

GST Distribution Review Final Report

October 2012

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Table of Contents

Foreword from the Panel	v
Executive Summary	1
1 What is HFE? — A review of the literature.....	23
1.1 The essence of the debate	23
1.2 Early discussions.....	23
1.3 The basic case for equalisation	25
1.4 Further work on equity.....	26
1.5 Further work on efficiency.....	29
1.6 Modelling	32
1.7 What conclusions can be drawn from the literature?.....	34
2 The contrast between models of equalisation.....	35
2.1 The challenge for the Panel.....	35
2.2 The joint submission of the four largest States	37
2.3 Issues beyond HFE	38
2.4 A simple illustration of the modern equalisation system.....	39
2.5 Support and criticisms of HFE	41
2.6 The search for a model for Australia’s future	43
2.7 The Panel’s findings on the ‘right’ model of equalisation.....	44
3 Examining alternative equalisation approaches	47
3.1 Proposals to do ‘less’ equalisation	47
3.2 Proposals for ‘less precise’ or ‘more general’ equalisation.....	56
3.3 ‘Comparable’ or ‘materially-the-same’ capacity?.....	61
4 Improving HFE system governance	63
4.1 Current governance arrangements	64
4.2 Endorsing and promulgating the definition of HFE	64
4.3 Reviewing the CGC Act.....	66
4.4 Reviewing the CGC’s implementation of HFE.....	67
4.5 Setting priorities for future methodology reviews	68
4.6 Providing further guidelines for the Treasurer and CGC	69
5 Improving communication and transparency.....	75
5.1 Clarifying the presentation of relativities	75
5.2 Clarifying or improving the projection of relativities	78
5.3 Broadening the engagement of the CGC.....	82
5.4 Improving the interaction between HFE and Payments for Specific Purposes (PSPs).....	83
6 Greater stability of GST shares and methodology improvements.....	89
6.1 The treatment of Commonwealth capital payments	89
6.2 Data revisions.....	94
6.3 A simplified and integrated assessment framework	97
6.4 Cost equalisation	100

7	Assessing mining revenue and expenditure	105
7.1	Should mining be treated differently to other revenue?	105
7.2	Changes to the mining revenue assessment	109
7.3	Are all mining related expenditure needs recognised?.....	113
8	State mining royalties and the MRRT	121
8.1	State royalties and the Commonwealth’s resource taxes.....	121
8.2	A cooperative approach remains the best solution.....	124
8.3	Fixing the interaction between MRRT and State royalties.....	128
8.4	What form should an agreement take?	130
9	Efficiency and tax reform	135
9.1	Relationship between HFE and efficiency.....	136
9.2	Tax reform	140
10	The role of HFE in Indigenous service provision	143
10.1	How much GST revenue does <i>Indigeneity</i> redistribute?	143
10.2	Drivers of GST redistribution due to <i>Indigeneity</i>	144
10.3	What the Panel found	146
10.4	Other <i>Indigeneity</i> related issues	148
11	Ensuring the GST pool is robust and stable	151
11.1	What is the GST pool designed to achieve?	151
11.2	How well has the GST pool performed?	153
11.3	Making the GST pool more robust and stable.....	157
12	HFE and federal finances in the longer term	165
12.1	The need for a longer term vision	165
12.2	Emerging fiscal pressures	166
12.3	State tax reform.....	168
12.4	Roles and responsibilities	170
12.5	Commonwealth assistance to States in the longer term.....	172
	Appendix A: Terms of Reference	177
	Appendix B: Aspects of vertical and horizontal equity in government policy action	181
	Appendix C: Ideas considered but not adopted	183
	Appendix D: Alternative mining scenarios	185
	Appendix E: Stabilised pool options	189
	Appendix F: Changes in State fiscal capacities over time	193
	Appendix G: OECD VAT rates	203
	Appendix H: Consultations	205
	Glossary	213
	Acronyms	219
	References	221

Foreword from the Panel

When we were invited to undertake the task of examining the mechanism by which the Goods and Services Tax is distributed between the States, the phrase ‘no win scenario’ crossed the minds of more than one of us. The idea that a dispute over a fixed pot of money could be resolved happily, when recognising anyone’s greater claim means that at least one and possibly all others suffer, seemed unlikely from the outset. States were clearly in two distinct camps.

Nevertheless, we have thrown ourselves into the task. Over the past 18 months the Panel has met formally 26 times, usually for day-long meetings, commissioned and examined over 150 individual briefings on various topics from our Secretariat, convened a symposium for academics, reviewed about 70 written submissions, some of which run to 100s of pages, and met with every State and Territory’s representatives at least twice (in several cases through changes of government). We have felt it necessary to become deeply involved in the entrails of very intricate aspects of the system as we discovered very early that failure to grasp the detail can make progress impossible — the HFE system is not for the faint hearted.

Along the journey we have had our Terms of Reference extended into the controversial fields of State tax reform and resource taxation, produced two interim reports and we now present this final report with findings and recommendations.

We have no illusions that this report will be met with acclaim. Advocates for radical change will say we have missed an opportunity, while defenders of the system will not like our ideas for the longer term. However, we believe that, together, our three reports will make a major contribution to the debate about HFE.

In this final report we have taken pains to examine the essence of the debate about the different models of HFE, providing a relatively simple starting point for future debate. Whether the reader ultimately agrees with our conclusions or not, at least there is now the possibility of future discussion proceeding from a base of common understanding.

We have also taken the time to examine the ‘myths’ about HFE and dispel a few that have been unproductive. In our view, many of the concerns about HFE have turned out to be overstated, while others have reflected either the practical limitations of the system, or a matter of judgement about the result, rather than a proposition capable of technical proof. Still other concerns have, in the Panel’s view, represented symptoms of the present economic times rather than problems with HFE per se. This does not mean they can be ignored, but it does mean that they need to be considered in the proper context, and the responses to them need to be appropriately restrained.

Even where concerns have proven legitimate, we have carefully examined all potential solutions to these concerns to ensure that the ‘cure’ is not worse than the ‘disease’, and to consider whether any cost associated with a solution is proportionate to the benefit it is expected to bring. Comparing the costs and benefits of any proposal is not straightforward, particularly when one is dealing with a federation as diverse as

Australia's — clearly, a funding reduction that is insignificant to a large State may be devastating to one of the smaller States.

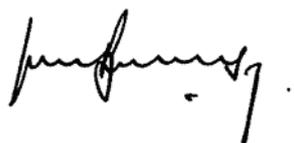
The result of all these considerations is a report containing a range of recommendations designed to improve understanding of the HFE system in Australia, increase the transparency of the process and strengthen governance arrangements.

Recommendations have been made to help simplify the system, improve the assessment of costs related to mining and also increase the stability of States' GST shares. While we have not proposed radical changes to the way GST is distributed, our report represents substantive improvements to Australia's HFE system.

We do, however, have a long term concern about the state of federal financial relations. A combination of history, constitutionality and political decisions taken over several generations has produced a situation where the States' spending responsibilities greatly exceed what they raise themselves, while the Commonwealth's revenue raising greatly exceeds its own spending 'obligations'. These circumstances, and the consequent pressures on revenue adequacy, underpin much of the current HFE debate. It has therefore proven difficult to properly consider how best to distribute the GST without also considering related aspects of the GST base itself — accordingly, we have made recommendations on that matter in this report.

As we further point out, in the longer term, the response to the States' likely future funding dilemma is not as simple as increasing the rates of existing State taxes. Without a process of national tax reform, reform of federal relations and responsibilities or collective decisions to reduce the 'size' of government, funding adequacy is set to become a more acute problem as the population ages and pressure to increase State spending grows faster than States' ability to raise revenue from their existing taxes. Moreover, the range of problems is too broad to be remedied by the States or the Commonwealth acting independently, or to be determined along party political lines — only a cooperative and coordinated national effort will maintain confidence in Australia's federal fiscal relations.

Finally, we wish to express our thanks to the Secretariat, led by Mr Paul McCullough. We simply could not have come this far without the support and assistance of the expert and experienced officers from The Treasury, the Commonwealth Grants Commission and State Treasuries to guide us past the many pitfalls.



The Hon. John Brumby



Mr Bruce Carter



The Hon. Nick Greiner AC

Executive Summary

What has the Review been asked to do?¹

The initial Terms of Reference

On 30 March 2011, the Commonwealth Government announced a review of Australia's system of distributing the GST amongst the States and Territories (collectively referred to hereafter as 'the States'). The Panel conducting the Review was asked to consider whether the current approach to distributing the GST (according to the principle of horizontal fiscal equalisation, hereafter referred to as HFE) would ensure that Australia is best placed to respond to the expected significant structural changes in the economy and would maintain public confidence in financial relationships within the Federation.

However, the commission was not given without restrictions. The Terms of Reference also state that the Review will be guided by a number of factors, including that:

- the long-standing practice of equalisation between States has served Australia well
- the GST will continue to be distributed to the States on the basis that they should have equal capacity to provide services and infrastructure to their citizens
- GST will be distributed as 'untied' payments
- the Commonwealth Grants Commission (CGC) will continue to make recommendations on the distribution of the GST.²

In addition, there is no extra Commonwealth revenue available with which to 'buy' reform, or smooth any transition. The Panel has therefore proceeded on the basis that States that are fiscally weaker at any given time must continue to have the capacity to provide substantially similar levels of services and infrastructure to their citizens from within the current revenue envelope.

The supplementary Terms of Reference

Supplementary Terms of Reference were issued on 17 November 2011, asking the Panel to consider possible changes to the form of equalisation to:

- ensure that HFE does not provide a disincentive to State tax reform
- utilise HFE to provide incentives and disincentives to promote future State policy decisions which improve the efficiency of State taxes and mineral royalties
- examine the incentives for States to reduce Minerals Resource Rent Tax (MRRT) or Petroleum Resource Rent Tax (PRRT) revenue through increasing mineral royalties.

1 The full Terms of Reference for the Review are set out in Appendix A.

2 GST Distribution Review Terms of Reference, issued on 30 March 2011, paragraph 6.

These supplementary Terms of Reference initially caused consternation amongst the States. Resource States felt the need to defend their jurisdictions against Commonwealth expansion into resource taxation. Most States, while acknowledging the accepted tax reform direction, are keen to explore the incentive ‘carrot’, but have no time for the disincentive ‘stick’. As to the general incentives of the HFE system on tax reform, some States claim to be dissuaded from improving policy by apparently minor and, in some cases, trivial GST effects, while others suggest the opposite.

Context of the Review

The economic outlook

While the Australian economy is performing very well by international standards, the Commonwealth’s recent Mid-Year Economic and Fiscal Outlook reported that:

Global growth has weakened since Budget and the international outlook remains highly uncertain. The euro area has fallen back into recession, the recovery in the United States remains subdued and weakness in the major advanced economies is bearing on growth in the large emerging market economies, including China and India.

Against this challenging global backdrop, the fundamentals of the Australian economy remain strong and the outlook remains positive. Economic activity is expected to grow at around its trend rate over the next two years, the unemployment rate is forecast to remain low and inflation is expected to be well-contained.

Australia’s favourable economic growth prospects are supported by a surge in business investment, strong growth in non-rural commodity exports and solid growth in household consumption.

The challenging global environment, high Australian dollar, household deleveraging, changed household spending patterns and subdued expectations for asset price increases are weighing heavily on some parts of the economy, consistent with forecasts for moderate employment growth and a slight rise in the unemployment rate.

Weaker global demand has also contributed to larger-than-anticipated declines in global iron ore and coal prices and in Australia’s terms of trade. As a result, Australia’s nominal GDP growth is expected to be a percentage point weaker in 2012-13 than forecast at Budget, with marked consequences for revenue collections.³

Implications of the economic outlook and other recent developments

The growth outlook has implications for Commonwealth and State budget revenue. All Commonwealth and State Governments are expecting to deliver fiscal deficits, or at best, very modest fiscal surpluses, in the medium-term.

3 2012-13 Mid-Year Economic and Fiscal Outlook, page 13.

Of particular relevance to the Review, the Panel notes:

- While growth in GST revenue — the current vehicle for equalisation — has averaged 6 per cent since the introduction of the GST, for the next few years only 5.2 per cent pool growth per year is expected.⁴ However, these figures mask a large difference between the period prior to the global financial crisis and the one after it. Up until 2007-08, the GST grew each year by around 8.3 per cent on average, far higher than the average 2.2 per cent increase between 2008-09 and 2011-12. Lower growth has had implications for the range of approaches the Panel has been able to recommend, as extra Commonwealth funding is not currently available to fund changes to Australia's equalisation system. Despite recent calls for Australia to reject the 'no losers' mentality that can impede reforms, the reality is that, in a world where revenues are weak, policy change is hard.
- Recent significant and rapid improvement in the relative financial position of Western Australia, at the same time that Queensland, another major resource State, has experienced temporary setbacks from major natural disasters, has led to greater divergence in State fiscal capacities and, therefore, substantial change in the distribution of the GST amongst the States. While the situation could prove to be temporary and less extreme than first thought, these recent rapid and significant changes have heightened scrutiny about the HFE process and its outcomes.⁵
- The Panel's Terms of Reference ask us to consider 'future challenges' and this requires having an eye not only on current and short term issues, but other pressures that are likely to affect States' budgets in a significant way in the longer term, such as the ageing population. Other longer term issues that may not be able to be predicted, but need to be contemplated, include the length of the mining boom and the countervailing or reinforcing circumstances that may apply.
- Several other special factors (of varying degrees of importance) have also contributed to recent heightened scrutiny, including large data revisions in a recent CGC Update, changes made in the CGC's 2010 Review, and a large one-off increase in the size of infrastructure payments to States as part of the Commonwealth Government's economic stimulus package from 2009. A series of recent moves involving substantial Commonwealth funding to States, either to produce special outcomes (e.g. 'closing the gap payments' to the Northern Territory and the Tasmanian health system payments), or to deliver uniform national outcomes (as in the recent health agreement and are in contemplation in the education arena) may also create tension with the HFE system unless managed carefully.

4 GST payments to 2011-12 have been sourced from Commonwealth Government *Final Budget Outcome*, various years. Forward estimates of GST entitlements have been sourced from *MYEFO 2012-13*, page 80. Growth is based on total GST entitlement.

5 See Appendix F for charts showing differences in State fiscal capacities since 1992-93.

The Panel's approach

The interim reports⁶

The Panel's first interim report, released by the Treasurer on 23 April 2012, outlined the Panel's thoughts on the matters set out in the initial Terms of Reference, taking into account the various positions and ideas put forward by States, academics and other interested parties in response to an initial issues paper. Various States and commentators expressed significant concerns about the theoretical model for GST distribution, the practical implementation of the model, the resultant outcomes and the inability of States to anticipate those outcomes with reasonable confidence.

The Panel's second interim report outlined the Panel's thoughts on the matters set out in the supplementary Terms of Reference, again taking into account such views as had been put by States and others in their submissions in response to a supplementary issues paper released in December 2011.

This final report has benefitted from further rounds of consultation along with thoughtful and detailed submissions from all jurisdictions and a number of other interested parties.

The consultation process

Over the past 18 months, the Panel has met with and consulted States (including Premiers, Treasurers and Shadows, as well as officials), the Commonwealth Grants Commission, academics with known interest in Commonwealth-State financial arrangements and other interested parties. Detailed information on the consultation undertaken by the Panel is in Appendix H.

All States have made submissions in response to the first and second issues papers and again following the release of the interim reports. While each State has put forward its individual perspective, the four smaller States have tended to share similar views, and the four larger States have also had a convergence of views — the latter group coming together to make a joint submission in response to the interim reports.

In our interim reports we were careful to demonstrate that we had paid detailed attention to the views of stakeholders and experts by quoting them extensively. This was done partly to ensure we were not inadvertently misconstruing submissions put to us, and partly to avoid the suggestion that we might be doing so with intent. However, the consultation process has been so comprehensive, open and constructive that we have not felt the need to repeat that approach here. While, no doubt, certain stakeholders will disagree with some of our conclusions, we trust that they will appreciate the *bona fides* of the motivation that has prompted them. Therefore, in this final report, we have opted to summarise the relevant key issues affecting our findings and recommendations, rather than setting out a verbatim account of the diverse positions and arguments.

⁶ The Panel's reports are available on the Review's website: <http://www.gstdistributionreview.gov.au/content/Content.aspx?doc=reports.htm>.

Overview of findings and recommendations

Since federation, the Commonwealth Government has provided some form of financial support for fiscally-weaker States. The view was taken that, unless some type of intervention occurred, the Federation would be unsustainable, as States with weaker financial positions would have had to reduce services and/or raise additional revenue. To enable these poorer States to provide services to their residents at anything close to the same standard as the fiscally-stronger States, it was recognised that a mechanism was required to adjust their fiscal capacities through special grants.

Chapter 1 reviews the academic literature to conduct a detailed tracing of the theoretical debate around models of equalisation. It explains that the essential difference between the modern theory of equalisation and that adopted from shortly after federation to the mid-twentieth century is that the current system reflects the goal of allowing interpersonal horizontal equity via equalising States' capacities, whereas previous arrangements were based on more general concepts of fairness that left greater room for debate about the appropriate level of redistribution.

The Chapter concludes that, while modern horizontal fiscal equalisation (HFE) theory provides a conceptual model for determining the financial transfers between States in order to be fair to all citizens and avoid inappropriate migration incentives, the model has its critics and there are practical issues with it. The preference of some States for an outcome consistent with this theory, whilst others seek a simpler model, lies behind many of the differences between the positions put to the Panel by the States. While South Australia, Tasmania, the Australian Capital Territory and the Northern Territory support the current equalisation system, New South Wales, Victoria, Queensland and Western Australia see major problems with it. The significant concerns of this second group of States — representing 90 per cent of Australia's population — has caused the Panel to inquire closely into whether modifications could be made to the current practices that might produce tangible benefits outweighing any costs of change.

Chapter 2 examines the difference in practical impact between the modern HFE model and other approaches, making five key findings about the parameters of the right model for the future. These findings relate to:

- the advantages of a rules-based system over ad hoc negotiations
- the target for equalisation
- the precision with which any target can be achieved
- the comprehensibility of the HFE system to outsiders
- issues outside HFE that add to States' concerns.

Chapter 3 examines specific proposals and ideas to modify the system put by the large States in order to establish whether any of the approaches are viable in the short to medium term. For convenience, the Panel has categorised these into two groups:

- In relation to proposals to do 'less equalisation' the Panel finds that none of the approaches canvassed would be simpler, more transparent or improve efficiency.

They would all require additional steps in the CGC's process, and additional steps would require additional explanation about how the distribution was determined, making the process less transparent.

- In relation to proposals to perform equalisation in a 'less precise' way, the Panel was initially drawn to the prospect of 'broad indicators' as a potential way to achieve the goal of reaching similar outcomes through simpler processes. Ultimately, however, we found this goal to be elusive. While there is no end of 'simpler' ways to allocate Commonwealth grants to States, very few could be adopted within the constraints of our Terms of Reference.

While the Panel has found that it is not possible to closely replicate the outcomes of the current system in a dramatically simpler way, we have recommended two small steps that can be taken relatively easily — increasing materiality thresholds and rounding relativities. Although these changes will only change GST shares in a minor way, the Panel believes the steps should be taken in order to act as resistance against the tension created by the contested nature of the current system, which can apply pressure on the CGC to adopt processes and assessments that are overly precise.

Chapter 4 considers improvements to the governance of the HFE system. The Panel has recommended a range of improvements designed to strengthen existing arrangements by increasing the timeliness and accountability for decisions, as well as improving collaboration in the processes surrounding them. The Panel recommends that:

- the governance arrangements reflect the need for the States and the Commonwealth to act more as joint stewards of the system rather than competitors or critics
- the definition of HFE be set out in the CGC Act
- the CGC Act itself be brought up to date with current practice
- the CGC be given clear authority to determine which assessments should be reviewed (and which ones should not) in its regular methodology reviews
- the Commonwealth Treasurer adopt guidelines governing the Commonwealth's decisions and consultation processes.

Chapter 5 examines ways to improve transparency and understanding of the system. The Panel has made recommendations designed to improve the way the HFE system is explained and communicated, thus increasing confidence in the system. The Panel recommends that:

- an additional presentation of relativities also reflect the full Commonwealth assistance to States
- both the projection of relativities and the interaction between HFE and Payments for Specific Purposes be clarified
- that the CGC engage more broadly.

Chapter 6 deals with improvements to the stability of GST shares by proposing changes to the treatment of Commonwealth capital payments to the States, so that all national network road infrastructure and rail based transport infrastructure payments be treated on a consistent basis, via 50 per cent of the payments affecting relativities. Changes to reduce the extent to which data revisions are incorporated are also recommended in order to further improve stability and potential methodology improvements are highlighted for the CGC to consider.

Reflecting the important role mining related issues have had in this review, Chapter 7 deals in detail with the assessment of mining revenue and expenditure. The Panel concludes that State mining revenue should continue to be equalised, but recommends that the CGC develop a new mining revenue assessment at the earliest opportunity to address policy neutrality concerns. The Panel also concludes that some mining related costs may not be properly recognised in the CGC's current assessments and therefore recommends that an amount equivalent to a three per cent discount to the mining revenue assessment be allowed as a temporary measure until the CGC conducts its next methodology review.

Chapter 8 deals with the interaction between States' mineral royalties and the Commonwealth's resource taxes. The Panel finds that the current impasse between the two levels of government on this issue is harmful and unsustainable, but that it won't be fixed by penalising States through the GST distribution system. The Panel concludes that what is needed is for the States and the Commonwealth to settle a negotiated outcome. Ideally, such an agreed position would enable State royalties to be lower and the revenue from the Commonwealth's resource taxes to be greater, with the Commonwealth guaranteeing to increase payments to each State to ensure its fiscal positions are maintained. The Panel's view is that the fiscal dividend from these improved arrangements should also be shared between the two levels of government, as occurred with the National Competition Policy reforms.

Chapter 9 examines concerns that HFE undermines efficiency or impedes tax reform. The Panel concludes that the current system creates perverse *theoretical* incentives in some instances, but they cannot be meaningfully reduced without significant reductions in equalisation outcomes, which would be unacceptable, given there is little practical evidence of efficiency losses. On tax reform, the Panel emphasises that a more broadly-based tax system is vital to Australia's future prosperity, but notes that equalisation is not an impediment, nor is it an appropriate tool to compel or encourage States to change their tax policies. The Panel concludes that if it ever became apparent that possible changes in GST shares were impeding tax reforms, specific and temporary adjustments should be made to the GST distribution in that context, rather than changing the equalisation system as a whole.

Chapter 10 examines *Indigeneity*, which is the disability responsible for the greatest redistribution on the expense side. The size of this factor has caused some States and commentators to conclude that removing it (in whole or part, or as a component of even larger changes) would improve the system. The Panel has not agreed with these calls. Chapter 10 sets out the Panel's reasons for deciding that there should be no change to the current approach to *Indigeneity* in the HFE system.

Chapter 11 looks at the GST pool itself, and its role in providing both the basis for untied grants to the States and for delivering HFE. While parts of the current arrangements work well for States, GST collections have been both less buoyant over recent times and more volatile than expected when the GST was introduced. In this Chapter the Panel suggests ways of ensuring the GST pool is as robust and stable as possible, including by preventing online imports from eroding the GST base and by allowing the States greater flexibility in relation to assisting first home buyers.

Chapter 12 sets out the Panel's thoughts about how HFE might be approached in a longer term scenario in which other aspects of federal fiscal relations are simultaneously in play. Chapter 12 discusses spending pressures and how they might be managed, how future tax reforms might better align Commonwealth and State revenue raising capacity with service responsibilities, and how this might lead to a reduced level of vertical fiscal imbalance. The Panel considers that under such a long term scenario, the current concept of HFE need not necessarily apply, but notes that any modified system would still need to recognise and accommodate the needs of the fiscally weaker States.

Summary of findings and recommendations

Chapter 2 — The contrast between models of equalisation

Findings on factors affecting the choice between models of equalisation:

Finding 2.1 on a rules-based system of allocating funds

Experience shows that a politically indifferent, rules-based, system of allocating finances to States has advantages over the ad hoc negotiation of special deals, especially, but not only, when governments of opposite persuasions are involved. An independent system even arguably has advantages for the ‘donors’, as New South Wales and Victoria might recall from their experience in the 1980s, when they began to do better from the first full equalisation process than they had under the previous process of considering the claims of individual States.

Finding 2.2 on the principle of horizontal fiscal equalisation

The purpose of a federation is to bring disparate constituent parts together and so the concept of bringing the weak up to the capacity of the strong has much to be said for it. However, the zeal with which an exact calculation of equalising all States’ fiscal capacities must be pursued, the precision with which the target can be determined and the effect it will have are disputed. While there is no reason to argue against providing States with the capacity for horizontal interpersonal equity (i.e. equality) amongst their citizens, inequality is tolerated in many features of government if there are identifiable benefits to be gained.

Finding 2.3 on the current HFE system

The current HFE system — requiring material equality and being guided by internally referenced principles and pillars, standards and capacities — is well established and internally consistent. It works satisfactorily if the goal and definition of equalisation as currently set out is accepted and one accepts (as we do) that the CGC does a good job of making its judgements and producing its numbers in the circumstances. However, by recognising that the CGC is often obliged to make decisions that turn on fine judgements and occasionally reverse direction, one is obliged to accept that there is a margin for error in the outcome. Despite the ‘conservative bias’ arguably applied by the CGC in its judgements, the margin for error could result in over-equalisation, or equalising for things that are effectively within a State’s control.

Finding 2.4 on people’s understanding of the current system

Outside of a small core group, very few people, politicians included, have a good understanding of the background to, or the features of, the current system. This lack of understanding, compounded by the ‘zero sum’ nature of the exercise and the capacity of all to view the arguments through the lens of a geographic perspective, means that debate about the system can be frustrating if not futile. If a simpler system allowed the democratic processes to operate in a better informed environment, that would be beneficial to transparency and good government. Decision-makers should not be captive to the advice of a very narrow pool of experts, especially when the objectives of the system are contested amongst those experts and, because of the relative nature of the calculations, its effects are hard to predict and sometimes counter-intuitive.

Finding 2.5 on issues connected to HFE

Apart from HFE itself, there are closely connected issues that aggravate the concerns of some States. Concerns about the size of GST shares because the GST has not ‘kept pace’ with the State taxes it replaced, has not grown at the expected rate, or is shrinking as a proportion of consumption, compound and conflate concerns about HFE. When HFE issues intersect with questions of tax reform and State and Commonwealth rights, the aggravation becomes extreme.

Chapter 3 — Examining alternative equalisation approaches

Finding 3.1 on proposals to do ‘less’ equalisation

Despite our initial desire to provide incentives to States to deliver services more efficiently, the Panel has concluded that the HFE system as currently manifested cannot achieve this through efficiency discounts, as there are factors beyond a State’s control that lead to higher than average expenditure. While it might theoretically be possible to overcome this deficiency if the CGC were to fully separate cost and use elements of its assessments, that result is not guaranteed, and the additional process would risk complicating the CGC’s assessments further.

Nevertheless, the Panel encourages States to continue to seek efficiencies wherever they can. In particular, we note that, under the present system, whenever large States such as New South Wales, Victoria and Queensland are able to reduce their costs of service delivery, their contribution to the average calculation (over 75 per cent) will drive the average to which all States are equalised.

Finding 3.2 on approaches to address confidence in the federation

Approaches to address confidence in the federation would only make sense if there was a real likelihood of a strong State seeking to leave the federation. In the Panel’s view, whatever concerns States may have about the delivery of HFE, they are not sufficient for them to realistically contemplate leaving the federation and we do not see the need to pursue these approaches. If a situation arose where the risk of a State seeking to leave the federation became realistic, this type of approach might be considered as an ‘emergency break glass’ option to apply in the short term to allow time for a negotiation of broader Commonwealth-State financial relations issues.

Finding 3.3 on the ‘effort’ approach

The effort approach provides an interesting and credible basis for adjusting the present system. However, the discounts indicated could only be considered to be minimal — perhaps even symbolic — from the large States’ point of view, while having a significant impact on small States. After deep deliberation, the Panel has decided, on balance, not to recommend adopting discounts to reflect the minimum effort.

Finding 3.4 on approaches that address State ‘property rights’

Whether any of the approaches examined above would improve the HFE system is ultimately a matter of judgement, depending on one’s point of view. On balance, the

Panel has come to the conclusion that we can neither recommend very small changes that would deliver only symbolic benefits to the large States (at the cost of even less simplicity), nor are we prepared to recommend larger changes that would have major negative impacts on small States.

However, if governments were minded to make changes, the Panel considers that the ‘effort’ approach would be the best way of determining the size of those changes.

Finding 3.5 on broad indicators

The Panel concludes that the ultimate goal of improving simplicity by adopting broad ‘cut-through’ indicators that can produce closely comparable results to those under the present arrangements remains elusive. That does not mean that we have concluded that no break-through simplification via broader indicators is possible, but just that it cannot be achieved in one bold stroke.

Recommendation 3.1 on materiality thresholds

To ensure the system is not driven to become falsely precise, the Panel recommends that materiality thresholds for the next methodology review be set at:

- *category total expense or revenue average of \$200 per capita*
- *category redistribution \$120 per capita for any State*
- *disability \$40 per capita for any State*
- *data adjustments \$12 per capita.*

Recommendation 3.2 on rounding relativities

To ensure the system does not appear to be falsely precise, the Panel recommends that relativities produced from the CGC’s process be rounded to two decimal places in the annual Updates and Reviews.

Chapter 4 — Improving HFE system governance

Finding 4.1 on governance arrangements

Governance arrangements for the HFE system should reflect the need for the States and the Commonwealth to act as joint stewards of the system, rather than competitors or critics.

Recommendation 4.1 on endorsing the definition of HFE

The Panel recommends that the definition of HFE be set out in the CGC Act.

Recommendation 4.2 on reviewing the CGC Act

The Panel recommends that the CGC Act be thoroughly reviewed (by the Commonwealth in close consultation with the States) with a view to updating its provisions to bring it in line with the practice of HFE today. In particular, sections to be

updated include those that relate to:

- 'special assistance' and 'applications for assistance'
- the definition of a State, and separate provisions for the Australian Capital Territory, Northern Territory, Jervis Bay Territory and Norfolk Island
- remuneration and termination of CGC members
- the operation of the CGC along judicial lines, such as giving evidence on oath.

Recommendation 4.3 on reviewing the CGC's implementation of HFE

The Panel recommends that the Commonwealth formally request the Auditor-General to consider conducting an audit of the CGC's administration of HFE within three years of the implementation of the outcomes of this Review, or following the next methodology review, whichever comes first.

Recommendation 4.4 on setting priorities for future methodology reviews

That the CGC be given clear authority to identify the assessments it regards as high priority for re-examination in the review and determine which lower priority assessments should be deferred until a future review.

Where significant issues arise late in a review, the CGC should be able to seek an extension from the Commonwealth for that element, to ensure there is adequate time for consultation.

Recommendation 4.5 on guidelines for the Treasurer's consultation with the States

That the Treasurer develop and publish guidelines governing consultation with the States along the following lines:

- *In consulting with the States in relation to the draft Terms of Reference for a CGC annual Update, the Treasurer shall:*
 - *finalise draft Terms of Reference by early November of the year prior to which the Update applies*
 - *allow a minimum of three weeks consultation by States on the draft*
 - *ensure all key elements are included in the draft provided to States*
 - *provide final Terms of Reference to the CGC by, at the latest, the end of December of the year prior to which the Update applies.*

Recommendation 4.6 on guidelines for the quarantining of payments

That the Treasurer develop and publish guidelines governing the quarantining of Commonwealth payments, along the following lines:

- *The Treasurer shall only quarantine payments to States on an exceptions basis,*

recognising that most payments are properly included in the HFE process.

Exceptions that may warrant quarantining a payment include:

- *where a payment is made solely and expressly for the purpose of allowing a State to temporarily provide above average services in a particular area*
 - : *in particular, where a payment is made for the purpose of allowing a State to provide above average services to address Indigenous disadvantage.*
- *The Treasurer shall avoid quarantining payments for reasons already considered by the CGC, including where:*
 - *the payment is being made 'through' the State to a third party*
 - *the payment is a purchase of services by the Commonwealth*
 - *the Commonwealth distribution is assumed to reflect States' needs*
 - *the relevant expenditure needs are not able to be assessed.*

Recommendation 4.7 on the timing of the Treasurer's decisions

That the Treasurer develop and publish guidelines governing the timing of decisions relating to quarantining of Commonwealth payments, along the following lines:

- *In relation to the timing of decisions on quarantining Commonwealth payments, the Treasurer will announce whether or not he or she intends to quarantine a payment as soon as the payment is announced, or as soon as practicable after the announcement.*

Recommendation 4.8 on the timing of the CGC's decisions

That the Treasurer instruct the CGC to make a decision on the treatment of all new Commonwealth payments in its Update immediately following the Budget in which the payments are first announced, or as soon as practicable thereafter.

Where a decision to make a payment to a State is announced outside of the Budget, the CGC should make and announce its decision on treatment of that payment within six months of the payment being announced or, where this is not possible due to the details of the payment not being finalised, as soon as practicable after payment details are finalised.

Chapter 5 — Improving communication and transparency

Recommendation 5.1 on the presentation of relativities

The Panel recommends that:

- *the CGC clarify that relativities do not represent a State's share of the GST collected*

within its borders or from its residents

- *when publishing the GST relativities, the CGC also show relativities based on total Commonwealth assistance*
- *the Commonwealth continue to publish relativities based on total Commonwealth assistance in its budget papers.*

Recommendation 5.2 on clarifying the projection of relativities

That the Commonwealth should either cease publication of the GST relativities for out years in the forward estimates period or very clearly explain the nature of the projections in the Budget papers.

Recommendation 5.3 on improving the projection of relativities

That, to enable more accurate forecasting of relativities, States provide the following information to all other States bi-annually:

- *revenue estimates for the next four years, by revenue line, with details in line with CGC assessments*
- *details of the impact of announced policy changes on revenue estimates and*
- *expenditure estimates for the next four years, by CGC assessment category.*

The Commonwealth should ensure it provides the States, on a bi-annual basis:

- *GST pool forecasts/estimates for the next four years*
- *SPP pool forecasts/estimates for the next four years*
- *Other PSP forecasts/estimates, by State, for the next four years.*

Recommendation 5.4 on broadening the engagement of the CGC

That the CGC engage with governments more broadly. Expanded engagement activities should include:

- *an annual public address following the release of the year's relativities*
- *briefing sessions for State and Commonwealth parliamentarians (including non-Treasury ministers and shadow ministers)*
- *staff briefing for State non-Treasury officials*
- *appearance by Commissioners before an appropriate Senate Committee.*

Recommendation 5.5 on the treatment of National Partnership Payments

The Panel recommends that apart from the listed exceptions, all National Partnership Payments should affect the relativities. The exceptions are:

- *payments quarantined by direction of the Commonwealth Treasurer*
- *reward payments*
- *payments otherwise determined by the CGC following its guidelines that should not affect the relativities (COPEs, needs not assessed and so on)*
- *certain capital payments for transport infrastructure (see Chapter 6).*

Recommendation 5.6 on the interaction between HFE and SPPs

The Panel recommends that, when finalising future national reform agreements, the Commonwealth and States clearly state whether the payments (or part thereof) should be included or excluded from the HFE process. This statement should be reflected in the relevant national reform agreement and the corresponding words repeated in the IGA and relevant CGC Terms of Reference.

Chapter 6 — Greater stability of GST shares and methodology improvements

Recommendation 6.1 on the treatment of Commonwealth payments

In recognition of the inter-related nature of transport networks and the national benefits that accrue from increasing the efficiency of these integrated transport networks, the CGC should identify all Commonwealth payments relating to national network road infrastructure and rail based transport infrastructure.

All identified payments should affect the relativities on a 50 per cent basis, to recognise their dual national/State purpose. To ensure that States that have previously received rail based transport payments are not disadvantaged, this change in treatment should apply from the CGC's 2013 Update.

Recommendation 6.2 on data revisions

Where data are updated or released annually with a lag, or updated or released less frequently than annually, the CGC should allow the newly available data to only inform changes in States' circumstances in the most recent assessment year and not be used to revise previous estimates of earlier inter-survey years.

Recommendation 6.3 on a simplified assessment framework

That the CGC examine the merits of adopting a simplified and integrated assessment framework in its next methodology review.

Recommendation 6.4 on cost equalisation

That the CGC investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis. This investigation should occur in the context of the assessment of other cost disability factors including costs of remote locations, and administrative scale.

Chapter 7 — Assessing mining revenue and expenditure

Finding 7.1 on the treatment of mining revenue

States' mining revenue should continue to be equalised through the HFE system, on the same basis as other own-source revenue.

Finding 7.2 on the mining revenue assessment

The current two-tier mining revenue assessment can produce excessively large GST share effects when a commodity moves between groups.

Finding 7.3 on the mining revenue assessment

The Commonwealth Treasurer's previous directions to the CGC to keep iron ore fines in the low-rate group appropriately ensured Western Australia was not unfairly penalised for removing its concessional rate.

Recommendation 7.1 on the mining revenue assessment

That, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to:

- continue to ensure that Western Australia's removal of iron ore fines royalty rate concessions in 2010 does not cause iron ore fines to move into the high royalty rate group in the 2010-11 or 2011-12 assessment years*
- consider the appropriate treatment of iron ore fines for the 2012-13 assessment year and future years, in light of Western Australia's decision to bring the iron ore fines royalty rate to the same level as that for iron ore lump.*

Recommendation 7.2 on the mining revenue assessment

That the CGC and other stakeholders develop a new mining revenue assessment at the earliest opportunity. The new assessment should:

- avoid excessively large GST share effects, such as when a commodity moves between groups under the current assessment*
- treat iron ore, coal and petroleum differently to minerals that are not subject to Commonwealth resource rent taxes.*

Recommendation 7.3 on mining related expenditure needs

The Panel recommends that, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to add an amount to its expenditure assessments equivalent to a 3 per cent discount of the mining revenue assessment in order to compensate for the fact that some mining related needs of the resource States are not fully recognised. This interim assessment should remain in place until the next methodology review is completed.

Chapter 8 — State mining royalties and the MRRT

Finding 8.1 on State royalties and Commonwealth resource taxes

The States and the Commonwealth both have legitimate roles in obtaining mining revenue on behalf of the community. The challenge is to reconcile these interests.

Finding 8.2 on State royalties and Commonwealth resource taxes

The Commonwealth's decision to fully credit State royalties under the MRRT and PRRT has created an incentive for States to increase these royalties. This situation is neither desirable nor sustainable.

Finding 8.3 on an interim measure

As an interim measure, the Commonwealth could announce that it intends to direct the CGC to assess any revenue raised from royalty increases on MRRT and PRRT commodities after a particular date on an actual per capita basis.

This would reduce, but not remove, individual States' incentives to increase their mineral royalties, while also potentially providing a windfall to other States. It would not represent an effective substitute for a negotiated outcome.

Recommendation 8.1 on a cooperative Commonwealth-State approach

The Commonwealth and the States should acknowledge that a cooperative approach to resource charging will produce a superior outcome to any available alternative.

Accordingly, the Commonwealth should actively seek to engage the States with a view to reaching agreement on the taxation of resource projects. The States should be receptive to such a request for negotiations.

Recommendation 8.2 on revisiting the design of the MRRT and PRRT

If the Commonwealth and the States are unwilling or unable to reach an accommodation regarding resource charging, the Commonwealth should amend the design of the MRRT and PRRT to remove the open-ended crediting of all royalties imposed by the States.

Recommendation 8.3 on the form an agreement should take

A negotiated outcome adhering to the following principles would secure and build upon the benefits of resource tax reforms already undertaken.

- *The MRRT and PRRT should be amended to sever the link between the royalty allowance provided and prevailing State policies. This would restore full accountability to the States for their royalty policy settings.*
- *State royalties on iron ore, coal and petroleum should be reduced (perhaps by around one-third).*
- *The Commonwealth should guarantee to increase payments to each State so as to offset the royalty revenue foregone.*

- *Most of the revenue to do this will come automatically through increased MRRT and PRRT collections. The Commonwealth should consider tightening aspects of its resource taxes to ensure an approximately revenue neutral overall result is achieved.*
- *The Commonwealth and the States should jointly commission a credible, independent estimate of the fiscal dividend expected to flow over time as a result of these improved arrangements. This amount should be shared between the Commonwealth and the States following a similar approach to that used for the National Competition Policy reforms.*

Chapter 9 — State tax reform and efficiency

Finding 9.1 on the relationship between HFE and efficiency

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

There may be some merit in addressing perverse incentives on principle alone. However, after exploring the alternatives, the Panel has concluded that they cannot be meaningfully reduced without significant reductions in equalisation outcomes. As there is little evidence of efficiency losses in practice, the Panel is not convinced that this would be a worthwhile trade-off.

One area where there may be merit in further investigation by the CGC is in relation to the impact of tax rates on the size of State tax bases.

Finding 9.2 on tax reform

The Panel is convinced that it is vital for all levels of government to pursue a tax system that favours broadly based taxes with fewer exemptions over narrow and distortionary transaction based taxes. Ideally, this would occur on a multilateral basis — amongst the States and including the Commonwealth — but it would not be a bad thing if some States chose to take a leadership role.

In relation to each of the supplementary Terms of Reference specifically:

- *There is no clear evidence that the current system of HFE is impeding State tax reform. If it ever became apparent that possible changes in GST shares were impeding tax reforms, specific and temporary adjustments should be made to the GST distribution in that context, rather than changing HFE.*
- *While our second interim report canvassed the possibility of GST grants being used to reinforce incentives to undertake agreed upon reforms, the Panel has concluded that the GST distribution should not be used to compel or encourage States to change policies — HFE should be policy neutral and GST should remain untied and freely available.*

- *A national agreement is needed in relation to resource taxation. Chapter 8 of this Report describes how such a deal might be reached. HFE is not a barrier.*

Chapter 10 — The role of horizontal fiscal equalisation in Indigenous service provision

Finding 10.1

The current HFE system seeks to address only the costs to States that are the average policy, including those associated with service provision to Indigenous communities. On that basis there is no rationale for removing Indigeneity from the HFE system.

However, precisely because the current system equalises to the average, it cannot overcome the disadvantage experienced by some Indigenous communities. Improving outcomes for these communities will require a concerted effort by Commonwealth and State governments. Where additional measures are required, they would best be undertaken outside the HFE system and excluded from it, so that the HFE system does not frustrate the desired change.

The Indigenous Expenditure Reports (IER) are important as a means to understanding differences in service provision costs between Indigenous and non-Indigenous people. It would assist the long term assessment of Indigeneity if stakeholders could expand the IER reporting process to include measures of revenue as well as expenditure.

Chapter 11 — Ensuring the GST pool is robust and stable

Finding 11.1 on GST revenue growth

GST revenue grew fairly strongly prior to 2007-08. Since then, like most other taxes, GST collections have grown only modestly. Some of this softness is cyclical, but it also appears that certain structural factors will continue to dampen GST growth into the future. If left unaddressed, this will place increasing strain on States' budgets.

Finding 11.2 on fluctuations in GST revenue collections

The GST revenue pool received by the States grew fairly steadily until 2007-08. Since then it has been highly volatile, contributing to the difficulties faced by States in managing their fiscal positions.

Recommendation 11.1 on the protection of the GST revenue base

As the Commonwealth exercises its responsibility for GST compliance and protection of the base on behalf of the States it should ensure that it vigilantly approaches this task. GST compliance should not be cross-negotiated with other Commonwealth-State issues.

Recommendation 11.2 on the low value import threshold for GST

That the low value import threshold for GST be lowered to prevent the ongoing erosion of the GST pool.

Initially, the threshold should be lowered so that it does not exceed \$500. This should occur as soon as practicable.

Recommendation 11.3 on other overseas suppliers

That the Commonwealth and the States jointly examine as a matter of priority ways to secure the GST revenue base against its continuing erosion through the growth in imports purchased online.

This examination should include considering amendments to the GST law so as to make overseas suppliers to Australian residents liable for remittance of GST on all supplies of both goods and services that would otherwise be subject to GST if purchased from a domestic supplier. Such an approach would enable the GST exemption threshold for physical parcels to be reduced to a nominal level, no more than \$20 or \$50.

Recommendation 11.4 on the First Home Owners Scheme

The Panel recommends that the States be relieved of the obligation to make a universal FHOS grant. It should become a matter for States' own policy decisions as to what financial assistance should be offered for new home buyers.

Recommendation 11.5 on applying an automatic stabiliser to the GST pool

That the Commonwealth and States jointly consider modifying existing arrangements to provide States with increased short-term certainty regarding the GST pool.

One potentially useful approach would be for the Commonwealth to underwrite a growth in the pool each year of no less than the increase in population and consumer prices (that is, maintenance in real per capita terms). Any additional funds transferred from the Commonwealth to the States in this way would then be recouped in future years, by withholding some part of the growth in GST collections above the base level.

Chapter 12 — The longer term

Finding 12.1 on the long term vision

In the longer term, citizens must make important decisions about the size of the government sector they expect and the taxes they pay for it. Maintaining government service delivery at about the same levels as currently will place increasing pressure on governments to raise taxes. On the other hand, maintaining taxes at about the same levels as currently will place increasing pressure on governments to reduce services.

In any future where revenues are tight, ensuring the most efficient and effective combination of taxes is vital to maximising the citizens' return from taxation. Tax reform — at State and Commonwealth level — to put greater focus on more efficient taxes and reduce reliance on less efficient taxes, would be an important response.

Along with decisions about the size of government overall, roles and responsibilities for services and revenue-raising may need to change between the levels of government. A closer matching of revenue-raising capacity with expenditure responsibilities could lead to improvements in the efficiency of service delivery and make all levels of government more accountable and responsible for their actions.

Such a change in roles and responsibilities would likely lead to, or could complement, a reduction in the Federation's VFI.

While the Commonwealth continues to have greater budget capacity than the States it would be best placed to take on the funding of equalisation payments to the smaller States to ensure they continue to have the capacity to provide comparable (State) services to those of the larger States. Commonwealth transfers to States could then largely address VFI, and be weighted more towards general revenue assistance (funded by GST) than tied funding (PSPs). In such a world, the simplest way of allocating the general revenue assistance would be on an EPC basis. No additional Commonwealth support need be provided to the larger States, other than that consistent with Commonwealth policy priorities.

The amount of equalisation funding for the smaller States could be a guaranteed proportion of GDP. The Commonwealth would fund the smaller States collectively the difference between this guaranteed amount of GDP and their EPC share of general revenue assistance. The expectation would be that this funding would be tied, depending upon policy priorities at the time. In order to reflect changing circumstances between the smaller States, the CGC could recommend how the guaranteed equalisation funding should be allocated across the smaller States.

1 What is HFE? — A review of the literature

This Chapter aims to present the theory of fiscal equalisation in an accessible way for the benefit of future policy makers by providing a non-technical guide to the major debates and unresolved questions. Other useful overviews of the literature include Hancock and Smith (2001), Boadway (2004), and Boadway and Shah (2007).

1.1 The essence of the debate

The idea of fiscal transfers within a federation to support fiscally weaker subnational jurisdictions (hereafter referred to as 'States') greatly preceded the development of the 'modern fiscal equalisation literature'. Provision of basic support to fiscally weaker States was, for example, a key issue in the lead up to the Federation of Australia in 1901 and led to formal arrangements for ongoing assistance to States through the establishment of the Commonwealth Grants Commission (CGC) in 1933.

Early discussion of equalisation transfers in Australia focused on practical and political issues such as ensuring the continued viability of all States, supporting a minimum standard of services and compensating for any losses in revenue associated with joining the federation. As such, the debate was centred on assisting States themselves rather than on delivering equity for their citizens.

In contrast, the modern fiscal equalisation literature focuses on interpersonal equity and locational efficiency. Buchanan (1950) argued that federal systems of government require fiscal transfers to offset the uneven distribution of taxpayers and service recipients between States. Without such transfers, identical people in different States would face higher taxes or lower services even if States attempt to apply identical policies. This would lead to inequitable treatment of individuals in like fiscal circumstances when compared with a unitary State and, in turn, to inefficient incentives to migrate based on fiscal differences rather than market forces.

Much of the subsequent literature extends and endorses Buchanan's basic theory and arguments. However, there are contrary views and arguments. First, there is concern that implementing a system of equalisation transfers creates its own problems by distorting State policy incentives. There is also debate about the merits of Buchanan's equity principle, with some disputing whether full interpersonal equity is supported by the nature of all federal compacts and others suggesting that differences in underlying wealth rather than fiscal differences should be the basis for equalisation transfers. Even Buchanan (2002) later softened his initial arguments, stating that final judgment must be pragmatic and must take into account the facts on the ground in particular settings.

1.2 Early discussions

It is unclear where the idea of transfers to support fiscally weaker states originated, but it was a key issue in the broader debate about the formation and functioning of federations in Australia and Canada, and probably elsewhere. It appears that the early

rationale for these transfers was largely to ensure that all States would benefit from joining the federation. There was also a general concern with equity among citizens, particularly with ensuring that all States could fulfil their constitutionally mandated responsibilities to a minimum standard.

Smith (1993) provides a comprehensive summary of the initial debates about fiscal transfers in Australia. She says that a key question in the lead up to federation in 1901 was how to ensure the continued viability of the smaller States after federation while still being fair to the large States.

Much of the focus around the time of federation was on the distribution of any surplus federal revenue between States. Consideration was initially given to whether the revenue should be distributed based on where it was collected, or the number of citizens in each State (per capita). Smaller States were concerned that they would not be viable under collections-based methodology, but the large States were opposed to a per capita distribution. The compromise reached was that revenue would be distributed on the basis of historical collections, which allowed States that had relied on taxing interstate trade to have more revenue returned to them. To this end, Western Australia was also allowed to continue to impose tariffs on goods from other States for a further five years. Arrangements were also made to allow the Commonwealth to make special assistance payments to any State if it deemed it necessary.

Another issue was how much of the federal surplus would go to States. The smaller States successfully argued that 75 per cent of Commonwealth revenues should be available to States. However, New South Wales was opposed to long-term continuation of this scheme, so it was set to expire in 1910.

Immediately after federation, the smaller States argued that, with the prospect of guaranteed access to the federal surplus disappearing in 1910, the financial clauses were unfair to them. These concerns came to a head in 1909 and 1910 in the debate about the introduction of a Commonwealth age pension, which would require a significant part of the Commonwealth's surplus revenue. Faced with the prospect of competing with the Commonwealth for tax revenue, the States agreed to a legislative guarantee of 25 shillings per capita of Commonwealth revenue for a further 10 years.

The agreement between the Commonwealth and States on the pension also allowed smaller States, which did not have the revenue to introduce their own age pension, to make a lesser contribution to the costs of funding the federal age pension. Smith (1993) argues that this is the first acknowledgement of interregional transfers on the basis of nationhood principles and the need to ensure some minimum level of service for all.

Between 1910 and 1920 large additional payments were also made to Western Australia and Tasmania, though these were seen as compensation for reduced customs revenue, rather than payments to address fiscal disadvantage.

Widespread use of fiscal transfers on the basis of 'need' began in the 1920s.¹ In 1923, the Commonwealth introduced payments for roads under a formula that particularly

1 The concept of 'need' that was used at this time was relatively general in comparison to the technical definition now used by the CGC, based on capacity to achieve average policy.

benefited the less populous States and was seen as being given to States whose needs and responsibilities exceeded their revenue raising capacity. It was also increasingly recognised that economic and fiscal differences between States were persisting after federation, rather than their capacities converging (as had been envisaged).

In 1926 the Lockyer Inquiry was established to examine Tasmania's need for further grants assistance. Tasmania's submission to the Inquiry argued for grants on the basis that weaker States in a federation are subject to persistent economic and fiscal differences. This included the concern that in a federation it was difficult to avoid raising standards of public services to match other States. The Inquiry recommended assistance to Tasmania based on capacity and the cost of providing necessary services conditional on certain tax reforms.

South Australia also requested consideration of its needs for special assistance to enable it to maintain the standard of progress of wealthier States. A Royal Commission established to investigate this issue reported in 1929, endorsing assistance on a similar basis to that for Tasmania.

Problems with the ad-hoc and political nature of ongoing payments led to the establishment of the CGC in 1933 to put payments on a more systematic footing. The CGC rejected the earlier principle of compensating for disabilities arising from the effects of joining the federation as it was generally agreed that, with the passage of time, such difficulties had become impossible to track. The CGC instead focused on the principle of fiscal need.² However, the idea was to provide for a minimum standard and the basis for determining this was explicitly stated to be the positions of State governments rather than individuals (Smith 1993).

Perhaps the closest foreshadowing of Buchanan's later concerns is Giblin (1930), referred to in Smith (1993), who argued that Tasmania was losing population to the mainland, making it hard to maintain public services within tolerable tax levels.

1.3 The basic case for equalisation

In these early discussions, the nature and extent of equalisation transfers were largely a matter for judgement. In contrast, Buchanan (1950) provides a more systematic foundation for equalisation.

Buchanan begins by identifying the following problem with federal systems of government. States generally adopt redistributive policies (that is, they tax some individuals³ and use the revenue to provide services to others), creating differences between the taxes paid by different types of individuals and the level of services they receive. These differences are later described as 'net fiscal benefits' (NFBs). If taxpayers and service recipients are unevenly distributed between States then some States would

2 Again, the definition of fiscal need was a general one, to be contrasted with the past focus on compensation, rather than the technical definition of need now employed by the CGC.

