.0), with the top-up funding being provided only to the other States whose relativity is persistently above 1.0.

The key benefit of this approach is that it seemingly breaks 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 four 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 it may create another set of moral hazard concerns among the fiscally weaker States, and may not reduce the complexity of any assessment process. And most importantly, this model is reliant on additional funding from the Commonwealth Government. This funding 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 pursued in the context of broader reform to federal financial relations that may be able to generate some compensating benefits.

Is there a way forward?

One thing that emerges from the assessment of different approaches is that none of the approaches are perfect, and none is universally supported by participants. All approaches (including the current one) come at a cost, whether to equity, efficiency or simplicity, or some combination of these.

Equalising to the fiscally strongest State is not desirable or fair when that State is such an outlier, and when the pursuit of full equalisation may be resulting in broader (albeit in most instances small) costs to the economy. The Productivity Commission believes HFE should aim for a different — 'reasonable' — level of fiscal capacity and is seeking participant views on what level would be considered reasonable.

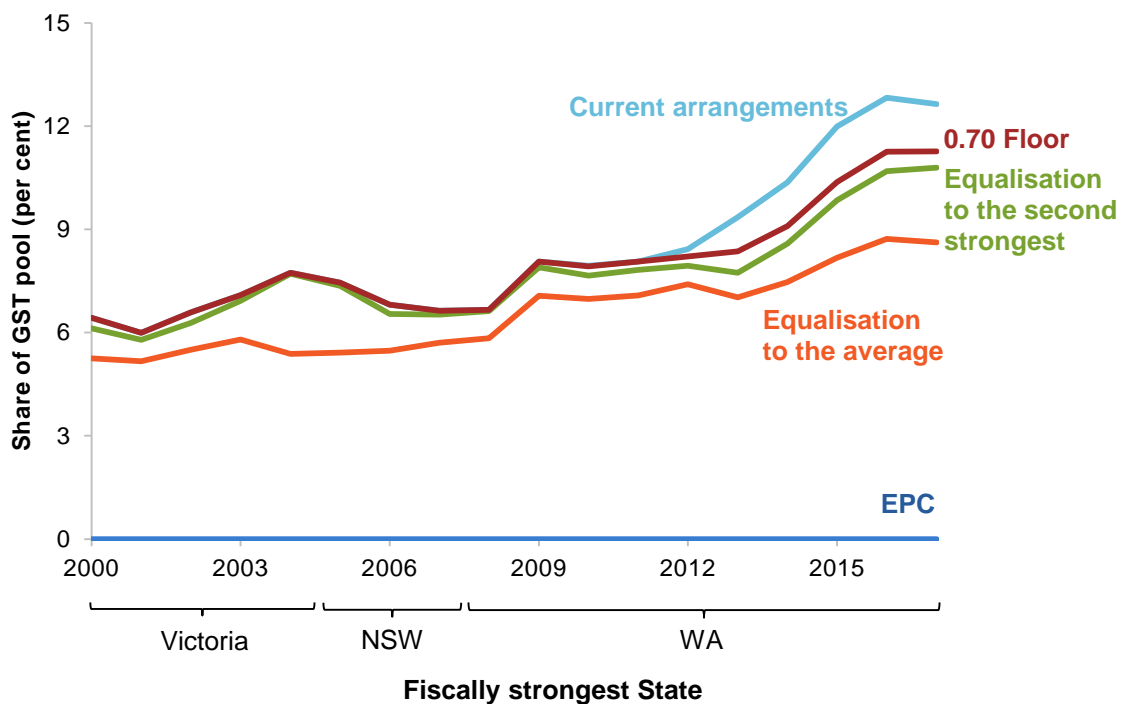
The Commonwealth Treasurer should articulate a revised objective for HFE, as envisaged in this Draft Report, and ask the CGC to recommend relativities consistent with this objective. The benefit of this approach is that it vests HFE/federal financial relations policy responsibility with government, and leaves implementation to the CGC. This retains many of the positive features of the current system, such as the CGC's independence and regular methodology reviews. And by not specifying a specific model, it makes this approach more time-neutral and amenable to changing circumstances over time.

Further, the Commonwealth Treasurer should direct the CGC to pursue significant simplification of the assessment process where it can still deliver 'good enough' equalisation results — that is, giving the CGC explicit permission to tolerate less or less precise equalisation where it has benefits for simplicity (and policy neutrality).

Any changes to HFE arrangements in the current extreme environment will result in a smaller amount redistributed away from EPC (figure 7), and commensurately a significant redistribution of GST payments to Western Australia at the expense of all the other States.

Reducing GST payments especially to the fiscally weaker States would be undesirable. Any changes would therefore need to be timed and implemented carefully, especially to ensure that fiscally weaker states are not disadvantaged. For example, changes may be implemented in the future, when Western Australia’s relativity is expected to be higher, and could be introduced gradually over a number of years. The CGC’s 2020 methodology review may be a good vehicle for considering and consulting on the most appropriate way to transition to any new approach.

Figure 7 The equalisation task under alternative approaches^a



^a The pool used for these calculations includes Health Care Grants in earlier periods.

What complementary reforms would be needed?

Reforms to improve governance and accountability are also needed — and have merit under any system of HFE. Most importantly, as identified above, there is a need for the Commonwealth Government to assume leadership here and articulate the objective of HFE. Vesting too much or all responsibility with an independent agency can lead to mission creep and creates incentives for greater complexity.

There is a dearth of public understanding of how HFE works, and this is compounded by the lack of a strong neutral voice in public discussion. The CGC can and should take on a more

prominent public communication and education role. This would involve clearly explaining its processes and the reasons for its decisions, and how this is meeting the objective of HFE.

The CGC could also engage better with governments. It should build on its extensive consultation practices by establishing a formal process to provide States with ‘draft rulings’ on the possible GST implications of a change in State policy (for example, a major tax reform). This can help to reduce some of the fiscal uncertainty that States face when considering reforms.

Greater accountability is needed too. GST funding should continue to be provided on an untied basis. That said, there is scope to improve accountability through the CGC making the data provided by the States (as well as its calculations using these data) 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.

This 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 reasonable and internally consistent with the CGC’s overall approach to HFE, they may not always be consistent with governments’ other, more direct, objectives for those payments. This is another one of the inescapable trade-offs inherent in HFE. Perhaps as a result of this, there has been a growing tendency to quarantining some Commonwealth payments purely on political grounds. There is clearly a need for a holistic assessment of how different kinds of payments interact with each other.

The patchwork of payments is symptomatic of broader problems with federal financial relations, the roots of which lie in the very high degree of vertical fiscal imbalance between the Commonwealth and the States and the unclear delineation of responsibilities for service provision across governments. Ultimately, reform to HFE will only go part of the way to improving outcomes within federal financial relations.

There is a need to revisit and renew efforts to reform federal financial relations in the broad, a process that should be led by the Council on Federal Financial Relations. In the first instance, governments should work to a well-delineated division of responsibilities. In particular, responsibilities and accountabilities for Indigenous policy — a policy area where there continues to be little improvement despite significant expenditure — should be given priority.

Genuinely reforming federal financial relations may then allow consideration for more fundamental reforms to HFE in the future and afford a greater focus on the needs of the fiscally weaker states.

Draft findings and recommendations

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

Objective of HFE

DRAFT FINDING 2.1

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

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

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

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

DRAFT RECOMMENDATION 2.1

The Commonwealth Government should clearly articulate the objective of HFE. This objective should aim for reasonable rather than full equalisation (as envisaged in draft finding 2.1).

The objective should be established through a process led by the Commonwealth and involving consultation with the States, and should be reflected in the Intergovernmental Agreement on Federal Financial Relations.

The objective should also be reflected in the terms of reference which the Commonwealth Government issues for the yearly update and five-yearly methodology review. The *Commonwealth Grants Commission Act 1973* (Cwlth) should also be updated to reflect the adopted objective.

HFE and equalisation

DRAFT FINDING 3.1

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

DRAFT FINDING 8.1

Fiscal equalisation to address disparities in the fiscal capacity of sub-central governments is common among OECD countries. But other countries' approaches to fiscal equalisation are inextricably linked to their unique institutional frameworks — this limits those schemes' applicability to Australia.

Despite this, overseas experience provides lessons that can inform the elements of our system in order to better meet the objectives of our fiscal equalisation scheme.

Australia is the only OECD country with a federal government that totally eliminates disparities in fiscal capacity between sub-central governments.