3 In this context, companies and their shareholders can be thought of as types of individuals.

have to levy higher taxes to deliver the same services.⁴ This means that some people would face higher taxes for the same services, or receive lower services for the same taxation level than otherwise equal people that live in a different State, even if those States attempted to apply identical policies. In other words, because States engage in redistribution, if they have different compositions of citizens — which is very likely — individuals who are otherwise identical will have different NFBs.

Buchanan then points out that if those same taxing and spending policies were applied by a single central government rather than separate States with different compositions of people within their borders, those differences in NFBs would not arise. He argues that it is inequitable and inefficient for individuals within a single political and economic union to be treated differently solely because of State borders. He says that individuals in like circumstances should receive the same fiscal deal, just as individuals in like circumstances should receive the same treatment before the law. He also argues that arbitrarily different treatment is inefficient because individuals could be motivated to migrate between States on the basis of fiscal differences rather than locating where they are most productive and happy.

Buchanan explains that these concerns can be addressed by transfers to offset differences in NFBs resulting from the uneven distribution of taxpayers and service recipients between States. In fact, Buchanan (2002) later observes that it is in the interest of the State with the higher NFBs to ‘pay’⁵ the citizens of the State with lower NFBs *not* to migrate, noting that the most direct solution would be to provide transfers directly to individuals. For example, he considers whether the federal government could levy higher taxes in one State and use the proceeds to provide compensation in another. However, he acknowledges that this would be impractical and may undo State level redistributive decisions. Therefore, he proposed the establishment of a system of equalising fiscal transfers to State governments, to provide them with the *capacity* to provide horizontal equity for their citizens, even if the system cannot ensure that outcome actually occurs without violating the sovereignty of State governments.

1.4 Further work on equity

Some subsequent works have challenged the strength of horizontal equity as a moral principle, while others have suggested that something other than horizontal equity should be the driving force behind fiscal transfers.

Challenges to horizontal equity as a moral principle

A number of authors have disputed the moral force of Buchanan’s notion of horizontal interpersonal equity.

4 Petchey and Walsh (1993) outline other possible sources of NFBs including cross subsidies through non-marginal cost pricing in the provision of services like water, electricity and transport, economic rents from government trading enterprises and differences in the cost of service provision.

5 Or as Buchanan put it in an interview in 2001, to ‘bribe people to stay in the poorer regions’. <http://www.aims.ca/en/home/library/details.aspx/359> accessed 22 June 2012.

Sovereignty based objections

Petchey and Walsh (1993) argue that the standard literature ignores the differences in societal values underlying the different degrees of equalisation that occur in different countries. They say that true federal systems are the result of a compact between autonomous political units and cannot simply be treated as a unitary State that has chosen to devolve responsibility to a subnational level.

Essentially returning to earlier justifications for equalisation, they argue that the case for equalisation can be derived in several ways:

- based on compensation for the effects of joining a federation, including the loss of an independent exchange rate and monetary policy to facilitate adjustment to economic shocks
- due to converging expectations for services post federation
- to facilitate regional economic convergence and promote social cohesion
- to ensure the viability of each State and promote conditions for effective interstate competition with all States on an equal footing.

Petchey and Walsh (1993) suggest that, for these reasons rational State governments should support a system of full and comprehensive equalisation regardless of the standard horizontal equity argument. However, observations show in practice a strong tendency of donor States in all federations to support a reduction in the level of equalisation. In any case, Walsh (2011) later expresses the view that there may not be sufficient unity within the Australian Federation to justify full equalisation. His reasoning is that State citizens are likely to feel that they have some 'property rights' in the relative fiscal strength of their jurisdiction.

Objections to cost equalisation

Brennan and Pincus (2010) endorse the idea of horizontal equity as a general principle. However, they argue an unreasonable commitment to interpersonal equity is required to justify equalisation on the basis of cost factors. Pincus (2011) goes on to argue that this means that the Australian system should not equalise for interstate cost differences, including those related to economies of scale in the distribution of the fixed costs of local government.

Equalising for past policy differences

An area that has not received much attention in the literature is how to deal with fiscal capacity differences that arise from past policy choices. In some instances, States may have lower (or higher) fiscal capacity because of past policy failures (or successes). Hancock and Smith (2001) suggest that perhaps States should receive compensation for past policy failures. If they do not, then individuals in States that now adopt the same set of policies may receive different outcomes, which may distort migration incentives. On the other hand, States may be less inclined to make good policy decisions if they know that failures will be compensated through equalisation. Hancock and Smith argue that, even on equity grounds, there is a limit to how long a State's current population should continue to be held responsible for the decisions of past governments.

Different definitions of capacity to provide horizontal equity

Buchanan supported the idea of transfers to State governments to provide the capacity for interpersonal horizontal equity. He explained that this involves transfers to enable all States to adopt the same tax and service policies. This raised the question of what to do when States adopt different policies (as they often do in practice), which led to the aim of providing transfers so that States could implement the average policy. The rationale is that if the goal of equalisation is to ensure the same policy choices in different States achieve the same results, then the States should achieve different outcomes only to the extent they make different policy choices.

Various authors have raised concerns with basing equalisation transfers on the amount required to achieve average policy, particularly on the revenue side.

Barro (1986, 2002) argues that all tax is ultimately paid from income of individuals so this is what should be used, not just the tax bases that governments can access. Collins (2000) makes a similar argument, as does Usher (1995, 2002). Usher is particularly concerned about the possibility of transfers from 'poorer' to 'wealthier' jurisdictions by looking at the revenue raised by States, rather than income. To illustrate Usher's concern, Wilson (2007) notes that in Malaysia equalisation based on average policy would redistribute funds away from Sabah and Sarawak even though they have much lower than average income because they have the largest share of revenue from petroleum resource rents and few other revenue sources are allocated to the States. Garnaut and FitzGerald (2002) raise a similar point when they criticise the Australian equalisation system for redistributing funds to the Australian Capital Territory even though it is the State with the highest per capita income.⁶

Barro (1986, 2002) proposes that the best measure of fiscal capacity is the total resources available to a State, modified by transfers from the federal government and the possibility of exporting the burden of some taxes to non-residents. Usher supports Barro's adjusted measure, but suggests there may be an additional need for imputation for leisure. Abelson (2010) makes a similar suggestion, focusing in particular on adjustments for transport costs. Albouy (2012) suggests a need to adjust for differences between nominal and real incomes, though it is not clear that he is arguing for an approach based on underlying capacity.

Boothe and Hermanutz (1999) and Smart (2002) also object to the link between capacity and government policy, but they propose relatively simple 'macro' measures based on State shares of gross national income (GNI) or personal disposable income.

Aubut and Vaillancourt (2001) and Wilson (2007) respond that all of these proposals serve an objective of redistribution, rather than equalisation — instead of equalising the capacity to provide comparable levels of public services at comparable levels of taxation, they attempt to level per capita national income. They argue that the proposals put forward by Barro and others would result in transfers to States with lower average incomes. This may deliver a similar result if States simply taxed income, however, if

6 The main reasons that the Australian Capital Territory is assessed as having below average revenue raising capacity is that it has no access to mining revenue and has a much greater proportion of untaxable government payrolls than other States.

States raise their revenue elsewhere, then States with low incomes may already be able to provide the average level of services. Alternatively, transfers on the basis of income may under represent the lack of capacity in low income States.

The source of some of the debate about this issue may be loose use of terminology. Buchanan (1950) appears to propose some objective measure of capacity based on wealth, though he emphasises that the key is equalising NFBs. Similarly, Boadway (2004) also talks about equalising differences in wealth, despite rejecting macro indicators of capacity. Additionally, although Wilson rejects an underlying measure of capacity, he does write about the need to equalise potential revenue. However, he is simply saying that capacity should be assessed based on average policy, so that, for example, States with lower tax rates do not receive additional transfers because they are receiving less revenue.

Benchmarking State capacity against what States could do, say if they adopted some ideal set of policies, would increase equalisation transfers to States that have a lower capacity under that ideal set of policies than they have when assessed against the average of current policies. States that benefit under this approach would not necessarily be those that come closest to adopting the ideal policies, nor would States that took steps to implement reform see any increase in their equalisation transfers.

1.5 Further work on efficiency

Buchanan argued that equalising transfers promote efficiency by offsetting incentives to locate based on arbitrary differences in fiscal capacity. Much of the subsequent literature on the efficiency of equalisation transfers is devoted to formalising and critiquing this idea. The other key theme, particularly in more recent work, is whether a system of equalisation transfers reduces efficiency by distorting State decisions.

Fiscal equalisation and migration

Buchanan and Wagner (1970), Buchanan and Goetz (1972), Flatters, Henderson and Mieszkowski (1974), and Boadway and Flatters (1982) support and formalise the theory behind Buchanan's initial claim that equalisation promotes more efficient settlement patterns. However, a number of possible limitations have also been raised.

Could equalisation transfers distort migration decisions?

Independently of Buchanan, Scott (1950) argues that fiscal transfers counteract market incentives for individuals to move where they are most productive. Buchanan (1952) initially responded by showing that not all transfers distorted decisions. In particular, equalisation transfers correct for distortionary fiscal incentives, but do not change an individual's incentive to locate where they are most productive or have the highest amenity. Buchanan and Wagner (1970) later acknowledged Scott (1950) was focusing on the effect of fiscal transfers in an economy that was not in a long-run equilibrium.

The key point here is that, if an economy is in disequilibrium then fiscal incentives may enhance incentives for necessary structural adjustment, though this would largely be by happenstance and would become distortionary over time. Ergas and Pincus (2011) further develop the idea that fiscal incentives could encourage structural adjustment, arguing that fiscal incentives that would otherwise distort settlement patterns may be

efficiency enhancing if they counteract other distortionary policies, such as labour market policies that reduce interregional wage differentials.

Is it distortionary to equalise for cost differences?

Boadway (2004), and Brennan and Pincus (2010) argue that one area where equalisation could distort settlements is in relation to cost equalisation. They argue that if some locations cost more to service then this should be allowed to influence settlement patterns and not be offset by equalisation payments. Petchey and Walsh (1993) note that equalising for cost can be efficiency enhancing as long as it only provides capacity to treat similar high cost locations in the same way.

Does equalisation produce optimal incentives?

Buchanan and Goetz (1972) show that equalisation can be efficiency enhancing, but also note that equalisation cannot be relied upon to generate the optimal migration pattern, given the potential for both positive and negative non-fiscal externalities. For example, equalisation cannot offset externalities in relation to traffic congestion. Buchanan (2002) re-emphasises this point in reflecting on his contribution to the fiscal equalisation literature and Petchey (2009) makes a similar argument.

Does equalisation promote locational efficiency if States adopt different policies?

Buchanan (2002) also adds a further caveat that if States do not adopt the average policy then their citizens will still face fiscal incentives to move. For example, he noted that a State with relatively more poor citizens may adopt tax policies which are detrimental to wealthy residents, causing them to leave despite the existence of equalisation transfers. On the other hand, a key motivation for having a federal system of government is to allow some policy variation, both to accommodate differing local preferences and to promote policy competition (which equalisation facilitates by ensuring that all States have the fiscal capacity to compete on the same footing).

Is equalisation unnecessary because fiscal benefits are capitalised into land values?

Feldstein (1970) argues that any differences in NFBs would be capitalised into the value of land, and so would not induce inefficient settlement patterns. However, Flatters, Henderson and Mieszkowski (1974), in investigating how to determine a region's optimal population, show that Buchanan's concerns hold even in a model where land is fixed and labour is mobile. Shah (1988) points out that most federations do not fulfil the conditions necessary for full capitalisation to occur (namely, small open areas and costless mobility).

Fiscal equalisation and State policy

Another key criticism of equalisation transfers is that they distort the decision making of State governments. These concerns are discussed below in several categories.

Rate effects

Courchene and Beavis (1973) point out, in the Canadian context, that equalisation creates an incentive for States to have higher taxes in areas where they have below average capacity (and vice-versa). In essence, these incentives occur because if the average revenue raised increases, so does the amount that must be transferred to give

States equal capacity to achieve average policy. This means that States gain by increasing tax rates where they have below average revenue raising capacity or decreasing tax rates where they have above average capacity. Courchene and Beavis note that the size of these incentives can be substantial, but do not know to what extent States actually respond. Subsequent work emphasising the existence of these effects includes Bird and Slack (1990), Courchene (1994), Usher (1995), Petchey (1995), Swan and Garvey (1995), and Petchey and Levchenkova (2004).

Petchey (2009) notes that most studies have focused on the effects of revenue equalisation, but many countries also practice expenditure side equalisation, which raises similar issues.

Base effects

Smart (1998) demonstrates that equalisation reduces a State's perceived marginal cost of public funds by compensating for any reduction in the size of a tax base that occurs when tax rates increase.

Kothenburger (2002), and Bucovetsky and Smart (2006) argue that this could actually improve efficiency by eliminating the benefits of inefficient interstate competition. Competition can occur because a tax cut in a single State causes an inflow of the tax base to that State, which will offset some of the revenue lost from the tax cut at the expense of other States. Cai and Treisman (2004) provide some practical evidence from Russia, China and the US on the costs of inefficient interstate competition.

There is no overall consensus on this issue. Bucovetsky and Smart (2006) acknowledge that equalisation could undermine efficiency to the extent that it compensates for losses to the country as a whole (rather than just movement of resources between States). Additionally, Ergas and Pincus (2011) argue that the downward bias from interstate competition may help to compensate for an upward bias that occurs because States fail to take into account the negative effect that an increase in State taxes has on the federal tax base.⁷ However, empirical analysis of Hayashi and Boadway (2001) suggest that this vertical interaction may actually drive State taxes down, as increases in federal taxes lower their capacity to levy their own taxes.

Smart (2007) examined the history of Canadian tax rates and found evidence that Provinces that received equalisation payments were more likely to have higher taxes, and this was influenced by changes in the equalisation system from 50 to 100 per cent. Hayashi and Boadway have similar findings. Other research, supporting a link between fiscal equalisation and incentives includes Esteller-More and Sole-Olle (2002), Buettner (2006), Dahlby and Warren (2002) and Snoddon (2003).

The flypaper effect

Henderson (1968) and Gramlich (1969) identify an issue with untied fiscal transfers that has come to be known as the 'flypaper effect'. They note that when an individual's income increases only the proportion paid in taxes is used to fund public services — the rest is used for private savings or private consumption. They say that increases in government income from non-tax sources (such as fiscal transfers) should be distributed

⁷ Keen (1998) provides a summary of the literature on these vertical tax externalities.

in a similar way (that is, most of it should be returned to individuals through tax cuts). However, they find that, in practice, grant revenue tends to stick with government, (as flies to ‘flypaper’) and only a small proportion is returned to individuals as tax cuts.

There is an enormous literature on the flypaper effect. Most summaries of this literature⁸ suggest that increases in personal income increases public spending by two to five cents for every dollar, whereas transfer payments increase public spending by 30 to 100 cents. Typically, this result is presented as an undesirable consequence of voter ignorance and self-interested governments that seek to maximise public spending.

However, there is ongoing debate about whether the flypaper effect really exists and, if it does, the extent to which it is undesirable. The key argument is that many transfers are made with the explicit purpose of increasing public spending by local or State government so you would expect to see an increase in their spending (potentially at the expense of spending by other levels of government). The related idea is that it would be inefficient for State or local governments to finance these expenditures themselves because they have access to less efficient tax bases, including because of potential interstate competition. Inman (2008), and Hines and Thaler (1995) contend that these arguments cannot fully explain the flypaper effect, but Dahlby (2011) disagrees.

Transfer dependency

Courchene (1981) found that equalisation meant people were more likely to stay in poorer States, creating a situation of ‘transfer dependence’. Garnaut and FitzGerald (2002) argue that a similar situation has arisen with respect to recipient States in Australia’s equalisation system.

Insurance and stabilisation

Another issue is whether equalisation encourages risk-taking by spreading the impact of fiscal shocks across all States. From a positive perspective, von Hagen and Hammond (1998) argue that equalisation can help stabilise State fiscal circumstances. On the other hand, Persson and Tabellini (1996), Lockwood (1999), and Bordignon et al (2001) argue that equalisation can discourage States from taking appropriate precautions to protect themselves.

1.6 Modelling

There have been several attempts to model the welfare effects of equalisation transfers. Consistent with the bulk of the theory, most of these works have suggested that equalisation results in welfare gains, though there have also been some contrary findings. As with all modelling, all of these findings are heavily driven by the underlying theoretical assumptions.

Winer and Gauthier (1982) estimated the migration effects of changes between 1971 and 1977 to make the Canadian equalisation system more comprehensive. They concluded that Provinces that are fiscally advantaged due to the presence of resource rents tend to attract migrants and that equalisation transfers tend to reduce migration out of the fiscally disadvantaged Provinces. Drawing on these results, Watson (1986) estimated that the marginal migration related efficiency gains from the 1971-1977

8 See for example, Inman (2008), and Hines and Thaler (1995).

changes were around \$1.4 million per annum (in 1971 Canadian dollars), with further gains from moving to a full equalisation system of \$35 million per annum. Watson noted that these results were small and well below the deadweight loss from raising the revenue used to fund it. On the other hand, he acknowledged that there might be significant non-marginal gains from equalisation.

Wilson (2003) argued that Watson (1986) underestimated the welfare gains from equalisation by calculating the annual efficiency gain from equalisation based on only annual changes in settlement patterns. Wilson points out that in the long run the annual welfare gains from equalisation need to be calculated based on the stock of inefficient migration prevented. He assumes that fiscally motivated migration will take around 50 years to reach the new equilibrium and finds that the marginal benefits of the 1971 to 1977 changes are around \$60.3 million per annum (in 1971 Canadian dollars). He also argues that a transcription error may have led Watson to estimate the deadweight loss at double its actual level, and that deadweight loss from the total transfer may be an inappropriate basis for estimating costs given Provinces may have raised the revenue themselves anyway. Additionally, this proposition only captures the benefits of a marginal change in equalisation, not the benefits of equalisation that might have existed prior to 1971 or additional equalisation on top of the 1977 changes.

Albouy (2012) finds that the combined effect of Canada's system of equalisation and other federal transfers is to reduce national income by 0.41 per cent, or \$4.3 billion per year (in Canadian 2012 dollars). One of Albouy's concerns is mining revenue not being fully equalised, but his key argument seems to boil down to the contention that even if nominal tax rates are the same, real tax rates are different because of cost of living factors. This means HFE may compensate States with lower nominal tax capacity, even if their real capacity is the same.

Dixon et al (1993, 2002, 2005) produce modelling that suggests equalisation in Australia produces efficiency costs, partly by encouraging people to live in high cost locations, but largely due to the flypaper effect. The most recent of these papers estimates that moving to an EPC distribution would improve welfare, but puts the upper bound at \$150 million a year (in 2000-01 dollars).

Murphy (2012) estimates that abolishing the current HFE system and moving to a modified EPC system, where HFE transfers are abolished for everything other than expenses related to indigeneity, is estimated to lead to a permanent loss in living standards of \$295 million per annum in 2009-10 terms. Murphy observes that although the quantification of loss would change depending on the size of HFE transfers, HFE was systematically pro efficiency. The main drivers of the welfare loss are population migration in response to different fiscal capacities in the States and increased taxes. It is assumed that migration reduces welfare if it is simply responding to differences in the fiscal benefits in each State rather than economic productivity. Therefore welfare is lower in all States if HFE is abolished in favour of a modified EPC system.

Murphy (2012) found that the Dixon et al (2002) result was due to an inconsistency in limiting migration movement from fiscal differences due to non-market amenity (congestion) effects on utility, but not calculating the welfare loss inclusive of those utility effects.

In a submission to the Review, Western Australia produces estimates (which it acknowledges are ‘conceptual’ and ‘indicative’) that suggest there would be potential national benefits from reducing the extent to which GST grants are redistributed from Western Australia to other States. They argue that if this additional money were used to fund public investments in Western Australia (specifically in the energy and transport sectors) it would result in three times more private investment in their State compared with if it were invested in other States. The results produced by Western Australia indicate a potential increase in national annual GDP of about 1.5 per cent in real terms (or \$19 billion per year) and a boost to Commonwealth tax revenues of \$4 billion per year in real terms — similar to the current full HFE subsidy to recipient States.

1.7 What conclusions can be drawn from the literature?

This review of the academic literature on equalisation shows that the modern theory, based on horizontal interpersonal equity and locational efficiency, provides a conceptual model for determining the financial transfers that should occur between States within a federation in order to be fair to all citizens and avoid inappropriate migration incentives. In theory, it provides a precise point of equalisation/equality for which to aim. However, the model is not without its critics, and even its original architect acknowledged the problems likely to be faced in seeking to give effect to the theory in practice.

Australia is the federation, amongst other nations with whom we often compare ourselves, that applies the theory of fiscal equalisation most rigorously. South Australia, Tasmania, the Australian Capital Territory and the Northern Territory regard this as a major achievement. On the other hand, New South Wales, Victoria, Queensland and Western Australia see major problems with the implementation and outcomes of the current system. The significant concerns of this second group of States — representing 90 per cent of Australia’s population — have caused the Panel to inquire closely into whether there are modifications to be made to the current practices that might produce tangible benefits outweighing any costs.

2 The contrast between models of equalisation

2.1 The challenge for the Panel

The Terms of Reference state that HFE has served Australia well and should continue, but ask the Panel to consider the appropriate *form* of HFE.¹ Without taking into account the history and development of HFE, particularly in Australia, it can be hard to understand what that task really means. If, under the strict interpretation of the modern theory, equalisation represents a particular and definite outcome, how can there be different *forms* of it? In that case, by definition, anything different is not strictly 'HFE', although it may be referred to as 'equalisation' in a broader sense.

The Panel has interpreted that aspect of our Terms of Reference to mean that we should inquire as to whether the modern HFE model (with the goal of comprehensively providing States with the capacity to deliver interpersonal horizontal equity) is the right form of equalisation to determine the level of assistance to fiscally weaker States, or whether a less comprehensive approach, or one that took a slightly broader view of equity, would be better in current circumstances. The comparison to be made should take into account whether any possible changes would be simpler, more transparent, easier for States to predict for budget purposes, maintain confidence in the Federation and be as efficient, or more efficient, than the current system.²

Chapter 1 shows the essential difference between the modern equalisation model based on interpersonal equity and locational efficiency and systems with earlier motivations, such as ensuring the continued viability of all States, supporting a minimum standard of services, or compensating for any losses in revenue associated with joining the federation. The modern model has some important consequences for implementation, as can be seen by some of the changes in equalisation practice in Australia since federation. Without seeking to be exhaustive, several differences in the implementation mechanisms for the models are important for the purposes of the current Review.

The current system provides each State with a GST share such that, after allowing for material factors affecting revenues and expenditures, it would have the capacity to provide services and associated infrastructure to its citizens 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 goal of providing States with the capacity to deliver 'materially-the-same' assessed average standard of service, for the 'same' assessed revenue raising effort describes the difference between the modern HFE concept and other forms. This point of 'sameness' is, in effect, the average capacity of the States, having corrected for their relative revenue raising and expenditure capacities and effort, disregarding minor, immaterial factors. For convenience — and without disregarding or diminishing the importance of these qualifications — the goal of the modern model will be referred to hereafter as providing them with the 'same capacity'.

1 See *GST Distribution Review Terms of Reference*, Objectives and Scope, paragraph 4.

2 See *GST Distribution Review Terms of Reference*, paragraphs 4 and 5.

Providing States with the same capacity needs to be distinguished from other forms of equalisation that might tend towards that direction, but not arrive in the same place. In the Panel's earlier reports we referred (as a convenient 'shorthand') to comparisons between models that deliver the *same* capacities or *comparable* capacities, and between the application of *full, comprehensive* HFE compared with a *partial, less comprehensive* form of equalisation.

The basis for 'full' equalisation has solid support amongst academics. Put very simply, the reasoning goes as follows: just as, in the absence of States, a unitary government would naturally want to treat citizens the same way unless there were specific policy decisions made to distinguish amongst them, so too, in a federation, providing States with the capacity to treat their citizens equally is critical. In 1950, in what is regarded by many as a seminal paper, James Buchanan showed that HFE payments are necessary to achieve the capacity for horizontal interpersonal equity across a federation.³

Whatever terminology is used, the motivations, outcomes and consequences of the 'full' modern model need to be distinguished from other models that seek to give fiscally weaker States some assistance, say via a minimum 'safety net', but do not prescribe the point to which all are brought. The current system brings all States to the same capacity — that of the strongest State — rather than simply bringing weaker States up to another arbitrary point. The point to which the States are equalised is determined by 'what States do' on average. This approach is consistent with modern HFE theory, although not always explicitly based on it.

Further, under the modern model the same capacity is not designed to set an external 'efficient' standard (however determined) — it is an internal average standard. Nor is the system designed to make judgements about how much should be spent by looking at the standard that is actually chosen by say the most frugal or efficient State.

For these reasons, the current system requires a consideration of all States' circumstances, rather than only those of States seeking assistance. Despite this, a single very large State or a very strong outlier in one revenue or expenditure category can significantly shift the average and affect the determination of capacity for all. (Previous systems, under which States made claims, looked at the needs or circumstances of the claiming State, rather than the average of all. In those circumstances it was conceivable for a claimant's capacity to be raised higher than that of non-claimants.⁴)

As an additional complication, because States are assisted by the Commonwealth in our model (rather than rich States assisting poor ones), all States end up getting significant payments from the Commonwealth from the same funding source, the GST. Thus, the GST is in effect both an equalisation pool and a pool to provide States with general revenue assistance in the light of vertical fiscal imbalance (VFI) within the Federation.

Features of the present system have been criticised, or at least questioned, in various submissions to the Review, but no State denies that an essential ingredient of our federation is the necessity to assist fiscally weaker States, for the ultimate benefit of all.

3 Buchanan J (1950), *Federalism and fiscal equity*, *American Economic Review* 40, pages 583-599.

4 In *Equity in Diversity*, page 145, including all States in the system was estimated to be a benefit of \$115m for New South Wales, \$55m for Victoria, and \$130m for Queensland in 1981 dollars.

2.2 The joint submission of the four largest States

The four largest States have made an argument for a radical change away from the present method of equalisation, but recognise that it could not be implemented in the short term and do not want the small States to be disadvantaged. Essentially, they argue for a system with an equal per capita (or EPC) distribution of GST, with the Commonwealth providing extra assistance to States with lower fiscal capacity, so that no State is financially worse off. Other issues they raise, such as strengthened governance standards, and greater protection for the GST base, are broadly shared by all States.

Despite the seemingly radical approach of the large States in advocating an EPC distribution of the GST pool, they still suggest that the smaller States be assisted, although they argue this should not come from the GST pool. While it is possible that they mean that, in the longer term, the Commonwealth should increase its own taxes (or cut its own expenditure) to provide smaller States with an extra \$4-5 billion or so per annum required for them to receive the same as they do under the current system, the Commonwealth Treasurer has made it clear to the Panel that there is no extra Commonwealth revenue available. Even if it were, it is hard to see why or how the Commonwealth would be motivated or inclined to increase States' funding when it already funds the States (via the GST and other grants) at around \$100 billion a year. The disinclination of the Commonwealth to raise its taxes to provide extra funding to the States would apply equally any time in the future, not just in the present straitened budget and political circumstances.

Since the Commonwealth provides significant assistance to the States through Special Purpose Payments (SPPs) and the SPPs tend to be allocated on close to an EPC basis, it is conceivable that the Commonwealth could adjust payments to States between SPPs and the GST given time, without actually affecting its own budget in any permanent way. Indeed, until recently, the SPP pool had been intended to become an EPC allocation in order to eliminate tensions with the HFE system⁵, so the same outcome could be reached by shifting the GST pool towards EPC and equalising through the SPP pool. However, any such shift would require time to implement as much of the alternative pot of non-GST funds is 'tied' to particular uses by agreements and legislation.

The Panel has taken the view that, although the four largest States have suggested that the Commonwealth should fund the fiscally weaker States, they are not naïve enough to imagine that the Commonwealth would simply choose to increase its overall funding to the States by such a large amount without facing a clear imperative to do so. They must realise that, if the Commonwealth is to 'protect' the small States without putting in extra funds, the revenue must come from somewhere. As there are no additional funds available and budgets are severely constrained, *any* increase in the assistance to the small States would ultimately result in a decrease to the others of roughly the same proportions, at least in the short term.

While perhaps the large States have been laying the groundwork for a future claim and are hoping for *some* extra contribution from the Commonwealth, their motivation seems to come from elsewhere. The large States' individual submissions make it clear

5 See Chapter 5, section 5.4.

that, even if additional Commonwealth funds were available to the States, they would still not want them to continue to be distributed via the current arrangements.

So the Panel views the four large States as arguing for a change in process as much as outcomes. That means that the fundamental question is: what is so problematic (from the large States' viewpoint) about the current arrangements that swapping the source of funding might change?

2.3 Issues beyond HFE

Part of the answer to the question posed above may lie in the States' current budgetary pressures. All States are having difficulty producing balanced budgets given the investments they wish to make in a range of policies, short and long term. Thus, they appear to incorporate issues that are beyond the strict operation of the HFE system in their GST share concerns. These separate, but related, issues are explained below (and some are so important that we return to explore them in detail in later Chapters).

First, there is an imbalance of taxing powers and spending obligations between the Commonwealth and State governments. By international standards, Australia has a high degree of this VFI. As detailed in the Panel's interim reports, developments since federation have changed the relative revenue raising between the two arms of government in favour of the Commonwealth. At the same time as the States' revenue sources were reducing in comparison to the Commonwealth's, the nature of the assistance from Commonwealth to States has morphed from providing limited grants to assist States in special circumstances, through addressing broadly-defined fiscal need and providing general revenue assistance, to the present concept of horizontal (interpersonal) fiscal equalisation. Some submissions to the Review have suggested that nothing short of major reform to the responsibilities of the different arms of government or the arrangements by which they are funded will do to put the Federation on the right path. Others call for significant reform of the nation's taxes as a step to remedying the VFI 'problem'.

Secondly, because the GST replaced several States taxes, the States may well feel a proprietary relationship to it, to the extent that when relativities change in a way negative to any of them, that one sees its revenue stream as being eroded. Under the large States' proposal, even if it ultimately resulted in no additional dollars for them, they would gain control of a larger share of the untied GST pie to count as their revenue, rather than having to rely on the Commonwealth 'granting' additional revenue to them subject to whatever conditions (such as matching State funding for the project) they may desire. For similar reasons all States are sensitive to base erosion, from several directions. They are worried that the incentive is not there for the Commonwealth to act swiftly when the base is threatened by legal challenges or administrative action. They are also conscious that the taxable share of consumption seems to be declining as a proportion of the whole (albeit perhaps not as quickly as might have occurred under the Wholesale Sales Tax and the State taxes repealed).

As highlighted in previous reports and summarised in the *Executive Summary*, a number of other factors have conspired in recent times to make the States shares of GST both unstable and unpredictable. Although these issues are less directly related to the Review's Terms of Reference than the core HFE issues, the Panel has felt it necessary to

address most of them in some detail. In particular, Chapter 11 on protecting the GST base deals with some important issues that require more public debate.

Finally, the fact that most Commonwealth payments to States for special purposes (for example, SPPs and NPPs) are formally tied, while GST payments are not, means that the greater the percentage of the former, the less flexible the State's budget. Large States find this perverse in that, the more recipient States are given GST to assist their needs, the *less* of their budget as a proportion is tied to achieving those ends. Conversely, donor States, who have less 'need' for GST, find that *more* of their budget is tied. Victoria's submission suggested that 48 per cent of Commonwealth transfers to donor States are tied, compared to only 36 per cent for recipient States.⁶ If States received more untied GST and less tied other grants, they would have greater discretion over a larger proportion of their own budgets. The counterview is that, as the lower untied grants only arise because of an *increase* in untied own source revenue, there is no issue regarding flexibility of budgets.

Which brings us to the question of what advantages — apart from a possible increase in budget flexibility — exist in the large States' model if there are no additional funds?

To find a substantial answer we need to examine the difference in practical impact between the HFE model based on the capacity for producing horizontal equity for individuals and the other models. To do this, we might start simply.

2.4 A simple illustration of the modern equalisation system

Imagine a federation with only two States, A and B, each with just 12 citizens. Each State in this imaginary federation has only one expense policy (the same one), namely that it should provide every citizen with an umbrella. Each State in this federation also has only one tax policy, namely that people earning over \$50,000 per year should pay tax necessary to produce a balanced budget.

The only difference (that affects fiscal capacities) between the two States is the number of citizens earning over \$50,000. State A has four of these taxpayers, while State B has eight, so tax rates are the equivalent of three umbrellas per taxpayer in State A (four taxpayers providing twelve umbrellas) and one-and-a-half umbrellas per taxpayer in State B (eight taxpayers providing twelve umbrellas). For convenience, we'll call these tax rates 3U for State A and 1.5U for State B.

Fortunately, umbrellas are cheap, so the taxes paid by both States' citizens are relatively low. A central federal government looking at the two States' circumstances may well conclude that the outcome was satisfactory and that no further assistance to either one (or no *equalisation* in the broad sense) was necessary.

However, the Buchanan model, focussing on the capacity of the States to treat citizens in like circumstances equally, leads to a different view. HFE looks at the fiscal circumstances of the individuals in the States and compares that with the situation that would have applied, but for the State borders. (The reason for doing this is that, central to the Buchanan model is the idea that States' citizens should not be treated differently

⁶ Victorian submission to the GST Distribution Review, August 2012, page 17.

solely because of State borders. This is not only *unfair*, when compared to what would happen if a single nation applied the same policies to its citizens, it would create an artificial incentive for State A's taxpayers to migrate to State B.)

In this imaginary federation, State A's four taxpayers have a tax rate of 3U and State B's eight taxpayers have a tax rate of 1.5U. However, when the situation is compared with that of a single unitary State that had the same policies, each taxpayer would pay 2U (12 taxpayers providing 24 umbrellas). Looked at in this light, State A taxpayers pay higher taxes than State B simply because of the placement of State borders. If fiscal motivations were the only concern, smart State A taxpayers would migrate to State B.

Buchanan reasoned, therefore, that it was in *everyone's* interests for State B taxpayers to *pay* State A taxpayers (or 'bribe' them as he later put it) to stay where they are. In theory, the subsidy required for State A's citizens not to migrate would be \$4U in total, or \$0.5U for each of State B's 8 taxpayers, to bring about the capacity for equalisation.

Beyond the theory

At the level of theory, HFE sounds so compelling that one wonders why all States don't enthusiastically endorse it. It is the gap between theory and practice that brings out the different views.

In the real world, the amount that needs to be paid to overcome inefficient fiscally motivated migration is quite hard to calculate and very much harder to see than in this example, and the signals sent by different fiscal capacities are confused by interrelated policies and effects. In Australia, there are eight States to consider, not just two, and there is not one single expenditure policy to evaluate, but over a hundred — each with potentially eight variations — and that's *after* a significant reduction in the number of 'disabilities' following the 2010 CGC Review. Similarly, on the revenue side, there are eight different categories of taxes and other revenue sources, each at least subtly different across jurisdictions.⁷ So the chance of a citizen at the border correctly identifying a difference in fiscal capacity that could be gained by migration is slim. The difference would have to be significant, if not extreme, to act as a driver.⁸ In addition, the level of confidence that one can have in the calculation of any real incentive is stretched by the number of moving parts. In practice, the CGC is forced to make difficult judgements in the face of (sometimes) poor quality data.

As a further complication, under HFE, the 'payment' to prevent migration, even if made by the stronger State, may never actually be made to the taxpayers of the weaker States to 'prevent' migration, or indeed to achieve the 'equality' outcome goal. This needs some explanation.

Return to our imaginary federation and assume that State B taxpayers understand the problem and decide to pay State A so that its taxpayers will not migrate. The first observation is that the payment goes to the State, not the taxpayer.⁹ If State A uses the money to lower tax rates for its taxpayers, everything should work out. However, the

7 See GST Distribution Review, *Interim Report*, March 2012, Section 3.2.

8 Modelling provided to the Review puts the loss if HFE was not pursued at \$295 million, or \$13 per capita. This calculation has its critics.

9 In his 2002 paper, Buchanan noted the risk of involving States in the interpersonal equity solution, musing that it would be better to pay the taxpayers directly.

funds are not tied to that purpose and States have autonomy over their own budget decisions. State A could decide that its disadvantaged people need welfare assistance more than the taxpayers need a tax cut. In effect, State B's taxpayers would then be funding a welfare initiative for State A's less well off. If that happens, horizontal interpersonal equity between the non-taxpayers of the two States is actually worsened and the incentive to migrate would still be there.

To take the example to extremes, State A might decide that its citizens needed ice cream more than tax cuts or welfare, or that State A's decision-makers need an overseas 'fact finding' trip. Seeing the subsidies 'wasted' (albeit by the democratic choices of another State) would make the taxpayers of State B resent the payment. (Of course, even if State A did something objectively meritorious with the subsidy, that would not necessarily stop State B from *judging* the use of it unfavourably.)

This analysis leaves out further complications including behavioural responses, such as:

- many of State A's taxpayers who were told of a fiscal incentive to migrate wouldn't believe it, or wouldn't want to migrate anyway
- even if they wanted to migrate, there are costs of moving and finding another job, so the full value of the subsidy may not be needed to dissuade them.

This deliberately oversimplified example demonstrates the concerns of the four States who feel they are in the position of State B. For these sorts of reasons they say the system is flawed as it requires them to pay too much, the 'equality point' is very hard to calculate in practice and, unless the weaker States actually use the money for the purpose it was given, the point of the subsidy is defeated.

2.5 Support and criticisms of HFE

Support for the current evolution of the system is evenly split into two camps, albeit with the occupants of each camp disagreeing amongst themselves on certain issues.

Small States say that, because the HFE system currently pursues the 'right' outcomes, the future vision is necessarily an extension or improved version of the present. From this point of view, the challenge is to make the system more rigorous, robust and accurate by improving reliability of assessments through better, more appropriate data and in other ways. Broadly speaking, the smaller States of South Australia, Tasmania, the Northern Territory and the Australian Capital Territory support the maintenance of a robust system of full equalisation, on the grounds that, without it, States would not be given the same capacities, so the system would not be equitable.¹⁰ These four 'supporters' of the system are also the States that receive more than their population share of GST — those with the most to lose directly if the system were removed.

The four remaining States (who receive less than their population share of GST and therefore have the most to gain) argue that equity could be achieved through a much less rigorous pursuit of the capacity for equal outcomes than is presently the case. They would prefer a lesser degree of, or a less precise calculation of, equalisation, for a range

¹⁰ The Australian Capital Territory favours a result that reflects the outcome of the current system, even if it would be open to achieving it in other ways.

of reasons. This is not to say that they would seek to treat any State unfairly, just that they see the system as currently equalising for things that are actually within a State's control. Through change they wish to encourage States to do more to help themselves.

While it would be possible to form the view that States simply favour or advocate the method that gives them the best outcome, the Panel is inclined to think the divisions go deeper than that. In our judgement, two States (South Australia and the Northern Territory) are strong supporters of the current system, while three others (New South Wales, Victoria and Western Australia) have little time for it. Queensland seems to support it in principle, but think it's gone too far, while the Australian Capital Territory has a pragmatic view, recognising its special place geographically (as an 'island' surrounded by New South Wales) and its unique status as the national capital. Tasmania has historically been a strong supporter of the system, but has recently accepted quarantined Commonwealth assistance in relation to its health sector. This seems to be a case where the dollars have trumped the principle, as Tasmania would ultimately have retained only its population share — or about two per cent of the payment — if it had not been quarantined.¹¹

A sample of the more conceptual and philosophical type of criticism presented to this review includes that HFE:

- fails to ensure equal treatment of people in similar fiscal positions because it focuses on States' capacities rather than outcomes for households or individuals
- fails to produce intergenerational equity because it equalises mining endowments across States instead of over time
- can only ever secure a relatively narrow form of equity, in which differences are allowed provided they arise from democratically supported decisions
- does little to reduce the inequity between rich and poor individuals and families, while the income tax and welfare transfer system is far more effective in moderating the income distribution of individuals and households
- can produce low relativities that are 'manifestly unfair' taking into account the efforts made to raise revenue from their own sources
- takes too narrow a view of States' underlying capacities to raise revenues, and instead equalises for some things that are actually within a States control
- encourages overspending and ineffective service delivery by States, especially since it does not require funds to be spent on the areas assessed as needing funds
- does not provide incentives for labour to flow where it is needed, or worse, provides incentives for labour to flow where it is not needed.

11 While it might be argued that even two per cent of the amount is still a benefit, Tasmania would be obliged to commit the full amount to the stated purpose.

Most of these arguments against the current HFE system can be countered by supporters of the system, or are ‘irrelevant’ as HFE does not seek to deliver in these areas.¹²

Apart from the conceptual criticisms, some consider that in practice the current process:

- is too unstable and or unpredictable for States to plan their own budgets properly
- is too complex to allow broad debate about the merits and workings of the system
- suffers from false precision (by including calculations that go into a fine level of detail despite resting on assumptions that require significant exercise of judgment)
- has methodological shortcomings of which the most notable relate to the treatment of Commonwealth payments to assist States’ capital investment in nationally significant infrastructure and the current mining assessment.

2.6 The search for a model for Australia’s future

Against the background of a highly technical topic and hotly contested views, in order to come to a decision on the question of whether an alternative model might be better, it is first necessary to ask whether fairness as between States can be achieved by anything other than full equalisation. In other words, is it possible to consciously choose something less than full equalisation without also actively deciding to discriminate between States and, ultimately, their constituent individuals? If this can be done conceptually, would there be any boundary — that is, where would one stop?

The Panel’s first Interim Report quoted extensively from State submissions to show that the answers to questions about fairness are often inherently subjective. At the one extreme some States suggested that the Commonwealth should simply give States the same amount of revenue per citizen (EPC), because this sort of outcome would be ‘fair’. At the other end of the spectrum of opinion, some argued that States ought to receive an amount based on an even more precise and comprehensive measurement of their revenue raising capacity and their service delivery costs than at present.

Academics are similarly divided on what a ‘fair’ distribution would be. Supporters of HFE argue that differing capacities lead to equals being treated unequally and full equalisation is required to remedy this. Others suggest that it is not at all clear that the equity rationale requires full equalisation.

The second question for the Panel is: even if less than full equalisation would be unfair in some way, or to some degree, could that cost be borne to achieve a greater benefit? Currently, other aims (such as the pursuit of simplicity, and predictability and stability of GST revenue) are subsidiary to the paramount objective of equality. But the Panel has been asked to consider what form of HFE is best for Australia overall, having regard to a range of factors and possible future challenges (some of which must be met with higher productivity, efficiency and robust State budgets). We have also been asked to consider

12 For example, criticisms that HFE does not ensure specific outcomes to individuals are met by the response that it doesn’t intend or purport to. Concerns that there are better ways to achieve vertical equity, while true, can similarly be met with that response. See also Appendix B.

whether there is room for other goals within the system, such as providing incentives for general economic or State tax reform, or for the efficient provision of services, or to maintain confidence in the Federation.

Some will argue that objectives other than interpersonal equity and locational efficiency are not necessary (because the system is already sufficiently simple and transparent), or that they are not ‘worth it’ (because the value of greater simplicity is less than the loss to equity), or that they are better pursued through other means (as HFE does not hurt efficiency and, in any case, efficiency is better encouraged through separate payments). Others will argue that the marginal benefit of pursuing equality is minimal, whereas greater simplicity would allow for a broader understanding of the system and greater confidence in federal fiscal relations. Similarly, they would argue that less than full equalisation would ensure that matters within a State’s control are not equalised, or would send an important signal about improving efficiency.

Finally, apart from considering these ‘radical’ changes, the Panel needs to consider the practical operation of the system. While we will understandably stop short of making detailed recommendations on methodology — that is quite properly a matter for the CGC — there may be some key issues on which the Panel’s guidance as to the direction of a methodological change will be productive.

Whatever changes to GST shares are ultimately indicated through these inquiries, there are also important questions as to future governance that need to be addressed.

None of these are matters in relation to which the CGC can be expected to act without clear direction from governments. On many occasions in the past, the CGC has made it clear that it is willing to modify its practices and goals in relation to HFE, but need to be told how and by how much.

2.7 The Panel’s findings on the ‘right’ model of equalisation

While the Panel has not found it necessary to decide every aspect of every argument put to us in submissions about which model is to be preferred, we have thought it potentially beneficial to reach findings on particular matters that have influenced us in reaching our final position.

In recognition of the large States’ concerns, the Panel has been keen to search for changes that might improve the transparency, simplicity, efficiency or stability of the system, even if such changes might come at a small cost to the theoretically equal outcome. In Chapter 3 the Panel has therefore exhaustively examined the large States’ alternatives for less equalisation, or for a less ‘falsely precise’ way to calculate it, in order to establish whether any of them are viable approaches in the medium term.

Findings on factors affecting the choice between models of equalisation:

- 2.1. *Experience shows that a politically indifferent, rules-based, system of allocating finances to States has advantages over the ad hoc negotiation of special deals, especially, but not only, when governments of opposite persuasions are involved. An independent system even arguably has advantages for the 'donors', as New South Wales and Victoria might recall from their experience in the 1980s, when they began to do better from the first full equalisation process than they had under the previous process of considering the claims of individual States.*
- 2.2. *The purpose of a federation is to bring disparate constituent parts together and so the concept of bringing the weak up to the capacity of the strong has much to be said for it. However, the zeal with which an exact calculation of equalising all States' fiscal capacities must be pursued, the precision with which the target can be determined and the effect it will have are disputed. While there is no reason to argue against providing States with the capacity for horizontal interpersonal equity (i.e. equality) amongst their citizens, inequality is tolerated in many features of government if there are identifiable benefits to be gained.*
- 2.3. *The current HFE system — requiring material equality and being guided by internally referenced principles and pillars, standards and capacities — is well established and internally consistent. It works satisfactorily if the goal and definition of equalisation as currently set out is accepted and one accepts (as we do) that the CGC does a good job of making its judgements and producing its numbers in the circumstances. However, by recognising that the CGC is often obliged to make decisions that turn on fine judgements and occasionally reverse direction, one is obliged to accept that there is a margin for error in the outcome. Despite the 'conservative bias' arguably applied by the CGC in its judgements, the margin for error could result in over-equalisation, or equalising for things that are effectively within a State's control.*
- 2.4. *Outside of a small core group, very few people, politicians included, have a good understanding of the background to, or the features of, the current system. This lack of understanding, compounded by the 'zero sum' nature of the exercise and the capacity of all to view the arguments through the lens of a geographic perspective, means that debate about the system can be frustrating if not futile. If a simpler system allowed the democratic processes to operate in a better informed environment, that would be beneficial to transparency and good government. Decision-makers should not be captive to the advice of a very narrow pool of experts, especially when the objectives of the system are contested amongst those experts and, because of the relative nature of the calculations, its effects are hard to predict and sometimes counter-intuitive.*
- 2.5. *Apart from HFE itself, there are closely connected issues that aggravate the concerns of some States. Concerns about the size of GST shares because the GST has not 'kept pace' with the State taxes it replaced, has not grown at the expected rate, or is shrinking as a proportion of consumption, compound and conflate concerns about HFE. When HFE issues intersect with questions of tax reform and State and Commonwealth rights, the aggravation becomes extreme.*

3 Examining alternative equalisation approaches

Chapter 2 explained that, because of the large States' concerns, the Panel has been alert for any changes that may improve the transparency, simplicity, efficiency or stability of the system, even if such changes might come at a small cost to the theoretically equal outcome. That Chapter drew out the differences in viewpoints of the small States (that support the 'fuller' HFE model, based on the Buchanan idea of providing States with the capacity for horizontal interpersonal equity) and the large States (that favour a more partial equalisation, or an approach that would reach the same, or very similar outcome in a simpler, more general way).

In this Chapter the Panel examines the specific proposals and ideas that have been put to us by the large States to modify the system in order to establish whether any of them are viable approaches in the short to medium term. These proposals fall under two categories, namely, proposals to do *less equalisation* than under the present model and proposals to perform equalisation in a *less precise* or more general way.

The notion of an equal per capita (EPC) approach has not been considered at length here as the Panel has interpreted that to be beyond our Terms of Reference, especially since the Commonwealth has made it clear that there is no additional money available to compensate States that would be otherwise worse off under an EPC model. However, the Panel has further considered the EPC model in Chapter 12, as part of examining a long term view of Commonwealth/State relations.

3.1 Proposals to do 'less' equalisation

The Panel notes that large States and some academics are concerned that, although the current system seeks to deliver close to full equalisation, that degree of equalisation is not necessary. Amongst other things, it is suggested that seeking full equalisation dulls incentives to deliver services efficiently, does not recognise States' property rights and reduces confidence in the federation. It has been put to the Panel that partial equalisation would address these concerns.

The process for evaluating options in this Chapter is somewhat akin to a cost-benefit style exercise in which the 'cost' against the HFE benchmark should be measured and compared with the 'benefit' to be gained. However, as with any cost/benefit analysis, the costs and benefits are not always readily identifiable or quantifiable. Further, in the context of HFE, there are some inherently subjective perspectives on whether a change is a cost or benefit. Because of the difficulty in putting a precise number on the cost/benefit ratio in these circumstances, the Panel has found it best to examine the purported benefit first and, where that has been found likely to be small, or the conceptual case for it is not compelling, we have concluded that detailed attempts to quantify the cost/benefit are not necessary.

Table 3.1 shows a range of headline approaches (each with a myriad of variations) that have been considered by the Panel. Some of these apply to revenue assessments only, some affect expense assessments, while some apply overall.

Table 3.1: Approaches that give rise to ‘less equalisation’

Approach
<i>Revenue side</i>
Apply a revenue discount to recognise States rights to having a share of revenue unequalised
Equalise to the standard of the State with the minimum revenue ‘effort’
<i>Expenditure side</i>
Apply an efficiency dividend to expenditure needs
Equalise to an externally determined efficient standard
Equalise to the standard of the State with the minimum expenditure ‘effort’
Equalise to a 7-State average
<i>Overall</i>
Equalise to a proportion of the strongest State
Raise recipients to a proportion of donor States
Distribute a set (minimum) amount of GST on an EPC basis
Establish a relativity floor

Note: The current standard is the Australian, or all States, average.

For convenience, in the sections that follow, the Panel has considered these approaches in categories according to the issues they seek to address, rather than the effect they have. Four broad categories have been identified for these purposes:

- equalising to a capacity other than the ‘all States’ average’, to promote efficiency
- allowing one State to remain above the average capacity to address ‘confidence in the federation’
- allowing States to retain some greater proportion of a ‘fiscal benefit’ to address States ‘rights’
- equalising to a capacity other than the ‘all States’ average’, to recognise that differences in expenditure ‘effort’ are States’ policy choices.

Approaches to promote efficiency

In the course of its Review the Panel has noted the concern that the current approach to equalisation dulls incentives to deliver services efficiently. This concern is distinct from the theoretical issue about whether HFE promotes *locational* efficiency or inefficiency. It is also quite separate from the concern that States do not receive the benefit from any efficiency savings made (that has previously been addressed by the CGC¹).

1 In Box 2-1 of its 2012 Update, the CGC notes States that are more efficient than the average get to keep the benefits of their efficiency, and those States that are less efficient than the average bear the costs. Commonwealth Grants Commission, *Report on GST revenue sharing relativities*, 2012 Update, page 31.

The efficiency concern arguments proceed on the basis that, by using the Australian average expense² for all States, the CGC's processes send a signal to every State that operating at the average efficiency is acceptable, rather than encouraging States to pursue greater efficiencies in service delivery. When this issue first arose in the initial round of consultations with States, the Panel was determined that States should be encouraged to be as efficient as possible in delivering services. The various proposals intended to encourage efficiency all operate through some type of discount, at least on expenses and, possibly, to overall relativities.

The way the Commonwealth, and many States, seek to achieve efficiency in service delivery is to impose an 'efficiency dividend' on Departmental budgets. For example, the Commonwealth generally has an efficiency dividend of around 1.25 per cent per annum. Other approaches such as equalising to less than the all-State average are also effectively discounts. There are, for example, a number of ways of equalising to less than the average, for example equalising to an efficient external standard, or equalising to a proportion of the average. As noted in our first interim report, using any standard other than the average creates the need to identify that standard, along with the attendant problems of who should determine the standard from time to time.³

Approaches to setting the standard for equalisation at lower than average that avoid the problems of determining an external standard are to exclude some States from the average, or to approximate that result by way of a general discount. For example, excluding the highest spending State from the average would lower the standard to which States are equalised, particularly if the highest spending State has a large population. A 7-State average could be approximated by an equivalent general discount for simplicity. There are numerous other variations that all rely on broadly the same mechanism and result in broadly the same outcome. However, the Panel notes that all such approaches assume that an efficient standard is somewhat *less* than the average standard, rather than more.

Do these approaches actually improve efficiency?

The proposed indicator of efficiency generally tends to be total expenses on services. This is based on the assumption that States with higher expenses are less efficient and those with low expenses are more efficient. The fundamental problem with this approach is that the level of State spending on its own is not an indicator of efficiency — actual levels of spending arise from both policy and non-policy influences. For example, a State may spend more on school education because it has a higher proportion of school aged children than other States, not because it spends more on each child for no improvement in outcome.

Unfortunately, because of the complexity of the system, outside observers sometimes appear to relate higher expenditure needs solely with either the quality of the service provided or the efficiency with which it is provided.

To recommend any form of approach to promote efficiency, the Panel would have to be able to conclude that States that have higher expenditure needs (either overall or at an assessment category level) are *less efficient* and those with lower expenditure are *more*

2 The Australian average or population weighted average is the sum of all State expenditure on a service divided by the sum of all States' populations.

3 GST Distribution Review, *Interim Report*, March 2012, pages 79-80.

efficient. We have been presented with no evidence to support such a claim, and have no other basis to come to that conclusion.

Finding 3.1

Despite our initial desire to provide incentives to States to deliver services more efficiently, the Panel has concluded that the HFE system as currently manifested cannot achieve this through efficiency discounts, as there are factors beyond a State's control that lead to higher than average expenditure. While it might theoretically be possible to overcome this deficiency if the CGC were to fully separate cost and use elements of its assessments, that result is not guaranteed, and the additional process would risk complicating the CGC's assessments further.

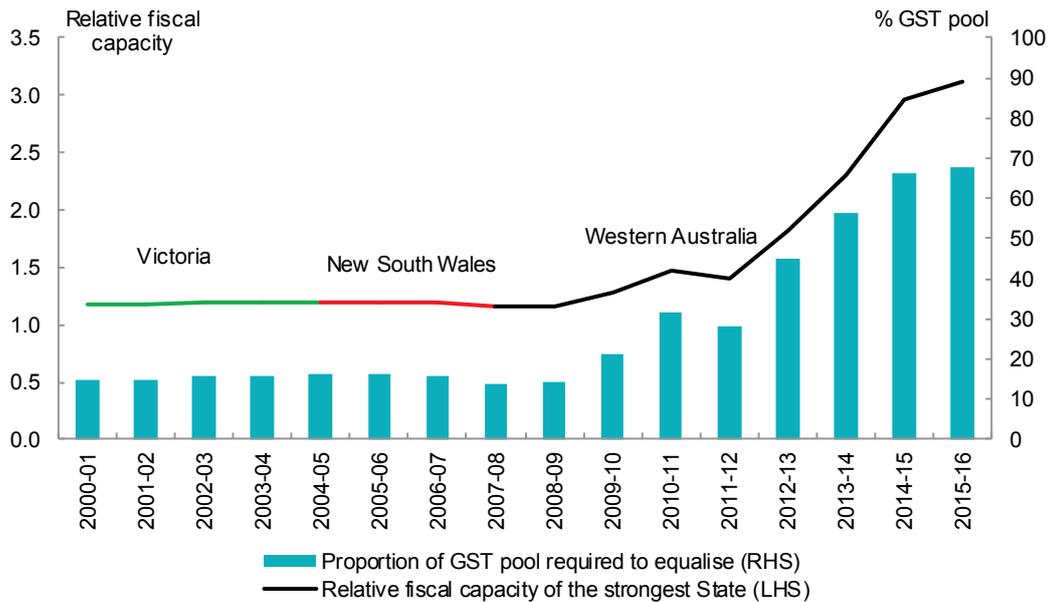
Nevertheless, the Panel encourages States to continue to seek efficiencies wherever they can. In particular, we note that, under the present system, whenever large States such as New South Wales, Victoria and Queensland are able to reduce their costs of service delivery, their contribution to the average calculation (over 75 per cent) will drive the average to which all States are equalised.

Approaches to address confidence in the federation

In our first interim report, the Panel observed that it is possible for a State to receive no GST funding because of the strength of its own revenue, and still have the capacity to provide at least the same standard of services to its citizens as the other States. While that observation is technically correct, it has been suggested that if a State received no GST, that very fact could lead to fractious relationships with other States and/or the Commonwealth, regardless of the circumstances. This dynamic already appears to be in play as Western Australia's relativity declines, even though it is not likely to reach zero in the short to medium term. This section deals with approaches that lend themselves to addressing these sorts of concerns about confidence in the federation.

The current HFE process effectively starts from a population share of GST, referred to as an EPC share. The CGC, through its assessment of revenues and expenses, determines the factors that result in a State requiring more or less than their population share of GST. This is equivalent to giving all States the same fiscal capacity as the strongest State. The strength of the State with the strongest fiscal capacity (in terms of the ability of its own-source revenues and Commonwealth payments other than GST to meet its expenditure needs) determines the amount required to equalise.⁴ The strongest State changes over time and is currently Western Australia — see Figure 3.1.

⁴ This alternative way of viewing the GST distribution is presented in Table 5-3 of the CGC's *Report on GST revenue sharing relativities — 2012 Update*, page 64.

Figure 3.1 Amount required to equalise, 2000-01 to 2015-16

Source: Historical years (2000-01 to 2012-13) are based on GST revenue sharing relativities. Forward estimates (2013-14 to 2015-16) use Secretariat estimates based on data available at August 2012.

Figure 3.1 shows that the amount required to deliver equalisation has increased between 2008-09 and 2012-13 and, based on forward estimates, is expected to rise significantly. By 2015-16 the proportion of the GST pool required to deliver equalisation is expected to be about 70 per cent, compared with around 10 to 15 per cent for all the years prior to 2008-09. This increase reflects the expected strength of Western Australia's own-source revenue.

Approaches that have been proposed as supporting confidence in the federation considered by the Panel include:

- equalising to a set proportion of the strongest State's capacity
- equalising recipients to the average capacity of some or all donor States
- establishing a relativity floor.

Under the first type of approach, States would be equalised to a set proportion — say, 95 per cent — of that of the strongest State. The main consequence is that less of the GST pool would be required to deliver 'equalisation', with more being allocated on an EPC basis. The strongest State would therefore end up with a higher fiscal capacity than all other States, while the other States would have the same fiscal capacity as each other. Using the example of equalising to 95 per cent of the strongest State in 2012-13 would have seen Western Australia receive an additional \$130m in GST at the expense of all the other States.

There are a range of variations to this approach, including equalising States to the average of the two strongest States, or to the State with the second strongest capacity. Under any of these approaches, less of the pool is required to 'equalise', leaving more distributed EPC. By way of example, equalising to the average capacity of the two strongest States in 2012-13 would have required about 20 per cent of the GST pool to achieve equalisation rather than 45 per cent.

The second type of approach that seeks to deal with confidence in the federation is to raise small States to a proportion of the average fiscal capacity of donor States. As the average fiscal capacity of donor States would be higher than the average that includes all States, the proportion of the donor State average would need to be quite low, and much lower than the proportion considered when compared with the strongest State.

The last type of approach that seeks to deal with confidence in the federation is having a floor on relativities. Say a floor of 0.3 was established, it would benefit any State with an assessed relativity below 0.3 and those States with relativities above 0.3 would have reduced GST payments. Historically, a floor at this level would have had no impact as no State has had a relativity below 0.3.⁵

The Panel observes that the approaches seeking to improve confidence in the federation cannot achieve that aim in the normal course of events. Because these approaches redirect GST funding to the strongest State and reduce the GST funding received by the other States they would, in our opinion, potentially *undermine* their confidence in the federation. Furthermore, these types of approaches have been proposed as a result of anticipation of a prolonged and increasing mining boom. Recent signs are that relativities may start to converge again sooner than was expected at the time this Review was commissioned.

Finding 3.2

Approaches to address confidence in the federation would only make sense if there was a real likelihood of a strong State seeking to leave the federation. In the Panel's view, whatever concerns States may have about the delivery of HFE, they are not sufficient for them to realistically contemplate leaving the federation and we do not see the need to pursue these approaches. If a situation arose where the risk of a State seeking to leave the federation became realistic, this type of approach might be considered as an 'emergency break glass' option to apply in the short term to allow time for a negotiation of broader Commonwealth-State financial relations issues.

Approaches that address State 'property rights'

During the course of the Review, the idea that States have some form of 'property rights' in the revenue they raise has been identified — particularly in academic work — and appears to underlie the positions of the resource States of Queensland and Western Australia. Broadly, the line of reasoning is that, although revenues should be generally subject to equalisation, a State should have some proportion of its revenue kept out of the equalisation process. Analogies have been drawn with Canada, where only 50 per cent of mining revenue is equalised.⁶

5 If a relativity floor were to have an effect on GST shares, it would be akin to all States receiving a set amount of the GST pool distributed on an EPC basis. In this example, the set amount would be equivalent to 30 per cent of the GST pool being distributed EPC.

6 Canada's system for determining equalisation transfers for the Provinces includes no expenditure side equalisation. See GST Distribution Review, *Interim Report*, March 2012, page 5.

These approaches are most often raised in relation to resource States' mineral wealth and the question of whether mining revenue should be treated differently from other revenue is dealt with at some length in Chapter 7.⁷

Leaving that issue aside, the Panel has reasoned that if there was a basis for concluding that States have such property rights, then all general revenue sources should have the same right. Indeed, under the current HFE system, which looks not just at *revenue*, but 'net fiscal benefits'⁸, it would follow that, if States had some form of right to have some of the revenue they raise not equalised, so too they would have the same right in respect of their total fiscal capacity. States could, for example, therefore have a right to the 'low cost' advantages of their State due to their compact size, or population distribution, age structure and so on. Extended further it could be argued that States have a right to the above-average Commonwealth payments they receive.

If the argument for allowing States to have some portion of their revenue or other fiscal advantages excluded from the equalisation process was accepted, the possible ways to implement this would be to apply a discount to own-source revenue, all revenue, to both revenue and expenses separately, or to relativities overall⁹. Discounts made for these reasons would not suffer from the same defects as discounts for 'efficiency', even though they may produce a similar effect. They would be justified solely by concluding that States should keep some portion of the accidental/historical benefit of their situation despite the otherwise homogeneous nature of the Australian Federation.¹⁰

What would the size of such a discount be?

Costs and benefits of these sorts of discounts would depend on their size. Clearly, very small discounts could produce only very small benefits and would result in only very small costs to 'equity', particularly since the current outcomes achieved through HFE are — as acknowledged by the CGC — only comparable anyway.¹¹ Having said that, it is possible that the further one moves from the HFE 'target', the greater the impact each additional incremental movement might have. Large discounts, on the other hand, would have severe impacts on recipient States. Severe impacts on very small States would undoubtedly subject them to very high costs and risks, even if one could conclude that they were to some degree temporary, while their economies adjusted.

It seems that there is no theoretical answer to the question of what sort of discount might be appropriate¹² and there is no definitive guidance from international experience either. While Canada applies a 50 per cent discount to mining revenue, they do so in the context of having no expenditure equalisation at all. It turns out that, in Australia, where we have close to full expenditure side equalisation, the result for Western Australia is currently about the same as if we had adopted the Canadian approach of a 50 per cent revenue discount with no expenditure equalisation. Historically, Australia's approach of full mining and expenditure equalisation has served Western Australia much better than Canada's would have.

7 See Section 7.1.

8 See Chapter 1 for the origin of the term.

9 The joint State submission proposal to calculate relativities with reference to the whole of the GST pool, but then apply relativities to only 60 per cent of it, with the remaining 40 per cent distributed EPC, is equivalent to a 40 per cent discount on relativities.

10 Although some States would counter that homogeneity has only been achieved *because of* HFE.

11 See Section 3.3.

12 See Buchanan's comments about applying HFE in the circumstances on the ground in Chapter 1.

For these reasons, the Panel has explored the fourth category of approaches — ones that seem to offer other avenues for determining the appropriate levels of discounting — before concluding its findings on this category.

Approaches that equalise to the minimum ‘effort’

It has been suggested to the Panel that, rather than seeking to equalise to the average of all States, the standard should be set at the minimum service level that any State’s residents, in practice, are willing to accept.

This approach was initially suggested by Queensland in its first submission to this Review and subsequently presented as a common position of New South Wales, Victoria, Queensland and Western Australia in their joint submission. It was asserted that this approach would enable all States to provide an acceptable standard of services in major service delivery areas. The joint submission stated that revenue would also need to be ‘scaled down’.

The minimum or acceptable level of service identified was that of the State with the lowest assessed *effort*. Effort in this context is a term that describes the differences between what the CGC assesses each State would need to spend to provide the average level of services and what each State actually spends.¹³ Those States that spend less than they are assessed to need to spend have ‘below average effort’.

These approaches require that, once the State with the minimum effort is identified, assessments by the CGC would be scaled down or discounted to ensure that States were only equalised to the standard of the minimum effort, rather than the average. The benefit of this type of approach over other rationales for discounts is that it *takes into account* the non-policy factors that cause differences in State spending. As the comparison being made is between the actual expenditure in the States and the level of expenditure required as assessed by the CGC, it would not, in theory, inadvertently punish efficiency or reward inefficiency. However, the approach does require acceptance that the effort calculations are sufficiently robust to be relied upon for this purpose and that over effort expenditure is purely an individual State’s choice.

The approach proposed by Queensland and supported by the other large States is to use the minimum State effort for *each assessment category* to determine a discount. That is, the State with minimum effort in each of the CGC’s categories of School Education, Admitted Patients, Justice Services and so on, would set the benchmark for all. It is highly likely that no single State would have the minimum effort in every assessment category, which means that different States would determine the discounts across categories, some of which may be offsetting.

The effort approach has also been suggested for revenue assessments. The logic for doing so is that, if a State *spends* less, they will need less *revenue*, and States that raise less own-source revenue will spend less (in the absence of other sources of revenue).

The Panel notes the practical concerns about adopting an approach based strictly on CGC categories. There have been examples in the recent past where reliance on

¹³ For simplicity, effort is used here to describe both revenue and expense ratios. Technically, the CGC uses *effort* to describe revenues only. For expenses, the CGC uses the term *assessed level of service*, although the concept is the same – see Glossary.

State-provided data has led to a temporary incorrect result that had to be corrected. Without overstating concerns about the quality of State Government Finance Statistics (GFS) data at a category level, we note that the CGC does not ‘vouch for’ State data at a category level. Moreover, adopting a further process to be applied category by category could hardly make the overall process simpler.

To overcome these concerns, an alternative could be to use the minimum effort concept at the overall spending and revenue levels rather than category-by-category. The overall approach would result in a single measure of effort for expenses, or revenue, rather than one for each of the 22 categories. Arguably, this would also better capture differences between States in their residents’ preferences for service levels overall. To avoid the policy neutrality problems that arise from adopting a standard set by a single State, rather than basing this approach on the State with the minimum effort for either expenses or revenues, it would be possible to use a proxy. Alternatives could be to average the effort ratios of all States with below average effort or, for simplicity, to pick a ‘half way point’ between the lowest effort and the average.

Adopting the minimum effort concept at the overall spending and revenue levels would result in small discounts. The minimum revenue effort averaged over the three 2012 Update assessments years was around 88 per cent, meaning that that State raised 88 per cent of the own-source revenue it was assessed as being able to raise if it followed average policy given its tax bases. This would imply an own-source revenue discount of 12 per cent. The average effort of the five States below 100 per cent was around 95 per cent implying a five per cent own-source revenue discount.

The minimum effort ratio for expenses was around 97 per cent, meaning that that State spent 97 per cent of the funds it was assessed as needing to spend if it provided the average level of service at the average efficiency given its population characteristics and distribution. This would imply a three per cent discount on expense assessments. The average effort of the five States with below average effort was around 98 per cent, implying a two per cent expense discount.

Even at these levels, discounts have a significant effect on small States. Secretariat calculations show that a five per cent discount on own-source revenue and a two per cent discount on expenses would have an impact averaging \$50 per capita across the small States. Whilst this might be a relatively small amount in total dollars — around \$150 million — the loss of those funds would affect the small States significantly.¹⁴

Finding 3.3

The effort approach provides an interesting and credible basis for adjusting the present system. However, the discounts indicated could only be considered to be minimal — perhaps even symbolic — from the large States’ point of view, while having a significant impact on small States. After deep deliberation, the Panel has decided, on balance, not to recommend adopting discounts to reflect the minimum effort.

14 In an effort to escape this conundrum, the Panel asked the Secretariat to find a way to protect the small States in transition, by way of a fiscal guarantee funded out of GST growth. This is dealt with in Appendix C, although ultimately it did not prove to be a mechanism that the Panel could recommend.

Returning to the issue canvassed in the previous section on States rights' justifications for discounts, whilst it would be possible to argue for higher discounts on that basis, the Panel have been unable to find a sensible rationale for determining how much these might be. Any decision to increase beyond the levels indicated by the effort rationale would be purely arbitrary, or guesswork. In addition, larger discounts would have significant impacts on small States.

Moreover, none of the approaches considered in this Chapter would be simpler, more transparent or improve efficiency. They all require additional steps in the CGC's process, from applying a single discount to the final State relativities or applying discounts within each assessment category. Additional steps would require additional explanation about how the distribution was determined, making the process less transparent.

Finding 3.4

Whether any of the approaches examined above would improve the HFE system is ultimately a matter of judgement, depending on one's point of view. On balance, the Panel has come to the conclusion that we can neither recommend very small changes that would deliver only symbolic benefits to the large States (at the cost of even less simplicity), nor are we prepared to recommend larger changes that would have major negative impacts on small States.

However, if governments were minded to make changes, the Panel considers that the 'effort' approach would be the best way of determining the size of those changes.

3.2 Proposals for 'less precise' or 'more general' equalisation

As well as proposals to do *less equalisation* than occurs under the present model, the Panel has been presented with numerous options to perform equalisation in a *less precise* or *more general* way.

When considering the submissions to the Review and consultations, the Panel noted that there was a level of concern, again mainly from the large States, that the current system was too precise, or actually had 'false' precision. While it is not clear that the current system in total is too precise, especially given the portions of State budgets that are not differentially assessed, the use of judgement, proxy data and 'reliability' discounts, there are elements of it that can lead in that direction. While the Panel has not examined methodological issues, due to the comprehensive nature of the system it is conceivable that the level of detail could be finer than is necessary.

In our consideration of these issues, we have again found it convenient to group the suggested approaches, this time into those that seek to deal with both revenue and expenses assessments together, those approaches that apply to revenue assessments only, and approaches that apply to expense assessments only. A multitude of suggested approaches have been considered by the Panel, ranging from adopting a single global indicator of State fiscal capacities to examining indicators for individual revenue or expense assessment categories, and multiple variations in between.

The Panel was initially drawn to the prospect of ‘broad indicators’ — particularly on the revenue side — as their proponents suggested they could achieve much the same outcomes, but in a very much simpler way. Unfortunately, the quest for similar outcomes through simpler processes has proven grail-like in its elusiveness. While there is no end of ‘simpler’ ways to determine the allocation of Commonwealth grants to States, the natural rule seems to be:

- the simpler the method, the less representative of current outcomes
- the less representative of current outcomes the method, the greater the differences in redistribution. (To some, these differences will seem arbitrary, volatile or unpredictable.)

To pick an example, an EPC allocation is *very* simple, but it would take away \$2.4 billion annually from Northern Territory — the proportional equivalent of an annual reduction for Victoria of \$60 billion, or \$75 billion for New South Wales.

Coming down just one level of detail, approaches such as using Gross State Product (GSP) or Household Disposable Income (HDI) as broad indicators of State fiscal capacity are only a little more complicated,¹⁵ but they still produce very large changes from the current GST shares for States. Of course, such results should probably not be a surprise, as the broader indicators do not seek to account for the variations in State policies and States do not directly tax gross state product or household incomes.

The impact of most of the combined revenue and expense approaches is a much different redistribution in aggregate and across States. An EPC approach would result in no redistribution in aggregate, with the impact on States simply the reverse of the current redistribution. The use of alternative single global indicators for both revenue and expenses results in an aggregate distribution ranging from \$2 billion less to \$9 billion more than the current distribution. At a State level, most of the global indicator approaches benefit the donor States. Where a single global indicator is used just for revenue assessments, the aggregate redistribution tends to increase by around \$1 billion, and tends to redirect GST towards resource States. The other revenue assessment only and expense only approaches tend to redistribute a similar amount of GST in aggregate, but can have substantial changes for individual States.

After continuing this process down several levels of detail, the Panel has come to the conclusion that it is not possible to use simple broad indicators and deliver States with the same, or very nearly the same GST shares. The approaches that differ most from the current system tend to produce the biggest changes in GST shares, while those that are similar tend to have smaller changes in GST shares. Where broader measures are restricted to revenue assessments only, the less closely the measures reflect the current arrangements, the greater the change in GST shares. The broadest measures of revenue raising capacity, such as GSP or HDI, reflect what States do as simply raising revenue, without reference to where or how the revenue is raised. These measures do not seek to account for the issues considered by States in raising revenue. These issues may be constitutional, legal and historical constraints, tax competitiveness, stability, administrative burden, efficiency and equity.

15 For example, in terms of defining which data sources and/or definitions of the terms are used.

While it might be possible to arrive at a combination of indicators to replicate the result of the present system relatively closely, the adjustments and judgements required to get there would probably end up being as complicated and contested as the present system. Worse, whereas the present system has a basis to resolve arguments in that the touch stone is ‘what States do’, any replacement construct would not have that advantage. It would be unlikely to remain robust over an extended time period and, once the existing arrangements were dismantled, it could be hard to replicate when that occurred.

Finding 3.5

The Panel concludes that the ultimate goal of improving simplicity by adopting broad ‘cut-through’ indicators that can produce closely comparable results to those under the present arrangements remains elusive. That does not mean that we have concluded that no break-through simplification via broader indicators is possible, but just that it cannot be achieved in one bold stroke.

For completeness, and to relieve anyone from having to undergo the full exercise again in the near future, we have included a table listing the outcomes of all the major approaches and variations we have considered.¹⁶ Table 3.2 lists the category of indicator, describes how it was modelled and indicates how closely it would match the existing arrangements by showing the impact on the jurisdiction on which it would have the largest negative effect.

Table 3.2: Approaches to less precise considered by the Panel

For both revenue and expense assessments		Biggest ‘loser’ (\$pc)
<i>Equal per capita</i>	Each State receives its population share of the GST pool	NT (\$10,015)
<i>Gross State Product (GSP) options</i>	Each State receives its population share of the GST pool:	
	— minus one percentage point for every point its share of total GSP exceeds its population share (and vice-versa)	NT (\$10,477)
	— multiplied by growth in total GSP divided by its growth	NT (\$10,683)
<i>Household disposable income (HDI)</i>	States with HDI above Australian HDI receive a smaller share of GST (and vice-versa)	NT (\$10,270)
<i>Materiality thresholds</i>	All materiality thresholds increase from current thresholds:	
	— twofold	ACT (\$19)
	— fourfold	QLD (\$36)
<i>Rounding relativities options</i>	Each State’s final relativity is rounded to:	
	— two decimal places	QLD (\$4)
	— one decimal place	NT (\$119)
For revenue assessments only		
<i>GSP options</i>	A State’s share of total own-source revenue is assessed as:	
	— its share of GSP	ACT (\$2,303)
	— half its share of GSP and half its population share	ACT (\$1,291)
<i>HDI options</i>	A State’s share of total own-source revenue is assessed as:	
	— its HDI relative to Australian HDI	ACT (\$3,507)
	— its HDI relative to Australian HDI except for mining which is assessed in the same way it is now	ACT (\$2,840)

16 Limitations of space prevent us from reproducing the work in full.

For both revenue and expense assessments		Biggest 'loser' (\$pc)
	— its HDI relative to Australian HDI except for mining and land taxes which are assessed as they are now	ACT (\$1,968)
	— it is now, with the exception of other revenue which uses HDI instead of population shares	ACT (\$1,386)
<i>Thresholds and progressivity removed options</i>	A State's share of total own-source revenue is determined using current assessments except that tax-free thresholds and progressive scales are removed: <ul style="list-style-type: none"> — but other adjustments (such as for public sector payrolls) continue to be made — and all other adjustments cease being made 	TAS (\$153) ACT (\$610)
<i>Broader indicators</i>	A State's share of GST, due to revenue assessments, is determined according to the indicators proposed in the: <ul style="list-style-type: none"> — Victorian submission — Commonwealth Treasury submission 	ACT (\$796) SA (\$197)
For expenses assessments only		
<i>Remove low reliability disabilities</i>	A State's share of GST, due to expense assessments, is determined in line with the proposed materiality and reliability guidelines in the Queensland submission	SA (\$73)
<i>Double any existing CGC discounts</i>	A State's share of GST, due to expenses assessments, is determined using the current assessments with any existing discounts being doubled	NT (\$1,021)
<i>Core services of national importance assessed only*</i>	A State's share of GST, due to expenses assessments, is determined using the current assessments with the exception of the following 'non-core services of national importance', which are removed: <ul style="list-style-type: none"> — Services to communities, justice, roads, other transport and services to industry — Roads, other transport and services to industry 	NT (\$3,853) NT (\$5,010)

* Variations to this approach included assessing and not assessing disabilities such as location costs and administrative scale.

Minor, but nevertheless important changes

The process described above has convinced the Panel that it is not possible to closely replicate the outcomes of the current system in a dramatically simpler way. However, in the process of examining the full suite of approaches, the Panel has identified two small steps that can be taken relatively easily without creating the problems mentioned.

Although changing these will alter little of substance, the Panel believes they should be taken up in order to act as resistance against the tension created by the contested nature of the current system, which can apply pressure on the CGC to adopt processes and assessments that are overly (or falsely) precise.

Increasing the 2010 CGC Review materiality thresholds

Materiality thresholds were introduced in the 2010 Review to assist with the simplification of the CGC's processes — see Table 3.3. At the conclusion of the 2010 Review, the CGC suggested that materiality thresholds should at the least be

indexed to reflect movements in price levels, to ensure the simplification gains achieved in that review are not eroded over time.¹⁷

When considering how much materiality thresholds should be increased, the Panel has examined maintaining thresholds in real terms, doubling the current thresholds and increasing the thresholds four-fold. Maintaining thresholds in real terms and doubling the current thresholds produce similar outcomes. The approach considered here is that of a four-fold increase in the 2010 Review materiality thresholds, as shown in Table 3.2 to deliver further simplicity.

To prevent the system becoming, or being viewed as, falsely precise the Panel considers greater simplicity is required. A four-fold increase in materiality thresholds would have a small impact on the current assessments —it is expected to remove one assessment category, and six disabilities — and ensure a greater degree of simplicity in the future, without affecting small States significantly.

Table 3.3: Proposed materiality thresholds

Level at which threshold applies	2010 Review thresholds	Quadrupling thresholds
Category — total	\$50 per capita	\$200 per capita
Category — redistribution	\$30 per capita	\$120 per capita
Disability	\$10 per capita	\$40 per capita
Data adjustment	\$3 per capita	\$12 per capita

Based on the size of categories, redistributions and disabilities, it is expected that increasing the materiality thresholds four-fold would remove one revenue category (Insurance tax). The impact of this increase in materiality thresholds would be largest in relation to disabilities, where it is expected that the following six disabilities would no longer be assessed:

- first home owners scheme expenses
- cultural and linguistic diversity
- natural disasters
- urban roads disabilities
- water subsidies
- concessions for water and electricity users on low incomes.

Some of these disabilities are volatile, such as the natural disasters assessment. Given this, and the potential for some disabilities to be material in some years and not others, materiality should be evaluated over a number of years rather than simply in one year.

¹⁷ CGC, *Report on GST revenue sharing relativities — 2010 Review, volume 1 – Main Report*, page 93.

Recommendation 3.1

To ensure the system is not driven to become falsely precise, the Panel recommends that materiality thresholds for the next methodology review be set at:

- *category total expense or revenue average of \$200 per capita*
- *category redistribution \$120 per capita for any State*
- *disability \$40 per capita for any State*
- *data adjustments \$12 per capita.*

Rounding relativities

One of the concerns reported to the Panel was that the current system is overly precise. The CGC's detailed analysis of conceptual matters and rich datasets culminates in a single relativity for each State presented at five decimal places. The Panel believes that reporting relativities at five decimal places could lead observers to the conclusion that the relativities themselves, or the process used to derive them, are too precise. Prior to the 1999 Review, relativities were presented at three decimal places.

Altering the number of decimal places relativities are reported at does not tend to have a significant impact on State GST shares unless they are rounded to one decimal place, where impacts can be in the order of hundreds of millions of dollars for some States.

The size of the impacts on GST share of rounding to two decimal places varies from year to year and for each State, but the impacts remain small. While the Panel recognises this change is essentially presentational, it could help overcome concerns that the CGC's outcomes are too precise.

Recommendation 3.2

To ensure the system does not appear to be falsely precise, the Panel recommends that relativities produced from the CGC's process be rounded to two decimal places in the annual Updates and Reviews.

3.3 'Comparable' or 'materially-the-same' capacity?

In our first interim Report, the Panel flagged a willingness to consider whether providing comparable capacities for States would be more suitable to present circumstances than providing materially the same capacities. We therefore invited submissions on how this concept might be accurately described and effectively implemented.

States' views

As with all important issues in this zero-sum game, responses were effectively divided.

As a general statement, the larger States favoured various ways to reduce the degree of equalisation, as well as various forms of less precise HFE, all potentially under the banner of moving from the present goal of providing 'materially-the-same' capacities to one of providing 'comparable' capacities. On the other hand, the smaller States do not favour a change, believing that the 2010 CGC review went as far as could feasibly be done without compromising equalisation too much.

In short, the four larger States see a move to comparable as a potential step on the path to less equalisation and therefore *support* it, while the four smaller States see a move to comparable as a step on the path to less equalisation and therefore *oppose* it.

The CGC's perspective

While the CGC has been careful not to enter the fray on issues requiring judgements that are rightly left to governments, they have made a contribution that may explain this impasse. Essentially, they point out that the Commission's current approach to equalisation results in comparable, not the same, State fiscal capacities. They say that lags in the system, and data and method problems dealt with through reliability and materiality criteria, mean that States fiscal capacities are not the same after the distribution of the GST, merely comparable. Perhaps, less helpfully, but equally consistently, they have told the Panel that a change in the stated goal to 'comparable' by itself would therefore change nothing — that if governments require some other degree of comparability than the present, that goal would need to be specified.

The Panel's view

The Panel can see both groups of States' and the CGC's points of view. We understand that a change to 'comparable' is being urged by the large States as a step in the direction of an EPC distribution and that outcome is strongly opposed by the small States. Given our analysis earlier in this Chapter, it should be clear that we do not support changes in this direction on that basis. We simply do not see an EPC outcome as a viable short or medium term position.¹⁸ However, as explained in Chapter 4, we also think the system would benefit if its governing principles were clearer and used language that better reflected the current practices.

Nevertheless, we are split on the question of whether to:

- change the wording to reflect the CGC's current interpretation and practice of HFE (on the strict understanding that it does not signal a step to EPC), or
- not change, as there is no demonstrated need.

While we have been able to reach a unanimous view on the myriad of other issues considered during the course of the Review, this question alone has eluded consensus. As a result, we neither reach a finding in support of the status quo, nor recommend change, but leave that vexed matter to the wisdom of governments.

¹⁸ For a very long term view, see Chapter 12.

4 Improving HFE system governance

While Chapter 3 dealt with issues on which States' views are fairly evenly split and reasonably entrenched, there is a greater commonality of views about aspects of the system that do not go directly to the bottom line of GST shares. All States have concerns, for example, about the governance of the HFE system.

Effective governance (along with transparency, which is dealt with in the following Chapter) is essential for public confidence in the HFE system specifically and Commonwealth-State financial relations more broadly. While the financial aspects of this relationship can lead to disharmony, sound governance arrangements go a long way to reducing tensions. Therefore, it is vital that the Commonwealth and the States work together to improve these arrangements.

Strong governance arrangements are particularly important for a policy such as HFE, where a sense of 'joint ownership' or 'buy in' from both States and the Commonwealth is essential for the policy to be effective. While a situation where the policy is entirely 'owned' by the States would clearly not be workable, it is equally undesirable for the Commonwealth to act unilaterally. The active involvement of both is essential if this policy, and its associated processes, is to be effective.

Finding 4.1

Governance arrangements for the HFE system should reflect the need for the States and the Commonwealth to act as joint stewards of the system, rather than competitors or critics.

The recommendations in this Chapter aim to strengthen the existing governance arrangements by increasing the timeliness of, and accountability for decisions, as well as improving collaboration in the processes leading up to them.¹

After briefly explaining the existing arrangements, this Chapter examines five areas in which governance arrangements could be improved, relating to:

- endorsing and promulgating the definition of HFE
- reviewing the *Commonwealth Grants Commission Act 1973*
- reviewing the implementation of HFE
- setting priorities for CGC methodology reviews
- providing guidelines for the Commonwealth Treasurer and further guidelines for the CGC to govern the exercise of discretion in certain of their decisions.

¹ Of course, proposals put forward to improve one aspect of the system may have other benefits.

4.1 Current governance arrangements

The current governance structure is set up under a combination of legislation, agreements, executive power and custom.

The CGC is established under the *Commonwealth Grants Commission Act 1973* (the CGC Act), which empowers the CGC to advise the Commonwealth Treasurer on financial assistance to allow States to function, by reasonable effort, at a standard ‘not appreciably below’ that of other States.² Under the *Federal Financial Relations Act 2009* (the FFR Act), the Commonwealth must allocate GST revenue according to State population, adjusted by a relativity determined by the Treasurer in consultation with States, having regard to the 2008 Intergovernmental Agreement on Federal Financial Relations (IGA) and any other agreements with States.

The key requirements of the IGA are that:

- the Commonwealth must distribute GST according to the principle of HFE
- the Treasurer must determine relativities based on the recommendations of the CGC.

To give effect to this latter requirement, the Treasurer issues Terms of Reference to the CGC annually, requiring it to inquire into and report on relativities for the distribution of GST revenue. Periodically (typically, once every five years) the Treasurer also issues the CGC with Terms of Reference for a methodology review. The last methodology review was commissioned in 2005 and finalised in 2010.

The IGA also:

- sets out high level criteria for determining the treatment of Commonwealth payments, subject to the judgement of the CGC and the Treasurer
- specifies that the recommendations of the CGC must be subject to discussion by the Standing Council on Federal Financial Relations prior to the Treasurer’s determination of the relativities.

4.2 Endorsing and promulgating the definition of HFE

Despite the legislation referred to above, HFE is not strictly defined in any act or agreement, so the CGC has developed its own interpretation, in close consultation with States.³ While the CGC’s definition has the implicit approval of the Commonwealth — which could reject the CGC’s advice or specify its own definition of HFE in the CGC’s Terms of Reference, but has chosen not to — it has not expressly adopted or enacted it.

2 Keen students of Chapters 2 and 3 will notice an apparent inconsistency between the wording in the current CGC Act and the CGC practice of equalising States to materially the same capacities.

3 As noted above, the CGC Act requires the CGC to provide advice on assistance to allow States to function by reasonable effort at a standard not appreciably below that of other States. However, in the early 1990s the CGC came under pressure to be more specific about what this meant. Around this time the CGC adopted something similar to the current definition in preference to the words in the CGC Act.

The Panel's first interim report said that the Panel saw merit in separating the responsibility for determining the objectives of the GST distribution from the responsibility for interpreting and implementing HFE.⁴ Blurred or overlapping accountability was identified as a problem for two reasons. First, it is generally regarded as good governance to have a degree of separation between policy development and implementation, so that one does not dominate or subsume the other. Secondly, it is difficult for the public to have confidence in a system where the goal has not been explicitly endorsed by government. It is therefore important for the Commonwealth to be clear about what HFE is supposed to achieve. In this regard, Canada's 2006 expert panel on HFE took the position that, given equalisation is paid for by federal taxes, the federal government should take responsibility for its allocation between Provinces.⁵

If the definition of HFE was to be formalised and set out in a manner independent of the CGC, this could be done in a variety of ways — through the CGC's Terms of Reference, the IGA, the FFR Act, or the CGC Act. Some of these would also appropriately reflect the stewardship role of the Commonwealth Government.

Defining HFE in the CGC's Terms of Reference

The Treasurer currently issues Terms of Reference — asking the CGC for advice on the distribution of GST and giving direction on specific issues — for annual updates and five-yearly methodology reviews. It would be a relatively simple matter to define HFE in the Terms, but doing so would mean the definition could be revisited every time new Terms were issued. While this could be restricted to the five-yearly Terms only, and it is unlikely that the definition would change regularly, the Panel has concluded that such an approach could prove unnecessarily fragile.

Defining HFE in the IGA

The IGA sets out that GST must be distributed according to HFE, but HFE is not defined. A definition could be included in the IGA, but any changes would require unanimous State support and could be subject to review every time a new federal financial arrangement was struck, or an aspect of an existing one was varied. The Panel has concluded that such an approach could prove unnecessarily contentious.

Defining HFE in the FFR Act

The FFR Act says that GST must be distributed by State population, adjusted by a relativity determined by the Treasurer, but apart from requiring the Treasurer to consult with States and make decisions having regard to the IGA, it contains little other guidance. The definition of HFE could be included in the FFR as a guiding principle. However, as the outcomes of this Act are theoretically justiciable between States, that approach may add an unnecessary degree of 'appeal' to the system, which could lead to undue delay, further complication and uncertainty.

4 GST Distribution Review, *Interim Report*, March 2012, page 132.

5 While Provinces are accountable to their residents in terms of *how* the equalisation funds are used: Expert Panel on Equalization and Territorial Formula Financing, *Achieving a National Purpose: Putting Equalization Back on Track*, May 2006, page 43, <http://www.eqtff-pfft.ca>.

Defining HFE in the CGC Act

The CGC Act empowers the CGC to advise the Commonwealth Treasurer on financial assistance to allow States to function, by reasonable effort, at a standard ‘not appreciably below’ that of other States. This description, referring to the earlier system, could be replaced with an up-to-date definition. In this case, there would be minimal risk of litigation between States since the CGC Act is about the powers of the CGC, not the distribution of GST per se.

Recommendation 4.1

The Panel recommends that the definition of HFE be set out in the CGC Act.

In reaching this recommendation it has come to the Panel’s notice that there are other inconsistencies between certain details in the CGC Act and the CGC’s current practice. Aligning the legislative framework and the practice is addressed below.

4.3 Reviewing the CGC Act

Inserting a definition of HFE in the CGC Act would provide the opportunity to thoroughly review that Act and update other sections that are no longer relevant to the current equalisation system. While a final decision on which sections to change would naturally be informed by legal advice, sections that could benefit from review include:

- The term ‘special assistance’
 - Section 5 refers to the granting of ‘special assistance’ to a State. While HFE in Australia was originally performed by means of special assistance to weaker States, the current system provides funding to all States to allow them to operate at the average standard. Given this, a term such as ‘financial grants’ or ‘financial transfers’ might be more appropriate.
- The concept of ‘applications for assistance’
 - Section 16 refers to a situation where a State makes an application for a ‘grant, under section 96 of the Constitution, of special assistance to the State.’ States no longer need to make such applications.
- The definition of ‘State’
 - Many other Acts define a ‘State’ as referring to the States and Territories, but this does not appear to be the case for the CGC Act. If this definition was included, several sections⁶ could be removed or significantly simplified.
- The remuneration and termination sections
 - Sections 8(6A) and 9 refer to the case where a former judge is appointed to the

⁶ For example, sections 5(1A), 5(2), 16A and 16B. Similarly, references to Jervis Bay Territory and Norfolk Island (sections 16B and 16C) may be able to be simplified.

CGC. This has not occurred for over twenty years. Section 9A, which requires that Commissioners' remuneration be determined by the remuneration tribunal is arguably sufficient. Section 12 should be reviewed to ensure it is consistent with termination provisions for similar bodies in other legislation.

- CGC taking evidence
 - As the CGC no longer operates along judicial lines, sections 20 to 24 referring to taking evidence from people under oath, with penalties for refusal and imprisonment for giving false evidence are no longer appropriate.

Recommendation 4.2

The Panel recommends that the CGC Act be thoroughly reviewed (by the Commonwealth in close consultation with the States) with a view to updating its provisions to bring it in line with the practice of HFE today. In particular, sections to be updated include those that relate to:

- *'special assistance' and 'applications for assistance'*
- *the definition of a State, and separate provisions for the Australian Capital Territory, Northern Territory, Jervis Bay Territory and Norfolk Island*
- *remuneration and termination of CGC members*
- *the operation of the CGC along judicial lines, such as giving evidence on oath.*

4.4 Reviewing the CGC's implementation of HFE

The Panel's first interim report said that the Panel saw merit in subjecting HFE outcomes to independent review. Defining HFE in the CGC Act would allow the CGC's recommendations to be reviewed more effectively against its Act from time to time.

Given the CGC's difficult role at the centre of a contested process, it may be useful to subject the system to some form of regular review to ensure that it is functioning as the legislated goal intends. This type of review is typically undertaken by the Australian National Audit Office (ANAO) in the form of a performance audit.⁷ While the selection of audit subjects is a matter for the Auditor-General, the Commonwealth Government could request that the CGC be considered for the ANAO's performance audit program.

Recommendation 4.3

The Panel recommends that the Commonwealth formally request the Auditor-General to consider conducting an audit of the CGC's administration of HFE within three years of the implementation of the outcomes of this Review, or following the next methodology review, whichever comes first.

⁷ See ANAO website: http://www.anao.gov.au/uploads/documents/Performance_Auditing.pdf.

4.5 Setting priorities for future methodology reviews

As noted earlier, the CGC is instructed by the Treasurer to conduct reviews of its methodology for determining GST shares, typically every five years.

At each methodology review, decisions on which assessments should be re-examined need to be made. Currently, that decision is made by the CGC after it has consulted with the States. However, the CGC regularly faces pressure to re-examine more assessments or disabilities than may be necessary — usually resulting in virtually everything being reviewed — so as not to be seen to be favouring any State’s preferences.

If all assessments and disabilities — irrespective of their effect, or the likelihood that the underlying circumstances have changed — are re-examined at each review, it can result in a lack of focus, given the available resources. Reviews that cover all assessments and disabilities can create large workloads for the CGC and States, with limited return.

In addition, re-examining all assessments and disabilities can lead some to think that this occurs because they are all problematic, or need to be changed. While this is not the case, it would reduce an element of misunderstanding of the process if the CGC was more clearly empowered to prioritise its agenda. A greater focus by the CGC on the most important assessments and disabilities would lead to greater confidence in the CGC’s assessments and the outcomes these assessments produce.

Dealing with late emerging issues

Consultation is an important aspect of the CGC methodology review processes. The CGC consults with States on many aspects of the system, from determining what assessments and disabilities should be re-examined, through the methods to assess differences between States, to the appropriateness of particular datasets.

Input from States is important to develop more robust assessment methods, as States know about proposed changes to their policies and whether data that may affect the CGC’s methods is available. However, for States to provide considered input to CGC methods, adequate time for examination of issues is required. This can prove difficult when important issues emerge towards the end of the set review period. Therefore, where significant issues emerge close to the end of a review, the CGC ought to be able to ask the Commonwealth to allow it to separate that particular issue from the rest of the methodology review (so as not to delay the bulk of the review work). The CGC would report on all other issues in the timeframe set out in the Terms of Reference, but be given an extension (of say a year) to address the emerging issue.

Recommendation 4.4

That the CGC be given clear authority to identify the assessments it regards as high priority for re-examination in the review and determine which lower priority assessments should be deferred until a future review.

Where significant issues arise late in a review, the CGC should be able to seek an extension from the Commonwealth for that element, to ensure there is adequate time for consultation.

4.6 Providing further guidelines for the Treasurer and CGC

Guidelines for the Treasurer on consulting with the States

Under the FFR Act, the Treasurer must consult the States prior to determining the relativities. This usually occurs via a meeting of all Treasurers in March or April each year (currently called the Standing Council on Federal Financial Relations). The Treasurer also consults with States on the Terms of Reference for the CGC's annual update, however consultation on the Terms is often less formal than on the relativities.

Concerns have been raised by States that the time allowed for consultation on the Terms of Reference is too brief, and that all matters are not always included in the draft. The joint large States' submission argues that the 'marginalisation of effective State involvement in the system weakens State 'ownership' and support.'⁸ The Victorian submission goes further, suggesting that the Terms for the CGC's annual updates and reviews should be subject to agreement between Commonwealth and State Treasurers.

Given the importance of consultation on the Terms of Reference (as the relativities once calculated are almost always adopted), it seems reasonable to expect the Treasurer to allow States an adequate period to raise any concerns with the draft. While requiring unanimous agreement might not be practical, a more robust system of consultation on the Terms of Reference should go some way towards addressing State concerns.

Further on the consultation theme, while negotiation on draft Terms of Reference between the Treasurer and the CGC actually begins well before the Update, on occasions the CGC has only formally received the final Terms of Reference shortly before the Update is released.⁹ In the interests of transparency, the Terms of Reference should be finalised well before the Update is due.

Recommendation 4.5

That the Treasurer develop and publish guidelines governing consultation with the States along the following lines:

- *In consulting with the States in relation to the draft Terms of Reference for a CGC annual Update, the Treasurer shall:*
 - *finalise draft Terms of Reference by early November of the year prior to which the Update applies*
 - *allow a minimum of three weeks consultation by States on the draft*
 - *ensure all key elements are included in the draft provided to States*
 - *provide final Terms of Reference to the CGC by, at the latest, the end of December of the year prior to which the Update applies.*

8 Joint Submission by the States of New South Wales, Victoria, Queensland and Western Australia to the GST Distribution Review, August 2012, page 7.

9 For example, the covering letter to the CGC's 2011 Update demonstrates that the Terms of Reference and the Update were both provided on 15 February 2011.

Guidelines to be followed by the Treasurer when determining the treatment of Commonwealth payments

The Treasurer has the power to ‘quarantine’ Commonwealth payments from HFE calculations. Quarantining has the effect of removing payments from the calculation of fiscal capacity — benefiting the State that receives the payment by effectively allowing it to keep the full value of the payment rather than losing the equivalent of all but its population share in GST, while still giving it a population share of non-quarantined payments made to other States. This one-sided result brings great scrutiny and controversy to bear on quarantined payments. If no payments were quarantined, each State would effectively end up with its population share of every Commonwealth payment, no matter which State it was paid to.

While few payments are quarantined in practice, a decision to quarantine can have a material impact on the total Commonwealth funding a State receives — particularly in the case of a large payment to a small State.

The CGC also makes decisions on whether to include or exclude particular Commonwealth payments from the assessment of State fiscal capacity. Even if the Treasurer has decided not to ‘quarantine’ payments in the CGC’s annual Terms of Reference, the CGC can itself decide to ‘include’ or ‘exclude’ it from the process.

As part of the 2010 review, the CGC published guidelines outlining how it makes decisions on whether to include or exclude Commonwealth payments from the calculations. While inevitably leaving some judgment to the CGC, these guidelines are a valuable aid to transparency. The guidelines clarify that, while most payments will be included (as they are an important source of budget support for States), certain categories will generally be excluded, including:

- payments made ‘through’ States to other entities
- the purchase of services by the Commonwealth
- expenditure needs that are not able to be assessed
- where the Commonwealth distribution is assumed to reflect States’ needs.¹⁰

Given the CGC has public guidelines relating to its decisions to exclude, the question naturally arises — should there be similar guidelines for the Treasurer?

At present, the Treasurer has not established (or at any rate, has not published) any guidelines or principles governing the treatment of payments. The development and publication of such guidelines would aid transparency, and may also improve predictability (by making it clear to States when a payment would, or would not, be expected to be quarantined). At the very least, it would remove a point of understandable irritation for the States — who sometimes view the Treasurer’s decisions to quarantine a payment as arbitrary and unpredictable.

¹⁰ See *Supporting Information – Treatment of Commonwealth payments for the 2012 Update*, available on the CGC’s website.

While the final adoption of any guidelines will inevitably be left to the Treasurer and COAG, ideally, guidelines would make it clear that Commonwealth payments:

- would only be quarantined as the exception (not the rule)
 - As Commonwealth funds are a large source of general budget support for States, quarantining significant amounts would undermine the policy of HFE.
- should only be quarantined for reasons not considered by the CGC
 - Obvious circumstances where exclusion or quarantining is appropriate are already covered by the CGC (such as when payments are made ‘through’ the States to separate entities). To avoid duplication, and because the CGC is best placed to make decisions in these circumstances, the Treasurer should not seek to quarantine payments for reasons already considered by the CGC.

As a result of later recommendations in this report, payments for national network roads and rail-based transport infrastructure need no longer be considered by the Treasurer for quarantining purely on the basis of part national economic benefit, as this should now be done by the CGC as a matter of course.¹¹

While this approach largely reflects the practice now, the benefit of issuing public guidelines would be to make this practice explicit and transparent.

Recommendation 4.6

That the Treasurer develop and publish guidelines governing the quarantining of Commonwealth payments, along the following lines:

- *The Treasurer shall only quarantine payments to States on an exceptions basis, recognising that most payments are properly included in the HFE process. Exceptions that may warrant quarantining a payment include:*
 - *where a payment is made solely and expressly for the purpose of allowing a State to temporarily provide above average services in a particular area*
 - : *in particular, where a payment is made for the purpose of allowing a State to provide above average services to address Indigenous disadvantage.*
- *The Treasurer shall avoid quarantining payments for reasons already considered by the CGC, including where:*
 - *the payment is being made ‘through’ the State to a third party*
 - *the payment is a purchase of services by the Commonwealth*
 - *the Commonwealth distribution is assumed to reflect States’ needs*
 - *the relevant expenditure needs are not able to be assessed.*

¹¹ See Chapter 6.

Timing of decisions on the treatment of Commonwealth payments

The current process does not require a timely decision on the treatment of Commonwealth payments either by the Treasurer or the CGC, as a decision is only required once the payment enters an ‘assessment year’. In some instances, this can result in a delay of several years between when the payment is announced and when States finally know how the payment will be treated.

This delay can cause unnecessary uncertainty for States, especially because in many cases a decision would be a fairly straightforward matter for both the Treasurer and the CGC. As an example, consider a hypothetical payment of \$100 million to State X announced by the Commonwealth in the 2010-11 Budget (handed down in May 2010), to be made in the year 2012-13. The CGC’s calculations are based on three assessment years. The first time that 2012-13 will become an assessment year is in the 2014-15 annual Update. As this Update would not be released until February 2014, no decision on the treatment of the payment would occur until then — almost four years after the payment was announced.

Of course, where a payment is announced only shortly before it is actually paid to a State, the delay will not be as long. Nevertheless, there could still be an unfortunate element of retrospective characterisation of the payment required. While most States are alert to this and seek to establish the HFE treatment at the time of negotiating the payment, surprises (or the risk of them) can be minimised by requiring both the Treasurer and the CGC to make and announce their decisions earlier.

Treasurer’s decisions

As the Treasurer should determine whether or not to quarantine a payment based on much the same information needed to decide to make it in the first place, he or she should be in a position to announce their decision on quarantining when the payment is first announced (which will often be in the Commonwealth Budget or mid-year budget update). In the event that some negotiation with a State is required over details of the payment, some delay may be required, but this should be short.

While there might be political pressure for the Treasurer to delay the announcement or, having made it, later revisit it before the year of first receipt becomes an ‘assessment year’, the pressure to abide by the published guidelines may mitigate this risk.

Recommendation 4.7

That the Treasurer develop and publish guidelines governing the timing of decisions relating to quarantining of Commonwealth payments, along the following lines:

- *In relation to the timing of decisions on quarantining Commonwealth payments, the Treasurer will announce whether or not he or she intends to quarantine a payment as soon as the payment is announced, or as soon as practicable after the announcement.*

CGC's decisions

The CGC, on the other hand, cannot be expected to make a decision on the treatment of a payment until sufficient information on the nature of the payment is available to it. In some cases, where national partnerships and implementation plans are required to be developed, this may take six months or longer.

Where payments are announced in the Commonwealth Budget (usually handed down in May), if it is assumed that six months is required for the details of the payment to be worked out, a CGC decision on these payments could then practically be sought by the following February (when the next CGC Update is released). This would allow nine months from the announcement of the payment to the publication of the CGC's decision on treatment. As such, the Panel considers that the CGC could reasonably be asked to make and publish its decision on Commonwealth payments in the normal course in the Update immediately following the Budget in which the payment is announced.¹²

Where a payment is announced outside of the Budget, the CGC should follow a similar procedure — it should explain in its Update why it has not been able to make a decision, and publish a decision as soon as sufficient information becomes available.

Recommendation 4.8

That the Treasurer instruct the CGC to make a decision on the treatment of all new Commonwealth payments in its Update immediately following the Budget in which the payments are first announced, or as soon as practicable thereafter.

Where a decision to make a payment to a State is announced outside of the Budget, the CGC should make and announce its decision on treatment of that payment within six months of the payment being announced or, where this is not possible due to the details of the payment not being finalised, as soon as practicable after payment details are finalised.

¹² Of course, in those (hopefully rare) cases where the details of the payment are not yet worked out sufficiently before the February update, the CGC may have to postpone its decision. In these cases, it should publish its reasons for not making a decision (including what information or detail of the payment is required to enable it to make a decision) and should then publish its decision as soon as this information is available.

5 Improving communication and transparency

Effective communication and transparency of process are essential for public confidence in the HFE system (and federal financing relations more broadly). The recommendations in this Chapter aim to improve the understanding of the way aspects of the HFE system are explained and communicated, thus increasing the transparency of the process and confidence in the system. The Chapter considers four proposals for enhancing communication and transparency, relating to:

- clarifying the presentation of relativities
- clarifying or improving the projection of relativities
- broadening the engagement of the CGC
- improving the interaction between HFE and Payments for Specific Purposes (PSPs).