HFE and State policies

DRAFT FINDING 4.1

For the most part, States considering tax reforms would generally not be deterred by the effects on GST redistribution. However, there are circumstances where the GST effects can be material — such as for a State undertaking large-scale tax reform — and act as a significant disincentive to States implementing efficient tax policy. These disincentives are likely to be exacerbated where the State is a first mover on reform or where there is uncertainty about how significant tax changes will be assessed by the CGC.

INFORMATION REQUEST

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

DRAFT FINDING 4.2

Changes in State service delivery policies can impact on GST payments, but the impacts are mostly trivial. HFE is unlikely to discourage — nor encourage — States from pursuing growth strategies or addressing their structural disadvantages given the broader and more significant benefits of doing so to the community.

DRAFT FINDING 4.3

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

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

HFE and State budgets

DRAFT FINDING 5.1

Features of Australia's HFE system detract from its contemporaneity. While this works to smooth out changes in GST payments, it can exacerbate the fiscal impact of economic cycles when States experience large economic shocks. Such a situation has occurred in Western Australia in recent years.

However, offsetting cyclical factors is not the primary objective of HFE, and alternative approaches do not offer unequivocal improvements. Reducing the length of the assessment period would have mixed impacts across States, and reducing the lag due to delayed data availability would introduce additional scope for dispute, volatility and the potential for unintended consequences.

DRAFT FINDING 5.2

GST payments are less volatile than other major sources of State government revenue. While some States have reported difficulty forecasting GST payments, others consider GST payments to be no less unpredictable than other sources of revenue.

HFE and migration

DRAFT FINDING 6.1

The redistribution that arises from Australia's system of HFE is small in magnitude relative to total government revenue for most States. As such, the GST distribution and net fiscal benefits are unlikely to be a significant driver of interstate movement of people.

Methodological changes to the current system of HFE

DRAFT FINDING 7.1

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

DRAFT FINDING 7.2

The introduction of a minimum relativity floor would blunt extreme equalisation outcomes and might theoretically introduce greater incentives for States to pursue development opportunities. But a floor will likely prove a band-aid solution as it does not address the identified deficiencies of HFE, and may even introduce greater uncertainty and unpredictability into the HFE system.

DRAFT FINDING 7.3

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

DRAFT RECOMMENDATION 7.1

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

DRAFT FINDING 7.4

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

INFORMATION REQUEST

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

INFORMATION REQUEST

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

DRAFT RECOMMENDATION 7.2

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

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

INFORMATION REQUEST

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

Alternative approaches to HFE

DRAFT FINDING 8.2

An equal per capita approach to distributing GST revenue is incapable of equalising the fiscal capacities of States. This approach is thus inimical to achieving the core equity rationale underpinning horizontal fiscal equalisation.

DRAFT FINDING 8.3

An equal per capita with top-up funding approach would provide all States with the fiscal capacity to deliver a similar level of services. While this would meet the equity rationale underpinning horizontal fiscal equalisation, the top-up funding would always be hostage to fiscal constraints faced by the Commonwealth Government and, thus, this approach poses uncertainty for the fiscally weaker States. Such an approach should only be meaningfully considered as part of a broader reform of Commonwealth–State financial relations.

DRAFT FINDING 8.4

An actual per capita approach (which is similar to the current system except that it uses *actual* revenue and expenses rather than *assessed* revenue and expenses) would provide all States with the fiscal capacity to deliver a similar standard of services and, in doing so, would meet the equity rationale that underpins horizontal fiscal equalisation. However, this approach has significant risks for adverse efficiency effects (less incentive to contain costs and pursue efficient service provision) — and on those grounds is an unacceptable alternative to current arrangements.

DRAFT FINDING 8.5

Equalisation can be designed to provide a spectrum of fiscal equalisation outcomes — for example, from equalising to the average fiscal capacity across the States up to equalising to that of the strongest State. The extent to which this approach would meet the equity rationale underpinning horizontal fiscal equalisation therefore depends on the level of equalisation this approach is intended to deliver.

INFORMATION REQUEST

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

INFORMATION REQUEST

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

Institutional reforms

DRAFT RECOMMENDATION 9.1

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

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

DRAFT RECOMMENDATION 9.2

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

DRAFT RECOMMENDATION 9.3

The Commonwealth and State Governments, through the Council on Federal Financial Relations, should develop a process that would work towards a longer term goal of reform to federal financial relations.

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

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