5.1 Clarifying the presentation of relativities

The Panel's first interim report noted that headline relativities — the ratio that determines the share of the GST pool for each State — drive much of the current debate about HFE. Too much focus on the relativity number can lead to misleading conclusions. For example, from time to time, various commentators have referred to a relativity of less than 1.0 as meaning that a State was 'getting back only x cents of the dollar of the State's GST', or made similar statements. As explained in the Panel's first interim report, there is practically no way (and indeed no reason) to link any State's share of GST with the proportion of tax paid by residents of that State or consumption within it.¹

Moreover, the headline relativities are only one way of representing the Commonwealth support to States and, at times, they can distract attention from the underlying issues of why States' fiscal capacities differ, and how best to measure their relative capacities.

While the public debate seems to focus on relativities, the CGC has moved in recent years to give more prominence to GST shares (see Table 5.1 which is reproduced from the CGC's press release for the 2012 Update). The CGC also gives a more comprehensive presentation in the appendices of its annual Update report that explains the calculation of relativities for each assessment year (these assessment year relativities are then averaged and applied to the application year GST pool).

1 GST 'paid' by residents of any State will be formally remitted by the business that levied it and, in the case of large national businesses, will typically occur centrally. Similarly, States with large proportions of their Gross State Product as GST-free exports will have low net GST shares. See GST Distribution Review, *Interim Report*, March 2012, page 17.

Table 5.1: CGC headline presentation of the 2012-13 GST relativities

	Relativities used for 2011-12	Relativities recommended for 2012-13	2011-12 share	2012-13 share
			%	%
NSW	0.95776	0.95340	30.9	30.7
VIC	0.90476	0.92135	22.5	23.0
QLD	0.92861	0.98506	18.9	20.1
WA	0.71729	0.55135	7.5	5.8
SA	1.27070	1.28491	9.3	9.3
TAS	1.59942	1.58105	3.6	3.5
ACT	1.11647	1.18058	1.8	1.9
NT	5.35708	5.52844	5.5	5.7

Source: CGC 2012 Update, Chairman’s Press Release.

The Commonwealth Budget also presents GST payments in dollars above its presentation of relativities and the 2012-13 Commonwealth Budget included a feature box that calculates relativities based on total Commonwealth payments (see Table 5.2).

Table 5.2: Commonwealth calculation of combined Commonwealth payment relativities

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Relative share of total payments	0.94	0.93	0.98	0.88	1.16	1.33	1.07	3.93
CGC determined GST relativity	0.95	0.92	0.98	0.55	1.28	1.58	1.20	5.53

Source: Budget Paper 3, 2012-13 Commonwealth Budget, Table 3.7.

In our first interim report the Panel sought comments on whether it might be better to present outcomes in dollar terms, or to calculate relativities based on the entire pool of Commonwealth support. The general view seems to be that there could be improvements, but there is little to be gained from reporting dollars rather than relativities. The better path therefore seems to be ensuring that the relativities tell the right story and are not presented in such a way as to mislead the unwitting.

The Northern Territory has argued that relativities result in misunderstandings about the GST distribution, such as that any State with a relativity below one was receiving less GST than it paid, or that its relativity of 5.53 meant that it spent over five times more than other States. Table 5.3 shows one of the alternative presentations suggested by the Northern Territory to deal with these concerns.

Table 5.3: Second Northern Territory alternative presentation of the 2012 Update GST relativities

	Estimated 31 December population	Expenditure ratio	Expenditure requirement	State own-source revenue	Tied Cwith payments	Share of GST pool
	No.		\$m	\$m	\$m	\$m
NSW	7,424,410	0.97212	60,761	30,080	15,886	14,796
VIC	5,749,634	0.92320	44,687	22,190	11,424	11,073
QLD	4,694,804	1.02416	40,479	20,344	10,468	9,667
WA	2,427,901	1.05846	21,635	13,691	5,147	2,797
SA	1,679,657	1.02368	14,475	6,026	3938	4512
TAS	515,633	1.10366	4,791	1,764	1,323	1,704
ACT	374,663	0.96802	3,053	1,394	721	938
NT	234,782	2.32888	4,603	946	944	2,714
Total	23,101,484	n.a.	194,484	146,284	49,850	48,200

Source: Northern Territory submission on the GST Distribution Review interim reports, July 2012, page 82.

The key feature of this alternative is that it calculates *expenditure ratios* rather than GST relativities. These expenditure ratios are much less divergent than GST relativities because the GST pool is only around a quarter of total State spending and the differential needs calculated by the CGC are a much larger proportion of the GST pool than they are of total State expenditure. This presentation illustrates how there can be large differences in the presentation of relativities although outcomes do not change.

Despite the attraction of some aspects of this approach, given the CGC is asked to make recommendations on the distribution of GST revenue, it seems difficult to justify reporting only an expenditure ratio.² For that reason, replacing GST relativities entirely could be seen as ‘smoke and mirrors’. An alternative would be to clarify what relativities mean and provide the proper perspective of Commonwealth payments in total.

The CGC should therefore take an approach similar to that of the Commonwealth, by publishing relativities based on GST payments plus other Commonwealth support in the application year. The CGC already publishes the ‘total requirement for assistance’ for each individual assessment year.³ The CGC could calculate relativities based on these figures and average them for the application year (for example, see Table 5.4).

Table 5.4: Per capita relativities based on ‘total requirement for assistance’

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Per capita relativities based on total requirement for assistance									
2008-09	0.96413	0.93362	0.96977	0.86819	1.16928	1.34318	1.02036	3.61623	1.00000
2009-10	0.96332	0.92226	1.02741	0.83197	1.16987	1.32000	0.99263	3.24942	1.00000
2010-11	0.97950	0.91092	1.04770	0.67967	1.17058	1.40474	1.08087	3.84983	1.00000
Assessed relativities	0.96898	0.92227	1.01497	0.79328	1.16991	1.35597	1.03129	3.57183	1.00000

Source: Secretariat calculations based on CGC 2012 Update, Attachment C

² Another problematic feature of the Northern Territory’s alternative presentations are that they include information on expenditure needs, own source revenue and other Commonwealth payments, rather than just GST payments. The problem with this approach is that the information used to derive these figures is based on assessment years (and is therefore up to five years out of date).

³ See, for example, tables C2, C5, C8 on pages 114-117 of the 2012 Update.

Recommendation 5.1

The Panel recommends that:

- *the CGC clarify that relativities do not represent a State's share of the GST collected within its borders or from its residents*
- *when publishing the GST relativities, the CGC also show relativities based on total Commonwealth assistance*
- *the Commonwealth continue to publish relativities based on total Commonwealth assistance in its budget papers.*

5.2 Clarifying or improving the projection of relativities

The unpredictability of GST payments has been a recurring theme through the course of this Review. One element of unpredictability stems from the process around projecting GST payments for future years. Robust projections would enable States to plan their budgets properly, and could improve everyone's understanding of how and why GST payments change over time.

A State's GST payment in any given year is determined by three things: the total GST revenue collected for that year, the State's share of the Australian population and the State's relativity (which adjusts the population share to account for States' differing fiscal capacities). This Chapter focusses on concerns raised in relation to the estimation of the third element — GST relativities.

As estimates of the GST shares are communicated to States in advance of them being final — States need to know how much they have to spend before the time to spend it commences, to budget properly — each of these elements have to be estimated in some way. Future estimates are essentially of two types:

- 'forecasts' are made for the immediate future year as accurately as possible
- 'projections' are made for the years following that, based on set assumptions, and known changes, but do not seek to predict things that might change.

Thus, while forecasts are effectively the forecaster's best efforts at predicting what will happen, projections aren't. Understandably, accuracy is not sought in the same way for projections as it is for forecasts.

Estimated GST collections are reported in the Commonwealth budget papers as forecasts for the first year, and projections for the remaining three years of the forward estimates period. Population estimates are projected for all four years, with relevant assumptions detailed in the Commonwealth's Budget Paper 3.

Current situation

The Commonwealth calculates relativity projections for the three out years in the forward estimates period⁴ and publishes these in its annual Budget papers.⁵ These projections are very simple and make no allowance for fiscal capacity changes.⁶

Essentially, the Commonwealth takes the assessed needs for the latest assessment year and assumes these remain constant in future years. It does, however, allow the three year averaging process to ‘flow through’ (see Table 5.5 for an example, using projection years from the 2012-13 Budget).

Table 5.5: Commonwealth projection method

Application year	Calculation method	Needs are an average of assessment year needs for...
2011-12	CGC calculated	2007-08, 2008-09, 2009-10
2012-13	CGC calculated	2008-09, 2009-10, 2010-11
2013-14	Commonwealth projections	2009-10, 2010-11, 2010-11
2014-15	Commonwealth projections	2010-11, 2010-11, 2010-11
2015-16	Commonwealth projections	2010-11, 2010-11, 2010-11

While States may project their relativities, only a few publish these projections. Some States publish projected grant shares (but not relativities) and some just adopt the Commonwealth projections.

There are two key concerns with the current situation, first that there is confusion around the purpose and intended accuracy of the Commonwealth projections and secondly, that all GST projections (both Commonwealth and State) are not as accurate as they could be, or should be.

Confusion around the Commonwealth projections

As foreshadowed above, the Commonwealth projections of GST shares can create confusion (with readers incorrectly believing them to be reasonably accurate forecasts). Some stakeholders mistakenly think the Commonwealth projections are reliable forecasts, rather than simple projections. For example, a report from a recent Victorian Public Accounts and Estimates Committee noted that the Victorian budget had different projections for GST payments compared to the Commonwealth.⁷ The discussion in that report suggests it was not immediately clear to the Committee that the Commonwealth numbers were based on simple ‘technical’ assumptions, such as that capacities would remain unchanged, whereas the Victorian numbers were likely based on Victoria’s own estimates of the effects of known and likely capacity changes.⁸

4 The CGC provides the relativities for the first year in its annual Update.

5 Commonwealth Government, 2012-13 Budget Paper 3: Federal Financial Relations, Part 3.

6 For an explanation of the methodology used by the Commonwealth see Commonwealth Government, 2012-13 Budget Paper 3: Federal Financial Relations, page 123.

7 See page 50 and 51 of the report:
http://www.parliament.vic.gov.au/images/stories/committees/paec/2012-13_Budget_Estimates/Reports/111_-_Part_Two_FINAL.pdf

8 The Australian, September 13 2012, ‘Big Budget Hole for Victoria’.

GST payments could be more predictable

Concerns have also been raised that the forward estimates of GST payments are not as accurate as they could be. Clearly, improving the quality of the estimates would be in the interests of all State governments. It would improve the predictability of State GST payments and allow for better budget planning.

It is worth noting here that GST relativities are probably always going to be difficult to estimate with any great degree of accuracy. State fiscal capacities are influenced by variables such as global commodity prices, the exchange rate, property booms and natural disasters and the relative nature of the system means that what is important is one State's situation compared to the others, rather than absolutely. To the extent that these variables are difficult to predict so too will GST relativities be. It is also worth noting that much of the unpredictability in GST payments comes from inaccurate estimates of future GST pools, rather than from the apportionment of State shares.⁹

Possible ways to improve projections

The Panel has considered four broad approaches to improving GST share projections:

- improving the Commonwealth estimates, by turning them into reliable forecasts
- improving the understanding of Commonwealth estimates and their use and purpose
- encouraging States to share their projections with each other and/or the Commonwealth
- asking the CGC to project relativities for the forward estimates period.

Each of these is examined below for practicability and the likelihood that they will improve understanding or predictability.

Improving Commonwealth projections

While the Panel has considered recommending that the Commonwealth examine how to improve its projections, we have concluded that this may not be very practical. First, some calculations rely on State data (which States may or may not be willing to provide to the Commonwealth). Secondly, if assumptions or calculations of future State capacity are *wrong*, the resultant estimated relativities could be even more inaccurate than the present simple projections. Given the difficulty of predicting relativities (for reasons discussed above), this is a material risk.

Further (and more importantly), if the Commonwealth were to forecast relativities in earnest, this might be perceived as somehow prejudicing future CGC decisions. While the CGC recommended relativities are almost always accepted, they are still only recommendations — it is the Commonwealth Treasurer who formally determines the relativities under the relevant legislation.

⁹ Commonwealth estimates of total GST are reported in Budget Paper 1: Statement 5, page 5-23.

Improving the understanding of the Commonwealth projections

While the Commonwealth Budget papers do state that the relativities are based on simple projections, this could arguably be made clearer. Indeed, given the simple nature of the Commonwealth projections, it is questionable whether they should be included at all. They do not greatly assist with predictability of GST payments for States, and possibly cause confusion.

If the Commonwealth continues to publish these projections, it should make their limitations clear and explicit, and consider publishing each of the three year annual relativities (to show how the average is reached, highlighting the simple nature of the projections). While neither ceasing publication of projections nor explaining the nature of those projections more clearly would improve the predictability of GST payments as such, both these options would at least reduce the risk of confusion.

Recommendation 5.2

That the Commonwealth should either cease publication of the GST relativities for out years in the forward estimates period or very clearly explain the nature of the projections in the Budget papers.

Asking the CGC to project relativities

Given the nature of projecting relativities, and the similarity to the job of recommending relativities, the Panel has considered recommending that CGC be asked to do it.

The CGC certainly has the necessary expertise, but has been reluctant to engage in projecting relativities in the past. Further, if the CGC were to project relativities, it may create pressure for it when it subsequently recommends relativities that differ from those projected. There is a risk that this additional task may compromise its ability to effectively perform its primary task — that is, recommending actual relativities.

Encouraging States to share projections

While forecasting relativities is always going to be difficult, States are probably best placed to project their own relativities. A State is probably more likely to be able to predict (for example) its future revenue collections than anyone else. However, as a State's relativity is a function of the fiscal capacity of other States as well as its own, sharing of information between States would greatly improve the quality of all State projections. Therefore, States should be encouraged to provide information to a central point of contact (either the Commonwealth, or a nominated State) for the purposes of calculating a joint forecast of GST relativities. The model developed by the Secretariat to this Review could be a starting point to developing a more sophisticated joint forecasting tool.¹⁰ Relevant information is often collected and prepared as part of usual State Budget processes, which generally happen twice a year. As such, it would seem sensible for information to similarly be provided to other States on a bi-annual basis.

¹⁰ The Secretariat to this Review developed an estimating tool to assist the Panel's consideration of various options. The estimating tool, covering the period from 1992-93 to 2015-16, provides a baseline against which the effects of high level changes to the HFE system can be modelled. The tool was developed with advice from Heads of Treasuries and circulated to State officials in July 2012.

The provision of information by the Commonwealth could also assist States to better forecast their GST payments. As Commonwealth payments influence relativities, the Commonwealth should provide information on future Commonwealth payments, both NPPs and SPPs and at a State level. Information should be provided on which parts of these payments are going ‘through’ States (e.g. to non-government schools or local government) and so will not affect relativities.

Recommendation 5.3

That, to enable more accurate forecasting of relativities, States provide the following information to all other States bi-annually:

- *revenue estimates for the next four years, by revenue line, with details in line with CGC assessments*
- *details of the impact of announced policy changes on revenue estimates and*
- *expenditure estimates for the next four years, by CGC assessment category.*

The Commonwealth should ensure it provides the States, on a bi-annual basis:

- *GST pool forecasts/estimates for the next four years*
- *SPP pool forecasts/estimates for the next four years*
- *Other PSP forecasts/estimates, by State, for the next four years.*

5.3 Broadening the engagement of the CGC

The Panel’s first interim report noted that another step to increase understanding of the HFE process would be for the CGC to play a more active role in educating those outside the various State Treasuries about the principles by which GST is distributed.¹¹

The CGC already provides public access to information about its deliberations and processes, including the rationale for equalisation. For example, the CGC produces an Update report each year to coincide with the release of the recommended relativities for distributing GST revenue, and the Chairman of the CGC and other staff make presentations at conferences, educational institutions and to politicians as requested.

Nevertheless, the CGC does not actively seek to promote understanding of HFE within the States outside of the various Treasuries. A more widespread program of engagement (with States and the public) may help to ensure that equalisation principles are better understood by politicians and throughout the bureaucracy, with the result that the GST distribution process is more widely supported.

Increased engagement by the CGC could occur in various ways. For example, the CGC Chairman could provide an annual public address following the release of the year’s relativities. Annual briefing sessions could also be provided for Commonwealth and

11 GST Distribution Review, *Interim Report*, March 2012, pages 133-134.

State parliamentarians (including non-Treasury ministers and shadow ministers), with staff briefings for State non-Treasury officials.

Finally, the tabling of each Update Report in Commonwealth Parliament and an explicit opportunity for the Commissioners to face questions on the Report before an appropriate Parliament Committee of the Senate (the ‘States’ House’) may help improve understanding, accountability, and scrutiny of the CGC’s decisions.

Recommendation 5.4

That the CGC engage with governments more broadly. Expanded engagement activities should include:

- *an annual public address following the release of the year’s relativities*
- *briefing sessions for State and Commonwealth parliamentarians (including non-Treasury ministers and shadow ministers)*
- *staff briefing for State non-Treasury officials*
- *appearance by Commissioners before an appropriate Senate Committee.*

5.4 Improving the interaction between HFE and Payments for Specific Purposes (PSPs)

As explained in the Panel’s first interim report, where States and the Commonwealth have agreed a formula for allocation of PSPs, this formula may or may not ‘stick’ if the payments are included in the equalisation system.¹² It would therefore be desirable to have some greater clarity of the role of HFE in relation to Commonwealth PSPs.

Payments for Specific Purposes

The Commonwealth makes two types of PSPs to the States:

- National Partnership Payments (NPPs)
 - comprising facilitation, project and reward payments
- National Specific Purpose Payments (SPPs)
 - in respect of key service delivery sectors and comprising funding for healthcare, schools, skills and workforce development, disability services and affordable housing.

¹² GST Distribution Review, *Interim Report*, March 2012, page 83-84.

Treatment of PSPs under the Intergovernmental Agreement (IGA)

The treatment of PSPs in the HFE system is described in Attachment D of the IGA on Federal Financial Relations.¹³ It says:

National SPPs, NHR [National Health Reform] funding and National Partnership project payments will be treated by 'inclusion', recognising that these payments provide the States and Territories with budget support for providing standard state and territory services ...

National Partnership facilitation and reward payments will be treated by 'exclusion' so that any benefit to a State or Territory from achieving specified outputs sought by the Commonwealth, or through implementing reforms, will not be redistributed to other States or Territories through the horizontal fiscal equalisation process...

Notwithstanding [the above] and following consultation involving the Commonwealth and the States and Territories ... the Commonwealth Grants Commission may treat, on a case by case basis, any National Partnership payment differently if it considers that such treatment is more appropriate ...

The IGA allows for the Commonwealth Treasurer to direct the CGC on the treatment of a National Partnership payment through Terms of Reference, if he considers such treatment is appropriate. Where it occurs, a direction is usually to exclude the payment from the HFE system, and is referred to as quarantining the payment.¹⁴

The Terms of Reference for the 2012 Update essentially restated the treatment as described in the IGA. In addition, they made clear that NPP reward payments should not influence the relativities (that is, they are excluded).

The CGC's approach

The CGC determines the treatment of each Commonwealth PSP on a case by case basis. In doing so, the CGC follows its set of guidelines for dealing with Commonwealth payments, developed in the 2010 Review.¹⁵ Around two-thirds of Commonwealth PSPs are taken into account by the CGC when calculating the GST distribution.

In summary, exceptions under the CGC's guidelines include:

- as specified by the Commonwealth Treasurer in Terms of Reference
- payments made 'through' States to other entities
- purchase of services by the Commonwealth
- if expenditure needs are not able to be assessed
- instances where the Commonwealth distribution is assumed to reflect State needs.

¹³ *Intergovernmental Agreement on Federal Financial Relations*, Schedule D Payment Arrangements paragraphs D66 to D67.

¹⁴ Guidelines for the Treasurer in identifying possible payments to quarantine are discussed in Section 4.6.

¹⁵ CGC, *Report on GST revenue sharing relativities — 2010 Review*, volume 1, chapter 5, pages 79-80.

National Partnership Payments (NPPs)

Under the current approach as described in the IGA, States have an incentive to have NPPs considered to be facilitation payments, as there are no GST consequences in receiving these payments. In practice, differentiating between project and facilitation NPPs has been problematic and unhelpful in determining the appropriate treatment for these payments.

A way forward for NPPs that is more transparent and reduces uncertainty is to have facilitation NPPs included in the HFE system by default. The result of this would be that, unless exempted, all NPPs (except rewards) will affect relativities. Exceptions would be as per the current CGC guidelines, that is:

- quarantined payments
- reward payments
- other payments the CGC determines should not affect the relativities.¹⁶

Recommendation 5.5

The Panel recommends that, apart from the listed exceptions, all National Partnership Payments should affect the relativities.

The exceptions are:

- *payments quarantined by direction of the Commonwealth Treasurer*
- *reward payments*
- *payments otherwise determined by the CGC following its guidelines that should not affect the relativities (COPEs, needs not assessed and so on)*
- *certain capital payments for transport infrastructure (see Chapter 6).*

Duelling policy priorities for national SPP allocations

The Commonwealth provides National Specific Purpose Payments (national SPPs) to the States and Territories as a financial contribution to support State and Territory service delivery in major service sectors. National SPPs affect the relativities and consequently State shares of GST revenue. While the inclusion of national SPPs in the HFE system is uncontroversial, a consequence is the potential for duelling allocations across States, between the historical Commonwealth allocations of national SPPs and the CGC's assessment of relative State needs in the major service delivery sectors. In the HFE system, the CGC's assessment of needs may overturn the Commonwealth's allocation.

In recognition of this potential duelling allocation effect, the 2008 IGA outlined a move over a transition period toward allocating national SPPs on a State population share

¹⁶ The treatment of capital payments for transport infrastructure is discussed in Chapter 6.

basis (an EPC allocation).¹⁷ The effect of this was to remove any differential allocation by the Commonwealth, so that the CGC's assessment of requirement was effectively the only one applied. The CGC operationalised this by using the application year share of national SPP allocations in the assessment years.¹⁸

Recent reforms affecting the payment of national SPPs, in particular the replacement of the national healthcare SPP by National Health Reform (NHR) funding from 1 July 2012 (and possibly future national reforms), mean that the moves in the 2008 IGA to remove 'dual allocation' of national SPPs may be overtaken.

Under the National Health Reform Agreement (NHRA), the majority of the Commonwealth's funding for public hospital services will be provided under activity based funding (ABF) arrangements, rather than the block grant basis used previously. After a transition period as the new approach evolves, it is likely that national health reform funding will not be allocated across the States on a population share basis. The Panel can speculate that if other national reforms come fully into being, for example for schools funding and the National Disability Insurance Scheme (NDIS), it is likely that the allocation of national SPPs for schools and disability services will no longer reflect student enrolments and population shares respectively.

A national reform usually seeks to achieve specific outcomes through policy changes, for example, more cost efficient delivery of health services. Funding arrangements in agreements for reforms reflect changes required in order to achieve these desired outcomes, for example, the move from block funding to ABF for health services. As national reforms become more pervasive, there may be ambiguity about which policy — national reform or equalisation — has primacy.

The CGC's approach

Where it has the discretion, the CGC follows its directions and principles, which generally lead to HFE outcomes taking precedence (unless the direction in its Terms of Reference states otherwise), in particular where the CGC determines that the payments fund normal State services — such as health services. The CGC adjusts GST shares to effectively reallocate payments to States so as to align with the CGC's assessment of 'needs'. Further, the CGC considers average, not efficient, costs.

A way forward for national SPPs (resolving the duel)

If nationally agreed reforms do capture both relative State use and cost aspects of need, then arguably no separate CGC assessment is required and the relevant national SPP could be excluded from the HFE system. For example, the proposed Gonski reforms may capture both use (student enrolments) and cost (certain classes of higher cost students) influences. That is not to say that the allocation across States is the same as what the CGC would arrive at, but that a common policy is applied across States that might recognise certain drivers of spending.

17 In the case of the government schools component of the National schools SPP, the relevant population will be each State's and Territory's share of full time equivalent student enrolments in government schools. The distribution of the non-government schools component of the National schools SPP will be determined in accordance with the Schools Assistance Act 2008.

18 CGC, *Report on GST revenue sharing relativities — 2010 Review*, volume 1, chapter 5, page 81.

On the other hand, if the reforms capture only one aspect of drivers of spending, there is still some work for the CGC to do. For example, health activity based funding reforms capture cost influences, but not relative demand (use) influences.

Recommendation 5.6

The Panel recommends that, when finalising future national reform agreements, the Commonwealth and States clearly state whether the payments (or part thereof) should be included or excluded from the HFE process. This statement should be reflected in the relevant national reform agreement and the corresponding words repeated in the IGA and relevant CGC Terms of Reference.

6 Greater stability of GST shares and methodology improvements

Along with the need to improve the frameworks for governance, communication and transparency of process covered in Chapters 4 and 5, a number of other issues have been put to the Panel, or have arisen indirectly out of our inquiries. Apart from mining (which is dealt with in Chapter 7), the most significant of these relate to concerns about the instability of GST shares as a side effect of decisions of the Commonwealth to fund large infrastructure projects in various States, and methodology changes and data revisions by the CGC.

Although methodology issues are rightly left to the wisdom of the CGC, the Panel has considered that two issues raised with us are worthy of being highlighted, for the CGC's future consideration.

6.1 The treatment of Commonwealth capital payments

This section discusses a rationale and approach for the future HFE treatment of capital payments from the Commonwealth, and makes recommendations relating to capital payments for road and rail based transport infrastructure in particular.

How does the CGC treat capital payments?

As explained in the Panel's first interim report¹, Commonwealth National Partnership Payments (NPPs) for capital purposes are generally included in the HFE system at present, and therefore affect relativities. Capital payments are treated in the same way as NPPs for recurrent purposes, fully included in the year of receipt (when that year becomes an assessment year).

Commonwealth payments included in the HFE system are assessed for revenue needs and the corresponding expense needs are also assessed. Capital payments and capital expenditure needs are treated in a consistent fashion, both being assessed 'upfront'.

The revenue side effect on the GST revenue distribution for included capital payments is easy to quantify, being the difference between an EPC distribution and the actual distribution of the payments (ignoring averaging and lag effects). On the other hand, primarily due to the inter-related nature of the capital assessments, the expenditure side effects can be problematic to quantify. Notwithstanding this difficulty, the main influence on capital needs is relative population growth.²

Broadly speaking therefore, when any State receives a capital payment from the Commonwealth, the amount it receives above its population share is 'equalised away' over time. While this might sound drastic at first, in context it has tended not to matter

1 GST Distribution Review, *Interim Report*, March 2012, pages 83-85.

2 For some areas of State expenditure, such as transport services and housing, the effects of population growth (known as population dilution needs) are the only capital needs assessed.

too much in the past — as prior to 2010 the equalisation period extended over 5 years and, over the very long term, all States get close to their population shares of Commonwealth capital payments.

State & other views from submissions on the interim reports

The Panel's first interim report said that:

The Panel sees merit in:

- *equalising all capital payments ... over a longer time frame to recognise the lasting nature of the asset being funded and reduce the impact of the payments on GST shares in any one year, or*
- *equalising most capital payments, but excluding capital payments for nationally significant projects.*

If [these] capital payments ... are to be excluded, a process for identifying ... the projects will [be needed].³

Summary of State views

All States addressed these issues in their final submissions. New South Wales considered them to be largely methodological, saying that any change to the treatment of Commonwealth payments would be a 'piecemeal solution' to a broader problem. Other State views on the issues raised by the Panel are summarised below.

Equalising capital payments over a longer period of time

Queensland and South Australia do not support equalising over a longer period because to do so would be inconsistent with the upfront approach to capital. The Australian Capital Territory supports equalising capital payments over time, but said this would be more consistent with an approach that recognises the use of infrastructure over its life. Tasmania and the Northern Territory do not rule out equalising over a longer period, although the Northern Territory does not support equalising over more than 10 years.

Excluding Commonwealth capital payments for nationally significant projects

All States support the general principle of *including* Commonwealth payments for capital purposes in the equalisation process. Victoria, Western Australia and the Australian Capital Territory did not support the introduction of a national significance principle. Victoria and the Australian Capital Territory said there should be consistent treatment of road and rail payments and they would prefer including 100 per cent of both. While supporting the general principle of inclusion, Queensland, South Australia and the Northern Territory see merit in a national significance principle for identifying Commonwealth capital payments to be excluded. South Australia notes the 50 per cent exclusion precedent for national network roads with a role in interstate freight.

On the question of how nationally significant projects should be identified, South Australia and the Northern Territory say that the CGC should be responsible for identifying eligible projects. Queensland said that the CGC was *not* the appropriate body and that identifying nationally significant projects should be a role for the

3 GST Distribution Review, *Interim Report*, March 2012, page 94.

Commonwealth Treasurer. Queensland and the Northern Territory say that the Infrastructure Australia priority list is not suitable for identifying relevant projects.

Other views

The CGC notes that there could be ‘double-dipping’ where a State receives a Commonwealth capital payment that is excluded from the equalisation process, but gets GST revenue to meet the related expenditure needs.

The Business Council of Australia puts the emphasis on payments being made on a consistent and transparent basis that is neutral in its treatment of different modes — for example, neutral between road and rail. Other commentators⁴ say that Commonwealth payments for nationally significant projects should be excluded from the equalisation process, but provide no guidance on how to identify such projects.

As this important matter is not a simple choice between clear alternatives, the Panel has felt it necessary to work through a number of issues before coming to its position. These are set out below.

How are Commonwealth transport infrastructure payments allocated?

Commonwealth capital funding for infrastructure projects is made through project National Partnership Payments (NPPs). In the Commonwealth Government Budget Paper 3, payments are classified to sectors, such as Health, Education, Infrastructure and so on. Economic infrastructure payments (including for roads and rail) tend to be classified to Infrastructure payments, while other social infrastructure payments (such as for hospitals and schools) are generally classified to their relevant sector.

Table 6.1 shows the proportion of total transport infrastructure payments for each State currently identified by the Commonwealth. For comparison, the table also includes each State’s share of total population as at 2012-13.

Table 6.1: Transport Infrastructure payments, 2008-09 to 2015-16

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
	%	%	%	%	%	%	%	%	\$m
2008-09	36	13	34	8	6	2	0	2	5,119
2009-10	27	13	37	7	10	3	0	3	4,961
2010-11	40	19	18	8	9	4	1	2	3,050
2011-12	35	19	27	7	10	1	1	2	7,006
2012-13	29	23	22	17	4	2	0	2	3,284
2013-14	31	30	20	13	3	2	1	2	4,441
2014-15	27	41	17	10	1	0	4	1	1,927
2015-16	15	39	17	10	17	0	2	1	1,455
Total	32	21	26	9	7	2	1	2	31,241
Pop (12-13)	32	25	20	10	7	2	2	1	

Note: Additional funding to New South Wales for the Pacific Highway not included.

Source: 2008-09 to 2010-11, Commonwealth Government Final Budget Outcome; 2011-12 to 2014-15, Commonwealth Government 2012-13 Budget Paper 3; CGC, 2012 Update Report.

⁴ Such as Mr John Hill and Mr Peter Emery. See John Hill, Final submission to the GST Distribution Review, August 2012. Also, Queensland Treasury Corporation in its submission to the Review.

Table 6.1 shows that, in any given year, States' shares of Commonwealth transport infrastructure payments vary from their population shares, sometimes substantially. This difference leads to GST redistributions. Ignoring expenditure effects, if these payments were excluded from the equalisation process, many States would be largely unaffected, but States receiving less than their population share, for example Victoria, would receive less GST revenue, and States receiving more than their population share, for example Queensland, would receive more GST revenue.

Identifying nationally significant projects

The Panel's first interim report noted the difficulties in identifying payments for nationally significant projects and recognising all relevant factors that influence State expenditure on them.

... [A] satisfactory process to identify eligible [nationally significant] projects does not currently exist.

... the current assessments do not recognise all the complex and multi-faceted factors that influence State infrastructure spending.⁵

These difficulties arise partly due to programs with similar aims being controlled or administered by different bodies. For example, the Nation Building Program (used to fund national and inter-regional land transport corridors of critical importance to national and regional growth) is administered by the Department of Infrastructure and Transport, while the allocation of the Building Australia Fund (similarly used to fund critical infrastructure in the transport sector, along with the communications, water and energy sectors) is primarily based upon the Infrastructure Australia priority list.

Infrastructure Australia

Infrastructure Australia's priority list identifies projects that would help solve a nationally significant infrastructure problem and deliver economic benefits. In its 2012 report, Infrastructure Australia's priority list included \$76.5 billion of projects that it says will make a valuable contribution to addressing nationally significant issues. However, these projects cover a range of completeness and readiness to proceed. Projects progress through four stages — *Early Stage* (\$48.1 billion), *Real Potential* (\$10.1 billion), *Threshold* (\$6.6 billion) and *Ready to Proceed* (\$11.8 billion).

Early Stage projects may fail to proceed or change substantially by the time they progress through to the *Ready to Proceed* stage, so that not all projects on the list could be considered to have definite national benefits. However, if Infrastructure Australia's priority list were in the future to become the primary determinant for the Commonwealth's funding of infrastructure, it could possibly be used to identify nationally significant projects.

National network roads

For transport infrastructure (and economic infrastructure more broadly) — as compared with social infrastructure — there is greater uncertainty around both the balance of national/State benefits and how well the CGC can capture 'needs' relating to the

⁵ GST Distribution Review, *Interim Report*, March 2012, page 93.

infrastructure. While individual school buildings, for example, have a clear and direct benefit to the jurisdiction in which they are located and a more intangible benefit to national education, almost all major transport infrastructure facilitates national economic growth and productivity directly to some degree.

In its 2010 review report, in relation to Commonwealth payments for national network roads, the CGC said:

We believe that part of the Commonwealth support for these [national network] roads and the consequent investment is influenced by Commonwealth considerations which are not captured in our State based disability measures. These include the need to develop an efficient national transport network to facilitate national economic growth and productivity gains in the long-term.⁶

In the absence of a better basis for determining the proportions of national and State benefit, the CGC decided that 50 per cent of national network road payments (and related expenditure) should not affect relativities to recognise the clear dual purpose. After consideration, the CGC did not make any similar findings for other Commonwealth payments for transport infrastructure, in particular for rail based infrastructure.

Conclusions on the treatment of Commonwealth capital payments

In the Panel's view, while there may be some merit in treating all nationally significant projects in a special, but consistent, fashion under the equalisation system, we do not believe there is currently a comprehensive way to identify these 'nationally significant' projects. In practice, as the examples of problems seem to relate to the treatment of transport infrastructure, this raises the question of the appropriateness of the differences in treatment of Commonwealth funding for road and rail based projects.

The Panel's main concern in this regard is that the CGC's current approach does not recognise the inter-related nature of national transport infrastructure and the long-term view required to ensure appropriate investment decisions. Different equalisation treatment of road and rail infrastructure has the potential to distort State decisions about what transport projects to undertake and when. Investing in rail infrastructure, especially in Australia's major cities, would allow more efficient use of the existing national road network, facilitating the movement of road-based freight, including to major capital city ports.

By treating Commonwealth funding for national network roads and rail based infrastructure in the same way, the equalisation system would be less likely to influence State decisions about what transport projects will proceed and when. This reasoning would indicate consistent treatment, either both fully included, or both excluded to the same extent. On balance, the Panel has favoured excluding both to the same extent, as full inclusion would still leave an unnecessary degree of lumpiness after equalisation.

There is no clear way of determining precisely the appropriate proportion of any payment that relates to its national benefits (or non-State needs). For some payments it may be greater than 50 per cent, in some cases it may be less than 50 per cent. However, similarly to the position adopted by the CGC, the Panel's view is that,

6 CGC, *Report on GST revenue sharing relativities — 2010 Review*, volume 2, chapter 21, page 444.

recognising the clear dual purpose and having regard to simplicity, a uniform 50 per cent of identified payments not affecting relativities seems suitable.

The Panel notes that, if 50 per cent of national network road and rail based payments did not affect relativities, this would substantially reduce volatility in GST shares arising from the lumpy nature of these payments. This approach would therefore negate any further need for the HFE system to include these payments over longer time frames.

The Panel has also noted that, as significant rail payments to States commenced in 2009-10, to ensure States that received payments since this time are not disadvantaged, the change in treatment should commence from the CGC's 2013 Update.

None of the above is intended to exclude the possibility that the CGC, through its usual processes, might decide that any Commonwealth payment for transport infrastructure other than for national network roads or rail might have national significance. For example, a road to facilitate access to a remotely located port might be considered to have national significance. In such a case the CGC may well decide to assess these payments similarly to national network road and rail payments.

Recommendation 6.1

In recognition of the inter-related nature of transport networks and the national benefits that accrue from increasing the efficiency of these integrated transport networks, the CGC should identify all Commonwealth payments relating to national network road infrastructure and rail based transport infrastructure.

All identified payments should affect the relativities on a 50 per cent basis, to recognise their dual national/State purpose. To ensure that States that have previously received rail based transport payments are not disadvantaged, this change in treatment should apply from the CGC's 2013 Update.

6.2 Data revisions

The core of the CGC's assessment of States' fiscal capacities relies on data. The CGC uses data from a range of sources, such as the Australian Bureau of Statistics (ABS), State provided data, and data from third party sources, such as the Australian Institute of Health and Welfare (AIHW).

The CGC seeks to use the data that is most recent and relevant to the assessment year in question, which sometimes requires revisions to data used in previous years. Previously used data may be subject to revision for a range of reasons, from the fact that more recent relevant data has become available, or to correct errors subsequently discovered, or following from changes to statistical collection methods.

The Panel's main area of concern is with revisions that cause undue volatility in GST shares. Revisions that cause the greatest volatility generally occur where data are revised for more than one of the three assessment years. This tends to occur when using data sets that are not produced or released on an annual basis. A recent example of this was in the 2011 Update where new data from the ABS Survey of Education and

Training (SET) led to changes in the assessment of interstate wages, resulting in much larger revision effects (changes to relativities) than is usual in an Update.⁷

How are data revisions dealt with?

Annual data

The CGC uses a range of data from various providers (predominantly the ABS) collected on an annual basis, that are subject to revision from time to time.

ABS revisions occur where there have been improvements in reporting of survey results, additional administrative data are provided to the ABS, through changes in statistical and/or survey methods, or international standards or classifications. In most cases the CGC will use any revised ABS data available as that will constitute the most up to date and relevant data for the CGC's purposes. In determining whether to use revised data, the CGC investigates the reasons for the revisions and establishes that the data remain the most relevant to its task.

However, in many instances States are the only source of data for the CGC to make its assessments. Some State data are provided directly to the CGC, through annual data collection processes as part of each update of the relativities. These are reviewed by the CGC in an effort to ensure their fitness for purpose, that is, the data are comparable with that provided by other States, and are reliable (such as being consistent with known trends in the activity to which the data relate). The main driver of revisions to State data is the availability of later administrative data. For example, as revenue compliance tasks are completed more accurate data becomes available. On occasion, States may identify errors in the data previously supplied to the CGC, and revise the data to be incorporated by the CGC into its assessments.

In some cases data may be collected and published annually, albeit with a lag.⁸ For example, the AIHW morbidity data set is published annually, but with a two year lag. The CGC applies the most recently available data to more recent years, which are then revised once the data set relating to that year becomes available. The resulting revisions can lead to changes in State's GST shares.

Non-Annual data

Some data used by the CGC are not produced annually, but less frequently. For example, the main sources of non-annual ABS data used by the CGC are Census data, collected every five years. While Census data themselves are not generally subject to revision, new Census data can lead to revisions to population estimates *between* Census years, thus affecting CGC assessments and possibly resulting in changed GST shares.

Similarly, for other non-annual data sets used by the CGC, when more recent data become available, the CGC will generally revise its estimates for years between the actual years to which the data relate. This was the issue in the 2011 Update, with the CGC revising its estimates for relative wage levels across States for the four years in between two SET collections, leading to larger than usual changes to GST shares.

7 The ABS has since advised the CGC that the SET is unlikely to be conducted in 2013 and the CGC is considering which other data sets may be suitable.

8 Lagged annual data sets in the context of this Chapter are those that at the time of a CGC Update do not relate to the most recent assessment year, but to an earlier year.

Accuracy and volatility

The incorporation of more recent (and more accurate) data, leading to revisions to earlier CGC estimates and consequently changes to GST shares, increases the volatility of GST shares. Currently, in its assessments the CGC aims to reflect State capacities as accurately as possible in earlier assessment years, without regard to any consequent volatility of GST shares. The Panel has considered ways that might lead to a reduction in GST share volatility without unduly affecting the accuracy of the CGC's assessments. The options considered by the Panel included:

- freezing relativities
- using the latest non-annual data for the year it applies to and for future years
- using the latest non-annual data for the final assessment year only.

Freezing relativities would mean that no data would be revised, regardless of whether errors were identified and whether the data set was annual or non-annual. While this approach would produce the most stable GST distribution between methodology reviews, it has several drawbacks. It would least reflect State capacities and could lead to greater changes in GST shares at methodology reviews. It would risk encouraging States to be conservative in their own interest when supplying data from their own sources. The current approach more closely reflects State capacities, but leads to the greatest volatility in GST shares when errors are identified and corrected.

Using the latest non-annual data for the year it applies to and for future years would potentially reduce volatility in GST shares compared with the current situation, but may still result in revisions leading to significant changes in GST shares where there is a lag between the release of the data and the year to which it relates. For example, if data relating to the 2010-11 year were not available until after February 2012, these data would not be applied to the 2010-11 year when that year first becomes an assessment year. The following year these data would be applied to two of the three assessment years, 2010-11 (as revisions) and to 2011-12 (as the most recently available data).

Although technically the Government Finance Statistics (GFS) data pertaining to the most recent assessment year are not available until after the CGC has completed its update processes, the work the CGC has undertaken with States to obtain their Uniform Presentation Framework (UPF) data is considered sufficiently robust that reliable estimates are available for the most recent assessment year. Any revisions to these data included in the actual ABS release reflect legitimate corrections of errors and misallocations and should be reflected in the assessments.

On balance, the Panel considers that revising earlier assessment year estimates using lagged annual data or revised inter-survey interpolation for non-annual data sets can produce undue volatility in GST shares, beyond that reflecting changes in States' circumstances. A better balance between accuracy and volatility would be found by:

- for annual data sets (including ABS GFS data) — allow revisions as per currently

- for all non-annual data sets and annual data sets with a lagged release — allow new data to only inform changes in States' circumstances (the most recent assessment year) and not be used to revise previous estimates of earlier inter-survey years.

Two examples show how new data would be incorporated into the assessments using this approach. The first is for a lagged annual data set, for example the AIHW morbidity data set. In this case the newly available data would be included for the most recent assessment year (2011-12 in the 2013 Update) only, and not be used to revise the preceding year (to which it relates). Over time, each annual data set will have its full effect on relativities, albeit lagged. The second example is for population estimates, based upon Census data. The new 2011 Census data estimates would only be applied to the 2011-12 year, while the previous estimates extrapolated from the 2006 Census estimates would not be revised by any new inter-census year interpolation.⁹

Recommendation 6.2

Where data are updated or released annually with a lag, or updated or released less frequently than annually, the CGC should allow the newly available data to only inform changes in States' circumstances in the most recent assessment year and not be used to revise previous estimates of earlier inter-survey years.

6.3 A simplified and integrated assessment framework

The Panel understands that the introduction of the 2010 Review capital assessment, emphasising 'up front' needs of high population growth States, was a contentious matter in the 2010 Review. While some States regard the capital assessment as remaining among the more complex of assessments (with South Australia and the Australian Capital Territory in particular favouring further simplification) this view is not universal, with some States regarding the assessment as relatively straightforward.

This section outlines a proposal for a simplified and integrated assessment framework for equalisation. The Panel considers this high level methodology change could improve simplicity, transparency and stability while addressing concerns about the treatment of subsidised public trading enterprises (PTEs), for example, public transport and social housing PTEs, in the current framework.

While acknowledging that the CGC is the appropriate body to consider the feasibility of this approach, the Panel suggests that when conducting its next methodology review, the CGC include the concept of a simplified and integrated assessment framework as one of the issues to focus on.

⁹ The approach may not work smoothly in all aspects. For example, the population dilution disability is dependent upon population growth across years. Any such implementation issues should be approached by the CGC with the view to minimising volatility in GST shares.

Why consider an alternative framework?

The current framework

HFE outcomes are derived in the context of a representative State budget. The representative State budget is used to calculate per capita revenues and expenditures used in assessing State fiscal capacities.¹⁰ The scope of the representative, or adjusted, budget has changed over time reflecting, amongst other things, the move to accrual accounting and changes to the treatment of capital needs and PTEs.

In the 2010 Review the CGC moved from an operating result framework to a net lending statement framework. The main motivation for the change was an encouragement from Heads of Treasury (HoTs) to recognise State capital needs in a simpler and more direct way than via an assessment related to net interest expense.¹¹ In the Review, the CGC also completed the transition to a subsidy based approach to recognising needs for PTEs. Under this approach, needs related to State budget support for PTEs are assessed through the grants and subsidies paid to PTEs.

Problems arising from the current framework

The Panel considers that the changes to the capital assessment in the 2010 Review — including the population growth needs assessment — were a positive step forward. In adopting this approach, the CGC said it preferred an approach to capital that recognises the financial consequences of population growth when needs arise. There are three aspects to the current capital assessment: depreciation, net investment (which is gross fixed capital expenditure less depreciation) and net borrowing/lending. While the 2010 changes were intended to simplify the assessment of State capital needs there are aspects of the net investment assessment that are still unnecessarily complex and volatile. In addition, the CGC's decision to 'equalise States' net financial worth' in the net lending assessment¹² imposes a constraint on the recognition of capital needs for subsidised PTEs.

Net investment assessment¹³

According to the CGC, the net investment assessment aims to provide States with capacity to fund the investment in 'new' infrastructure required to maintain an assessed level of infrastructure. It does this by recognising two effects. The first is that of differential population growth on the stock of physical assets and the second is differences between the States in the quantity of infrastructure required to provide services and its cost.¹⁴ There are issues with the net investment assessment:

10 The main source of data for the representative State budget has also changed over time. Currently, ABS GFS is the starting point. These data are supplemented by data from the States and other sources to improve comparability between States and to ensure the representative State budget is suitable for the CGC's purposes.

11 The treatment of capital was a major issue in the 2010 methodology review. The treatment of capital is discussed in the CGC *Report on GST revenue sharing relativities — 2010 Review, volume 1 — Main Report*, 2010, pages 55 to 61.

12 See CGC *Report on GST revenue sharing relativities — 2010 Review, volume 1 — Main Report*, 2010, page 7.

13 For a description of the net investment and depreciation assessments, see CGC *Report on GST revenue sharing relativities — 2010 Review, volume 2 — Assessment of State Fiscal Capacities*, 2010, Chapter 21.

14 The second effect is proxied by using recurrent service use and cost disabilities.

- The assessment of net investment and depreciation appears to involve a double count because ‘new’ investment in one year gives rise to depreciation expenses that are then assessed over the life of the assets.
- While in concept the net investment assessment is simple, in practice, applying current period capital stock disabilities to the large stock of physical assets estimates gives rise to a volatile element. The CGC took steps in the 2010 Review to reduce the amount of volatility by adopting a three year moving average for the capital stock disability factor. Nevertheless, small changes in disabilities continue to have an effect on assessment outcomes that is difficult to predict and explain, and resulting in unnecessary volatility in GST shares.

Net lending assessment¹⁵

Through the net lending assessment, the CGC seeks to recognise the impact of differential population growth on a States’ net financial worth (NFW) and therefore their capacity to earn revenue in the form of interest and dividends. Since the CGC considered the equalisation of NFW central to the measurement of equalisation, any assessment of State capital subsidies to PTEs could not recognise differential needs other than the impact of total State population growth.¹⁶ Therefore, capital needs for subsidised PTEs may not be fully recognised. This is notwithstanding that the CGC treats most Commonwealth capital grants to PTEs (including transport PTEs) by inclusion.

Conclusions on a simplified and integrated assessment framework

In its next methodology review, the Panel encourages the CGC to consider a simplified and integrated assessment framework that:

- returns to an operating statement framework while retaining the population growth needs assessment
- includes the net operating deficits of subsidised PTEs including depreciation and before subsidies.

The effect of these changes would be to move from the net lending statement for the State general government sector to a modified net operating statement. The Panel considers this change could improve simplicity, transparency and stability without any significant impact on HFE outcomes. The benefits of a modified operating statement framework might include that:

- an operating statement framework is more accessible and familiar than a net lending statement framework
- transparency, predictability and stability are improved through the removal of a volatile element in the net investment assessment

15 For a description of the net lending assessment, see *CGC Report on GST revenue sharing relativities — 2010 Review, volume 2 — Assessment of State fiscal capacities, 2010, Chapter 22.*

16 A further complication arising from moving to a net lending assessment framework and the equalisation of NFW was the need to ensure consistent treatment of equity injections and capital subsidies to PTEs. The CGC said different treatments of equity injections and capital subsidies could influence how States make these contributions to PTEs because it could affect their assessed differences and thus their relativity. See *Report on GST revenue sharing relativities — 2010 Review, volume 1 — Main Report, 2010, page 62.*

- capital needs for subsidised PTEs can be fully recognised
- the approach is consistent with the upfront inclusion of Commonwealth capital payments
- population growth needs, based on population growth dilution of net worth,¹⁷ are unchanged
- outcomes are expected to be largely unchanged in the long term because the largest component of the current capital assessment is retained and a user financial cost of capital element ‘scales up’ the depreciation assessment.¹⁸

Under the modified operating statement framework, revenues would be as per the GFS operating statement, but expenses would be expanded to reflect the net operating deficits of the subsidised PTEs. Population growth disabilities would be applied in respect of the net worth of the State general government sector. Therefore, adopting this type of framework means that the assessment framework would not strictly align with the GFS operating statement for the State general government sector, although it would be possible to reconcile the two frameworks.

Recommendation 6.3

That the CGC examine the merits of adopting a simplified and integrated assessment framework in its next methodology review.

6.4 Cost equalisation

Background

Differences in fiscal capacity on the expenditure side of State budgets can arise from demand (or use) factors or from cost factors.

The CGC currently equalises two types of location costs:

- Intrastate costs, which reflect differences in the number of high cost locations within States
- Interstate costs, which reflect the fact that some State governments face higher costs as a whole (predominantly because of higher wage costs).

The CGC also equalises for costs of administration scale. This relates to the fixed costs of State governments arising from the existence of States and Territories (which are unaffected by population settlement patterns.)

¹⁷ Net worth for the State general government sector comprises physical assets and net financial worth and is also equal to net worth of the total State public sector.

¹⁸ It is likely that similar outcomes would be achieved if a financial cost of capital or lease equivalent payment is included in the modified net operating statement. Including an amount would more accurately reflect the full user cost of capital which is not captured in the depreciation estimate alone, and effectively replaces those elements of the net investment assessment other than pure population growth. Ideally, the depreciation estimates used to calculate the net deficit of subsidies to PTEs should also be ‘scaled up’.

Even those who argue that HFE promotes efficient population settlement patterns generally concede that there is a question mark over equalising for location costs. The argument goes that if people faced the full cost of providing services in high cost areas (through higher taxes or lower services) they would be less likely to live there, which would create fiscal savings. Therefore, by equalising these costs HFE promotes more expensive migration/settlement patterns.¹⁹ One way to test these concerns is to consider what would happen if location costs were not equalised.

Scenario 1 — not equalising intrastate costs

Intrastate costs reflect differences in the number of high cost locations within States (primarily due to population dispersion). These costs (that is, cost differences within States) are recognised to allow high cost locations to be treated the same way regardless of what State they are in. This does not give everyone the same service standard — it just allows the similar high cost locations to have the same services in different States.

If intrastate costs were removed from the equalisation process the States that lose GST would have to raise taxes, cut services or improve efficiency, while other States could lower taxes or expand services (see Table 6.2 for indicative impacts).

Table 6.2: Indicative changes in GST from removing intrastate costs from the HFE (Scenario 1)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Change in GST shares (\$m)	606	884	-411	-706	-175	86	211	-494

Source: CGC, Report on GST revenue sharing relativities — 2012 Update, Table 7.

The impact of these changes could fall on relatively higher cost (generally remote) areas (scenario 1a) or relatively lower cost (generally metropolitan) areas (scenario 1b).

Scenario 1a

Relatively higher cost remote areas may bear the brunt of lower services/higher taxes because States save from discouraging people from living there or because cuts to services in cities are more difficult since most of the population lives there. If this occurred then people would be less likely to live in regional areas of Queensland, Western Australia, South Australia and the Northern Territory. However, since the other States now have higher capacity (and can provide lower taxes or better services) the incentive could be to re-locate interstate not intrastate. This would create some fiscal savings due to people leaving high cost locations, but it would also create costs due to distorted interstate migration patterns. The net effect may be a small positive, but it is hard to say. In terms of equity, it could seem inequitable to treat high cost locations better in some States unless the number of high cost locations is policy driven.

Scenario 1b

Alternatively, relatively lower cost metropolitan areas may bear the brunt of lower services/higher taxes because services in remote areas need to be cut by too much to

¹⁹ This is not an issue for non-location related cost equalisation – high cost people (e.g. the elderly) cost more regardless of where they live. It is also a conceptual concern about whether location costs should be equalised. It does not deal with methodological concerns about whether they are accurately and appropriately measured in the current CGC assessment.

achieve the savings (given relatively few people live there) or because services in remote areas are already much lower, so the impact of further cuts is much higher. If this occurred then people would be less likely to live in low cost metropolitan areas of Queensland, Western Australia, South Australia and the Northern Territory and people in high cost areas may be even less likely to move (since services in nearby cities are now lower). Movement out of low cost areas would further reduce State fiscal capacity and create inefficiency due to fiscally motivated interstate migration (which is what HFE is supposed to prevent). Under this scenario, the efficiency effects of not equalising for intrastate costs are probably negative, although the effect is probably small. In terms of equity, it seems inappropriate to give unequal treatment to low cost areas just because a State has more high cost areas.

Scenario 2 — not equalising for interstate costs

Interstate costs are recognised to allow different States to deliver the same services regardless of State level cost differences. For example, this allows Western Australia to provide the same education service as Victoria, even though Western Australia has to pay its teachers more to compete with higher private sector wages.

If these costs were not equalised States that lose GST revenue would have to raise taxes, cut services or improve efficiency — other States could lower taxes or expand services (see Table 6.3).

Table 6.3: Indicative changes in GST from removing interstate costs from the HFE (Scenario 2)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Change in GST shares (\$m)	- 402	636	462	- 671	133	71	- 110	- 119

Source: Secretariat calculation.

In this case, the distribution of tax and service cuts within States is less important since the idea is that some States as a whole are more expensive. People would simply be less likely to live in high cost States, which would produce overall fiscal savings. In terms of equity, perhaps those living in high cost States should bear the additional costs of their location decisions. On the other hand, if high cost sub-State regions are partly subsidised by lower cost sub-state regions it may be unfair if high cost States do not effectively get the same treatment.

Implications

The Panel believes there are some valid questions raised about fully equalising for interstate cost differences without allowing for the possibility that expenditure on high cost inputs should be economised in a similar way as service standards are reduced for high cost intra state locations.

There seems to be an efficiency and equity rationale for discounting the *interstate* wage and non-wage costs assessment to bring that assessment into line with the CGC’s treatment of intrastate costs, and potentially promote more efficient settlement patterns. People living in high cost areas within a State face lower service standards, even though States spend more per person in those areas. On the face of it high cost States should be treated the same way — that is, high cost States should have needs

recognised, but not so much as to provide the same services as low cost States without an additional local contribution.

Murphy (2012) reports that there should be full equalisation for costs, including for diseconomies of small scale and remoteness (on a stratified spend gradient basis), but only partially for interstate wage levels. This is consistent with Pincus' (2011) observation that little or no allowance should be made for interstate differences in the unit costs of public provision of goods and services.

Identifying a discount or elasticity factor is difficult as it would be hard to measure how much services would appropriately decline with cost, and it would depend on the service being considered. The Panel has not been able to do this, or provide an indication in the time available.

Recommendation 6.4

That the CGC investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis. This investigation should occur in the context of the assessment of other cost disability factors including costs of remote locations, and administrative scale.

7 Assessing mining revenue and expenditure

The relationship between States' mining revenues and their GST shares has been an important aspect of this Review. The Panel's first interim report explored how the system currently works.¹

Mining, and the ability to generate royalty revenue, is highly concentrated in a few States. This fiscal advantage is a key driver of the GST distribution process — the major resource States (principally Western Australia and Queensland) receive lower GST shares than they would otherwise because of it, while those States with relatively little mining receive higher GST shares. Because State mining revenues have grown so strongly in recent years, so too has the scale of mining redistribution, which reached \$4.7 billion in 2012-13. This is a far larger amount than is due to any other revenue factor, making it especially important to consider whether the current approach — of fully equalising mining royalties — remains the right one. Section 7.1 sets out the Panel's views on the threshold question of whether mining revenue should be treated differently to other revenue.

Separate to the question of *whether* mining revenue should be fully equalised, the Panel has identified several aspects of concern with *how* this equalisation is pursued. Our consideration of how to improve the mining revenue assessment and ensure that States' related costs are properly recognised is presented in Sections 7.2 and 7.3.

7.1 Should mining be treated differently to other revenue?

How mining revenue is currently treated

Mining revenue is one of the six categories of States' own source revenue that are considered by the CGC when determining GST shares. The CGC uses information on the value and type of mining production in each State and the associated royalty revenue to calculate two average royalty rates — one for low royalty rate minerals and another for high royalty rate minerals. These average rates, applied to the quantity of mining production occurring each year, produce an estimate of the amount of mining revenue that each State would raise, if it applied the average policy (Table 7.1).

Table 7.1: Assessed mining revenue (\$per capita) 2008-09 to 2010-11

Year	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Average
2008-09	199	23	779	1,378	100	91	0	467	382
2009-10	142	11	474	1,342	110	86	0	467	297
2010-11	181	10	601	2,154	178	115	0	537	426

Source: Commonwealth Grants Commission, 2012 Update Report, Tables B-1, B-2, and B-3, pages 109-111.

Western Australia's assessed capacity to generate mining revenue is far in excess of the other States' (with Queensland and the Northern Territory also being above the

¹ See GST Distribution Review, *Interim Report*, March 2012, Chapter 6.

average). In 2012-13, equalising this mining revenue advantage reduces Western Australia’s GST share by around \$3.4 billion (or around \$1,400 per person).

Table 7.2: Redistribution of GST due to mining revenue differences, 2012 Update

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
\$ pc	221	400	-279	-1,394	273	308	416	-130	204
\$ m	1,640	2,300	-1,316	-3,364	458	159	155	-31	4,711

Source: Commonwealth Grants Commission, 2012 Update Report, Tables 5-4 and A-1, pages 65 and 106.

States have strongly opposing views on whether mining revenue ought to continue to be treated similarly to revenue from other State taxes, or whether it should be treated differently.² Perhaps unsurprisingly, the States with the largest mining sectors, Western Australia and Queensland, have argued for a fundamental change in approach. Meanwhile, States with a small share of mining activity (as compared to their population shares), including New South Wales and Victoria, are firmly opposed to the idea that mining revenue should be treated differently to revenue raised from other State taxes.

The Panel has considered the merits of three suggested reasons for treating mining revenue differently, namely:

- that the sheer scale of its effect on GST shares is, in itself, unreasonable
- that the outcomes under the current approach are influenced by individual State policies to a far greater degree than for other types of revenue
- that mining royalties are categorically different to other taxes, including because of the non-renewability of the underlying resource, and so should be thought of as akin to the sale of an asset and not bracketed with other State taxes.

These ‘threshold’ issues regarding *whether* mining revenue should be treated differently from other revenue have been considered separately to the important practical matters relating to *how* this part of the equalisation system should operate (see Section 7.2).

Is the sheer scale of mining’s effect on GST shares unreasonable?

Differences between States’ capacities to generate mining revenue are currently having a large effect on how the GST is distributed. This year, these mining differences are responsible for \$4.7 billion, or 85 per cent of the total revenue-side redistribution (\$5.5 billion), even though mining revenue only directly accounted for 8.4 per cent of States’ own-source revenue during the relevant assessment years (2008-09 to 2010-11).

This represents a large increase from previous years. The amount of GST redistributed due to mining has tripled over the past five years (from less than \$1.6 billion in 2007-08)

2 This question would become moot if the preferred option of New South Wales, Victoria, Queensland and Western Australia, an equal per capita distribution of GST revenue, were adopted. However, given the Panel is not recommending that approach, we focus here on the ‘fall-back’ positions put by those States in their individual submissions to the Review.

and will almost certainly increase further over the next couple of years — whatever happens on commodity markets in the meantime — due to the lag in the HFE system.³

Under the current system this increase is the natural consequence of sharp increases in both the quantity of mining production and the price received for this output, and the fact that so much of Australia's mining production is located in Western Australia and Queensland. As mining royalties increase, both in absolute terms and as a share of States' budgets, the fiscal position of the main resource States relative to the other States is made stronger, so they are assessed as needing lower GST shares.

Queensland and Western Australia claim that this much redistribution is not fair — that the current outcome is too extreme. The other States say that it *is* fair — that this is the way the system is supposed to work.

The Panel agrees with the major resource States that the sheer scale of the effect that mining is having on GST shares warrants close scrutiny. We have attempted to provide that scrutiny later in this Chapter, particularly in examining whether some related costs are being insufficiently recognised. However, the mere fact that the mining part of the HFE system is currently driving a large amount of redistribution is not, in our view, a reason to treat mining differently from other revenue.

Mining is concentrated in a few States

Two pillars of the current HFE system are that equalisation should be implemented through methods that reflect what States collectively do, and are 'policy neutral'. Essentially, this means that the policies of the States, looked at collectively, *should* be used to determine their GST shares but that the specific policy choices of any individual State *should not* significantly influence its GST share.

States have competing views as to how well overall the current system manages the inherent tension between these two principles. However, all States recognise that mining, with its highly skewed geographic distribution, poses the most difficult challenge in this regard.

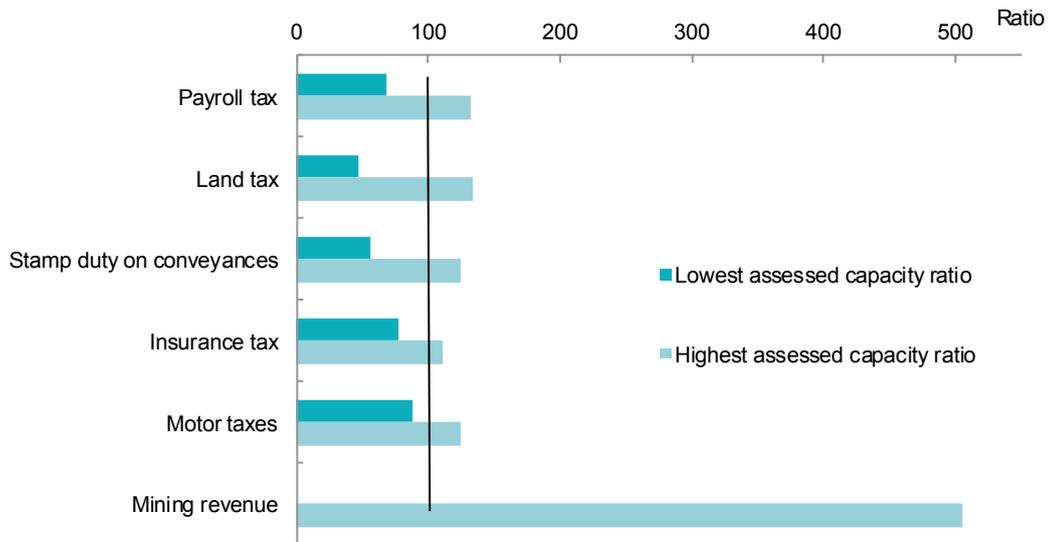
As discussed in the second interim report, just three States — Western Australia, Queensland and New South Wales — collect more than 95 per cent of all State mining royalties.⁴ The breakdown is even more pronounced for the two principal commodities, iron ore and black coal. Virtually all (around 97 per cent) iron ore production takes place in Western Australia, while black coal mining is dominated by Queensland (about two-thirds) and New South Wales (about one-third).

As shown by Figure 7.1, States' capacities to raise revenue from mining vary to a much greater degree than their capacities to raise revenue from other sources.

3 See Appendix D, which shows the possible effect on State relativities if mining royalties were not to grow as strongly as expected in the next few years.

4 By themselves, Western Australia and Queensland account for 80 per cent of total mining royalties.

Figure 7.1 Assessed revenue raising capacity ratios, 2010-11



Source: Commonwealth Grants Commission, 2012 Update, data downloads, Table S3-1.

This highly skewed distribution means that individual royalty policy decisions can have far greater impacts on GST shares than decisions to increase or decrease other taxes. For most taxes the indirect GST share effects are no more than two or three per cent of the size of the direct change in revenue. Western Australia, however, would currently lose more than forty cents in GST share for every additional royalty dollar it collected from a rate increase.⁵ (As Western Australia has pointed out, the specific design of the mining revenue assessment means that in certain circumstances this GST share effect can be substantially higher).

It is clearly undesirable that individual policy decisions can have such large effects on GST shares. But it is far less obvious what the appropriate response should be. One option would be to no longer separately consider States' mining revenue raising capacities when deciding their GST shares (for example, by distributing the GST on an equal per capita basis or by using a global revenue indicator like household disposable income). This would address the policy neutrality problem, but would mean no longer recognising a very large driver of differences between the States' fiscal circumstances.

Ultimately, the fact that such a large source of revenue is so highly concentrated in a few States makes it particularly important to include mining within the HFE system, while at the same time making it practically difficult to do. Nevertheless, the Panel does not favour treating mining revenue differently on the basis that mining activity is geographically concentrated in a few States.

Should mining revenue be treated like an asset sale?

The two arguments discussed so far for treating mining revenue differently to other revenue relate to concerns with how the principles of HFE are given practical effect. A third possible reason that has been raised is that mining royalty revenue is categorically different to tax revenue, and so as a matter of principle should not be equalised (or perhaps only equalised over a much longer period).

⁵ See GST Distribution Review, *Second Interim Report*, June 2012, Table 3.1, page 30.

This argument (as put by Queensland and Western Australia) rests on the claim that royalties are essentially the price received by State governments for the sale of an asset owned by the people of that State (through the Crown). According to this view, rather than treating royalties like revenue from State taxes, they should be treated like the proceeds of other asset sales, such as of land, and not included in the HFE system.

Conceptually, there is some merit in the argument that looking only at royalty receipts without recognising the accompanying loss of the mineral assets provides an incomplete picture. Royalties are different from taxes. However, it does not necessarily follow that royalties should cease being treated like other State revenue for HFE purposes. The reality is that the longstanding practice of all Australian governments has been to treat royalties as recurrent revenue for accounting and budgeting purposes. Current royalty revenue is available to meet current expenditure needs, and in that sense is a close substitute for revenue from State taxes.

In any case, the corollary of treating royalties as an asset sale would be the recognition of the minerals themselves as assets on States' balance sheets. It is not clear that the combination of these changes would materially alter equalisation outcomes over time.

Accordingly, the Panel is not convinced that royalty revenue should be treated as being akin to an asset sale for HFE purposes.

Conclusion on the HFE treatment of mining revenue

Differences between States' mining revenues are having large effects on the GST distribution process. However, the Panel is mindful that HFE outcomes change over time. The large redistributions due to mining are a fairly recent phenomenon. Future results could well differ markedly from current outcomes, for example if the resource sector becomes a much larger part of States such as the Northern Territory or South Australia, or if the recent 'mining boom' unwinds. By itself the fact that mining revenue currently accounts for a large share of the redistribution occurring through the HFE system does not demonstrate that mining revenue should be treated fundamentally differently to other State revenue.

While we agree with the major resource States that there are specific problems with *how* mining revenue is currently equalised (and we turn to those in the next section), we do not consider the case has been made that mining revenue should be treated differently to States' other own-source revenue.

Finding 7.1

States' mining revenue should continue to be equalised through the HFE system, on the same basis as other own-source revenue.

7.2 Changes to the mining revenue assessment

The previous section explained why the Panel considers that the mining royalties collected by States should continue to be equalised. This section discusses some 'no regrets' improvements to how this part of the HFE system operates, which the Panel

believes should be made whether or not a broader deal on resource charging is struck between the two levels of government.

These suggested improvements fall into two groups. The Panel considers that there are problems with the current two-tier mining revenue assessment itself, so a new assessment should be developed to address these. Further, the Panel considers that some mining-related expense needs are not being fully taken into account under the current system, so we have recommended a way of recognising them.

Assessing States' capacities to raise mining revenue

As touched on above, the highly uneven distribution of mining activity between the States is difficult for the HFE system to deal with satisfactorily. For example, separately considering States' capacities to raise revenue from each individual commodity (as might be suggested by closely adhering to the principle of 'what States do') is not a realistic option. Iron ore provides the starkest example of the problems that would be caused by such an approach. Western Australia would have dominated a separate 'iron ore mining' category to the extent that there would have been a virtually one-to-one trade-off between its iron ore royalty revenue and its GST share. Totally removing that State's incentive to maximise the community's return from iron ore mining would clearly have not been in the national interest.

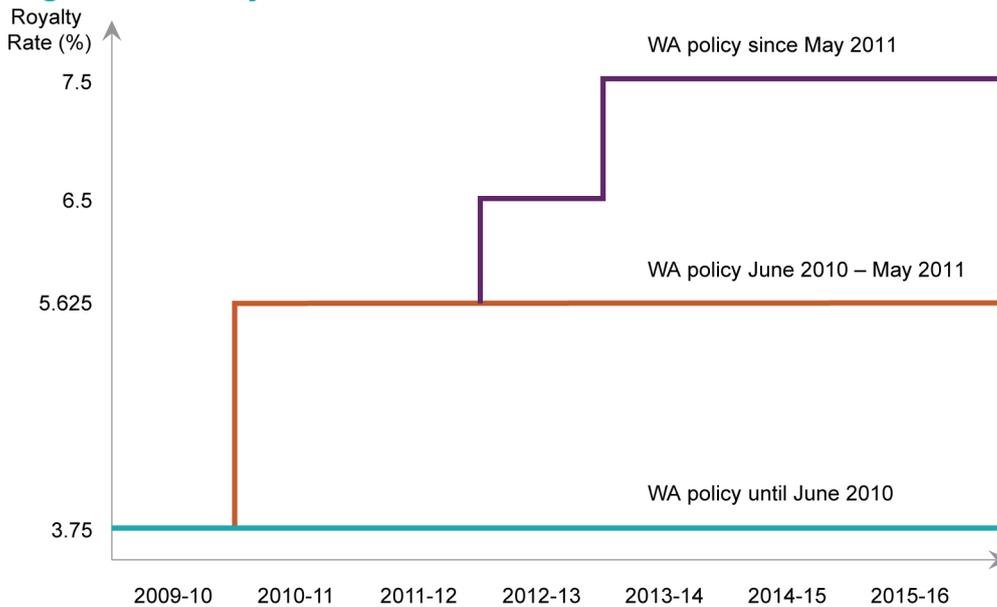
Another option would be to treat all minerals alike for HFE purposes and apply a single, undifferentiated mining assessment based on the average royalty rate across all commodities. This would have the virtue of simplicity, but at the cost of neglecting material differences between average profit levels of individual commodities.

Instead, the CGC has attempted to strike a balance between these two extremes. The current mining assessment separates minerals into two groups based on whether their average royalty rate is above or below five per cent.⁶ This division is based on the idea that differences in average royalty rates are broadly reflective of differences in profitability, and therefore 'capacity to pay' over the long-term. It also groups most iron ore and coal together, which serves to somewhat limit the effect that individual policy decisions of Western Australia, Queensland or New South Wales have on GST shares. This approach should work reasonably well in certain circumstances, but it is not well suited to handling the situation where a mineral might move between the low and high royalty rate groups.

The treatment of iron ore fines

The first interim report explored the dramatic effect on GST shares that could occur if the CGC were to move a mineral from the low royalty rate group to the high royalty rate group (or vice-versa). This is a live issue, given Western Australia's decision to increase, in stages, its effective royalty rate on this commodity from 3.75 per cent to 7.5 per cent from 2013-14 onwards.

⁶ There is a third component that comprises payments from the Commonwealth to the States in lieu of royalties pursuant to agreed revenue sharing arrangements.

Figure 7.2 Royalties on certain Western Australian iron ore fines

Source: Western Australia Government, Budget Paper No. 3, 2012-13, page 74.

Western Australia's first decision to remove the concessional 3.75 per cent royalty rate effectively increased the rate to 5.625 per cent. It expected to raise around \$340 million a year from this decision.⁷ However, it would have lost far more than this amount via a reduction in its GST share if the CGC had decided to move iron ore fines from the low rate into the high rate category. In any event, before the CGC was required to make its decision, the Commonwealth Treasurer instructed it to keep iron ore fines in the low rate group for the time being.

The potential for a State to lose more in GST revenue than it gains from an increase in its royalties does seem to be a perverse and inappropriate side-effect of the two-tier mining revenue assessment.⁸ The Panel notes that the Commonwealth Treasurer has used the Terms of Reference for the 2011 Update and the 2012 Update to ensure this does not occur in this case. The Panel agrees that this was an appropriate response.

Finding 7.2

The current two-tier mining revenue assessment can produce excessively large GST share effects when a commodity moves between groups.

Finding 7.3

The Commonwealth Treasurer's previous directions to the CGC to keep iron ore fines in the low-rate group appropriately ensured Western Australia was not unfairly penalised for removing its concessional rate.

7 Western Australia Department of State Development, *Agreement benefits Western Australia and iron ore producers*, http://www.dsd.wa.gov.au/4868_8006.aspx, accessed 17 October 2012.

8 As Western Australia has pointed out, this could also create the opposite incentive in relation to potential reductions in royalty rates. See Western Australian supplementary submission to the GST Distribution Review, March 2012, page 8.

Western Australia subsequently formally announced, in its 2011-12 Budget, its intention to bring its fines royalty rate up to the 7.5 per cent rate applying to iron ore lump. In its most recent budget, Western Australia estimated that, when fully phased-in, this change will generate around \$1 billion a year in additional royalty revenue.

Table 7.3: Western Australian iron ore fines royalty rate changes

	2011-12	2012-13	2013-14	2014-15	2015-16	Total
Royalty rate — iron ore fines	5.625%	6.5%	7.5%	7.5%	7.5%	
Extra royalty income (\$m)		399	939	966	975	3,280
GST impact (\$m)				-86	-298	-384
Net revenue impact (\$m)		399	939	880	677	2,896

Source: Western Australia Government, Budget Paper No. 3, 2011-12, page 89.

In contrast to its initial decision to increase the royalty rate to 5.625 per cent, the additional royalty revenue that Western Australia will receive from this decision will be considerably larger than the reduction in its GST share. This remains the case even though Table 7.3 significantly understates the ongoing GST share effect because of the HFE system’s three-year averaging process. Looking forward, the additional \$1 billion in royalty revenue could be expected to reduce Western Australia’s GST share by around \$400 million a year in the event that iron ore fines were kept in the low royalty rate group, or by around \$500 million a year if fines were moved into the high rate group.

It would be untenable to keep iron ore fines in the low royalty rate group indefinitely when subject to the same royalty rate as iron ore lump (7.5 per cent). At some point, under the current approach iron ore fines must move into the high royalty rate group. The point when this occurs is important though, because of the large difference between assessing iron ore fines in the low royalty group (where the average rate is around 3.8 per cent) and in the high rate group (average rate around 7.4 per cent). Obviously, Western Australia would prefer fines be kept in the low rate group for as long as possible, while other States would prefer the switch occurs more quickly.

The Panel considers the Commonwealth Treasurer was correct to intervene to ensure that iron ore fines did not move into the high royalty group in either the 2010-11 or 2011-12 assessment years (while the rate was 5.625 per cent). Further intervention is no longer required. The Treasurer should direct the CGC to consider the appropriate treatment of iron ore fines from the 2012-13 assessment year.

Recommendation 7.1

That, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to:

- *continue to ensure that Western Australia’s removal of iron ore fines royalty rate concessions in 2010 does not cause iron ore fines to move into the high royalty rate group in the 2010-11 or 2011-12 assessment years*
- *consider the appropriate treatment of iron ore fines for the 2012-13 assessment year and future years, in light of Western Australia’s decision to bring the iron ore fines royalty rate to the same level as that for iron ore lump.*

The mining revenue assessment

The circumstances surrounding iron ore fines provide a specific example of the general problem that can be created by splitting the mining revenue assessment into discrete groups. In its first interim report the Panel encouraged the CGC and other stakeholders to review the mining revenue assessment method at the earliest opportunity. This remains our advice.

In the Panel's view, the mining assessment would be ideally based directly on profit levels, rather than using average royalty rates applied to the value of production as a proxy. However, the Panel recognises the difficulties that have existed in obtaining the necessary data to employ a single profit-based mining assessment.⁹

In Chapter 8 the Panel sets out its views on what the States and the Commonwealth should do to put the interaction between the State royalties and the Commonwealth's resource taxes on an improved, sustainable footing. Governments may choose not to adopt these suggestions, leaving the current tension between State royalties and the MRRT and PRRT in place. In that event, the CGC should recognise that the introduction of the MRRT and PRRT has altered the economics of States' iron ore, coal and petroleum royalties along with the incentives faced by the States when setting these royalties. The Panel sees a strong case for treating iron ore, coal and petroleum royalties differently to other royalties in such circumstances.

Recommendation 7.2

That the CGC and other stakeholders develop a new mining revenue assessment at the earliest opportunity. The new assessment should:

- *avoid excessively large GST share effects, such as when a commodity moves between groups under the current assessment*
- *treat iron ore, coal and petroleum differently to minerals that are not subject to Commonwealth resource rent taxes.*

7.3 Are all mining related expenditure needs recognised?

The Panel has examined concerns raised by Queensland and Western Australia about whether the system recognises all mining related expenditure needs.¹⁰ Queensland and Western Australia say that, while mining revenue is fully equalised, their mining related expenditure needs are not fully recognised and this prevents them from attracting the labour and capital necessary to facilitate structural adjustment. Western Australia is particularly concerned that failure to recognise these needs forces a focus on cost recovery or private sector provision of mining infrastructure and that this has implications for smaller miners who would benefit from a greater public sector role.

⁹ Over time, this may change somewhat following the introduction of the MRRT on iron ore and coal projects and the PRRT on onshore petroleum projects. However, this would be of no assistance in relation to other minerals not subject to the MRRT or PRRT.

¹⁰ In an HFE context, expenditure 'needs' refer to factors outside a State's control that influence spending.

Queensland and Western Australia identified some unrecognised needs linked to direct mining related costs that they say are not sufficiently recognised in the current system. These include:

- costs linked to managing new and ongoing projects (including regulation costs)
- costs of providing services and related infrastructure in regional mining communities
- additional costs associated with fly-in fly-out workers
- very high service delivery and capital unit costs in remote mining communities
- mining related road construction costs.

In addition, Queensland and Western Australia say the equalisation system does not recognise the opportunity cost and risk associated with providing infrastructure to facilitate mining activity. Queensland and Western Australia say the 'gaps' in the current equalisation system could be recognised through appropriate expenditure assessments or a discount to the mining revenue assessment.

The Northern Territory¹¹ and some of the non-resource States say they support changes to ensure mining related expenditure needs are properly recognised, but their preference is to do this through appropriate expenditure assessments rather than a discount to the mining revenue assessment. Other non-resource States say that these needs are already recognised including through the capital assessments introduced in the last CGC methodology review, and that mining infrastructure should be provided by the private sector or government business enterprises (GBEs) on a cost recovery basis.

The Panel notes that while State governments have a major role in providing economic and social infrastructure in mining regions, the Commonwealth has indicated a willingness to play an increasing role. In the 2012-13 Budget, the Commonwealth confirmed its commitment to spend \$6 billion over 11 years to 2020-21 on regional infrastructure investment to support Australia's economic development through investment in resource and export capacity, and address potential capacity constraints arising from export production and resource projects.¹² This support supplements past and ongoing programs for State road and social infrastructure services.

The Panel has examined the scale and type of mining related expenditures identified by Queensland and Western Australia. The following sub-sections outline the Panel's findings and conclusions on the issues raised by Queensland and Western Australia.

Direct costs

Mining industry support costs

States with a large mining sector incur costs directly linked to the regulation and management of new and ongoing mining projects including environmental impact

11 The Northern Territory has a relatively large mining sector. The Northern Territory, together with Queensland and Western Australia, is one of the main resource States in an HFE context.

12 Commonwealth Government, 2012-13 Budget Paper No.3, Support for State infrastructure services, page 100.

assessments, community consultation and infrastructure planning.¹³ Since resource States are likely to incur higher per capita costs due to the larger scale of mining activity, the Panel agrees there is a conceptual case for recognising these higher costs.

The Panel understands that the CGC considered making an assessment in the 2010 Review, but concluded at that time that it would not be material. Given the recent growth in mining activity it is likely that mining industry support costs have increased. The Panel recommends that the CGC develop an assessment for mining industry support costs along similar lines to the assessment of regulation costs for the agricultural sector in the services to industry category. The CGC should also examine whether a similar assessment for other industries would be practical and material.

Social infrastructure and community amenities in regional mining towns

Western Australia and Queensland say there is growing demand for services in mining communities and that the high cost of providing social infrastructure in these communities is not fully recognised — particularly in the areas of health and education. Western Australia also identified support for local governments and general community amenities (for example, cultural, sporting and other recreational facilities) as areas where the CGC's assessments are inadequate. Western Australia estimates that the amount of its unrecognised needs in 2010-11 was \$500 million.¹⁴

The Panel does not agree that there are significant unrecognised needs for social infrastructure including general community amenities. The current infrastructure assessments take account of population growth and where people live, and how this influences both the quantity and unit cost of infrastructure.¹⁵

The Panel notes some needs related to State government support for local government are recognised because State financial support for local government is included in the relevant expense categories and assessed in the same way as State expenses for similar functions.¹⁶ The CGC does not equalise local government activities across the board because it does not consider that its Terms of Reference gives it a mandate to do so.¹⁷

The Panel accepts that local government areas experiencing rapid population growth will face higher costs related to the provision of community amenities, but without any information about the revenue capacity of local governments or the level of State financial support for local government, the Panel is unable to determine the extent of any unrecognised needs, if they exist.

13 The Queensland Government says the total cost of administration for the mining sector was \$100 million in 2008-09, rising to \$120 million by 2011-12, see Queensland Government submission to the GST Distribution Review, August 2012, page 33. Western Australia did not provide an estimate of costs.

14 Western Australian submission to the GST Distribution Review, August 2012, page 16.

15 The latter is achieved by applying all expense use and cost disabilities in the depreciation and net investment assessments. See Commonwealth Grants Commission, *Report on GST revenue sharing relativities — 2010 Review, volume 2*, Canberra, 2010, pages 465 to 477 for a detailed explanation of how capital stock (or use) and cost disabilities are derived for the infrastructure assessments.

16 State support for local governments is provided across the full range of government functions but major areas are welfare, housing, water, sanitation, community amenities, natural disaster and roads.

17 Commonwealth Grants Commission, *Report on GST revenue sharing relativities — 2010 Review, volume 1, Main Report*, Canberra, 2010, page 32.

Fly-in-fly out (FIFO) and drive-in-drive out (DIDO) workers

A significant proportion of the mining workforce is employed on a FIFO or DIDO basis. The Panel understands that the ongoing presence of FIFO/DIDO workers creates additional demand for services in mining communities. The CGC's expenditure assessments use ABS estimated resident population (ERP) data to calculate service populations in different geographic regions. ERP data are based on place of usual residence and therefore are unlikely to pick up FIFO/DIDO workers. Western Australia estimates that the amount of its unrecognised needs in 2010-11 was \$100 million.¹⁸

The Panel agrees that resource States' needs are likely to be somewhat understated because FIFO/DIDO workers are not included in ERP estimates, and the current assessments could be improved by including an adjustment for FIFO/DIDO workers.

Very high unit costs in remote mining communities

Western Australia says it faces very high costs in providing services in remote mining communities due to the high demand for labour and housing and that the equalisation system makes no distinction between equivalent areas of remoteness in different States. This means that Western Australia's very high costs are not recognised. Western Australia estimates that the amount of its unrecognised needs in 2010-11 was \$315 million.¹⁹ Western Australia says it spend substantial amounts on:

- district allowances and other benefits for regional public sector employees
- housing for government employees and non-government service workers in mining communities.

The Panel notes that the equalisation system recognises that the cost of service provision increases with remoteness due to a number of factors, including higher wages paid to government employees working in more remote locations and high employee housing expenses. The Panel considers that some government employee costs in remote locations may not be fully recognised due to the discount applied by the CGC to the regional location assessment and recommends that the CGC re-examine this assessment in a future methodology review.²⁰

Capital costs

Western Australia says that the CGC uses recurrent cost disabilities to approximate capital cost disabilities in its infrastructure assessments and that capital specific cost disabilities would be better — it says that approximating capital cost disabilities results in its capital costs being understated by \$100 million each year.²¹

The Panel understands that the CGC considered using a direct measure of capital costs in the 2010 Review, but could not identify a suitable data source. Consequently, the CGC decided to use the recurrent cost disabilities, including regional location cost disabilities, to approximate capital cost disabilities. The Panel agrees that it would be

18 Western Australian submission to the GST Distribution Review, August 2012, page 16.

19 Western Australian submission to the GST Distribution Review, October 2012.

20 The CGC applied a discount due to uncertainty surrounding the comparability of the data used. Commonwealth Grants Commission, *Report on GST revenue sharing relativities — 2010 Review*, volume 2, Canberra, 2010, page 520.

21 Western Australian submission to the GST Distribution Review, August 2012, page 16.

preferable to use capital specific cost disabilities if they were available and recommends that the CGC re-examine this issue in the next methodology review to determine if any new data sources or approaches are available for measuring capital costs.

Roads

Queensland and Western Australia identified a number of road projects directly linked to mining activity (including roads to meet the transport needs of the DIDO workforce) for which needs were not fully recognised. Most of the road projects identified in their submissions were road upgrades to accommodate increased traffic volumes and heavy vehicle use. Western Australia says it is planning to fund a \$123 million access road to the Browse Liquefied Natural Gas (LNG) Precinct about 60 kilometres north of Broome.²²

The infrastructure assessments seek to measure State road investment needs with the rural roads investment assessment picking up differences in needs due to road use and length. The use measure takes account of traffic volume and heavy vehicle use while the measure of road length focuses on State managed roads linking localities larger than 400 people by the fastest route.²³ In the Panel's view, needs for most of the mining related road projects identified in State submissions are therefore recognised. One area the Panel identified where needs may not be recognised are roads that link common-user facilities (for example, ports, regional airports) that do not coincide with population centres. The Panel recommends that the CGC examine this issue in the next methodology review to determine if the parameters for defining the length of State managed rural roads could be refined further. That said, the Panel observes that if States choose to fund roads to mining related sites that primarily benefit a single operator it is not appropriate for the HFE system to recognise these roads.

Other multi-user economic infrastructure

In addition to roads, the public sector provides other multi-user facilities such as ports, rail, electricity and water infrastructure to support development of the mining sector. Much of this infrastructure is provided through government business enterprises (GBEs). The resource States consider there is a risk that this infrastructure will be under-provided if left to the private sector and/or user pays funding and that this poses a problem for small- and medium-sized operators. The Panel examined a number of examples provided by Western Australia of multi-user infrastructure projects but concluded that, for the most part, these projects do not directly impact the State budget. The Panel agrees that upfront funding of these projects may place pressure on State debt levels and in turn limit the State's capacity to fund other investments. However, in the long-term these projects should be fully cost recovered and are likely to generate profits (and additional fiscal capacity) for the resource States.

Opportunity costs and risk

Western Australia (and Queensland in a different context) says the opportunity cost and risk of providing mining related infrastructure is not recognised in the equalisation system. Western Australia estimates the scale of its opportunity cost and risk was \$870 million in 2010-11.²⁴ Western Australia says these intangible costs relate to

22 Western Australian submission to the GST Distribution Review, October 2011, page 22.

23 Commonwealth Grants Commission, *Report on GST revenue sharing relativities — 2010 Review*, volume 2, Canberra, 2010, page 346.

24 Western Australian submission to the GST Distribution Review, August 2012, page 16.

infrastructure that is initially not fully utilised and the risk of eventual under-utilisation.²⁵ Queensland says the opportunity cost arises because governments face budget constraints and spending on mining infrastructure means less spending in other areas and the timeframes for cost recovery are extremely long.²⁶

The Panel has examined Western Australia's calculation of opportunity cost and risk, noting that it hinges on an assumption that Western Australia's population should be growing at 2 per cent a year above the national average. The estimate also assumes an opportunity cost applies to all public sector infrastructure, whether tax-funded or provided on a full cost recovery basis. While the Panel appreciates the conceptual argument put forward by Western Australia, the estimate of these costs is highly contestable, especially in the absence of any evidence to support the population target.

The Panel understands that changes to the assessment of capital in the 2010 Review were designed to ensure that the needs of States experiencing rapid population growth (such as Queensland and Western Australia) are recognised as population growth occurs. The Panel does not agree that further changes are required to create capacity for States in advance of actual population growth.

The Panel recognises that there is a risk that State funded social and economic infrastructure related to mining activity may not be fully utilised in the future if the level of mining activity declines. However, this type of risk exists for all States undergoing structural change, and the Panel has no basis for concluding that the resource States face relatively greater risk, or for assigning a value to this risk.

Summary on mining related expenditure needs

The Panel has thoroughly examined the scale and type of mining related expenditures identified by Queensland and Western Australia and concludes that, while most of their direct mining related needs are recognised, some small gaps exist including:

- Mining industry support costs are not fully recognised. For Western Australia the Panel considers the potential size of unrecognised needs may be \$30 to \$60 million. This estimate is based on an estimate of needs derived from our own indicative assessment for mining support costs along similar lines to the one for agriculture.
- Costs related to FIFO/DIDO workers. For Western Australia the potential size of unrecognised needs may be \$20 to \$40 million. This amount is less than Western Australia's estimate because only a proportion of the total number of FIFO/DIDO workers are present at any one time and no supporting information has been provided on the additional cost of each FIFO/DIDO worker.
- Very high government employee costs in remote locations. For Western Australia the potential size of unrecognised needs may be \$10 to \$20 million. This amount assumes that Western Australia's regional location needs may be 5 to 10 per cent higher than currently recognised.

25 Western Australian submission to the GST Distribution Review, August 2012, page 15.

26 Queensland submission to the GST Distribution Review, August 2012, page 33.

In a number of other areas, the Panel concludes that there are no significant unrecognised needs related to:

- the provision of services and social infrastructure in mining communities (except those for FIFO/DIDO workers)
- State financial support for local government for the provision of community amenities
- how capital specific cost disabilities are estimated
- mining related road projects.

Finally, the Panel considers that the equalisation system should not recognise opportunity cost and risk associated with mining related infrastructure.

These findings are summarised in Table 7.4. The table includes estimates of the potential scale of Western Australia’s unrecognised needs in 2010-11. They amount to about \$60 to \$120 million. This amount for Western Australia is equivalent to around a 3 per cent discount to the mining revenue assessment.

Table 7.4: Summary of potential gaps in the assessment of mining related costs²⁷

Description of unrecognised needs	WA’s estimate of additional unrecognised needs in 2010-11	Panel’s conclusion on the size of WA’s unrecognised needs
Mining industry support costs	No estimate provided	Additional \$30 to 60 million
State provided services, social infrastructure and other community amenities in mining regions	Additional \$500 million	Needs are already fully recognised in the CGC’s assessments.
Financial support for local government for the provision of community amenities	Part of the additional \$500 million estimate provided above.	Unable to quantify any additional unrecognised needs
Services and infrastructure for FIFO and DIDO workers	Additional \$100 million	Additional \$20 to \$40 million
Very high costs in Western Australia’s remote mining communities	Additional \$315 million	Additional \$10 to \$20 million
Capital costs approximated using recurrent costs	Additional \$100 million	Unable to quantify any additional unrecognised needs
Roads in mining regions	No estimate provided	Needs are already fully recognised in the CGC’s assessments.
Opportunity cost and risk (or cost of in-advance provision of infrastructure)	Additional \$870 million	The equalisation system should not recognise opportunity cost and risk as needs.

²⁷ Queensland provided information on total spending over the last 4 years on roads and social infrastructure in mining regions and areas that have linkages to the mining region. The amounts are equivalent to an average annual spend of \$370 million. This was in addition to mining industry support costs. Queensland did not include an estimate of the size of unrecognised needs. See Queensland submission to the GST Distribution Review, August 2012, page 32.

The issues and circumstances referred to above can be re-examined in detail by the CGC at its next methodology review. As this may take several years to occur, the Panel has felt the need to recommend interim action. The Panel therefore recommends that the CGC add an amount to its expenditure assessments equivalent to a 3 per cent discount to the mining revenue assessment. In this way the scale of the unmeasured needs for each State will be linked to the scale of the mining revenue assessment.

In recommending this approach the Panel acknowledges that the scale of unrecognised needs for Queensland is based on information for Western Australia. Nevertheless, the types of costs identified by Queensland were similar to those identified by Western Australia. This interim assessment should remain in place until the next methodology review is completed.

Recommendation 7.3

The Panel recommends that, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to add an amount to its expenditure assessments equivalent to a 3 per cent discount of the mining revenue assessment in order to compensate for the fact that some mining related needs of the resource States are not fully recognised. This interim assessment should remain in place until the next methodology review is completed.

8 State mining royalties and the MRRT

8.1 State royalties and the Commonwealth's resource taxes

The Panel's second interim report explored at some length the interaction between the Commonwealth's new resource taxes (the MRRT and the expanded PRRT) and State mineral royalties. Some of the key conclusions of this analysis were that:

- well-designed rent-based taxes are likely to be more economically efficient than royalties, particularly in periods of low commodity prices or high costs
- other factors, such as the size, variability and timing of the return received by government, as well as administration and compliance costs, are also important considerations when choosing between alternative resource charging regimes
- the States, through their long-standing role in charging for the right to mine under their soils, and the Commonwealth, via its well-established position in the field of taxation, have roles in obtaining mining revenue on behalf of the community
- the Commonwealth's design of the MRRT and PRRT has created an opportunity for States to seek to increase their revenue at the expense of the Commonwealth — an undesirable and unsustainable situation, which needs to be resolved
- the Commonwealth and the States should negotiate an integrated resource charging system, addressing how the revenue is shared between them.

While the Panel notes the strength of several States' objections to the Commonwealth's expansion of its role in resource charging, the submissions received in response to the interim reports have not given the Panel cause to alter these conclusions.

Finding 8.1

The States and the Commonwealth both have legitimate roles in obtaining mining revenue on behalf of the community. The challenge is to reconcile these interests.

Developments since the second interim report

Since the Panel finalised the second interim report, there have been two important developments, both of which serve to highlight weaknesses with current arrangements:

- iron ore and coal prices have declined considerably¹
- the Queensland Government has announced it will increase its coal royalties.

1 Falls in commodity prices have led the Commonwealth to reduce its expectations of MRRT revenue. In its 2012-13 Mid-Year Economic and Fiscal Outlook the Commonwealth estimates net revenue from the MRRT will be around one-third lower than estimated in the 2012-13 Budget.

Iron ore and coal prices have declined in recent months

The Panel finalised its second interim report in late May 2012. Since that time, both iron ore and coal prices have fallen considerably, although the iron ore price in particular remains well above its long-term historical average (see Figure 8.1).

Since the 2012-13 Commonwealth Budget in early May the spot prices for iron ore and thermal and metallurgical coal have fallen between 15 and 33 per cent.² These price falls, coupled with increasing costs, have contributed to some proposed mine expansions being postponed, as well as some earlier closure of existing capacity. The closures have in turn contributed to job losses, particularly in the regions affected.

Figure 8.1 Monthly iron ore and thermal coal prices



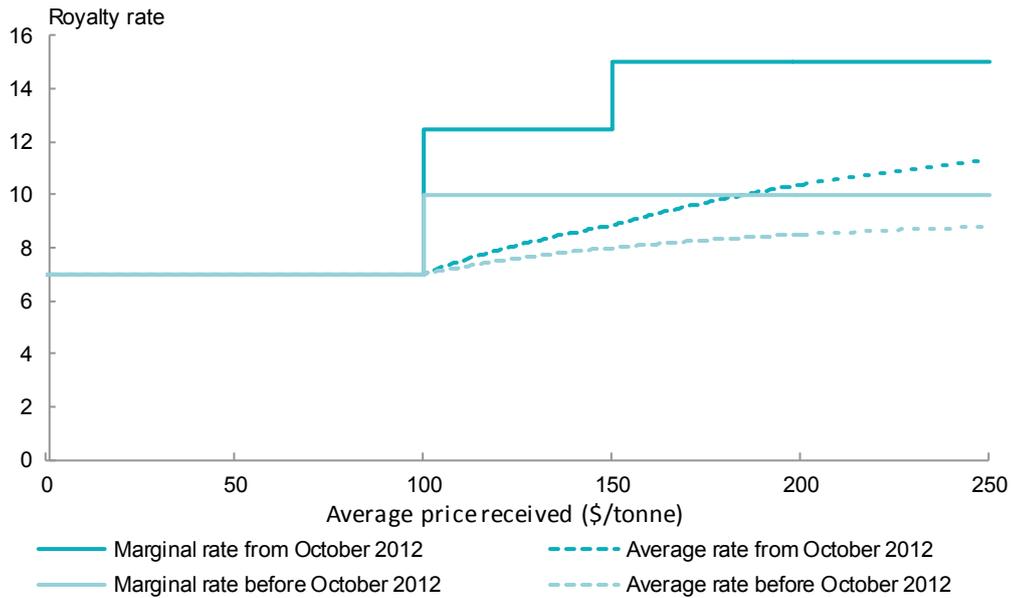
Source: www.indexmundi.com.

Queensland has increased its coal royalties

The Queensland Government announced an increase in coal royalties in its 2012-13 Budget, delivered on 11 September 2012. With effect from 1 October 2012 the previous single rate of 10 per cent on the value above \$100 per tonne was replaced with a rate of 12.5 per cent on the value between \$100 and \$150 per tonne, with a rate of 15 per cent applied to the value above \$150 per tonne. The base 7 per cent rate that applies on the first \$100 received per tonne was left unchanged. Queensland estimates that this change will increase coal royalties by around \$1.6 billion over the four years to 2015-16.³

2 Metallurgical coal and iron ore prices, in particular, have also been highly volatile. The iron ore spot price fell around 38 per cent in US dollar terms between the Commonwealth Budget and the first week of September, before recovering around two thirds of this fall by the second week of October. See Commonwealth Government, 2012-13 Mid-Year and Fiscal Outlook, page 19.

3 Queensland Government, 2012-13 Budget, Budget Paper 4, page 134. As part of this budget measure, the Queensland Government also announced that a Cabinet Committee would work with the coal industry to 'reduce costs and the regulatory burden with the package to be finalised within 100 days of the 2012-13 Budget' and that the Government 'will also guarantee for a period of ten years (end of 2021-22 financial year) that coal royalties will not be increased again.'

Figure 8.2 Queensland's coal royalty regime

Source: Based on Secretariat analysis of Queensland's 2012-13 Budget.

With this increase, Queensland joins Western Australia, New South Wales, Tasmania and South Australia as having increased its royalties since the announcement of the MRRT. There should now no longer be any doubt that the Commonwealth's decision to fully credit State royalties under the MRRT and PRRT (without reaching any agreement with the States regarding their royalty regimes) has created an incentive for States to increase these royalties. The States have chosen to act on this incentive.

While the States' decisions to increase royalties are unsurprising, particularly given the current fiscal environment, they are regrettable when looked at from a system-wide perspective. Their decisions will cost jobs and investment, as well as hinder regional development. This is because as commodity prices decrease, the economic harm caused by royalties tends to increase as production and investment decisions become increasingly distorted.⁴ In the second interim report the Panel suggested that an improved overall system could comprise lower royalties on iron ore, coal and petroleum, with greater use being made of resource rent taxes to deliver a return to the community (along with negotiated arrangements to ensure that no State is left worse off).⁵ Instead of moving in this direction, all available evidence is that the opposite is occurring.

Finding 8.2

The Commonwealth's decision to fully credit State royalties under the MRRT and PRRT has created an incentive for States to increase these royalties. This situation is neither desirable nor sustainable.

4 Queensland's coal royalty regime attempts to limit these distortions by having the royalty rate vary somewhat with price. See Figure 8.2.

5 GST Distribution Review, *Second Interim Report*, June 2012, Chapter 4.

8.2 A cooperative approach remains the best solution

Having reiterated the Panel’s conclusion that the current impasse is neither desirable nor sustainable, it is worth also restating the Panel’s position on the relative merits of the possible resolutions to the problem.

- The Panel agrees with the States that it would not be desirable for the Commonwealth to adjust the GST distribution system to penalise States for increasing their royalties.⁶
 - Not only might this not achieve the Commonwealth’s goals, the zero-sum nature of the GST distribution system would result in a corresponding unintended reward for other States.
- Given that the Commonwealth provides significant non-GST revenues to the States, there are other means at the Commonwealth’s disposal to seek to dissuade States from eroding its resource rent tax revenue base. However, use of these means would be a less desirable alternative to a cooperative solution.
- The Commonwealth and the States could act on the advice of the Australia’s Future Tax System (AFTS) review, the Policy Transition Group and this Panel and strike an agreement on the taxation of resource projects to secure, and build upon, the benefits of the resource tax reforms already undertaken.

The third of these alternatives represents the best approach. Given that the cause of the current impasse is the Commonwealth’s decision to provide an open-ended guarantee to credit State royalties without reaching an accommodation with the States as to their levels, the primary onus to seek a resolution rests with the Commonwealth. The Panel encourages the Commonwealth to take the lead in proposing discussions, and urges the States to respond positively and negotiate in good faith.

Recommendation 8.1

The Commonwealth and the States should acknowledge that a cooperative approach to resource charging will produce a superior outcome to any available alternative.

Accordingly, the Commonwealth should actively seek to engage the States with a view to reaching agreement on the taxation of resource projects. The States should be receptive to such a request for negotiations.

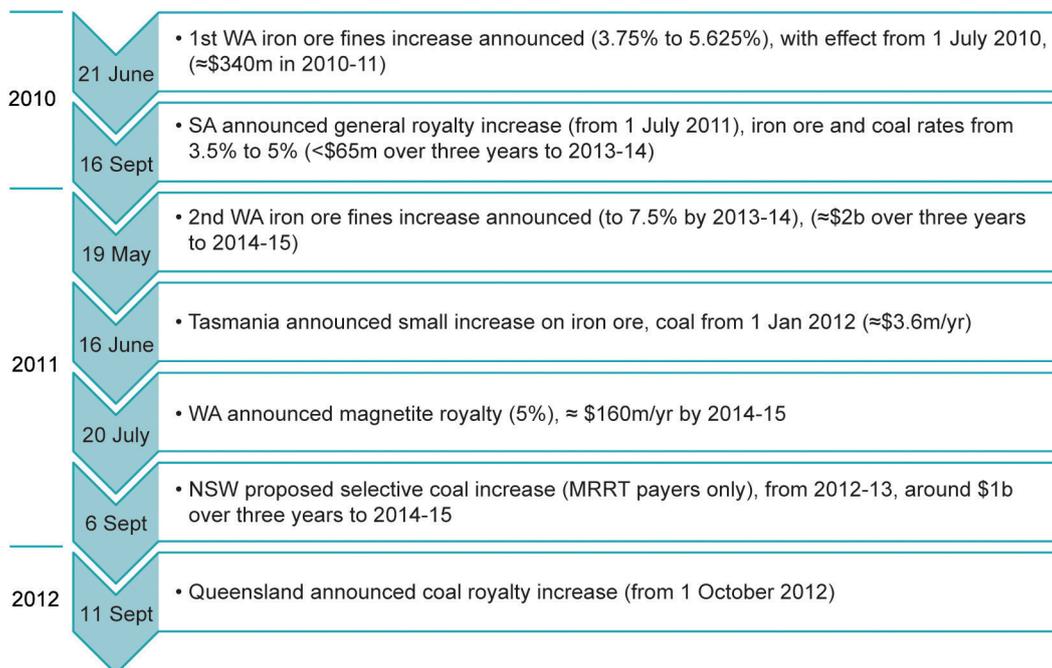
Options in the absence of cooperation

As discussed above, and shown in Figure 8.3, five States, including the large resource States of Western Australia, Queensland and New South Wales, have increased royalties on commodities subject to the MRRT since the Commonwealth’s original announcement on 2 May 2010 of its intention to introduce a Resource Super Profits Tax.

⁶ Box 8.1 canvasses the limited circumstances in which a departure from this principle may be justified.

The Commonwealth Treasurer has criticised States for these royalty increases. In August 2012 it was reported that Mr Swan wrote to his State counterparts stating, in part that, ‘in the event that we are not able to reach an agreement on the interaction between state minerals royalties and the MRRT, the Commonwealth will implement measures to protect MRRT revenue from recently announced or future royalty increases.’ The report further stated that the Commonwealth was referring specifically to royalty increases occurring after 1 July 2011.⁷ This date would indicate that the Commonwealth does not intend to pursue further the relatively small increases made by South Australia or Tasmania, or Western Australia’s changes to its iron ore fines royalties, but that it does intend to respond in some way to New South Wales’ and Queensland’s announcements, as well as any future increases.⁸

Figure 8.3 Announced increases to State royalties on MRRT commodities since 2 May 2010



Source: Compiled from various State Budget documents and media statements.

The Panel sees its role under the Terms of Reference as being to examine the incentives for States to increase their royalties under the current arrangements. Having concluded that the current situation is undesirable and unsustainable, the Panel has also offered some suggestions for how to improve it.

7 See Coorey, P, 2012, ‘Swan Warns States Not To Gouge Royalties’, Sydney Morning Herald, 21 August 2012, accessed 17 October 2012, <http://www.smh.com.au/opinion/political-news/swan-warns-states-not-to-gouge-royalties-20120821-24kql.html#ixzz28DSyxe53>. It has also been reported that Mr Swan wrote to the New South Wales Treasurer in November 2011 on this issue, see Salusinszky, I, 2012, ‘NSW Premier Barry O’Farrell calls Gillard government a pack of thieves over mining royalties’, The Australian, 23 November 2011, accessed 17 October 2012, <<http://www.theaustralian.com.au/national-affairs/state-politics/nsw-premier-calls-gillard-government-a-pack-of-thieves-over-mining-royalties/story-e6frgczx-1226202979951>>.

8 This division is consistent with other statements made by the Commonwealth Treasurer. Less clear is the Commonwealth’s attitude towards Western Australia’s announcement on 20 July 2011 to impose a 5 per cent royalty on magnetite (a form of iron ore). In any case, this increase is expected to have much less impact on MRRT revenue than the New South Wales or Queensland changes.

The Panel's role does not extend to passing an opinion on the merits or otherwise of any State's individual policy decision, or on whether or not the Commonwealth would be justified in 'penalising' that State for increasing its royalties.

That said, the current dynamic is neither stable nor conducive to the sort of negotiated 'win-win' outcome that the Panel recommends be pursued. States continue to have an incentive to increase their royalties, not only to gain revenue (collectively) at the expense of the Commonwealth, but also to seek to gain at the expense of other States by increasing their 'relative effort' to raise revenue as assessed by the CGC. The way that coal and iron ore royalties interact with the MRRT means that the concept of relative effort is largely meaningless in this context. This creates a risk that, for example, New South Wales and Queensland might engage in escalating coal royalty increases. If this happened, then it would become harder to craft a 'deal' acceptable to all parties.

In these circumstances, a stop-gap measure may serve to improve the likelihood of a negotiated agreement being struck. The CGC could be instructed to assess the extra revenue that States receive from royalty rate increases after a given date on an 'actual per capita' basis. The effect of this would be to reduce the GST share of a State increasing its royalties so as to offset the additional own-source revenue it receives. Ultimately, after the lag and averaging in the HFE system has taken effect, each State would receive its population share of the additional royalty revenue (see Box 8.1).

Box 8.1 Assessing certain royalty increases on an actual per capita basis

Although mining is dominated by a few States, and so they have more scope to affect the average than in other areas, States still retain the majority of the benefit of a policy decision to increase their royalties.

To take some hypothetical examples based on current estimates for 2013-14, and holding everything else constant:

- If New South Wales increased its royalties by \$500 million, then, after taking into account GST share effects it would ultimately end up \$526 million better off.
- If Queensland increased its royalties by \$500 million then it would ultimately end up \$373 million better off.
- If Western Australia increased its royalties by \$500 million then it would ultimately end up \$428 million better off.⁹

Like most policy changes under the current system, royalty increases like these will affect all States, sometimes adversely. For example, a \$500 million increase by New South Wales would ultimately make the other major mining States *worse off* (Queensland by \$127 million and Western Australia by \$72 million).

⁹ These estimates are Secretariat calculations based on data from current State budget estimates, and on the simplifying assumptions that the current mining revenue assessment remains in place and that all royalty rate increases relate to minerals in the high royalty rate group. If a different method of assessing mining revenue were to be put in place, then this would lead to different financial impacts for each State in these examples. However, the main conclusions would not be affected.

The distribution of a hypothetical \$500 million increase in New South Wales' royalties under the current approach

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Additional royalty revenue from policy change (\$m)	500	0	0	0	0	0	0	0	500
Final budget effect, including GST share effects (\$m)	526	124	-127	-72	26	11	8	4	500

This may be seen as an inappropriate outcome, particularly in the current circumstances where States have an artificial incentive to increase certain royalties due to the way they interact with the MRRT and PRRT. It could easily be seen as perverse that a decision by, say, New South Wales, to collect an extra \$500 million in royalties, that might have little or no practical effect on miners and ultimately is borne by the Commonwealth's budget, would also harm Queensland and Western Australia.¹⁰ It also arguably creates a situation where those States may feel obliged to ratchet up their own royalties so as to maintain their relative position.

If the Commonwealth directed the CGC to assess the revenue from such additional royalty increases on an actual per capita basis, this would ensure that each State received exactly its population share of the extra revenue.

Continuing with the New South Wales example, instead of getting \$526 million from its increase, ultimately it would retain only \$160 million. Queensland and Western Australia would also get their population shares of the extra revenue rather than going backwards as they would otherwise do. This may reduce their imperative to respond with royalty rate increases of their own.

How the same \$500 million increase in New South Wales' royalties would end up being distributed if it was assessed on an 'actual per capita' basis

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Additional royalty revenue from policy change (\$m)	500	0	0	0	0	0	0	0	500
Final budget effect, including GST share effects (\$m)	160	124	102	53	36	11	8	5	500

This approach would be most effective if applied to an increase by only one State. If several States all increased their royalties, then adjusting the mining revenue assessment in this way would be of limited benefit.

Of course, in the event that States proceed with increasing their royalties on MRRT commodities under the existing arrangements, then the Commonwealth's budget will be left in a worse position, regardless of how the additional royalty revenue is ultimately shared between the States.

Such an approach might serve in the short-term to reduce the incentives for States to increase their royalties on MRRT commodities. However, it is not a substitute for a long-term solution, and still suffers from the drawbacks the Panel identified in the second interim report. For example, reducing the GST share of one State would increase

¹⁰ The point here is not to single out New South Wales in any way, but instead just to use one example to illustrate the sorts of perverse outcomes that may arise under the existing arrangements.

the GST shares of the other States, giving them an arbitrary windfall. It also would do nothing to support the Commonwealth's revenue base in the event that States proceed with increasing their royalties.

Finding 8.3

As an interim measure, the Commonwealth could announce that it intends to direct the CGC to assess any revenue raised from royalty increases on MRRT and PRRT commodities after a particular date on an actual per capita basis.

This would reduce, but not remove, individual States' incentives to increase their mineral royalties, while also potentially providing a windfall to other States. It would not represent an effective substitute for a negotiated outcome.

8.3 Fixing the interaction between MRRT and State royalties

While the details of any changes to the current arrangements are a matter for governments to decide, the Panel has considered it may be worthwhile to outline some principles which could serve as a guide to any negotiations between governments on these issues. While such advice perhaps lies at the outer edge of our Terms of Reference, we hope that all parties receive these suggestions in the manner that we intend them, as a genuine attempt to make ground on a real, and worsening, problem.

The Panel considers that at a minimum, the following three conditions will need to be satisfied if the nation's resource charging arrangements are to be placed on a sustainable footing:

- The States must retain their autonomy to set their royalty policies.
- The States must be accountable for the effects of their royalty policies.
- The gains from the Commonwealth's introduction of the MRRT and expansion of the PRRT must be secured.

States must retain their autonomy to set their royalty policies

As several States have pointed out, the responsibility for regulating mining activity and the right to charge for accessing the community's mineral resources have long rested with the States. The resource States see this as one of their fundamental responsibilities. There is no prospect over the short or medium term of the States agreeing to any significant reduction in their autonomy to set their royalty policies.¹¹

In the Panel's view, this effectively precludes any arrangement requiring the States to 'fix' in place their royalty regimes, even if this were to be limited to the MRRT and PRRT commodities. The States greatly value the flexibility to adjust their policies over time to suit their changing priorities and circumstances. While in theory there might be some

11 Over the longer-term, the States and the Commonwealth may agree to revisit their respective roles and responsibilities as part of a broader consideration of how the Federation operates. Responsibility for the mining industry could conceivably form part of that discussion (see Chapter 12).

price at which the Commonwealth could ‘buy off’ the States, it is likely to be so high as to prevent this from being a realistic approach, even if thought to be desirable.

In the Panel’s view, the States should retain the flexibility to charge royalties that they deem appropriate for the right to extract minerals from within their jurisdiction.

States must be accountable for the effects of their royalty policies

While States retain their ability to set royalty policies, they are now less accountable for the consequences of these policies. Prior to the introduction of the MRRT each State’s best interests clearly lay in seeking to strike the right balance between short-term royalty revenue (suggesting a high rate) and encouraging exploration and development of projects over the longer term (suggesting a lower rate). If a State government failed to achieve this balance, the accountability was clear.

Now, accountability is blurred and States face different and somewhat perverse incentives. Because at least part (and in some cases, most) of the additional revenue from an increase in iron ore or coal royalties will effectively flow to the States from the Commonwealth rather than being borne by the miners, States have an incentive (at least at the margin) to set higher *ad valorem* royalty rates. This would be most harmful to the least profitable miners.¹² These higher rates will, in some cases, cause a marginal mine to close earlier than it would have, or contribute to mine expansion plans being delayed. Allocating responsibility for the resulting economic and social costs between the State and the Commonwealth would be unsatisfactorily difficult. The link between States’ mining royalty policy settings and their consequences should be fully restored.

The Commonwealth’s resource revenue base should not be further eroded

It is desirable for States to retain the flexibility to adjust their royalty policy settings to respond to changing priorities and circumstances. However, this does not extend *carte blanche* to deliberately undermine the Commonwealth’s MRRT and PRRT revenue base. Such actions, even if they may be consistent in the short-term with the incentives provided to the States by the Commonwealth’s actions, would nevertheless be harmful over time, including to the States themselves.

As the Panel said in the second interim report, if it is unreasonable for the Commonwealth to expect the States to relinquish their discretion over royalty policy, it is equally unrealistic for the States to expect the Commonwealth to allow them to capture the revenue stream generated by the Commonwealth’s undertaking of a significant and challenging reform.

If a Commonwealth-State agreement on resource charging is not reached, then the MRRT and PRRT design should be revisited

There are only two possible ways of satisfying all of the above principles. One, the States and the Commonwealth could reach an accommodation regarding their respective shares of future mining revenues. If the parties were minded to do so, it would be possible to design a framework within which the States would have the ability to adjust their royalties to suit their particular circumstances, while also reassuring the

¹² Western Australia has suggested that the current arrangements could in theory also *discourage* States from reducing mineral royalties, to the extent that such reductions would result in an offsetting increase in the Commonwealth’s MRRT.

Commonwealth that the States would not seek to undermine the MRRT and PRRT revenue base. The Panel outlines one such framework in the next section.

In the absence of an accommodation along these lines, the only other way of preserving both the States' royalty policy autonomy and the Commonwealth's tax base is to revisit the MRRT's and PRRT's design. The sustainability of the Commonwealth's open-ended guarantee to credit all State royalties has always depended on its ability to reach an accommodation with the States regarding their royalties. If it is judged that such an accommodation is unable to be reached, then the MRRT and PRRT royalty crediting arrangements should be adjusted so as to do delink them from future State decisions.

As discussed in the second interim report, instead of linking the royalty credit to payments actually made to State governments, a credit based on some notional royalty rate could be applied uniformly. This could be calculated in any number of ways, and would be a matter for the Commonwealth to decide (although clearly the miners would have a significant stake in the particular rate chosen).¹³

Recommendation 8.2

If the Commonwealth and the States are unwilling or unable to reach an accommodation regarding resource charging, the Commonwealth should amend the design of the MRRT and PRRT to remove the open-ended crediting of all royalties imposed by the States.

8.4 What form should an agreement take?

The Panel has reaffirmed that an agreement between the States and the Commonwealth is the best available solution to the current impasse over resource charging. It has outlined a temporary measure which may help make a deal easier to strike (by directing the CGC to assess some royalty revenue on an 'actual per capita' basis) and it has suggested what it thinks needs to happen in the event an agreement is not reached (the design of the MRRT and PRRT ought to be revisited). This Chapter concludes with the Panel's views on what a national agreement on resource charging should look like.

In the second interim report the Panel suggested that there are potential solutions which could benefit all parties.¹⁴ For example, a reduction in the rate of *ad valorem* royalties on iron ore, coal and petroleum, with greater use being made of resource rent taxes to deliver a return to the community would:

- secure the MRRT and PRRT revenue base, allowing the Commonwealth to return to the States the value of foregone royalty revenue

¹³ In the second interim report the Panel noted that the options would include calculating a uniform allowance with reference to the average (or highest or lowest) royalty rate that applied at a point in time, such as the announcement of the Commonwealth's resource tax reforms (2 May 2010), the announcement of the MRRT (1 July 2010), the commencement of the MRRT (1 July 2012) or other date.

¹⁴ GST Distribution Review, *Second Interim Report*, June 2012, page 75.

- produce a more efficient system overall, by reducing the distortions to production and investment decisions that can be caused by royalties
- be expected to deliver a tangible fiscal dividend over time.

The Panel noted such a fiscal dividend would be available to be shared between levels of government. This remains the Panel's view and, alongside the principles described above, would represent a realistic, sustainable improvement to current arrangements.

A potential resource charging model

In the Panel's view, a hybrid resource charging structure, at least for iron ore, coal and petroleum, represents the best way forward for the Commonwealth, the States, and the nation as a whole. In part this reflects a slightly different conclusion by the Panel on the relative merits of royalties and resource rent taxation to that of the AFTS review. While we agree with that panel that a resource rent tax offers the most efficient way to collect an appropriate return from mining production, we see there is merit in having this operate alongside an *ad valorem* charge that ensures the community always receives something for the use of its valuable non-renewable resources. This approach would also be an easier transition from the current system which already acts as a hybrid of the two approaches (with a royalty payable by all miners, topped up by the MRRT or PRRT payable by the most profitable projects). Nevertheless, we consider it would be ideal if the royalty component was somewhat lower, perhaps more in the order of around 5 per cent of sales value in the case of iron ore and coal, rather than the typical prevailing rates of around 7.5 per cent.

A reduction in royalties on this scale by itself would cost the States a large amount of revenue, perhaps around \$4 billion a year based on current estimates.¹⁵ Realistically, a reduction in royalties on this scale could only occur if it was accompanied by (at least) an equivalent guaranteed increase in payments from the Commonwealth to the States. Much of this amount would be able to be sourced from the additional MRRT and PRRT revenue that would be expected to flow as a consequence of the reduced royalty allowances. As for the remainder, the Commonwealth would have at least two options. It could allow the fiscal cost to hit its own budget bottom-line. On one view, such a cost, while painful for the Commonwealth might nonetheless be preferable to the current situation whereby its MRRT and PRRT base is being steadily eroded. However, the Panel recognises that the Commonwealth itself is unlikely to be so sanguine about the prospect of taking such a budget 'hit', especially in the current tight fiscal environment.

Accordingly, a second option may be more attractive. The Commonwealth could seek to revisit aspects of the design of the MRRT and PRRT to ensure that overall revenue neutrality (in combination with the reduction in State royalties) was achieved (see Table 8.1). For example, one possibility worth careful consideration would be making royalty payments deductible for MRRT purposes like they are for income tax, instead of them being grossed-up and credited.¹⁶ Another option might be to reduce (or remove) the generous uplift arrangements provided for unused royalty allowances.

15 Initially this effect would be felt predominantly by Western Australia, Queensland and New South Wales, but would flow through to all States over time through the operation of the equalisation system.

16 GST Distribution Review, *Second Interim Report*, June 2012, pages 52-53.

Table 8.1: Revenue neutrality by adjusting royalties and MRRT/PRRT

Scenario	Most profitable projects would ...	Less profitable projects would ...	Revenue would be ...		
			States	Commonwealth	Total
MRRT/PRRT tightened to achieve revenue neutrality	pay more	pay less	lower by \$x	higher by \$x	the same
MRRT/PRRT parameters unchanged	pay the same	pay less	lower by \$x	higher by <\$x	lower

The net effect of these changes would be to improve the overall efficiency of the system by reducing the distortions caused by inefficient royalties, without altering the Commonwealth’s or the States’ fiscal positions, or increasing the total burden faced by the mining industry.¹⁷ However, by themselves these changes would neither restore full accountability to the States for the consequences of their policies, nor would they resolve the fundamental clash of incentives at the core of the current impasse.

The only way of fully restoring the States’ accountability for their royalty policy decisions within a hybrid system is to sever the automatic link between the royalty allowance provided under the MRRT and PRRT and the amount imposed by the States. The Panel considers that if an overarching agreement along these lines was in prospect, the Commonwealth should amend the MRRT and PRRT to provide miners with a fixed credit, perhaps equivalent to 5 per cent of the sale price, in lieu of the existing royalty allowance that is linked to States’ policies. States would then be free, as now, to adjust their royalty rates (either up or down). However, unlike the current situation, they would be clearly accountable for the effects of such decisions on the development of the industry within their State.

Finally, there is the question of how to bring the Commonwealth’s and the States’ fiscal incentives into line. What would be in this for the States? Ultimately, the Commonwealth may need to provide the States with some additional benefit to secure their support. Clearly this would be a matter for negotiation. One possibility though would be for the Commonwealth to commit to share with the States any expected fiscal dividend flowing from the improved efficiency of the overall system (see Box 8.2).

Box 8.2: A fiscal dividend from a better resource charging system?

The logic for certain reforms yielding a fiscal dividend is that by improving overall efficiency and productivity, they contribute to an increase over time in economic activity. Part of this increase then flows to governments as higher tax revenue.

KPMG Econtech modelling done for the AFTS review found that completely replacing royalties with an equivalent amount of resource rent tax revenue would improve welfare by an average of 50 cents for every dollar of revenue replaced, or \$1.2 billion per year in aggregate in the long run. If an incremental approach to reducing royalties was adopted, the first steps in the reform process would deliver the greatest benefits

¹⁷ The constraint of revenue neutrality coupled with a lesser role for royalties and a somewhat tighter MRRT and PRRT would however produce a change in the way that this burden is shared amongst the mining industry. More would be paid by the most highly profitable projects, and less would be paid by the less profitable ones.

(initially improving welfare by 70 cents for every dollar of revenue).¹⁸

As with all modelling, these estimates are highly sensitive to the assumptions used, especially the relevant commodity prices in this case. The KPMG Econtech modelling assumed a return in the long run to mineral prices prevailing in 2004-05, significantly lower than their current levels. If higher prices were assumed instead, the distortion caused by royalties would be found to be lower, and so the welfare gain flowing from replacing them with a rent tax would also be lower.

These welfare gains also rely on the assumption that the decrease in royalty revenue is exactly offset by the gain in resource rent tax revenue. Essentially, the estimated gains are the product of a change in the distribution of the tax burden. The less profitable mining projects, those where royalties do most damage, would have paid less (or even had losses partly refunded, under the Resource Super Profits Tax). The more highly profitable mining projects would have paid more (without having much or any impact on their production and investment decisions, at least according to the theory that underpinned the modelling). Whether displacing State royalties with the MRRT would produce similar gains would depend on the precise details of the change.

Because most tax revenue, especially that from the major personal and business income bases, is collected by the Commonwealth, it will receive most of the extra tax that is collected as a result of reforms that increase the overall size of the economy. This is the case whoever undertakes the initial reforms.

For example, in the mid-1990s the then Industry Commission estimated that the proposed suite of National Competition Policy (NCP) reforms would result in a long-run increase in real GDP of around \$23 billion a year (in 1993-94 dollars), which in turn would increase total tax revenues by around \$9 billion a year. Around two-thirds of this was estimated to flow to the Commonwealth, even though its reforms were thought to generate less than one-fifth of the extra revenue.¹⁹

A key principle of the NCP reforms was that all governments should share in the benefits of higher tax revenue resulting from the reform program. The Industry Commission's analysis formed the basis for calculating the size of the 'competition payments' made by the Commonwealth to the States that effectively 'returned' to them their share of the fiscal dividend from the reforms.

Australia's acute vertical fiscal imbalance means that most of any fiscal dividend flowing from an improved, cooperative resource charging model along the lines outlined here would flow to the Commonwealth. The National Competition Policy model offers a useful template, which the Panel endorses, for ensuring States get a fair share of this fiscal dividend, especially in cases where the dividend is the product of reforms partly implemented by the States themselves.

¹⁸ KPMG Econtech, CGE analysis of the current Australian tax system, Final Report, March 2010.

¹⁹ Industry Commission, *The growth and revenue implications of Hilmer and related reforms: A report by the Industry Commission to the Council of Australian Governments*, Canberra, 1995.

Recommendation 8.3

A negotiated outcome adhering to the following principles would secure and build upon the benefits of resource tax reforms already undertaken.

- *The MRRT and PRRT should be amended to sever the link between the royalty allowance provided and prevailing State policies. This would restore full accountability to the States for their royalty policy settings.*
- *State royalties on iron ore, coal and petroleum should be reduced (perhaps by around one-third).*
- *The Commonwealth should guarantee to increase payments to each State so as to offset the royalty revenue foregone.*
 - *Most of the revenue to do this will come automatically through increased MRRT and PRRT collections. The Commonwealth should consider tightening aspects of its resource taxes to ensure an approximately revenue neutral overall result is achieved.*
- *The Commonwealth and the States should jointly commission a credible, independent estimate of the fiscal dividend expected to flow over time as a result of these improved arrangements. This amount should be shared between the Commonwealth and the States following a similar approach to that used for the National Competition Policy reforms.*

9 Efficiency and tax reform

A key issue for the Review has been whether the pursuit of HFE leads to unacceptable trade-offs with efficiency, or discourages tax reform. For a variety of reasons, many submissions (including those from New South Wales, Victoria, Queensland and Western Australia) have argued that the current system of HFE impedes tax reform and creates other efficiency reducing distortions. On the other hand, many other submissions (including those from South Australia, Tasmania, the Australian Capital Territory and the Northern Territory) have argued that HFE is generally efficiency enhancing.

The Panel's interim reports thoroughly examined concerns about the relationship between HFE, efficiency and tax reform.¹ Having considered further comments on these issues in subsequent submissions, the Panel has formed the view that the current system can and does create perverse incentives in theory, but that there is little evidence of those incentives having any effect in the real world. In particular, there is no evidence that HFE acts as a material disincentive to State tax reform.

While there may be some merit in addressing perverse incentives on principle alone, after exploring the alternatives, the Panel has concluded that they cannot be meaningfully reduced without significant reductions in equalisation outcomes. As there is little evidence of real world efficiency losses, the Panel is not convinced that this would be a worthwhile trade-off.

On tax reform, the Panel believes that it is vital for all levels of government to pursue a tax system that favours broadly based taxes with fewer exemptions over narrow and distortionary transaction based taxes. Ideally, this would occur on a multilateral basis — amongst the States and including the Commonwealth — but it would not be a bad thing if some States chose to take a leadership role.

In relation to each of the supplementary Terms of Reference specifically:

- There is no clear evidence that the current system of HFE is impeding State tax reform. If it ever became apparent that possible changes in GST shares were impeding tax reforms, specific and temporary adjustments to the GST distribution should be made in that context, rather than changing HFE.
- While the Panel's Second Interim Report canvassed the possibility of GST grants being used to reinforce incentives to undertake agreed upon reforms, the Panel has concluded that the GST distribution should not be used to compel or encourage States to change policies — HFE should be policy neutral and GST should remain untied and freely available.
- A national agreement is needed in relation to resource taxation. Chapter 8 of this Report describes how such a deal might be achieved. HFE is not a significant barrier.

1 GST Distribution Review, *Interim Report*, March 2012, Chapter 4, and GST Distribution Review, *Second Interim Report*, June 2012, Chapter 3.

9.1 Relationship between HFE and efficiency

Does HFE encourage States to manipulate tax or spending policies to maximise their GST share?

A State is able to increase its GST share by increasing its policy effort (that is, raising higher taxes or spending more on services) in areas where the CGC assesses that it has below average capacity and decreasing its policy effort in areas where the CGC assesses it has above average capacity.

The median magnitude of these incentives is less than 1 per cent of the change in State spending/revenue and less than 5 per cent in all cases except mining revenue. Intuitively, this seems too small to have any decisive impact on State decisions, particularly in the context of other drivers, such as public preferences for services and the gross incidence effects of tax mix switches. Empirically, there is no obvious correlation between GST incentives and a State's policy effort. Indeed the Panel has not been presented with even anecdotal evidence of GST incentives playing into State decisions, and there are many recent examples of States acting in spite of them.

Although there are some issues to resolve with the mining revenue assessment, the Panel is not convinced that the concern that HFE encourages States to manipulate policies to maximise their GST share provides grounds to change the system.

Does HFE discourage tax reform?

While the GST share effects that result from a single State changing its policy are relatively small, their magnitude increases when several States act simultaneously.

Major tax reform is likely to require a tax mix switch. There are different ways to approach a tax mix switch, including on an own-source revenue neutral, or a net budget neutral, basis. If a State seeks to raise the same amount of revenue from both the new tax and the old tax, changes in GST can have a significant impact on State budgets. On the other hand, if States were to maintain the same tax rate (and coverage) relative to other States, there would be no net budget impact, as States that received less GST would receive more own source revenue and vice versa.

Regardless of how tax reform is pursued, under the current HFE arrangements, there will always be gains and losses in GST shares. While these gains and losses will be equal across the system, they will affect States differently, with some States getting a reduction in GST share and others an increase. In practice, where a State's GST share is reduced, that State would generally view itself as a 'loser', notwithstanding that it could avoid the budget impact by collecting more from the replacement taxes.

Nevertheless, a number of factors other than changes in GST shares drive State tax policy decisions, in particular, the political constraints associated with large changes in the gross incidence of taxation. The significance of changes in GST shares to State tax policy decisions is probably diminished further by the delay in changes to GST being felt — because of the lag, any change in GST will not occur until several years after a tax policy change has been implemented.²

2 For an explanation of the lag, see GST Distribution Review, *Interim Report*, March 2012, page 28.

Examining the empirical evidence, States do not necessarily appear to act in accordance with the apparent GST share incentives. Ultimately, there is no hard evidence on whether GST share effects influence State tax reform decisions. The Panel doubts that GST share effects are a very powerful factor when States are considering tax reform.

Does HFE encourage higher taxes?

Another concern put to the Panel is that HFE does not take into account the effect of a State's tax rates on the size of its tax base. If a tax base is relatively elastic (meaning that activity is relatively sensitive to price changes), then a change in the tax rate could have a significant impact on a State's GST share (unless tax policy changes are undertaken multilaterally).

For example, the Australian Capital Territory raised the concern that its moves to switch from stamp duty to a more broadly based land tax would cause it to lose GST by increasing the volume of housing transactions.³ Similarly, New South Wales argued that, although cutting its insurance tax rates would increase its GST share by lowering the average tax rate in a tax where it is assessed to have above average capacity, it would ultimately lose GST because more people would take out insurance. If more people in New South Wales take out insurance then it would be assessed to have an even higher capacity than it currently does.⁴

Adjustments were previously made to some revenue assessments to take into account elasticity effects, but this was discontinued because of the lack of a reliable measure. An attempt by researchers in 2002 to calculate the size of elasticity effects in respect of land tax found that if a single State increased its rates it was likely to receive a GST increase of between two and three cents for each additional dollar of land tax. New South Wales argues that modelling to support the Australia's Future Tax System (AFTS) review, suggests the elasticity of State tax bases is much higher, and therefore the effect on GST shares is much larger, particularly for inefficient taxes like insurance duty.⁵

Elasticity effects could have a relatively significant impact on a State's GST share if it moved to abolish an inefficient tax unilaterally. However, in circumstances where a State's tax base did observably change significantly following a major tax policy change, the CGC may be more amenable to introducing elasticity adjustments.

As with other theoretical incentives, there is no evidence that HFE has affected State decisions. Indeed it seems unlikely that States would increase their taxes so that they could receive more GST, given the amount would be uncertain, small relative to the overall effect on revenue, and at the expense of a large tax increase. However, at the margin, HFE may be a disincentive to lower tax rates.

While the Panel does not believe that these effects have a significant influence on State policy, failure to account for elasticity effects may lead to less accurate equalisation

3 Australian Capital Territory supplementary submission to the GST Distribution Review, March 2012, page 2.

4 New South Wales third submission to the GST Distribution Review, August 2012, pages 59-61.

5 New South Wales also argues that it is only assessed as having above average capacity in relation to insurance duty because it has a below average tax rate. However, it is not clear that this explanation is correct, given New South Wales also imposes a fire services levy on insurance premiums, which moves its overall tax rate close to the national average.

outcomes. However, accounting for elasticity effects would make the system considerably more complex.

Does HFE discourage policies to promote economic development?

If a State's share of the tax base expands its GST share is reduced, so that it effectively only receives a per capita share of additional tax revenue (plus or minus the effect of any above or below average tax rates). For example, if employment increases in Queensland it will raise more payroll tax revenue, but if employment in other States remains steady or falls, Queensland's share of the payroll tax base will also increase. However, Queensland's GST share will be reduced so that it effectively only receives its population share of the increase, adjusted for its below- or above-average tax rates. This represents a significant reduction in the fiscal incentives that a State has to implement policies designed to increase its per capita tax base.

However, increases in a State's tax base are generally the result of economic growth, and a State has many reasons to pursue economic development beyond the potential fiscal gains. Nonetheless, the Panel has recognised that some of the costs associated with pursuing mining related activity may not be adequately recognised in the HFE system. Ensuring adequate recognition of these industry support costs will remove a potential discouragement from promoting mining related activity.⁶

Once again, there is no clear evidence of any instance when GST share effects have changed a State's decisions.

Does HFE discourage efficient service delivery?

Some States are concerned that, because HFE recognises the prevailing cost of delivering services, States are discouraged from pursuing efficiency and cost reductions.

In the case of cost savings, clearly the factors motivating States to pursue efficiency are primarily fiscal, and any significant reduction in those fiscal incentives would be of concern. On the other hand, if a State is able to reduce the amount it spends, say by more efficiently servicing remote communities, that State is able to keep the entire saving, bar some minor effects that emerge from the impact on average policy.⁷

It is true that a State would not receive fiscal benefits beyond its population share from addressing the underlying drivers of cost factors (that is, not just how much it costs to provide services to remote communities, but the numbers of remote communities). This is also true in relation to use factors, such as the number of elderly and school aged children. This is problematic, but only to the extent that such factors are within a State's control. The CGC deliberately seeks to avoid equalising based on factors that a State can control. New South Wales provides the example of private versus public school enrolments as a factor that States can influence.⁸ If States showed any inclination to move towards a voucher-based model of education funding, there may be some grounds to modify that assessment. However, States have not, and the potential GST effects have not been the defining factor.

6 See Chapter 7.

7 See Commonwealth Grants Commission, *Report on GST revenue sharing relativities*, 2012 Update, Box 2-1, page 31.

8 New South Wales submission to the GST Distribution Review, November 2011, page 29.

In general, it is much less clear that States have any control over the disability factors included in the CGC's assessments — for example, States are not realistically able to control the number of elderly people within their State. Nor would policies aimed at reducing the number of elderly be acceptable. Similarly, when it comes to decisions about whether or not people should be more or less dispersed there are many non-fiscal reasons why States do not adopt a policy of 'forcing' a centralised settlement pattern.

Does HFE discourage efficient migration?

Some submissions express the concern that HFE discourages efficient migration, because in the absence of HFE more people would live in Western Australia to take advantage of the better fiscal deal it would be able to provide. They argue that the extra incentive is necessary to counteract other government policies (such as stamp duty) which impede mobility.

However, individuals and businesses may be inclined to locate in States with stronger economic growth anyway and it is difficult for government to determine what the appropriate settlement pattern should be. The change in the outlook for mining over the course of this Review indicates the difficulties involved in making such predictions.

Even if the ideal settlement pattern were known, it is not clear that modifying HFE would be the best way to achieve it as it would involve paying for additional services (or lower taxes) for everyone in particular States, not just those who move. There are also some specific concerns in relation to location costs.⁹

Does HFE create grant dependency?

Separate from the specific effects of changes in the GST distribution on State incentives, an underlying theme in some submissions is that recipient States become dependent on grant funding and are less likely to pursue policies to improve their circumstances.

Garnaut and FitzGerald¹⁰ argued that having a larger proportion of public sector workers in recipient States creates distortions in the local political economy. The theory is that States with a larger proportion of public sector workers will be more inclined to prefer social and environmental objectives to economic ones. Garnaut and FitzGerald note that the scale of this effect is difficult to quantify, but suggest that it may be significant.

There seems to be little firm evidence to support these concerns. As noted in Chapter 5, State shares of Commonwealth support are much closer together when all Commonwealth payments are considered and State performance on economic and social indicators is often much closer than differences in fiscal capacity. Differences in fiscal capacity (or other indicators) can largely be traced to geographic, demographic and economic factors outside a State's control. While State governments sometimes make poor decisions, this is surely true of both donor and recipient States.

⁹ See Chapter 6, Section 6.4.

¹⁰ Garnaut, R and FitzGerald, V, *Review of Commonwealth-State Funding, Final Report*, Melbourne, 2002, pages 145-6.

Does HFE lead to excessive provision of public services?

In their 2002 review of the distribution of the GST and Commonwealth payments, Garnaut and FitzGerald argued that intergovernmental transfers like the GST tend to ‘stick’ with governments and are used to fund public services rather than being allocated back to citizens in tax cuts resulting in excessively large public sectors in recipient States. As explained in Chapter 1, this is known as the flypaper effect.

The obvious explanation for this is that grants are generally given to State and local governments with the explicit purpose of being used to fund public services, particularly in the Australian context where the service responsibilities of State and local governments generally exceed their taxation powers. Moreover, as the Commonwealth Treasury noted in its submission to the Review, it is not true that recipient States as a whole have larger public sectors. Instead, those States that spend more are the ones that are assessed to have above average spending needs.¹¹

Finding 9.1

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

There may be some merit in addressing perverse incentives on principle alone. However, after exploring the alternatives, the Panel has concluded that they cannot be meaningfully reduced without significant reductions in equalisation outcomes. As there is little evidence of efficiency losses in practice, the Panel is not convinced that this would be a worthwhile trade-off.

One area where there may be merit in further investigation by the CGC is in relation to the impact of tax rates on the size of State tax bases.

9.2 Tax reform

What might tax reform look like?

Findings on State taxes in the AFTS report and the outcomes of State tax reviews are useful starting points for a discussion between States and the Commonwealth on identifying a preferred future tax mix and establishing a preferred tax reform path.

AFTS recommended replacing less efficient State taxes with more efficient ones. A broader based land tax, for example, could replace the existing land tax and stamp duty on conveyances. Motor taxes could be replaced with an improved road user charging system. Insurance taxes could be replaced in a number of ways, including an improved payroll tax, and the payroll tax itself could be replaced by a business cash flow tax.

¹¹ Commonwealth Treasury submission to the GST Distribution Review, October 2011, page 35.

Whatever the final shape and direction of reform, the recommended general trend can be summarised as:

- placing more reliance on a few main taxes and less on smaller ‘nuisance’ taxes
- replacing less efficient taxes with more efficient ones (which usually means replacing high impact, narrow-based taxes, with broader-based, lower-rate ones)
- raising more revenue from less mobile tax bases and raising less revenue from the more mobile tax bases.¹²

While AFTS was precluded from examining the rate and base of the GST, it is worth pointing out that the business cash flow tax has much the same economic incidence as a GST with a broader base. Similarly, the payroll tax and the GST have much the same economic incidence, with overlapping, but not identical bases.

How should tax reform be pursued?

Of the States that raised State tax reform in submissions, all agree that the ideal way to achieve reform is through a multilateral negotiation or discussion that includes the Commonwealth. Many States also identify the approach taken in implementing the A New Tax System (ANTS) reforms as a model for future State tax reform.

AFTS recommendation 119 also urged the use of intergovernmental agreements between the Commonwealth and State Governments to coordinate State tax reform by providing the States with revenue stability and facilitating good policy outcomes.

Any effective intergovernmental agreement on State tax reform would identify what taxes would be abolished, amended, or reformed, the timeline for achieving the reforms, and the means to address any GST share effects — if they are considered important. While State tax reform does not strictly require Commonwealth involvement, the Panel would encourage the Commonwealth to be actively engaged in any proposed reforms, as State tax reform will be important in positioning the Federation to respond to future challenges. The Commonwealth’s role could be as a neutral facilitator in deliberations among States on the direction and pace of reform. On the other hand, States that wish to pursue tax reform independently should not feel constrained by the need for a multilateral consensus.

Dealing with any GST effects

While the Panel is comfortable that HFE is not preventing State tax reform, it is clear that tax reform would result in changes in States’ GST shares. Various options for addressing these effects in the system as a whole have been considered, including equalisation to a minimum standard, an external standard, or using broader indicators. The Panel has opted not to pursue these options at present as any potential efficiency gains are minimal and are outweighed by large losses in equity.

If changes in GST shares do prove a barrier to some future tax reform, they should be addressed in the context of the specific tax changes that are being proposed. In this regard, the Panel’s second interim report discussed the possibility of the

¹² *Australia’s Future Tax System*, Report to the Treasurer, Part 1, Overview.

Commonwealth providing compensation for GST share effects.¹³ As long as the reform process led to quantifiable fiscal benefits for the Commonwealth, compensation would not breach the Commonwealth's injunction that it will not fund State tax reform.

Another option considered was using any fiscal dividend from reform to adjust the GST distribution so that in the case of major multilateral changes, GST share effects did not occur. Like other options to break the link between State policy and the GST distribution, this option may raise equity concerns, but in a much more narrow context than an overarching change to the distribution of GST. Moreover, these equity concerns may be outweighed by the efficiency gains if compensation for GST effects allowed tax reform to proceed when it would otherwise have failed.

Reinforcing agreed reform

The Panel's second interim report outlined the view that the GST distribution should remain untied and freely available, and not be used to provide positive incentives for tax reform. Nevertheless, it also canvassed various ways that the GST distribution might be used to reinforce agreed upon commitments. However, such a change to the GST distribution would be dependent on State support and there was no support for these options in subsequent submissions.

Finding 9.2

The Panel is convinced that it is vital for all levels of government to pursue a tax system that favours broadly based taxes with fewer exemptions over narrow and distortionary transaction based taxes. Ideally, this would occur on a multilateral basis — amongst the States and including the Commonwealth — but it would not be a bad thing if some States chose to take a leadership role.

In relation to each of the supplementary Terms of Reference specifically:

- There is no clear evidence that the current system of HFE is impeding State tax reform. If it ever became apparent that possible changes in GST shares were impeding tax reforms, specific and temporary adjustments should be made to the GST distribution in that context, rather than changing HFE.*
- While our second interim report canvassed the possibility of GST grants being used to reinforce incentives to undertake agreed upon reforms, the Panel has concluded that the GST distribution should not be used to compel or encourage States to change policies — HFE should be policy neutral and GST should remain untied and freely available.*
- A national agreement is needed in relation to resource taxation. Chapter 8 of this Report describes how such a deal might be reached. HFE is not a barrier.*

13 See GST Distribution Review, *Second Interim Report*, June 2012, Chapter 5, Section 5.4.

10 The role of HFE in Indigenous service provision

The redistribution of GST revenue that occurs as a result of differences between the proportion of Indigenous people in States' populations is referred to (in CGC parlance) as the effect of *Indigeneity*.

The CGC currently captures *Indigeneity* in seven of the 14 expense assessment categories. These are predominantly social services assessments, that is, education, health, justice services, welfare and housing and services to communities.

During the course of this review the Panel has received submissions that advocate the removal of *Indigeneity* from HFE and submissions that seek its retention. A common theme amongst many submissions was that more needed to be done to address entrenched disadvantage, and that HFE did no more than give States the capacity to provide the average level of services. Although it is beyond the Panel's Terms of Reference, some submissions suggested additional Commonwealth funding is required.

Stakeholder interest in *Indigeneity* appears to be heightened because of the significant amount attributed to that disability in the CGC's tables showing the redistribution by disability (Table 7 in the 2012 Update report).

10.1 How much GST revenue does *Indigeneity* redistribute?

Indigeneity has historically been the biggest influence on the GST distribution on the expense side. Table 10.1 below shows the amounts of GST revenue redistributed due to *Indigeneity* in each of the past five years.

Table 10.1: Amount redistributed due to *Indigeneity*

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total	% of expense redist
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	
2008 Update	-372	-839	290	231	-125	8	-38	844	1,373	44
2009 Update	-376	-884	308	213	-124	15	-39	888	1,423	45
2010 Review	-466	-1,426	441	427	-184	18	-68	1,258	2,143	55
2011 Update	-551	-1,696	527	521	-231	16	-87	1,501	2,565	49
2012 Update	-434	-1,637	655	530	-215	40	-73	1,134	2,360	42

Source: CGC, various Updates and 2010 Review.

Until the 2012 Update, the redistribution attributed to *Indigeneity* had been increasing in line with the increase in the redistribution from all expenditure disabilities in recent years. The amount redistributed due to *Indigeneity* has generally increased over time, because State spending per Indigenous person is increasing faster than State spending per non-Indigenous person, as governments seek to address entrenched disadvantage.

Although increases in average spending and growth in the GST pool increase the size of the redistribution of GST due to *Indigeneity*, the main driver of the redistribution is the diverse distribution of Indigenous people across States. If each State had the same proportion of Indigenous people, an increase in spending on Indigenous people would have little or no effect on the GST redistribution.

As shown in Table 10.1, the Northern Territory can expect to receive around \$1.1 billion more GST revenue in 2012-13 than if it had the average proportion of Indigenous people in its population.

10.2 Drivers of GST redistribution due to *Indigeneity*

As noted earlier, two key factors drive the redistribution of GST due to *Indigeneity*:

- the States’ proportion of Indigenous people
- the additional cost of providing services to Indigenous people.

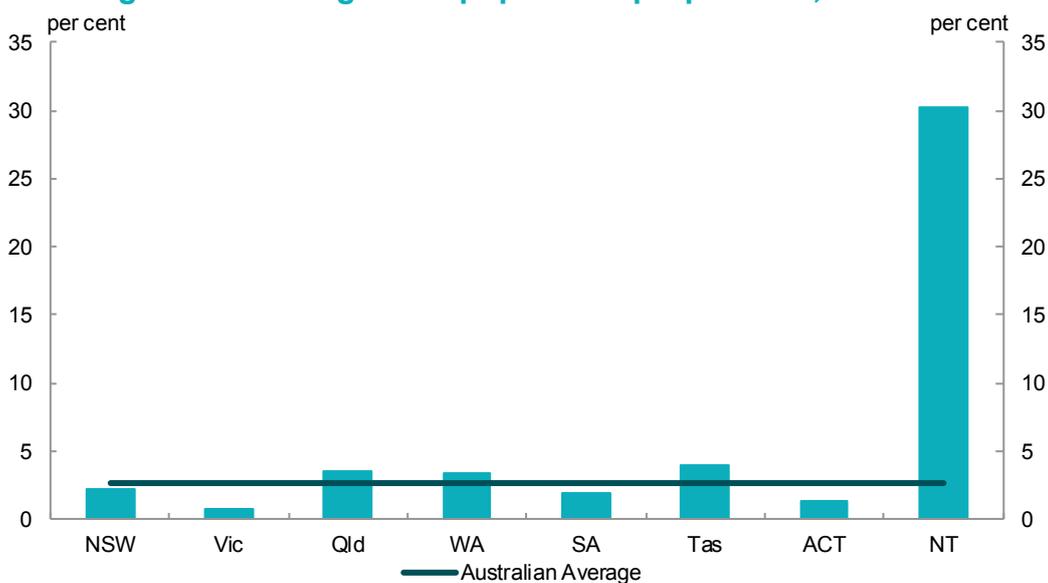
Details of these drivers are in the paragraphs below.

State shares of Indigenous people are different

A key driver of the CGC’s assessment of needs related to indigenous communities is the State’s proportion of Indigenous people.

The largest numbers of Indigenous people live in New South Wales and Queensland, with around 170,000 and 165,000 respectively. Western Australia and the Northern Territory have similar Indigenous populations, around 78,000 and 70,000 respectively. However, the CGC’s assessments are based around the proportion of Indigenous people in States rather than total Indigenous population. Figure 10.1 shows the proportion of each State’s population represented by Indigenous people.

Figure 10.1: Indigenous population proportions, 2010-11



Source: Productivity Commission, 2012 *Indigenous Expenditure Report*.

The Northern Territory’s proportion of Indigenous population, at around 30 per cent, is substantially greater than the Australian average, at around 2.5 per cent. The proportion of Indigenous people in the Northern Territory is markedly different to any other State in Australia. Queensland and Western Australia have similar proportions of Indigenous population — about 3.5 per cent. Although more than double the number of Indigenous people live in Queensland compared with Western Australia, the total population in Queensland is about double that of Western Australia. Many more Indigenous people live in New South Wales, but because of New South Wales’ large population overall, it has a smaller proportion than the Australian average.

Those States with Indigenous population proportions above the Australian average (Figure 10.1) receive a greater share of GST (Table 10.1). Having different Indigenous population proportions alone does not cause a redistribution of GST. The redistribution arises because States spend more on services for Indigenous people.

States spend more on services for Indigenous people

The 2012 Indigenous Expenditure Report (IER) found that on average States’ spending per capita on Indigenous people was 2.9 times that spent per capita on non-Indigenous people in 2010-11. There was some variation with Western Australia having the highest spending ratio with spending per capita on Indigenous people 3.4 times that on non-Indigenous people. The Northern Territory spending ratio was about the average (2.9) and slightly above that in Queensland and New South Wales.

Although the Northern Territory ratio of Indigenous to non-Indigenous spending was about the same as the Australian average¹, its higher proportion of Indigenous people results in Indigenous spending accounting for more than half the Territory budget.

Table 10.2 below shows the spending per capita ratio on Indigenous to non-Indigenous people for each State.

Table 10.2: Indigenous to non-Indigenous expenditure per head of population ratio, 2010-11

NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
2.5	3.1	2.5	3.4	3.2	1.4	2.6	2.9	2.9

Source: Productivity Commission, 2012 Indigenous Expenditure Report.

On average, States spend more on providing services per Indigenous person than per non-Indigenous person, especially in areas such as health, justice, and welfare and housing, which are increasing as a proportion of State budgets. It follows that (all else being equal) States with a higher proportion of Indigenous people than average will be assessed as having higher service costs overall and will be given a higher than average proportion of GST revenue.

¹ The Northern Territory’s spending ratio was marginally above the Australian average.

10.3 What the Panel found

After examining concerns put to it about the operation of the HFE system in relation to Indigenous needs, the Panel has concluded that:

- the Northern Territory does not unduly influence its GST share
- there is no evidence the Northern Territory underspends on Indigenous services
- HFE is not the right vehicle to address entrenched disadvantage.

Details of how the Panel drew these conclusions are in the paragraphs below.

The Northern Territory does not unduly influence its GST share

The substantial proportion of the Northern Territory budget devoted to services for Indigenous people can lead some to the conclusion that it drives the size of the Indigenous disability and ensures that the Northern Territory continues to receive a large GST distribution.

However, the CGC’s assessments are based on a calculation of average spending by States on Indigenous people and States contribute to the average level of spending in proportion to their share of total Indigenous residents. The States with the highest absolute number of Indigenous people, New South Wales and Queensland, have the greatest effect on the average. If these States changed their spending on Indigenous people, increasing or decreasing, this would have a much larger impact than any change the Northern Territory made in its spending on Indigenous people.

Should the gap between what States spend on average on Indigenous people compared to others decline, the GST distribution effect would also decline. Finally, in the unlikely event that spending per Indigenous person was to become less than for the population as a whole, the HFE system would redistribute GST revenue away from the Northern Territory.

There is no evidence the Northern Territory underspends on Indigenous services

The latest Indigenous Expenditure Reports (IER) data indicate that the Northern Territory’s relative spending on Indigenous people is comparable with other States. As shown earlier the Northern Territory’s per capita spending ratio of 2.9 is at the Australian average, and is meeting ‘average’ spending requirements.

Although the Northern Territory spends more than half its budget on service provision to Indigenous people, this appears to allow them to provide services at the Australian average standard of services to Indigenous people, but this may not necessarily be ‘enough’ to address Indigenous disadvantage.

HFE is not the right vehicle to address entrenched disadvantage

The current system of fiscal equalisation is based on average spending across all States, it is not the appropriate vehicle to promote above average spending in a particular State or States. While simply funding Indigenous spending outside the GST distribution could

enable above average spending in any particular year, the equalisation process will redistribute the funding over time. Removing that part of the GST redistribution relating to *Indigeneity*, or a subset of Indigenous people, from the equalisation process and funding it through other payments would change the mix of tied and untied funding, but not the total Commonwealth funds to each State. New *Indigeneity* SPP/NPP payments would not affect the relativities for GST redistribution purposes if excluded from the CGC's assessment.

Table 10.3 below shows the change in the mix of tied and untied funding for each State of this approach for 2012-13.

Table 10.3: Funding Indigeneity through PSPs, 2012-13

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Change in GST	434	1,637	-655	-530	215	-40	73	-1,134
Change in PSPs	-434	-1,637	655	530	-215	40	-73	1,134
Total Change	0	0	0	0	0	0	0	0

Source: CGC, various Updates and 2010 Review.

While this approach would not change the total funding of any State, it would ensure the funding allocated to services for Indigenous Australians is spent in that way, and increase the accountability for States with above average proportions of Indigenous people. This could imply those States are not spending enough now, but the Panel does not consider that to be the case.

Practical problems in adopting this approach would arise if other States' SPPs need to be reduced to fund *Indigeneity* due to the amounts involved being large in relation to some States' SPP funding. For example, the reduction in Victoria's SPP funding required by this approach of around \$1.7 billion represents around half its national payment for schools. As the current system of fiscal equalisation is based on average spending across all States, the CGC will give each State the average capacity to address disadvantages and make no assessment of what needs to be spent to tackle any particular disadvantage. Where States increase spending to overcome disadvantage, be it from a realignment of priorities or from additional taxes, the spending becomes part of the average against which all States are assessed. Changing the source of funding from the GST pool to a National Partnership (NP) will only allow States to provide the average level of service, not overcome any disadvantage.

To overcome Indigenous disadvantage above average spending is required, and any additional funding must be external to the equalisation process. This has occurred in recent years, with the Northern Territory Emergency Response (NTER) and subsequent (Northern Territory) Closing the Gap programs that address Indigenous disadvantage in the Northern Territory.

Commonwealth funding for State government service provision for indigenous people is generally included in the current system, and equalised over time. However, where the intention is for the funding to overcome a disadvantage these may be quarantined, or kept out of the CGC's assessments. This currently occurs for the National Partnership on Closing the Gap in the Northern Territory payments.

The Northern Territory should not be removed from equalisation

During the course of the Review the Panel was urged to recommend removing the Northern Territory from the equalisation process, usually with the suggestion that the Commonwealth fund the Territory directly.

The Panel does not consider removing the Northern Territory from equalisation to be an appropriate path to take as it is a sovereign entity within the Federation and it should not be treated differently to other States. The Panel considers that all States, and Territories, should be able to tailor the delivery of services to meet the needs and desires of their citizens, and removing any State or Territory from the equalisation process would prevent this.

10.4 Other *Indigeneity* related issues

Measuring Indigenous expenses directly

The CGC does not currently assess *Indigeneity* at an aggregate level but captures the costs faced by States within relevant expense assessment categories. These are predominantly social services assessments, such as, education, health, justice services, welfare and housing, and services to communities.

In reporting on the impact of *Indigeneity* on the redistribution (Table 7 of the 2012 Update report), the CGC does not directly estimate the redistribution due to *Indigeneity*. Instead, the estimate is derived by assigning to Indigenous people the cost weights and / or spending levels relating to non-Indigenous people in each expenditure category, with all else unchanged, then comparing the resulting GST redistribution with the GST redistribution from the actual assessments. Estimates for other disability factors are obtained in a similar fashion, by applying average spending for (or removing) that disability, holding everything else constant, and comparing the resultant redistributions with the actual assessment redistributions.

In its first interim report, the Panel saw merit in exploring whether assessments could be developed to more directly measure needs due to disabilities than the category of spending approach currently adopted.² The Panel has been advised the data required for assessments to be made on this basis are not available.

Recognition of above average costs

In its submission, Western Australia says that its *Indigeneity* costs are not fully recognised due to population undercounts and insufficient recognition of higher costs.

Western Australia considers that Australian Bureau of Statistics population estimates undercount its Indigenous population and also argues that the CGC wrongly assumes that Indigenous persons are equally disadvantaged across the nation in comparable areas, whereas Western Australian Indigenous people in fact suffer higher disadvantage. Western Australia estimates the adverse annual impact on its GST share of a range of issues it has with current CGC methods. Western Australia estimates that the

² GST Distribution Review, *Interim Report*, March 2012, Chapter 7.

Indigenous population undercount costs it \$50 million per annum and that differences in Indigenous disadvantage cost it \$300 million per annum.³

The use of averages in the HFE system will equalise all States to the average, but cannot recognise all of their higher costs. Any State concerned about undercount and incomplete recognition of costs should take its claims to the CGC in the next review.

Reporting on Indigenous expenses

Reports such as the Indigenous Expenditure Reports, National Indigenous Reform Agreement reporting, and Overcoming Indigenous Disadvantage reports provide an evidence base upon which to design policies and programs to improve outcomes for Indigenous Australians. The Panel found the information in these reports helpful in developing its understanding of the issues Commonwealth and State governments face in providing services to Indigenous Australians.

The Indigenous Expenditure Reports contain estimates of expenditure on Indigenous specific services and services provided to Indigenous people through mainstream services, by the Commonwealth and States. Much of the Commonwealth's indirect spending is in the form of payments for specific purposes and general revenue assistance (including GST payments). Information on State based revenues does not appear in the Indigenous Expenditure Reports, and including it in future reports would widen the evidence base.

Finding 10.1

The current HFE system seeks to address only the costs to States that are the average policy, including those associated with service provision to Indigenous communities. On that basis there is no rationale for removing Indigeneity from the HFE system.

However, precisely because the current system equalises to the average, it cannot overcome the disadvantage experienced by some Indigenous communities. Improving outcomes for these communities will require a concerted effort by Commonwealth and State governments. Where additional measures are required, they would best be undertaken outside the HFE system and excluded from it, so that the HFE system does not frustrate the desired change.

The Indigenous Expenditure Reports (IER) are important as a means to understanding differences in service provision costs between Indigenous and non-Indigenous people. It would assist the long term assessment of Indigeneity if stakeholders could expand the IER reporting process to include measures of revenue as well as expenditure.

3 Western Australian Government submission to the GST Distribution Review, October 2011, pages 65-66.

11 Ensuring the GST pool is robust and stable

The primary focus of this Review is to examine the HFE system, by which the GST revenue is divided between the States. Our views on that question are set out in earlier Chapters. However, any rounded assessment of the GST distribution must also take into account the size, predictability and stability of the pool itself. After all, States' budget stability is often more greatly affected by movements in the overall pool than they are by movements in their share of it.

Several issues are addressed in this Chapter:

- First, we briefly recap the dual role played by GST revenue — as both the base for untied grants from the Commonwealth to the States and the vehicle for pursuing horizontal fiscal equalisation between the States.
- Second, we examine whether the existing arrangements have lived up to expectations.
- Third, we explore ways of making the GST pool better suited to the needs and circumstances of the Federation. In particular, we look at options for ensuring the GST pool is as robust and stable as possible in the years ahead.

Through its examination of these issues, the Panel has concluded that several more radical departures from the status quo should be widely debated and carefully considered in the longer term. The Panel sets out its long term vision for the fiscal relationships within the federation in Chapter 12.

11.1 What is the GST pool designed to achieve?

Since its introduction in 2001, the revenue from the GST has been used to perform two important roles:

- It provides the basis for calculating the amount of untied, freely available funds transferred each year from the Commonwealth to the States.
- It provides the mechanism for delivering fiscal equalisation between the States.

It is worth briefly considering the features of the GST that were thought to make it well suited to being used in these ways. We can then assess whether the experience has met those expectations (and speculate as to whether they are likely to be met in the future).

Why is the GST used to determine States' untied Commonwealth grants?

The introduction of the GST from 1 July 2000 was one part of a major suite of changes to taxation and federal financial arrangements, which also included the replacement of Wholesale Sales Tax at the Commonwealth level and, over time, the abolition of several

inefficient State taxes.¹ The Commonwealth and the States also agreed to replace the system of financial assistance grants with the revenue collected from the GST.²

The decision to adopt the GST as the basis for the level of untied grants from the Commonwealth to the States was made for a range of reasons. From the Commonwealth's perspective, it gave the States a stake in the success of the GST, and so helped secure a level of national support for its politically contentious tax changes. The agreement between the Commonwealth and the States stated that any change to the rate or the base of GST required the unanimous support of the Commonwealth and every State, creating an environment in which any increase in the GST could only be made when there was an overwhelming consensus that it was required. Conversely, although the GST was effectively States' money, States could only allow concessions with Commonwealth approval. Thus, the agreement mechanism served both as political protection against the electorate's concern about the prospect of future rate increases and practical protection against the future erosion of the base.

From the States' viewpoint, having a formal agreement to receive 100 per cent of the GST revenue stream was seen as offering greater security than the previous funding arrangements, which were susceptible to unilateral Commonwealth changes.³ The primary rationale, though, for providing the GST revenue to the States was to improve their medium term fiscal position, especially in the light of the High Court's recent decision that States' imposition of business franchise fees was invalid.⁴ It was widely expected that GST revenues would grow broadly in line with the economy as a whole, in contrast to the taxes it replaced, which tended to grow more slowly and be more volatile. The GST was expected to grow much faster than the financial assistance grants that the States had been receiving, which typically were pegged only to increases in population and consumer prices.⁵

Why is the GST used to deliver fiscal equalisation between the States?

As discussed elsewhere in this report, Australia's approach to the pursuit of HFE has always been to provide States with differing amounts of Commonwealth funds (from one source or another). Transfers directly between States (as occur in Germany, for example) have not been used.

As well as providing the States with a large amount of untied revenue collected by the Commonwealth, in recognition of the large vertical fiscal imbalance between the two levels of government, the GST pool is also used to deliver fiscal equalisation

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- 1 Abolished taxes included accommodation taxes, financial institutions duties, and quoted marketable securities and debits taxes. For further details, refer to GST Distribution Review, *Second Interim Report*, June 2012, pages 7-8.
 - 2 See the (1999) Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, included in Appendix B of Commonwealth Budget Paper No. 3, 1999-2000.
 - 3 A linkage to 100 per cent of GST revenue, as compared with a less than complete linkage to, for example, personal income tax collections, may also have been considered to offer some protection against later Commonwealth renegeing.
 - 4 *Walter Hammond and Associates v the State of NSW and others* and *Ha and anor v the State of NSW and others*. Business franchise fees were characterised by the Court as excises, which may not be imposed by States under Section 90 of the *Commonwealth of Australia Constitution Act 1900*. For a brief history of developments, see GST Distribution Review, *Second Interim Report*, June 2012, pages 3-5.
 - 5 In addition, the establishment of a guaranteed minimum amount, based on former financial assistance grants real per capita growth and pre-2000 forward estimates of the State taxes to be abolished, ensured that no State was worse off during the period when States were to abolish certain taxes.

between the States. That is, the GST is distributed on the basis of HFE, as was the case with the financial assistance grants.⁶

Neither its absolute size, nor the average pace of its growth matter greatly when judging the usefulness of the GST pool as a vehicle for pursuing HFE.⁷ While such concerns are clearly relevant to States' budgets overall, whether the GST grows at 3 per cent a year or 6 per cent makes no difference to the task of equalising States' fiscal capacities. What does matter though is that the pool used to pursue HFE should be stable and predictable. Changes that improve the stability and predictability of States' GST shares will be of little help though if the pool itself is volatile and unpredictable.

More technically, the way in which States' assessed needs under the current HFE system are translated into GST shares, with a lag and a three-year averaging process, relies for its soundness on the assumption that the pool grows fairly steadily from year-to-year. The more volatile the pool is, the more that States' actual GST shares risk becoming divorced from the needs originally assessed (three to five years earlier) by the CGC.

11.2 How well has the GST pool performed?

The initial expectations of the GST were that it would:

- provide States with a robust source of revenue that grew broadly in line with the national economy, so as to improve States' fiscal positions
- be predictable, so as to assist States in managing their fiscal positions and to facilitate the use of GST pool to pursue fiscal equalisation between States.

These remain good criteria to measure the strength of the current arrangements.

GST revenue trends

When the GST was introduced it was expected to grow (on average over the medium term) by around six per cent per year.⁸ Overall, GST revenue has in fact grown exactly in line with this expectation, from \$24.4 billion in 2000-01 to \$46.0 billion in 2011-12, an average annual growth rate of 6.0 per cent (see Table 11.1). However, this overall figure masks a large difference between the period prior to the global financial crisis and the one after it. Until 2007-08, the GST grew each year by around 8.3 per cent on average, far higher than the average 2.2 per cent increase between 2008-09 and 2011-12 (see Figure 11.1).⁹ GST revenue grew very strongly, partly for reasons associated with its start-up, to around GMA levels by 2002-03.

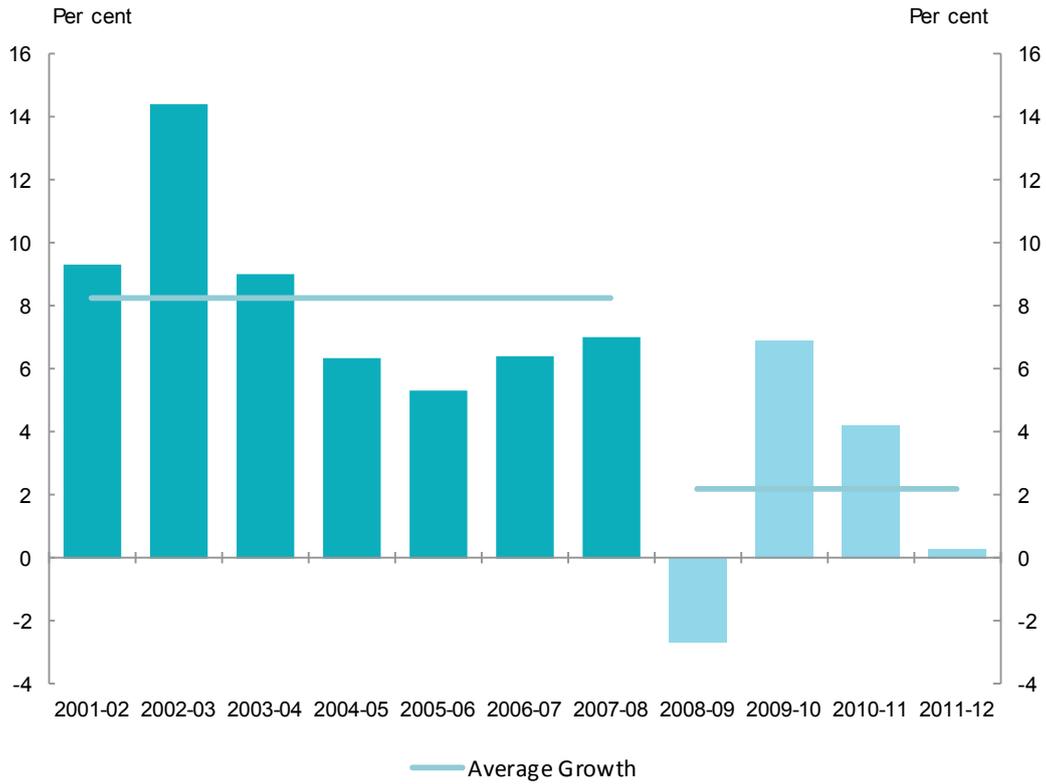
6 Separately from the GST, the Commonwealth makes a range of other payments to the States. Differences in the amounts provided to each State (beyond differences in their populations) are the product of considerations other than HFE (and in fact, the HFE system takes such differences into account in the determination of GST shares). See GST Distribution Review, *Interim Report*, March 2012, Chapter 5 for a full explanation.

7 The main technical concern is to ensure the pool is large enough to prevent any State's assessed GST share falling below zero. This has not been a problem yet with the GST pool.

8 See GST Distribution Review, *Interim Report*, March 2012, page ix.

9 In 2008-09, at the height of the financial crisis, GST revenue *fell* by 2.7 per cent.

Figure 11.1 Two phases of GST revenue growth



Source: Australian Government, Final Budget Outcome, various years.

Table 11.1: Annual GST revenue since its introduction

Year	Revenue (\$m)	Annual growth rate (%)	Annual average growth rate to this point (%)
2000-01	24,355		
2001-02	26,632	9.3	9.3
2002-03	30,479	14.4	11.9
2003-04	33,219	9.0	10.9
2004-05	35,323	6.3	9.8
2005-06	37,182	5.3	8.9
2006-07	39,552	6.4	8.5
2007-08	42,330	7.0	8.3
2008-09	41,189	-2.7	6.9
2009-10	44,041	6.9	6.9
2010-11	45,887	4.2	6.6
2011-12	46,037	0.3	6.0
2012-13 (e)	48,250	4.8	5.9
2013-14 (e)	51,000	5.7	5.9
2014-15 (p)	53,700	5.3	5.9
2015-16 (p)	56,400	5.0	5.8

Source: Commonwealth Budget papers, Final Budget Outcome, and Mid-Year Economic and Fiscal Outlook. (e) — estimate; (p) — projection.

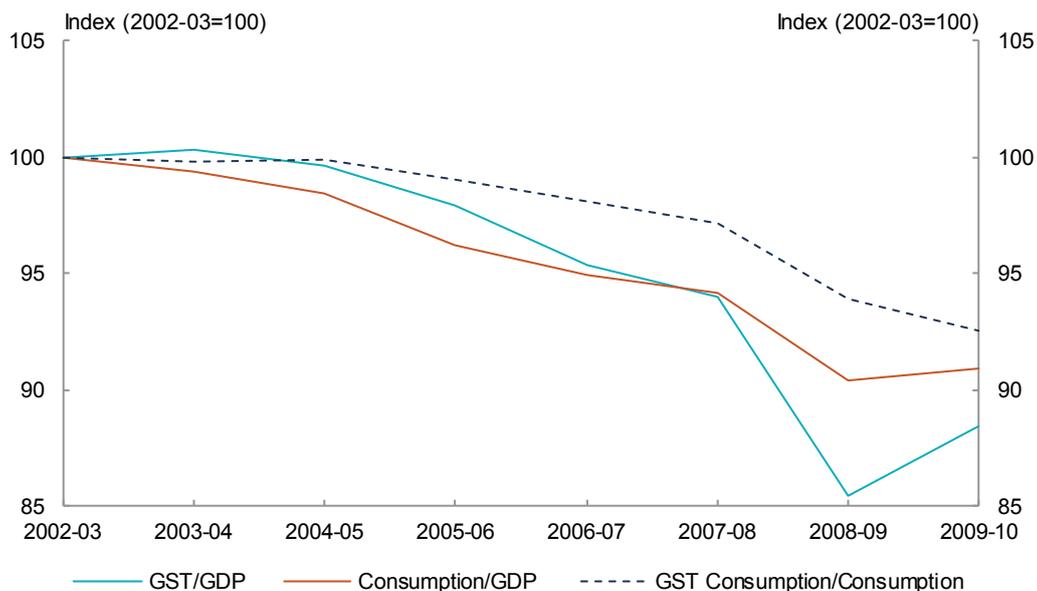
While GST revenue growth is expected to rebound somewhat over the next few years, the outlook for GST revenue to 2015-16 (for annual growth of around 5.2 per cent a year) remains more subdued than before the global financial crisis.

A number of factors are contributing to this weakness of GST revenue. Some are cyclical and therefore likely to dissipate somewhat as economic conditions continue to improve. These include:

- increased household savings by the 'cautious consumer' consolidating the household balance sheet which has contributed to a decline in consumption as a share of GDP
- a slowdown in employment growth in certain sectors, as well as uneven conditions across the economy more generally
- the strength of the Australian dollar.

However, there are also large and growing structural weaknesses in the GST revenue base. Although the GST is more broadly based than the taxes it replaced (most notably, it covers services), it is far from comprehensive, in that fresh food, health and education expenditures are exempt, and banking services are comparatively lightly taxed.¹⁰ As a result, GST revenue will grow more slowly than the economy as a whole if untaxed components take up a larger share of consumption. This is indeed what has been happening in recent years (see Figure 11.2) a trend that is likely to continue in line with the aging of the population.

Figure 11.2: GST as a share of consumption and GDP



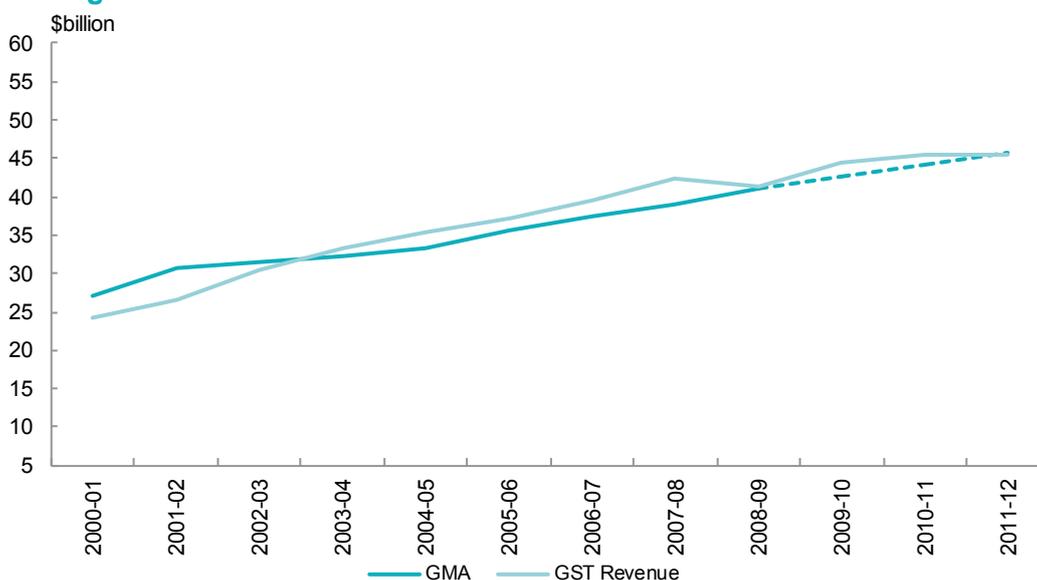
Sources: Australian National Accounts, ABS, Cat. no. 5204.0, 2010-11, Australian Government, Final Budget Outcome, various years and Australian Treasury.

Overall, the record of the GST in improving States' fiscal positions is mixed. For several years in the middle of the last decade GST revenue grew rapidly, faster even than the States had anticipated (which in turn was faster than the growth they would have received under the pre-GST arrangements). Recently though, growth has been decidedly sluggish, and expectations for the future are more subdued than they once

¹⁰ Australia's GST is less broadly based than many other countries' value-added taxes (VATs). On one measure compiled by the OECD, Australia's 'VAT coverage ratio' in 2008 was 0.49 (New Zealand's was 0.98). Australia's coverage was broader than only six of the 32 countries included. The average coverage ratio (unweighted) was 0.55. See OECD Consumption Tax Trends, 2010.

were. More than ten years since its introduction, GST collections are barely above the minimum level that the Commonwealth agreed to underwrite (see Figure 11.3).¹¹

Figure 11.3: GST revenue and the Guaranteed Minimum Amount



Note: GMA was not in effect after 2009-10. Amounts from 2009-10 estimated by Secretariat.

Source: Australian Government, Final Budget Outcome, various years.

Finding 11.1

GST revenue grew fairly strongly prior to 2007-08. Since then, like most other taxes, GST collections have grown only modestly. Some of this softness is cyclical, but it also appears that certain structural factors will continue to dampen GST growth into the future. If left unaddressed, this will place increasing strain on States’ budgets.

Fluctuations in GST collections

For several years, GST collections grew fairly steadily. Setting aside the first few years, where special circumstances relating to the introduction of the tax caused large fluctuations, in five of the six years from 2004-05 to 2009-10 GST revenue grew by between 5 per cent and 7 per cent. Of course, the problem is that this pattern was broken by the sixth year (2008-09) where collections fell by 2.7 per cent.

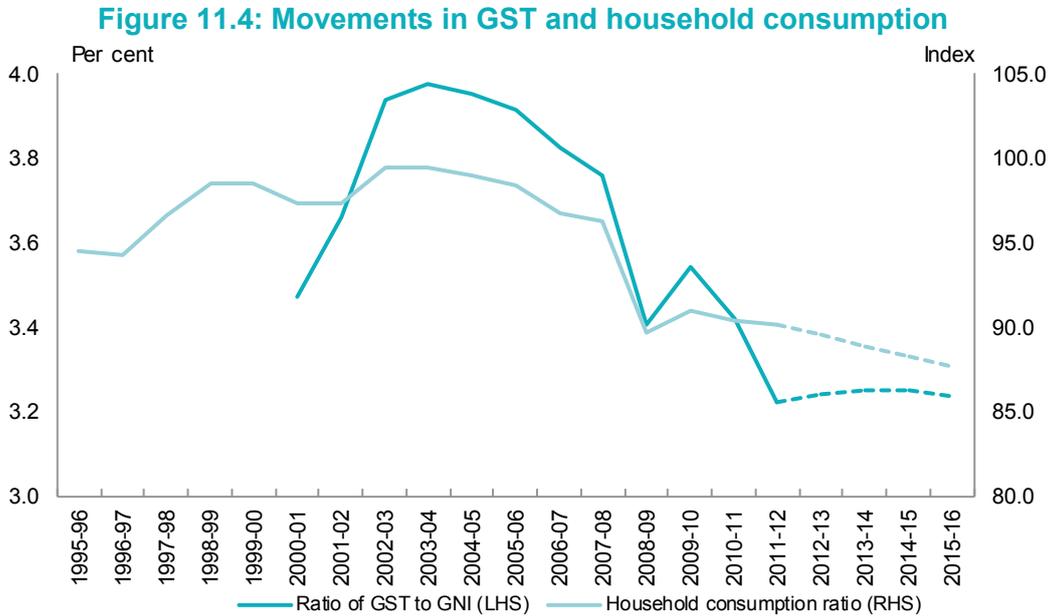
This volatility in tax collections is not limited to the GST. Collections from all other taxes also suffered in the wake of the financial crisis.¹² The GST pool exhibits similar variability to States’ other sources of revenues, particularly stamp duty on property transactions.

However, it does mean that when the economy is weak across the board and States’ own source revenues are weaker, GST payments, for all States, also tend to be weaker, at a point when the States’ budgets are under the most pressure.¹³

11 Budget balancing assistance to make up any shortfall in GST was abolished in the 2008 IGA, with effect from 2009-10. However, in 2011-12 it is likely that GST payments are still not much above GMA levels.

12 For example, the Commonwealth’s company tax revenue, which had increased by 78 per cent over the four years to 2007-08, then declined by 6 per cent and a further 12 per cent in the following two years.

More technically, the particular form of GST used in Australia (an ‘invoice credit model’) can also be prone to short term volatility and unpredictability, especially around turning points in the economic cycle. Figure 11.4 shows that GST collections (shown as a share of gross national income) are more volatile than consumption spending (shown as the household consumption ratio).



Sources: Australian National Accounts, ABS, Cat. no. 5206.0, June 2012, Australian Government, Final Budget Outcome, various years and Australian Treasury.

Finding 11.2

The GST revenue pool received by the States grew fairly steadily until 2007-08. Since then it has been highly volatile, contributing to the difficulties faced by States in managing their fiscal positions.

11.3 Making the GST pool more robust and stable

As shown above, GST collections have been both less buoyant over the medium term and more volatile than expected when the GST was introduced. These circumstances have driven the Panel to question whether the current arrangements, namely the use of the GST pool to provide untied revenue assistance to all of the States as well as pursuing fiscal equalisation between them, will remain in the best interests of the Federation.

Specifically, the Panel believes that, in the longer term, the national debate around matters such as the rate and the base of the GST, and public financing arrangements more generally, needs to be ‘unfrozen’. Even if it is accepted that the current arrangements have served the States well in the past, it should not automatically be assumed that they will continue to best equip the Federation to meet its future challenges. The Panel sets out its own views on these longer term issues in Chapter 12.

13 In contrast, if a slump is concentrated in one State, say in the local property market, then the HFE system will see that State’s share of the GST pool rise and partially offset its revenue slump. Of course, this does not happen if all States’ revenues are weak at the same time.

However, having a frank debate about federal financial relations over the longer term should not obscure the case for taking specific actions to improve matters in the shorter term. Having recognised that weaknesses exist in the GST pool, the remainder of this Chapter sets out our views on what should be done to make the pool both more robust and more stable.

Ensuring the GST pool is as robust as possible

A very important part of ensuring the adequacy of the GST pool is the ongoing ‘care and maintenance’ of the existing revenue base, including vigorously responding to Court cases that can provide the opportunity for the emergence of unintended loopholes. Beyond this, the Panel has identified two specific opportunities for augmenting the pool of untied funds received by the States in the short term, namely:

- preventing the leakage of GST revenue from online imports
- revisiting States’ obligations to fund the current First Home Owners Scheme.

Vigilance is needed to protect the intended GST revenue base

Queensland’s submission to the Review draws attention to an unusual feature of the current arrangements, namely that the Commonwealth Government has responsibility for GST compliance and legislative protection of the intended base, while the revenue consequences of this tax base protection are felt fully by the States.

Queensland goes on to claim that the Commonwealth’s response to several recent Court decisions with adverse consequences for GST revenue has been ‘less than timely’. The Panel forms no conclusion on this point, but recognises that the incentives of the two levels of government seem to be misaligned. This creates at least a risk that the GST could slip in terms of legislative priority and vigour of compliance effort.

A similar situation exists in relation to administration costs. The amount received by the States is reduced by the size of the Commonwealth’s costs (through the Australian Taxation Office) incurred in collecting the GST on their behalf. These amounts are far from trivial — in 2012-13 the GST administration budget is \$681 million. Again, while the Panel does not suggest that these costs necessarily are excessive, the current arrangements may not be optimally designed to keep administration costs as low as possible, as the Commonwealth’s costs are billed to the States.

The proposal outlined at the end of this Chapter to ‘stabilise’ the GST pool would, at the margin, also serve to better align responsibility for protecting the GST base with the fiscal incentive to do so.

Recommendation 11.1

As the Commonwealth exercises its responsibility for GST compliance and protection of the base on behalf of the States it should ensure that it vigilantly approaches this task. GST compliance should not be cross-negotiated with other Commonwealth-State issues.

Preventing the leakage of GST revenue from online imports

High priority should be given to measures that reduce the erosion of GST collections from overseas internet purchases. Not only does the current situation place domestic suppliers at a competitive disadvantage, this loophole is costing the States hundreds of millions of dollars in lost revenue.

The Panel's views on how this issue should be addressed are set out below, in two parts:

- First, the current low value import threshold could (and in the Panel's view, should) be at least halved. This could be done almost immediately and would ameliorate the problem without requiring any structural changes to either the existing GST law or customs arrangements.
- Secondly, the Panel urges both the Commonwealth and the States to consider how best to bring Australia into line with international practice in this area. Over the medium term, innovative ways of ensuring a level-playing field and preventing revenue loss need to be found. One option worth close consideration would be to replace the current approach to collecting GST 'at the border' with one that imposed a GST liability directly on overseas suppliers of goods and services to Australians.

Physical goods purchased online from overseas suppliers

In 2011 the Commonwealth Government established a taskforce to examine this issue. The Taskforce's report (the Report of the Low Value Parcel Processing Taskforce, or LVPPT) was published in July 2012 and a response from the Commonwealth is awaited at the time of finalising this report. During the deliberations of the LVPPT, this Panel made available to them an analysis commissioned by us on the issue of collecting GST on low value imports. This work suggested various ways to reduce the GST base erosion.

The current threshold of \$1,000 is out of line with overseas standards¹⁴ and seems open to flagrant abuse. The Panel has become aware of a number of practices, including overseas arrangements for parcelling purchases in amounts that will not trigger the threshold. Expensive cameras, for example, costing much more than the threshold can currently be purchased in their component parts and assembled by the purchaser without incurring any GST as long as each component (such as the body, lens, motor, battery and filters, etc.) can each be purchased for less than \$1,000. Anything other than a very low tax free threshold is exposed to such practices.

The final report of the LVPPT suggests that if the low value threshold were reduced to (say) \$500, the additional GST collected would exceed the additional administration costs that would be incurred. There would be a net revenue benefit as a result, but it may not be large — perhaps around \$30 million per annum. Beyond this, according to the LVPPT, lowering the threshold further would generate additional revenue, but administrative costs would increase by more, making that approach less attractive from a net revenue point of view.

¹⁴ Australia's threshold is far higher than many other comparable countries. For example, Britain's and Canada's are equivalent to around \$20. New Zealand's threshold, while also higher than many other countries, is still only about one-third of Australia's.

The Panel accepts that the driver of overseas purchases is not necessarily GST, as often the direct import overseas price including GST would be less than the local purchase price. We are under no illusions that lowering the threshold would be a panacea to local retailers, as has sometimes been suggested. But to some extent this is beside the point. We can see no reason why the GST should not be paid on this category of domestic consumption as long as the costs of collection are lower than the tax paid. We therefore think that the GST low value import threshold should be lowered immediately to the lowest practical level that would increase the overall (net) size of the GST pool.

Recommendation 11.2

That the low value import threshold for GST be lowered to prevent the ongoing erosion of the GST pool.

Initially, the threshold should be lowered so that it does not exceed \$500. This should occur as soon as practicable.

Other overseas supplies

The LVPPT noted that overseas suppliers may already agree to voluntarily pay GST (on parcels worth more than \$1,000) to facilitate streamlined importation and processing of goods through customs. However, it dealt only tangentially with a number of proposals for making this mandatory — that is, overseas suppliers to Australian residents would be made directly liable for Australian tax.

The Panel is inclined to the view that collecting GST and other taxes on imports physically at the border is not the long term solution. This is a product both of the rapidly increasing volume of relatively low-value physical goods that are imported after being purchased by individuals online, as well as the growing consumption of intangible goods and services (such as ebooks, for example). The amount of money at stake for the States is already significant and, if left unaddressed, could continue to increase.

Ultimately, only placing direct liability on overseas suppliers will address the avoidance of GST on intangible imports such as online purchases of music, videos and other software. If this occurred, then the administratively costly collection of GST at the border would no longer be required for ‘GST paid’ imports of any value.

The Panel considers that the cooperation of overseas suppliers could be forthcoming for the bulk of transactions, but accepts that incentives for compliance would need to be put in place with the direct liability approach.¹⁵ The Panel notes that if compliance is at its most problematic for low value items, the incentives for non-compliance are also least for such items. Likewise, the possible hardship or unfairness from confiscation of tax unpaid items is limited for low value items.

15 For example, imports on which the GST has not been paid could be made subject to confiscation. Depending on the circumstance and the value of the package it could then be released to the purchaser only after the payment of some penalty, in addition to the GST and any import duty owing.

Recommendation 11.3

That the Commonwealth and the States jointly examine as a matter of priority ways to secure the GST revenue base against its continuing erosion through the growth in imports purchased online.

This examination should include considering amendments to the GST law so as to make overseas suppliers to Australian residents liable for remittance of GST on all supplies of both goods and services that would otherwise be subject to GST if purchased from a domestic supplier. Such an approach would enable the GST exemption threshold for physical parcels to be reduced to a nominal level, no more than \$20 or \$50.

States' obligation to fund the First Home Owners Scheme (FHOS)

While not part of the GST base, the FHOS is a related impost on State budgets. All States are obliged under the intergovernmental agreement with the Commonwealth to fund and administer the FHOS, and to do so according to a range of specific conditions.

The FHOS payment of \$7,000 was introduced at the time of the introduction of the GST on grounds of intergenerational equity. Whereas, prior to the GST, home construction was subject to Wholesale Sales Tax (WST) on certain components and inputs only, the sale of new homes became subject to GST, effectively raising the price of the new homes by the extra tax amount. The difference in tax was calculated as \$7,000 in 2000 and was expected to flow through to the existing house market. For this reason, the \$7,000 FHOS was included in the tax reform package as compensation for those who happened to be outside the housing market at the time of introduction of the GST. It was not indexed as those not in the housing market at the time were expected to benefit over time from the income tax cuts and other measures that accompanied the GST and the FHOS 'compensation' was intended to diminish in real terms over time.

In this context, and given States' tight fiscal positions, it is far from clear that the States should still be obliged to make payments of \$7,000 to every first home purchaser. The Panel notes that both New South Wales and Queensland have recently announced changes to limit their assistance through the scheme to first home buyers purchasing newly constructed homes only. While this would appear to be in breach of the intergovernmental agreement, many will think this is a good policy reform, and in any case has not been objected to by the Commonwealth Treasurer.

Recommendation 11.4

The Panel recommends that the States be relieved of the obligation to make a universal FHOS grant. It should become a matter for States' own policy decisions as to what financial assistance should be offered for new home buyers.

Potential savings from targeting assistance for first home buyers

Although somewhat volatile, the burden of the FHOS on States’ budgets averaged around \$1 billion per annum between 2005-06 and 2010-11. This is equivalent to around 2 per cent of the GST pool. Payments in the future are likely to be somewhat lower than this, perhaps in the order of \$750 million a year, following the removal of the First Home Owners’ Boost. Considering the prevailing difficult budgetary conditions faced by the States, the requirement to make universal FHOS payments is a source of inflexibility for States.

While the exact proportion varies between States and over time, roughly 20 per cent of first home purchases are newly constructed dwellings. As such, if the existing rate of the incentive (\$7,000) was maintained, but limited only to these purchases, then States would realise a budget saving of around 80 per cent of their budgeted expenditure, approximately \$600 million a year overall.

Alternatively, if the targeting of the assistance to new homes was coupled with a doubling of the incentive to this group (to \$14,000), then the overall saving would be lower, but still substantial (perhaps around \$450 million overall).

Table 11.2: Potential savings from limiting assistance to new homes

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Average FHOS spending in recent years (\$m p.a.)	326	266	193	116	70	21	19	8	1,019
Indicative future FHOS spending (\$m p.a.)	240	196	142	85	52	15	14	6	750
<i>Guide to potential saving from limiting assistance to newly constructed homes</i>									
\$7,000 payment	190	160	110	70	40	10	10	5	600
\$14,000 payment	140	120	85	50	30	10	10	5	450

Note: Amounts may not add due to rounding.

Ensuring the GST pool is as stable as possible

There is value in exploring options to ensure that the funding pool available to the States is as stable and predictable as possible,¹⁶ for a range of reasons including:

- assisting States’ budgeting and management of their fiscal position
- ensuring that the GST is an appropriate vehicle for delivering HFE, including that assessment year needs are translated into actual GST shares in a sensible way
- insulating State governments, with their large service delivery responsibilities, from the fiscal effects of short term macroeconomic fluctuations.

While the States’ access to the GST pool provides them with some advantages, the Panel has heard that the volatility of grants based on GST collections can be difficult for States to manage. Although fluctuations in the GST cannot be eliminated, there are several possible ways their effects on State budgets could be smoothed.

¹⁶ In addition to ensuring that States’ shares of the pool are not subject to undue volatility (see Chapter 6).

The Panel has looked closely at several ways in which the stability of the pool of grants received by the States from the Commonwealth could be enhanced. These all contemplate a softening or breaking of the direct link between States' grants and the amount of GST collected in a given year such as:

- applying an 'automatic stabiliser' to the GST pool
- applying a growth floor to the GST pool
- completely delinking States' grants from the GST pool.¹⁷

In doing so, the Panel has been mindful that, in recent years, the downward revisions to States' GST-based grants that have caused them such alarm have, in most cases, arisen as much from revisions to the *total* GST pool, as revisions to their *shares* of the pool.

Applying an 'automatic stabiliser' to the GST pool

While fluctuations in the GST cannot be eliminated, there are several possible ways that their effects on State budgets could be smoothed. Since the Commonwealth is responsible for estimating GST and has a much bigger budget than the States, it seems feasible that the Commonwealth absorb excessive fluctuations of revenue, or departures from estimates.

If, for example, the forward estimates of GST were not linked to forecasts and projections of consumption and economic activity, but set at a slightly conservative, but steady growth rate — for example, real growth per capita plus 1 per cent — the States would have a definite grant amount for planning purposes. If the actual end of year collection dipped below that in a given year, the Commonwealth could provide interim top up support for States, but claw that back in future years. If the actual end of year collection rose above the growth rate in a given year, the Commonwealth could first use that to claw back past years overpayments (if any) or balance any current year shortfalls, or top up support for States. Under this approach, any Commonwealth budget impact and benefit to States would be fully recouped. Effectively the Commonwealth would act as automatic banker to the States in respect of downwards volatility in GST collections. GST based payments to the States would be smoothed over time, with the larger Commonwealth budget accepting the volatility risk.

A variation on the approach described above would be for the Commonwealth to provide a slightly higher minimum growth guarantee, in exchange for 50:50 sharing of upside beyond the guarantee. Again, the rationale is that fiscal volatility is best incurred and handled by the Commonwealth with a macroeconomic management perspective, and not by the States who have an ongoing service delivery requirement. This option would give a better alignment at the margin between legislative and compliance burden and the revenue result.

A third approach would be to sever the link between the GST and the size of the general purpose grants to the States. The Commonwealth and States could agree a growth rate from a starting point GST/general purpose grants level. If general purpose grants were guaranteed to grow at real per capita plus x%, there may be an x% that would be satisfactory to both levels of Government.

¹⁷ The options examined by the Panel are outlined in Appendix E.

Recommendation 11.5

That the Commonwealth and States jointly consider modifying existing arrangements to provide States with increased short-term certainty regarding the GST pool.

One potentially useful approach would be for the Commonwealth to underwrite a growth in the pool each year of no less than the increase in population and consumer prices (that is, maintenance in real per capita terms). Any additional funds transferred from the Commonwealth to the States in this way would then be recouped in future years, by withholding some part of the growth in GST collections above the base level.

12 HFE and federal finances in the longer term

12.1 The need for a longer term vision

The Panel has been conscious that a Review like this comes along infrequently. So, while we have made our inquiries into the present problems detailed, comprehensive and geared towards current circumstances, we have also felt the need to consider a vision for federal fiscal cooperation that might prove valuable for the longer term. Indeed, several contributors of views have argued that the HFE system can only be changed in the long term, preferably when there are other moving parts in play.

As has been addressed earlier in this report, the Review's Terms of Reference state that HFE has served Australia well and is to continue via untied grants from GST revenue. Faced with that constraint, together with the current practical and fiscal realities in a climate where all levels of government face tight budget constraints over the short to medium term, the Panel considers that there is presently little scope for changes that would have substantial (negative) effects on any State's GST revenues. This is particularly so since the changes being argued for are generally in the direction of less HFE and those sorts of changes have a disproportionate payoff when considered as incremental movements from the present position — simply put, they give relatively small benefits to donor States and come at a comparatively high cost to recipient States. For example, while a \$500 million gain in GST share is still comparatively minor for donor States, a loss of that degree is very significant for recipient States. The population-weighted value of a dollar between donors and recipients is about 9:1.

For these reasons the Panel has not recommended fundamental change to the HFE system over the short to medium term and has instead focused on recommendations that will improve the system's governance, transparency, stability and simplicity, but will have only minor impacts on any State's GST share. In fact, upon the deep reflection of eighteen months' immersion in HFE and related issues, we have concluded that it will not be viable just to make 'tweaks' to the current system and that, in fact, there is no middle ground between the current system and the alternative.

Our recommendations to reduce the low value threshold for GST applying to internationally purchased goods, along with removal of Inter-governmental Agreement (IGA) requirements to fund all first home buyers, will effectively enlarge the level of GST revenue available to all States, providing some 'breathing space' for State finances. The recommendations around improving the HFE system are aimed at giving States greater confidence and certainty in their shares of GST revenue.

Beyond the medium term, however, further thought needs to be given to how federal fiscal relations should be structured to best manage longer term spending pressures. The Panel considers that a longer term vision need not necessarily include the current concept of HFE, although it will need to recognise (and accommodate) the needs of the clearly fiscally weaker States.

12.2 Emerging fiscal pressures

State fiscal outlook

An examination of State budget papers indicates that by the end of the forward estimates period, a number of States are expecting to move from narrow fiscal deficits and return to operating surplus. However, this result is based upon conservative expense growth forecasts over the forward years, with the States in aggregate expecting expenses to grow by an average 3.1 per cent per annum, whereas between 2000-01 and 2011-12, expenses actually grew at an average 7.1 per cent per annum. If States are unable to limit expense growth to the budget estimates then continued deficits (and pressure to identify new revenue sources) are likely. For example, if expenses were to continue to grow at 7.1 per cent per annum, the aggregate result instead would be a deficit of 2.3 per cent of GDP in 2015-16.

Long term pressures

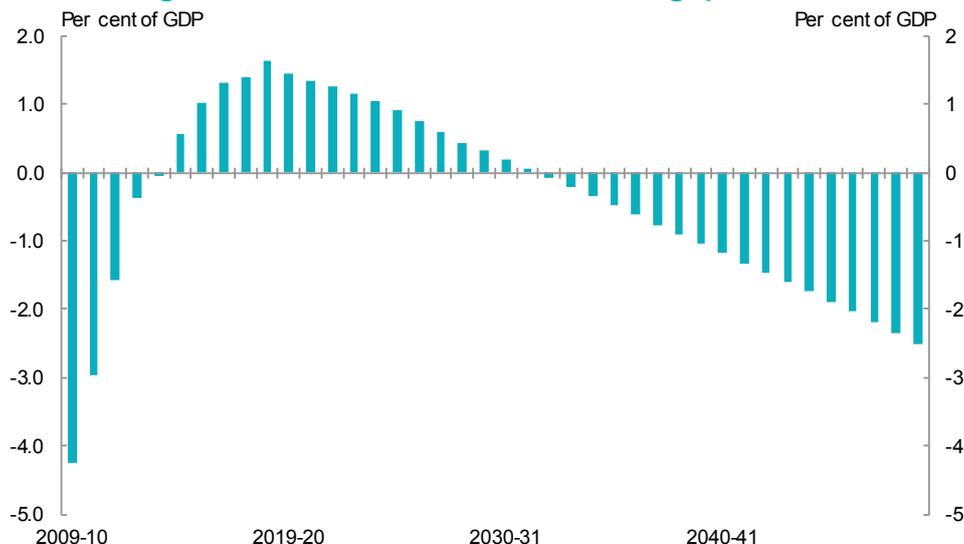
One reason that States may have difficulty in containing expense growth is that they are facing underlying economic and demographic budget pressures. In a recent speech, the Secretary to the Treasury, Dr Martin Parkinson, identified the longer term pressures on fiscal sustainability at all levels of government as:

- an ageing population, leading to slower rates of economic growth as workforce participation rates fall
- higher standards of living, leading to higher community expectations for goods and services delivered by governments, for example new services such as the National Disability Insurance Scheme, and substantial reforms to existing services that could entail more spending (such as the school funding proposals)
- significant structural change in the economy and global economic weakness, meaning that the amount of tax collected for the size of the economy is changing, with revenue growth having slowed and likely to slow further.¹

At the Commonwealth level, the 2010 Intergenerational Report (IGR) indicated that health care costs are expected to grow five-fold in coming decades, with a substantial portion of this growth being driven by the ageing of the population. Figure 12.1 shows the potential future fiscal gap for the Commonwealth included in the IGR.

1 Dr Martin Parkinson, Secretary to the Treasury, *Challenges and opportunities for the Australian economy*, speech to the John Curtin Institute of Public Policy, 5 October 2012.

Figure 12.1: Commonwealth fiscal gap to 2050

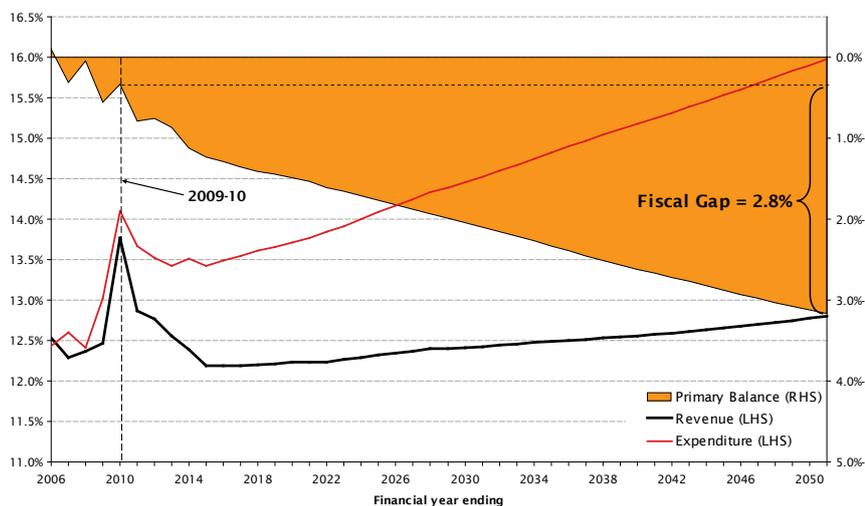


Note: The fiscal gap is total Australian Government receipts minus total Australian Government payments (excluding interest).

Source: Commonwealth Treasury, Intergenerational Report 2010.

Similar pressures are being felt at the State level. New South Wales produces a Long-Term Fiscal Pressures Report, similar to the Commonwealth IGR, every five years. The 2011-12 report indicates that, in the absence of policy action, underlying economic and demographic factors would result in expenses continuing to grow at a faster rate than revenues over the long term, acting to increase the already existing fiscal gap, as shown in Figure 12.2.

Figure 12.2: New South Wales fiscal projections



Source: NSW Budget Paper No. 6, *NSW Long-Term Fiscal Pressures Report*, 2011-12, page 6-2.

12.3 State tax reform

While a focus on stronger productivity growth and nationwide economic efficiencies will help reduce the fiscal gap, the reality is that in order to manage the longer term fiscal pressures on their budgets, there is likely to be increasing pressure on governments to reform their tax bases. For States, this might translate to increasing pressure for less reliance on inefficient narrow transactions taxes, with greater reliance on more efficient broader-based taxes.

GST reform

As noted previously in Chapter 11, the GST is not fully applied to banks, food, health and education. If GST were applied to some of these items, collections would be more buoyant in the long term since some of these items tend to grow proportionally faster as income rises and the population ages. This is likely to be true even though GST would only apply to the non-taxation funded consumption in these areas, such as general practitioner 'gap' payments and private hospital charges.

Even if the GST base were strengthened, the reality is that some tax rates would also have to be stepped up from time to time over the next few decades on a revenue positive basis to meet the expected community requirement for a switch in the composition of consumption to publicly provided (tax funded) items — in future there is likely to be relatively more hip replacements and fewer iTunes.

Of course these are contentious matters, and are ultimately for decisions by the Commonwealth and State governments collectively in the course of enhancing federal financial relations. The Panel wishes to do no more than 'unfreeze' the debate on the rate and base of GST. Medium term thinking and a national plan for the direction of tax reform (State and Commonwealth) is required. In this spirit, the Panel observes that in OECD terms, the level of consumption tax in Australia is among the lowest. As at January 2012, of the 33 OECD countries that levy a Value Added Tax (VAT), 28 countries imposed a higher rate than Australia. In the period since Australia introduced its GST in 2000, 20 OECD countries have increased their VAT rate.²

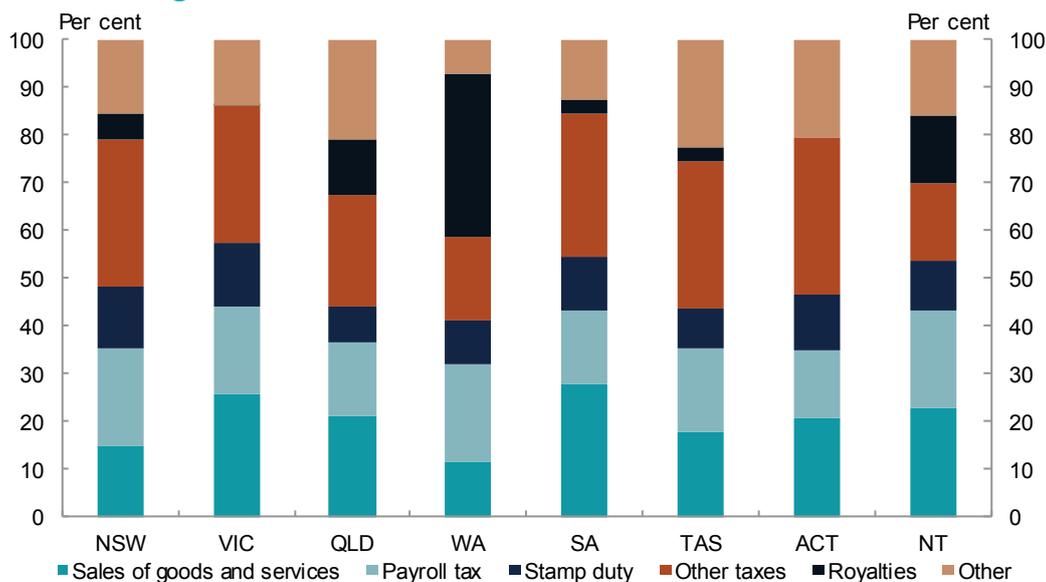
State own source revenue reform

As discussed in the Panel's second interim report, many of the States' own source taxes are considered to be inefficient, in the sense that they have relatively high compliance costs, distort investment incentives, or have a large 'welfare cost' in comparison to the amount of revenue they raise. The major revenue raising State taxes are payroll tax and stamp duty on conveyances, with mining royalties also particularly important for the mining States.

Figure 12.3 shows the proportion of own source revenue contributed by the major State taxes for each State.

2 All OECD countries except the United States levy a national VAT. A complete table of OECD member country VAT rates from 2000 to 2012 is included in Appendix G.

Figure 12.3: State own-source revenues, 2012-13

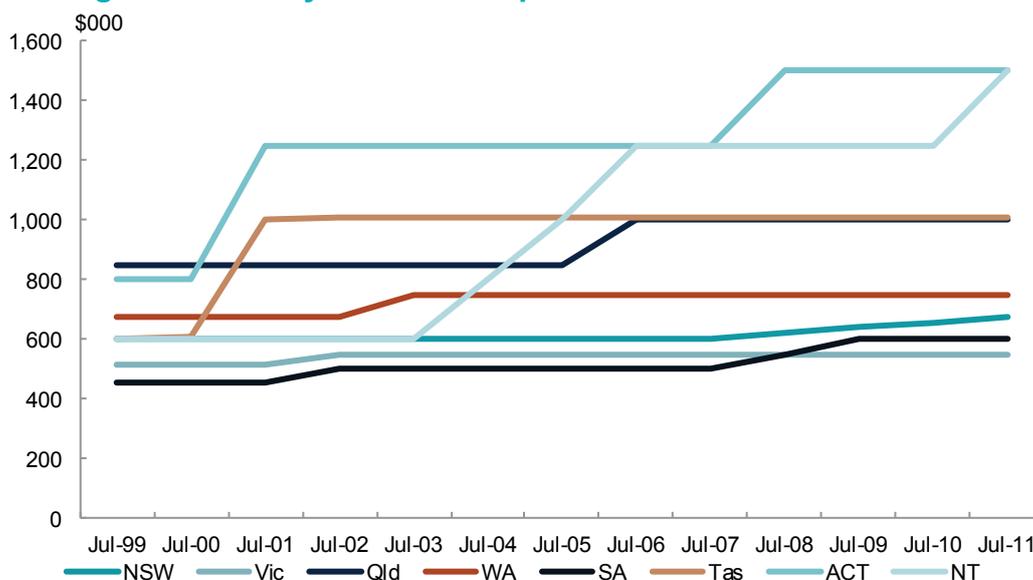


Source: State 2012-13 budgets (except ACT figures which are sourced from 2012-13 pre-election update).

The thrust of the national tax reform debate at present is that, in the long term, it may be better if taxes are able to be rationalised, removing the ‘worst’ and placing greater reliance on the ‘best’.

Dr Parkinson observed that while States have made good progress in harmonising their payroll tax bases, almost every State budget this year saw a cut in the payroll tax rate and a narrowing of the base, as shown in the charts. This has considerably reduced the effectiveness of, and the revenue collected from, this tax source.³ Figures 12.4 and 12.5 show the increase in payroll tax exemption thresholds and decrease in payroll tax rates respectively across States over the past ten years.

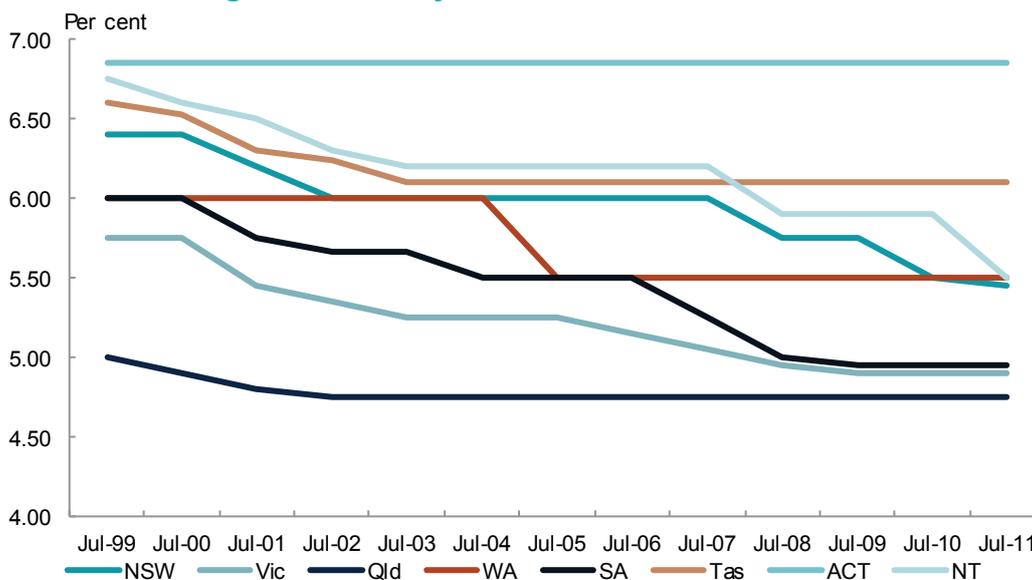
Figure 12.4: Payroll tax exemption thresholds 1999 to 2011



Source: New South Wales Treasury, New South Wales Interstate Comparison of Taxes.

³ Payroll tax is the largest single source of State tax revenue, accounting for around one-third.

Figure 12.5: Payroll tax rates 1999 to 2011



Source: New South Wales Treasury, New South Wales Interstate Comparison of Taxes.

The direction in which States are heading with regard to payroll tax is the reverse of that recommended in the AFTS review, which said that greater efficiencies would be gained by removing (not raising) payroll tax thresholds. The clear implication from Dr Parkinson’s observations is that any attempt to manage State revenues more generally is likely to require ‘major’ or ‘structural’ tax reform on behalf of the States, as well as the Commonwealth.

Perhaps due to its unique circumstances of having both State and local government characteristics, the Australian Capital Territory is the only jurisdiction to have attempted to introduce a major long term reform of its tax mix. In its 2012-13 budget, the ACT government announced that it was moving to remove the inefficient stamp duties on conveyances and insurance taxes, replacing them with expanded property taxes (rates). The long term nature of such reforms is evidenced by the government planning on a 20-year transition period to complete the tax mix change.

12.4 Roles and responsibilities

These fiscal pressures are likely to lead to a debate about the size and scope of government, both at each level of government and between the levels of government.

The impact of vertical fiscal imbalance

There is currently an imbalance, known as the vertical fiscal imbalance (VFI), between the taxing powers and spending obligations of the Commonwealth and State governments. By international standards, Australia’s VFI is high. In the longer term, a more preferable outcome may be if States are able to match their expenditure more closely with their own revenues and become less dependent on the Commonwealth, while the Commonwealth matches its revenues more closely to its own needs.

As detailed in the Panel’s second interim report, developments since federation have changed the relative revenue raising powers between the two arms of government in

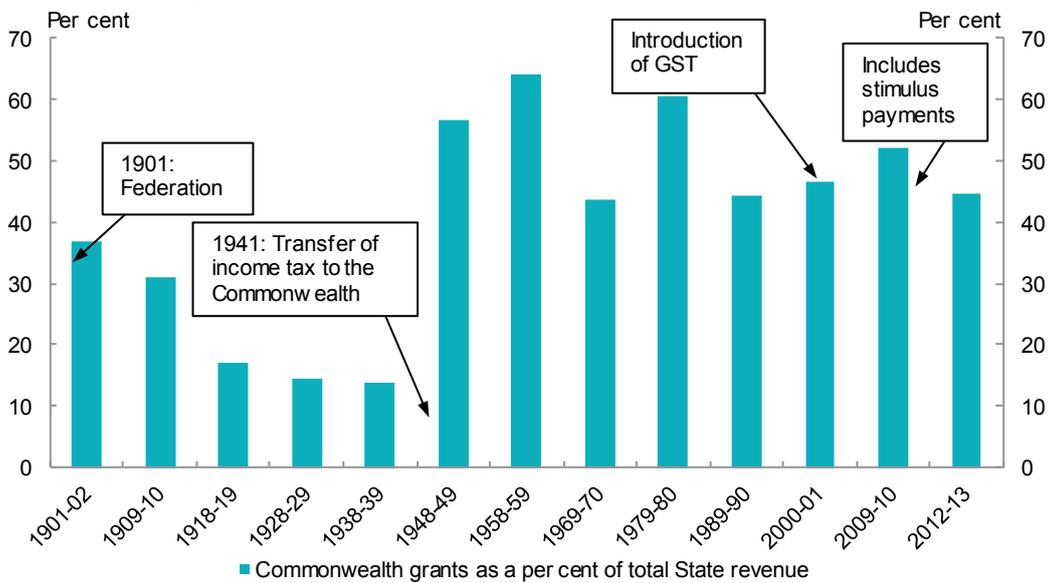
favour of the Commonwealth.⁴ At the same time as the States' revenue sources were reducing in comparison to the Commonwealth's, the nature of the assistance from Commonwealth to States has changed from providing limited grants to assist States in special circumstances, through addressing broadly-defined fiscal need, to the present concept of horizontal (interpersonal) fiscal equalisation.

Some submissions to the Review have suggested that nothing short of major reform to the responsibilities of the different arms of government or the arrangements by which they are funded will do to put the Federation on the right path. Others call for significant reform of the nation's taxes as a step to remedying the VFI 'problem'.

Shared funding responsibilities

The high level of VFI means in practice that Commonwealth transfers to the States comprise a large proportion of State budgets (at present on average across States around 50 per cent). Figure 12.6 shows grants from the Commonwealth as a proportion of total State revenue over time.

Figure 12.6: Vertical fiscal imbalance over time



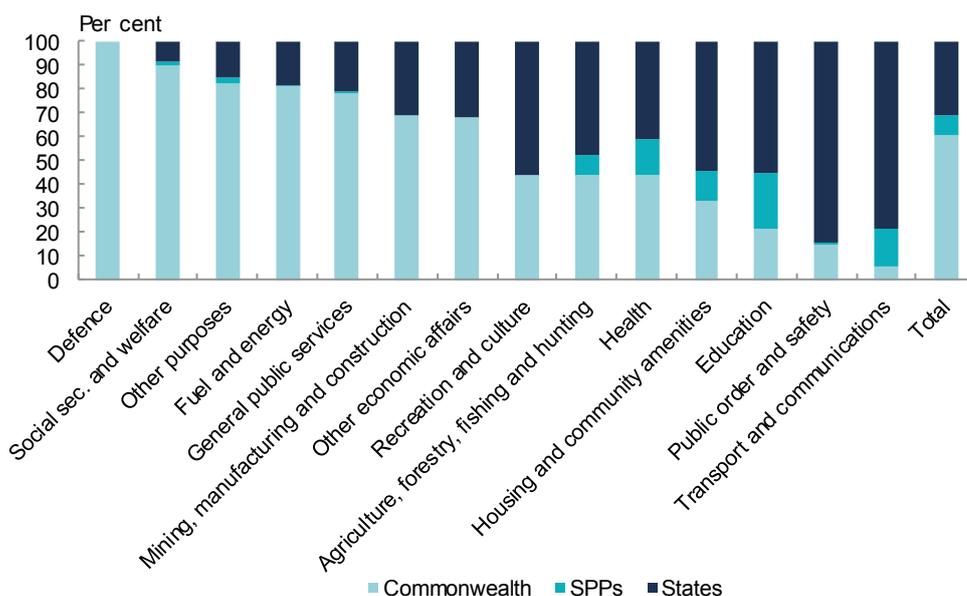
Source: Calculations based on data contained in the AFTS architecture paper (Chart 10.5), State budget papers and 5512.0 Government Finance Statistics, Australia, 2010-11.

As a result of the high level of transfers from the Commonwealth to the States, the Commonwealth plays a significant role in areas of traditional State responsibilities, such as health and education. The 2008 Intergovernmental Agreement on Federal Fiscal Relations aimed to clarify the respective responsibilities of the Commonwealth and the States. However, in the six major National Agreements, 45 responsibilities are assigned to the Commonwealth, 38 responsibilities to the States, while 58 responsibilities are listed as shared. Similar issues can be found in National partnerships.

Figure 12.7 shows the relative share of spending between the Commonwealth and the States across a range of sectors.

4 GST Distribution Review, *Second Interim Report*, June 2012, Chapter 1, Section 1.2.

Figure 12.7: Shared Commonwealth and State responsibilities, 2012-13



Source: State Budget papers, Commonwealth Mid-Year Economic and Fiscal Outlook, 2012-13.

VFI and HFE

The high level of VFI means that the pool of funds available for horizontal fiscal equalisation can also be relatively large (on average across States GST revenue represents around 25 per cent of State revenues). A consequence of the large pool of funds available for HFE is that, no matter how fiscally strong a State becomes, the pool will likely be sufficient to bring other States to that capacity. This is different to Canada, for example, where the amount of equalisation funding is only sufficient to bring the fiscally weaker States up to a minimum level.

Equalising to the level of the strongest State can lead to very large proportions of the equalisation pool being required for equalisation, in turn leading to a wide divergence in States' shares of equalisation funds (that is, GST revenue). This is the issue being experienced currently in the case of Western Australia. In 2012-13, around 45 per cent of the GST will be required to bring the other States to Western Australia's fiscal capacity, compared with around 28 per cent in 2011-12 and the long run average through the 2000's of around 15 per cent.⁵

12.5 Commonwealth assistance to States in the longer term

Any realignment of national tax bases and service responsibilities is likely to result in a continuation of some, albeit ideally reduced, level of VFI. If this occurred, VFI could be largely addressed through general revenue assistance, with the reduction in Commonwealth transfers to States being achieved through reductions in tied funding. Such an approach would act to mitigate one of the major irritants for the larger States with the current system.

⁵ Figure 3.1 (Chapter 3) shows the changes over time in the relative fiscal capacity of the strongest State and the proportion of GST pool required for equalisation. The proportion has increased in recent years and is expected to continue to do so over the forward estimates period.

Conditions for imposing assistance to States

Because the GST replaced several State taxes, the States understandably feel a proprietary relationship to it, to the extent that, when relativities change in a way negative to any of them, that one sees its revenue stream as being eroded. Under the large States' proposal (discussed in Chapters 2 and 3), even if it ultimately resulted in no additional dollars for them, they would gain control of a larger share of untied GST to count as their revenue, rather than having to rely on the Commonwealth 'granting' additional revenue to them, subject to whatever conditions (such as matching State funding for the project) they may desire.

For similar reasons all States are sensitive to base erosion, from several directions. They are worried that the incentive is not there for the Commonwealth to act swiftly when the base is threatened by legal challenges or administrative action. They are also conscious that the taxable share of consumption seems to be declining as a proportion of the whole (albeit perhaps not as quickly as might have occurred under the Wholesale Sales Tax and the State taxes repealed).

The fact that most Commonwealth payments to States for special purposes (for example, SPPs and NPPs) are formally tied, while GST payments are not, means that the greater the percentage of the former, the less flexible the State's budget (in theory, at least). Large States find this perverse in that, the more recipient States are given GST to assist their needs, the less of their budget as a proportion is tied to achieving those ends. Conversely, donor States, who have less 'need' for GST, find that more of their budget is tied. Victoria's submission suggested that 48 per cent of Commonwealth transfers to donor States are tied, compared to only 36 per cent for recipient States. If States received more untied GST and less tied other grants, they would have greater discretion over a larger proportion of their own budgets. The counterview is that, as the decrease in untied grants only comes about because of an increase in untied own source revenue, there is no issue.

HFE in the longer term

In a future world where there has been a realignment of national tax bases and service responsibilities, resulting in a reduced level of VFI, the constraints that led to our conclusions in Chapter 3 would no longer apply. Therefore, this future need not necessarily include the current concept of HFE. However, any replacement would still need to recognise and accommodate the needs of the clearly fiscally weaker States.

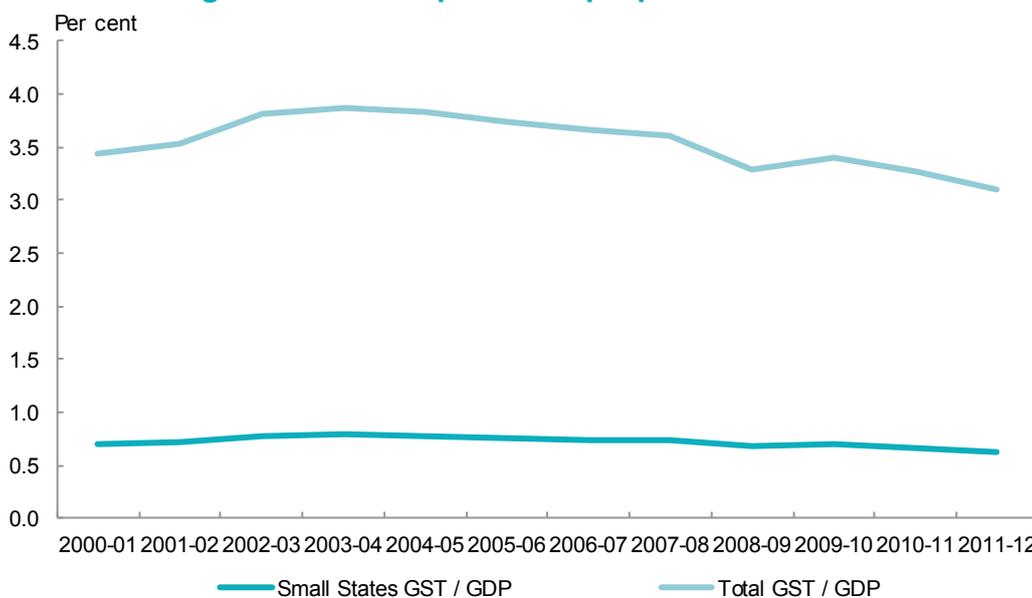
In this longer term model of federal funding, general assistance grants might most simply be distributed on an EPC basis, with the continuing larger Commonwealth budget — which has the greatest capacity — taking on the task of horizontal fiscal equalisation and ensuring that the smaller States are able to provide a comparable level of services to the larger States. This is the approach adopted in Canada, where responsibility and funding of equalisation payments resides with the national government.

The question in that scenario would be: what level of funding should be provided by the Commonwealth to the smaller States for the purpose of horizontal fiscal equalisation? As a starting point, since the introduction of GST revenue as the vehicle for HFE, the smaller States have collectively received consistently just over 20 per cent of the GST pool, or around twice their population share. Alternatively, if GST collections are not

expected to keep pace with general economic growth (and there are indications of this), then perhaps a guaranteed share of GDP would be a more sustainable benchmark.

Figure 12.8 below shows the HFE share of the GST revenue pool as a proportion of GDP since the introduction of the GST. It shows that, after a high in 2003-04 (of close to four per cent of GDP), the proportion of GDP represented by the GST pool has been steadily declining to now stand at just over three per cent of GDP.

Figure 12.8: GST pool as a proportion of GDP



Sources: GST Distribution Review, Issues paper; Commonwealth Final Budget Outcome, 2010-11 and 2011-12; Mid-Year Economic and Fiscal Outlook, 2011-12.

While the actual level of support to the fiscally weaker States would be subject to negotiation between those States and the Commonwealth, if a proportion of GDP approach was adopted, a reasonable guaranteed proportion of HFE revenue for the smaller States (on present indications) could be between 0.7 to 0.75 per cent of GDP.

Thus, in the longer term, the Commonwealth could make equalisation payments to the smaller States equal to the difference between their collective EPC share of general assistance grants (GST revenue) and the guaranteed proportion of GDP. This assistance could then be tied to particular service areas, depending upon the policy priorities at the time. In order to be able to reflect changing fiscal circumstances between the smaller States over time, the CGC could have the task of recommending how the equalisation funding should be allocated across the smaller States.

By definition, the larger States, currently being donors in the HFE system, would be better off by receiving an EPC share of general assistance grants. In addition, they generally have a larger proportion than the smaller States of their overall revenues as own source revenues compared to GST revenue and hence, in the longer term, consistent with reform of State taxes, would be in a better position than the smaller States to access revenues that grow in line with general economic growth. Therefore, in this longer term federal fiscal relations world, no equalisation payments would be required for the larger States.

Finding 12.1: The long term vision

In the longer term, citizens must make important decisions about the size of the government sector they expect and the taxes they pay for it. Maintaining government service delivery at about the same levels as currently will place increasing pressure on governments to raise taxes. On the other hand, maintaining taxes at about the same levels as currently will place increasing pressure on governments to reduce services.

In any future where revenues are tight, ensuring the most efficient and effective combination of taxes is vital to maximising the citizens' return from taxation. Tax reform — at State and Commonwealth level — to put greater focus on more efficient taxes and reduce reliance on less efficient taxes, would be an important response.

Along with decisions about the size of government overall, roles and responsibilities for services and revenue-raising may need to change between the levels of government. A closer matching of revenue-raising capacity with expenditure responsibilities could lead to improvements in the efficiency of service delivery and make all levels of government more accountable and responsible for their actions. Such a change in roles and responsibilities would likely lead to, or could complement, a reduction in the Federation's VFI.

While the Commonwealth continues to have greater budget capacity than the States it would be best placed to take on the funding of equalisation payments to the smaller States to ensure they continue to have the capacity to provide comparable (State) services to those of the larger States. Commonwealth transfers to States could then largely address VFI, and be weighted more towards general revenue assistance (funded by GST) than tied funding (PSPs). In such a world, the simplest way of allocating the general revenue assistance would be on an EPC basis. No additional Commonwealth support need be provided to the larger States, other than that consistent with Commonwealth policy priorities.

The amount of equalisation funding for the smaller States could be a guaranteed proportion of GDP. The Commonwealth would fund the smaller States collectively the difference between this guaranteed amount of GDP and their EPC share of general revenue assistance. The expectation would be that this funding would be tied, depending upon policy priorities at the time. In order to reflect changing circumstances between the smaller States, the CGC could recommend how the guaranteed equalisation funding should be allocated across the smaller States.

Appendix A: Terms of Reference

Issued on 30 March 2011 and additional terms (6A and 6B) issued on 17 November 2011.

Objectives and scope

1. Australia is facing a number of long term trends that are driving pronounced and challenging structural change in the economy, including:
 - (a) the rise of China and India, and continuing globalisation;
 - (b) the challenge of mitigating and adapting to climate change;
 - (c) population growth and demographic change; and
 - (d) the continuing effects of innovation and technological change.
2. In addition, Australia has ongoing challenges in tackling the entrenched disadvantage of many Australians, especially Indigenous Australians.
3. These trends and challenges are likely to have differing impacts on the ability of States and Territories (the States) to deliver broadly equivalent levels of services and infrastructure to their residents, in ways that maximise sustainable growth and improvements in quality of life for all Australians.
4. In this context, the Review will consider whether the distribution of the GST and the current form of horizontal fiscal equalisation will ensure that Australia is best placed to respond to these challenges and public confidence in the financial relationships within the Australian Federation is maintained.
5. In considering any possible changes to the form of equalisation, the Review will have regard to the following:
 - (a) efficiency, including the effect of alternate approaches on the allocation of resources in the national economy and on the States' reform, service delivery and investment decisions to best meet the requirements for growth;
 - (b) equity, including the extent to which alternate approaches would affect States' fiscal capacities to provide for Australians' access to government services, regardless of where they reside;
 - (c) simplicity, including the extent to which alternate approaches would provide for reduced complexity and increased transparency; and
 - (d) predictability and stability in the determination of States' GST shares so as to better support long term decision making and reform by Governments.

6. The Review will be guided by the following:
- (a) that the long standing practice of equalisation between the States has served Australia well;
 - (b) that the GST will continue to be distributed to the States on the basis of equalising payments to the States, consistent with the principle that jurisdictions should have equal capacity to provide infrastructure and services to their citizens;
 - (c) as per the current arrangements, all the GST revenue will be distributed to the States as 'untied' payments;
 - (d) that the Commonwealth Grants Commission will continue to make recommendations on the distribution of the GST; and
 - (e) it is not intended that the Review will consider detailed methodological and data issues, however the Review will seek the assistance and advice of the Commonwealth Grants Commission on technical matters as required.
- 6A. The Review should examine and make recommendations on possible changes to the form of equalisation to achieve the following objectives:
- (a) ensure that HFE does not provide a disincentive to State tax reform,
 - (b) utilise HFE to provide incentives and disincentives to promote future State policy decisions which improve the efficiency of State taxes and mineral royalties, and
 - (c) examine the incentives for States to reduce Minerals Resource Rent Tax or Petroleum Resource Rent Tax revenue through increasing State mineral royalties.
- 6B. In considering this issue, the Review will be guided by the following:
- (a) the findings of the Australia's Future Tax System Review relating to existing State taxes and mineral royalties,
 - (b) the Minerals Resource Rent Tax and Petroleum Resource Rent Tax provide a more efficient approach to charging for Australia's non renewable resources than mineral royalties, and
 - (c) State tax reform will not be financed by the Australian Government.

Composition and consultation

7. The Review would be undertaken by two or three eminent people.
8. The Treasurer will bring the final report to the Council of Australian Governments (COAG) for consideration before a final decision is made on new arrangements by the end of 2013.
9. The Review will be supported by a Secretariat in the Commonwealth Treasury. It is expected that the Review will second a number of staff with particular expertise,

including officials from State Treasuries and the CGC. A Heads of Treasuries Advisory Committee, consisting of all States, will provide advice to the Review.

10. The Review will consult the public and State Governments and seek written submissions.

Timing

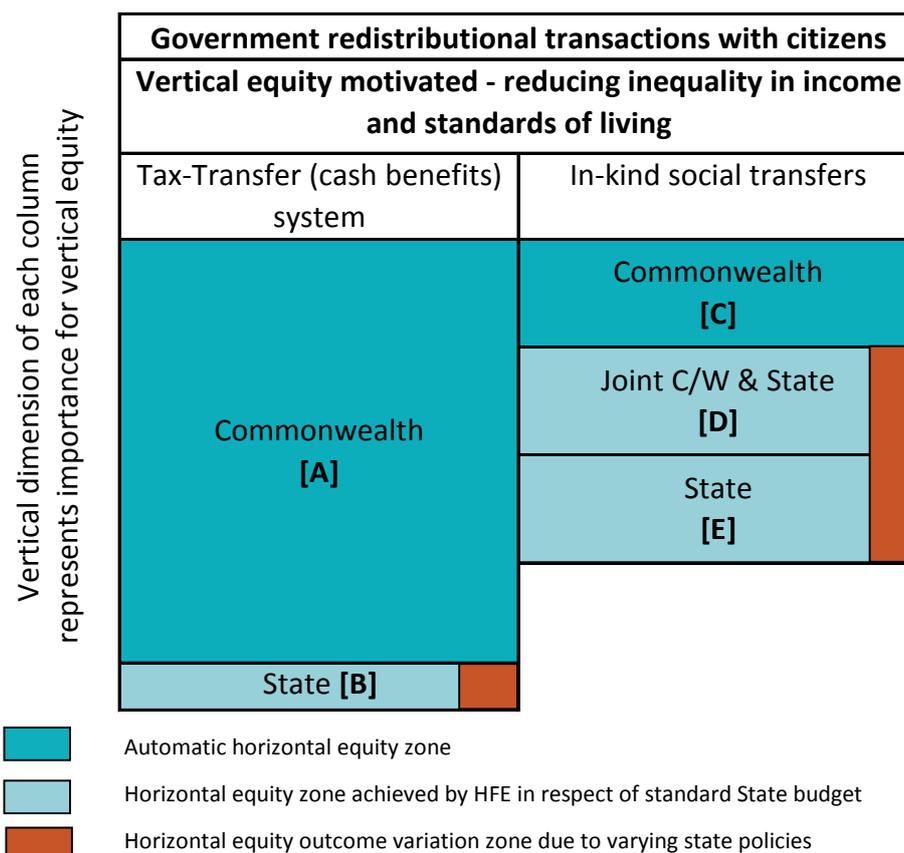
11. The Review is to provide an interim report to the Treasurer by March 2012 and a final report by October 2012.¹

12. The GST shares will be distributed in 2011-12 and 2012-13 based on the current arrangements.

1 In late 2011 the Commonwealth Treasurer extended the interim reporting date to allow for the CGC's 2012 Update figures to be incorporated in that report. In mid-2012 the Commonwealth Treasurer extended the final reporting date from August/September to allow further time for consultation and submissions in the light of the additional terms of reference.

Appendix B: Aspects of vertical and horizontal equity in government policy action

The diagram and text below seek to explain how vertical and horizontal equity in government policy action relate to *Horizontal Fiscal Equalisation*. As Chapter 2 highlights, this perspective is held by some only.



Both the Commonwealth and the States engage in a range of transactions with their citizens which have a substantial redistributive character and motivation. Often this motivation is to reduce differences in incomes and living standards more broadly — what might be termed ‘vertical equity’ considerations. The most obvious and visible example of this is the Commonwealth’s tax and cash transfer system, which includes the progressive income tax system and means-tested income support payments (depicted by the rectangle marked ‘A’). The States also play a (considerably smaller) role in this form of cash redistribution, through the provision of utilities concessions and some cash assistance for needy individuals (see area ‘B’).

Vertical equity is also pursued through a range of policies that are known as *in-kind social transfers* (as well as public goods), funded by Commonwealth and State general taxation. In this category, shown in the second column, are such programs as Medicare, the Pharmaceutical Benefits Scheme (PBS), public hospitals, schools and so on. The redistributive effects of these programs often relate to more specific circumstances

faced by households than just levels of income and wealth. Overall, the States play a bigger role in this area, often in partnership with the Commonwealth.¹

When the observation is made that governments do not seek exact equality of private incomes and living standards, seeking only to modify or restrain unequal market outcomes to a degree, this is an observation about *vertical* equity. In pursuing vertical equity objectives however, they do so from a starting point of treating like individuals equally.² This kind of *horizontal equity* is automatically achieved at the Commonwealth level (where there is only a single government). The situation is different at the State level though, where there are eight separate governments operating with different fiscal capacities rather than one State type government. In these circumstances, explicit horizontal fiscal equalisation is necessary to enable the kind of horizontal equity that naturally occurs with a single government to be achieved.

While a necessary precondition, HFE does not guarantee that horizontal equity will actually be achieved. If individual State government policy settings are very similar, then close to strict horizontal equity will be realised. Some deviation in outcomes will occur to the extent that individual State policy settings vary from the average — some above and some below (see orange bars).³

1 The areas marked 'C', 'D' and 'E' depict, respectively, the roles performed in relation to *in-kind social transfers* by the Commonwealth exclusively, the States in partnership with the Commonwealth, and the States by themselves.

2 In respect of government services, services levels vary across regions (intra-nation, and intra-state) because of different supply costs – cost based differential treatment of otherwise equals occurs. Nevertheless 'policy relevant equals', that is those situated in comparable cost locations, are treated equally. It is not the case, for example, that the tax revenue generated from a particular suburb or region constrains the amount of public expenditure that a State government may choose to make there.

3 Interstate policy variation is an intrinsic feature of federal systems, and if of concern, can be addressed by greater conditionality attaching to national grants, or overriding COAG/ Commonwealth uniform national rules (such as the requirement for free treatment of public patients in State hospitals).

Appendix C: Ideas considered but not adopted

Over the course of the eighteen months duration of the Review, the Panel has considered a wide array of ideas — ranging from preliminary and untested concepts through to well-developed concrete options. While many of these ideas have not been ultimately adopted, and the Panel has not thought it necessary to devote space to them in the body of the report, they are noted here for the benefit of future policy debate. Key options are discussed briefly in the text below. Additional issues are listed in Table C.1.

‘No small State worse off’ guarantee

Before reaching the position that options for ‘less’ equalisation (or partial equalisation) as well as a ‘less precise’ form of equalisation should not be pursued, the Panel set about considering how these options could be made to work in practice if necessary. In particular, the Panel considered how small States could be protected from any major cuts to their GST payments, should changes to the system result in less equalisation.

In this context, the Panel explored the option of using the growth in the GST pool to compensate small States for lower GST payments caused by a move towards ‘less’ equalisation. This approach was considered alongside proposals to stabilise the pool used for equalisation and, as a result, involved the possibility of applying discounted relativities to a stabilised pool. For example, the previous year’s GST pool could be increased by real per capita growth, then the relativities applied (incorporating any move towards ‘less’ equalisation) to the new stabilised pool. However, as the GST generally grows at more than real per capita, GST revenue ‘left over’ could be used to compensate small States for what they ‘lost’ in the move towards ‘less equalisation’.

Clearly, for this to work, the ‘loss’ would always have to be less than the pool ‘left over’, so this approach placed a natural bound on the degree of change that could be accommodated. Any GST remaining after small States were compensated could be distributed between the large States, or all States, on an equal per capita basis, or it could be shared with the Commonwealth if that were necessary to compensate the Commonwealth for bearing the downside risk if GST revenue growth drops below real per capita. The Panel considered this ‘using the growth in the pool’ option both as a permanent solution and also as a transition mechanism.

More minor changes

Other issues were considered, but not pursued as the Panel decided that they were in fact detailed methodological issues and were more appropriately considered by the CGC. The Panel also noted that its Terms of Reference required they avoid considering detailed methodological questions. Of course, some of these issues needed to be first considered before the Panel could conclude they were in fact methodological and that there were not broader conceptual issues. An example of an issue that fell into this category was the question of how best to escalate needs.

Currently, needs are calculated for assessment years and are then escalated to reflect the application year (this happens automatically when the three assessment year relativities are averaged and applied to the application year GST pool). It has been suggested that (effectively) increasing needs by GST pool growth means the needs are ‘inflated’ merely because of the growth in the pool, rather than necessarily any change in circumstances. In the pre-GST context when the general purpose grants pool (FAGs) only grew by population and inflation, needs in per capita terms were effectively escalated by CPI.

An alternative could involve consciously using a different escalation factor for needs (such as one based on spending growth or CPI) rather than GST pool growth. Various arguments can be put forward for alternative escalation factors. An escalation factor that grew more slowly than the GST pool would mean lower application year HFE redistributions occurring. However, just escalating needs per capita by CPI could be regarded as insufficient, since expense levels tend to grow faster than CPI. As with many other issues considered but not adopted, the Panel concluded that this was a methodological issue and did not require a recommendation from the Panel.

Table C.1: Other ideas considered by the Panel but not adopted

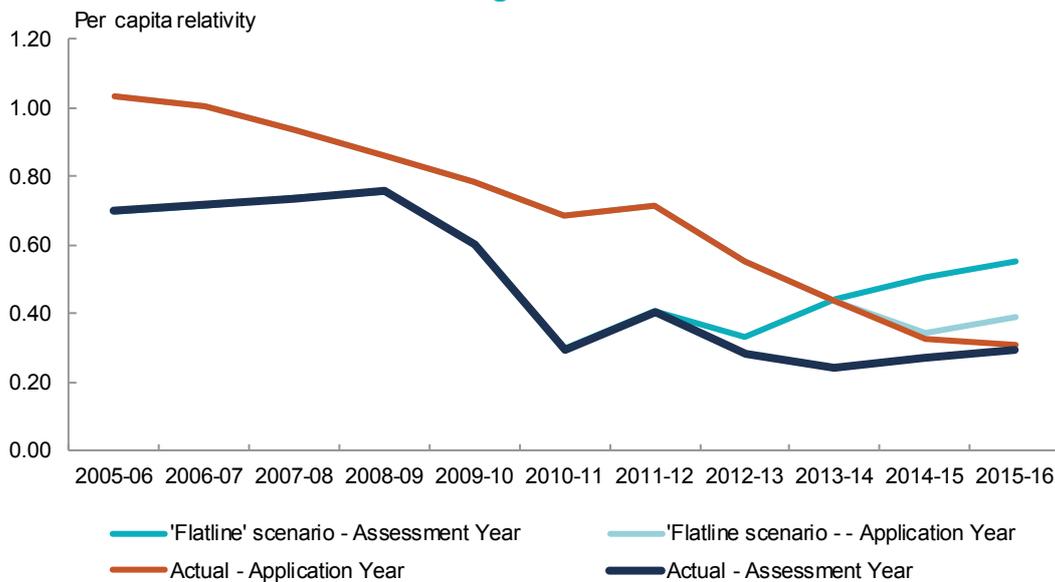
Idea	Short description
Changing the averaging period	Currently three annual relativities of past years are averaged to produce the recommended relativity for the upcoming application year. Options involved averaging <i>more</i> than three past years (i.e. returning to the past practice of averaging five years), or <i>less</i> (i.e. striving for even greater contemporaneity).
Fixing annual relativities	Currently of the three years of relativities that are averaged, the earlier two may be revised in subsequent years due to new data. This option involves not making any revisions to earlier assessment years.
Other options to limit relativity changes	Other options that aim to limit State’s relativity changes. These include not allowing a relativity to fall by more than a certain percentage a year.
Freezing expenditure disabilities between reviews	This option involves the CGC calculating expenditure disabilities in each methodology review, but not updating them annually. The CGC would continue to update assessments of revenue and Commonwealth payments each year.
Removing adjustments for tax implementation differences	This option involves setting the ‘average of what States collectively do’ benchmark at one tax rate only, without various tax-free thresholds or exemptions. For example, the assessment for payroll tax would not take into account that States have tax-free thresholds for small businesses.
Equalising for major items only	This option involves reducing the number of expense and revenue categories assessed, and only considering a smaller number of ‘core’ services.
Partial equalisation of donor States	This option is also often called a ‘donor recipient’ model. There are many variants of this option, but they generally involve donor States providing support to recipient States but without the donor States necessarily all being fully and comprehensively equalised.
Broadbanding	This option groups similar States together at some point in the CGC’s analysis of State fiscal capacities. For example, States with similar relativities could be banded together at the end of the process, or ‘inside the process’ by banding States at an assessment category or disability factor level.
Equalising revenue only	This involves equalising revenue capacity (both own source revenue and Commonwealth payments) but not expenses or capital.
Freezing relativities between reviews	This involves determining the relativities at each review and distributing the GST according to that relativity for every year until the next review.
Adopting measures to reward good policy	This involves setting aside some proportion of GST revenue to form a ‘reward pool’, to be distributed to reward States that undertake certain reforms.

Appendix D: Alternative mining scenarios

The following Figures illustrate the effect on the relativities in the event that mining royalties do not grow as strongly as States have budgeted for over the forward estimates period. In the alternative scenarios presented it is assumed that actual mining royalties for Western Australia, Queensland and New South Wales 'flat-line' at 2011-12 levels over the forward estimates period.

Figure D1 shows the effect on Western Australia's relativity if all mining royalties were to stay at 2011-12 levels over the forward estimates period.¹ In this Figure the relativities are shown on both an assessment year and application year basis. Figures D2, D3, and D4 show how the other States' relativities would change under this same scenario. All of those Figures are presented on an assessment year basis only.²

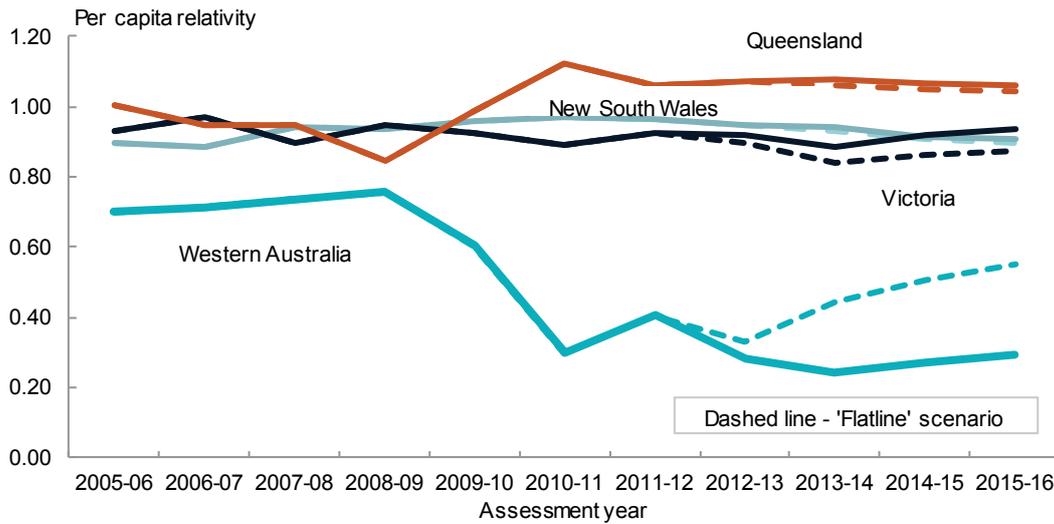
Figure D1: Western Australia's per capita relativity under alternative mining scenarios



Note: For application year data, relativities after 2012-13 are estimates and not actual figures. For assessment year data, relativities after 2010-11 are estimates and not actual figures.
 Source: Commonwealth Grants Commission and Secretariat calculations. Figures based on data available at 5 July 2012.

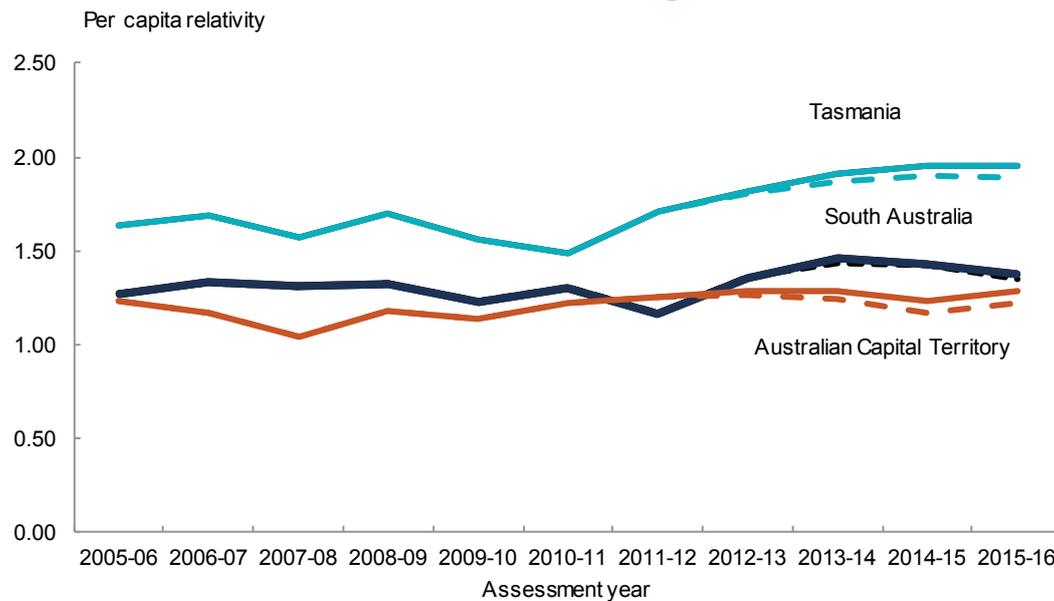
1 Estimates for the forward estimates period are based on data from the Secretariat's model agreed with Heads of Treasuries.
 2 See Glossary for definitions of application year and assessment year.

Figure D2: Per capita annual relativities for the four most populous States under alternative mining scenarios



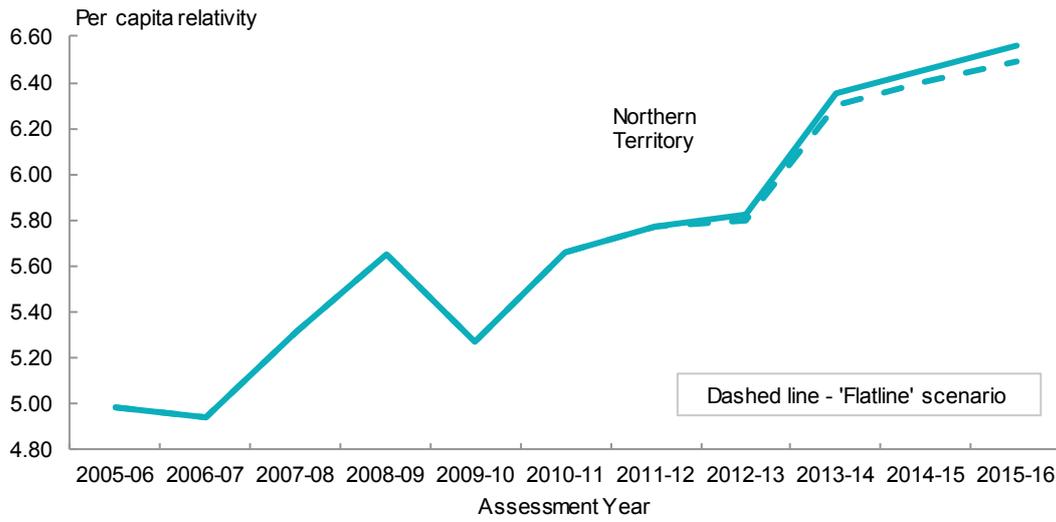
Source: Commonwealth Grants Commission and Secretariat calculations. Figures based on data available at 5 July 2012.

Figure D3: Per capita annual relativities for SA, Tasmania and the ACT under alternative mining scenarios



Source: Commonwealth Grants Commission and Secretariat calculations. Figures based on data available at 5 July 2012.

Figure D4: Per capita annual relativities for the Northern Territory under alternative mining scenarios



Source: Commonwealth Grants Commission and Secretariat calculations. Figures based on data available at 5 July 2012.

Appendix E: Stabilised pool options

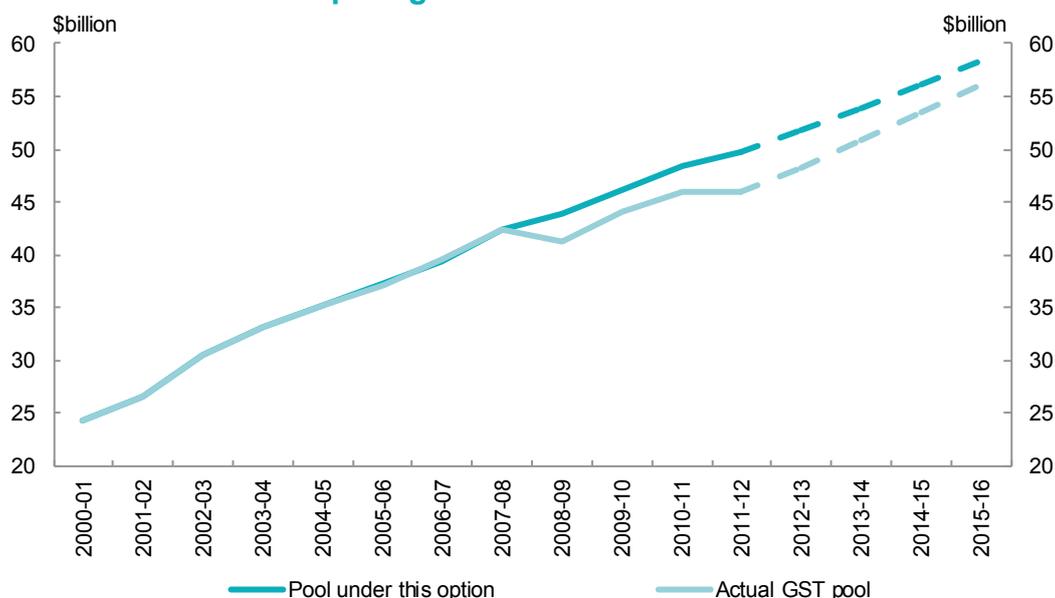
Chapter 11 described a number of options examined by the Panel to ensure that the GST pool is as stable and predictable as possible involving some softening or breaking of the direct link between States' grants and the amount of GST collected in any one year. These options fall into three groups — 'automatic stabiliser' options, 'growth floor' options and 'delinked' options.

The following Figures further illustrate some of the options examined by the Panel. Discussion of these options is included in Chapter 11. Rather than attempting to predict the future pattern of GST growth, the Panel looked at how each of the options would have worked, if they had been in place since the GST's commencement.¹

Appendix E Figures are Secretariat calculations based on Final Budget Outcomes; Consumer Price Index, Australia, ABS Catalogue no. 6401.0; CGC 2012 Update and Commonwealth Budget Paper No. 3. Figures based on data available at 5 July 2012.

Figure E1 illustrates an automatic stabiliser option in which each year, the Commonwealth guarantees that the GST pool will increase in line with population and consumer prices. If the actual GST pool provides less than that amount, then the Commonwealth 'tops-up' the pool. The Commonwealth then 'claws-back' this top-up amount when pool growth returns to greater than real per capita growth. The claw-back is assumed to operate on a nominal basis.

Figure E1: Automatic stabiliser — Commonwealth guarantees minimum pool growth with nominal clawback



¹ In this thought experiment, it is assumed that the different options would have replaced the Guaranteed Minimum Amount and Budget Balancing Assistance arrangements.

Figure E2 illustrates a similar automatic stabiliser option. As in the previous option the Commonwealth underwrites annual growth in the pool at least equal to population and consumer price growth. However, once this guarantee has been triggered, it is replaced by a ‘no nominal decline’ guarantee until the additional Commonwealth money has been ‘clawed-back’. Once the ‘claw back’ is complete, the arrangement is ‘reset’ and the initial guarantee is reactivated.

Figure E2: Automatic stabiliser — Commonwealth guarantees minimum pool growth and no nominal decline with nominal clawback

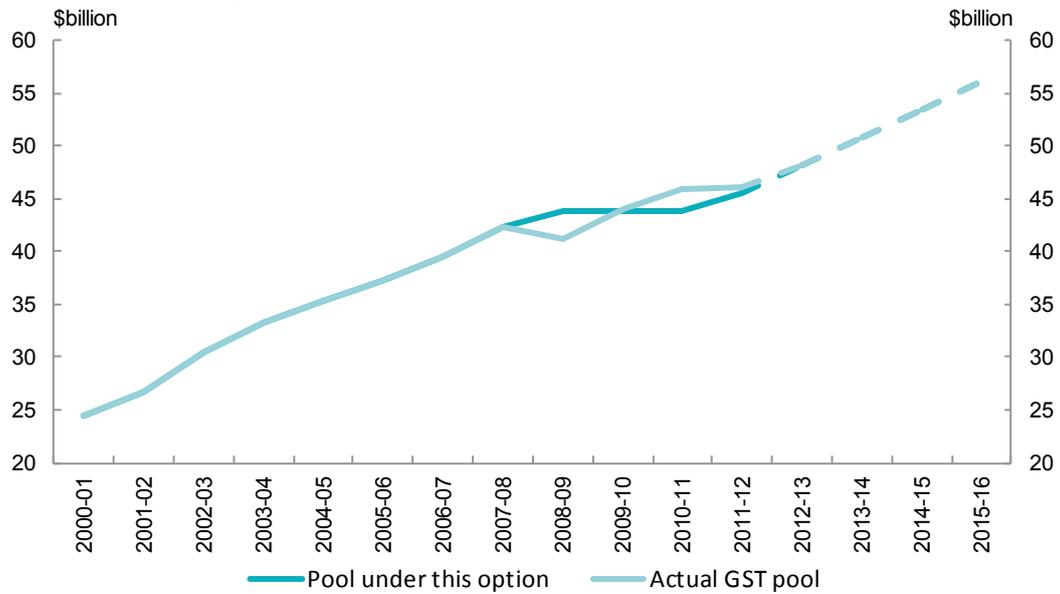


Figure E3 illustrates a growth floor option in which the Commonwealth underwrites a minimum level of growth in the pool (linked to population and consumer price growth). If actual GST collections are lower than this, the Commonwealth would ‘make up the difference’. If actual collections are stronger than the guaranteed minimum amount, this surplus is shared equally between the Commonwealth and the States. There is no claw-back of previous years’ outcomes under this option.

Figure E3: Growth Floor — Commonwealth underwrites minimum pool growth real per capita growth with no nominal clawback

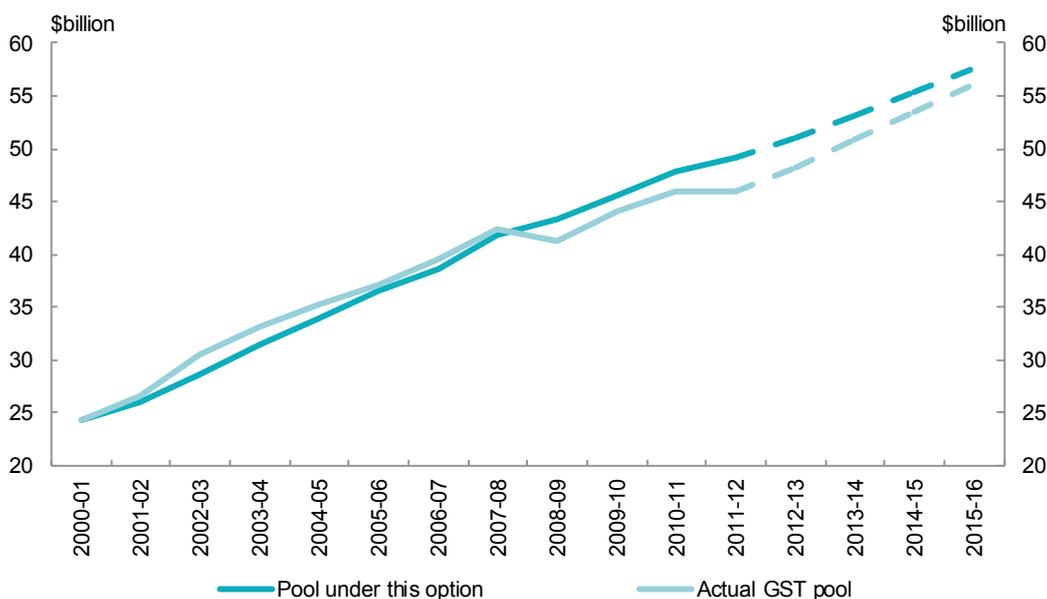
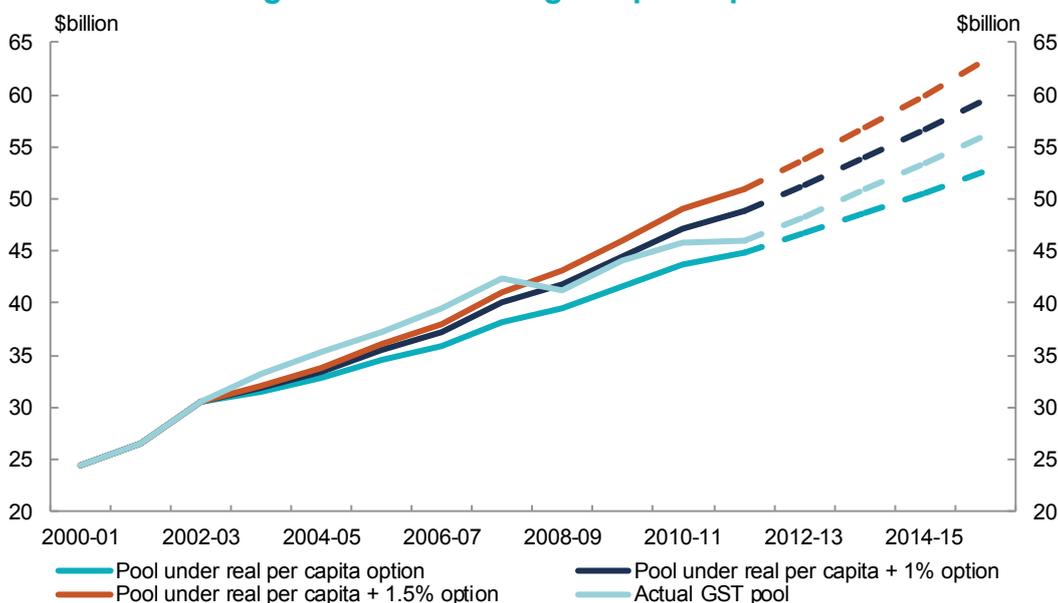


Figure E4 illustrates various grant pool options in which there is no link to GST collections. This option shows how the grant pool would have varied since 2002-03 if this GST amount (\$30.5 billion) had been indexed to either population plus consumer price growth, population plus consumer price growth plus 1% or population growth plus consumer price growth plus 1.5 per cent.²

Figure E4: Delinked grant pool options



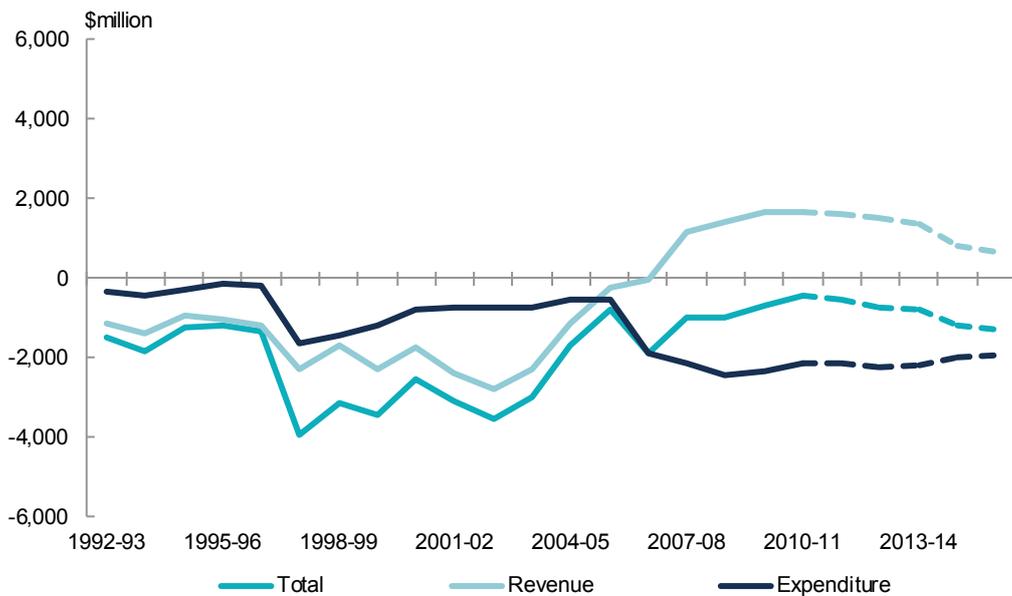
² In this option 2002-03 is used as the base year because 2000-01 and 2001-02 are not considered typical.

Appendix F: Changes in State fiscal capacities over time

Total redistribution and redistribution due to revenue and expenditure assessments

The following Figures are one way of showing differences in State fiscal capacities over the period since 1992-93 (the dashed lines out to 2015-16 are indicative estimates).¹ The Figures show the total differences from an equal per capita distribution of GST for each State as well breaking this total down into the differences due to the revenue and expenditure assessments.² All of the figures have been rebased in line with growth in nominal GDP, with 2010-11 as the reference year, and all figures relate to assessment years. Figures F1 to F8 present the redistributions in millions of dollars and Figures F9 to F16 present the redistributions in dollars per capita.

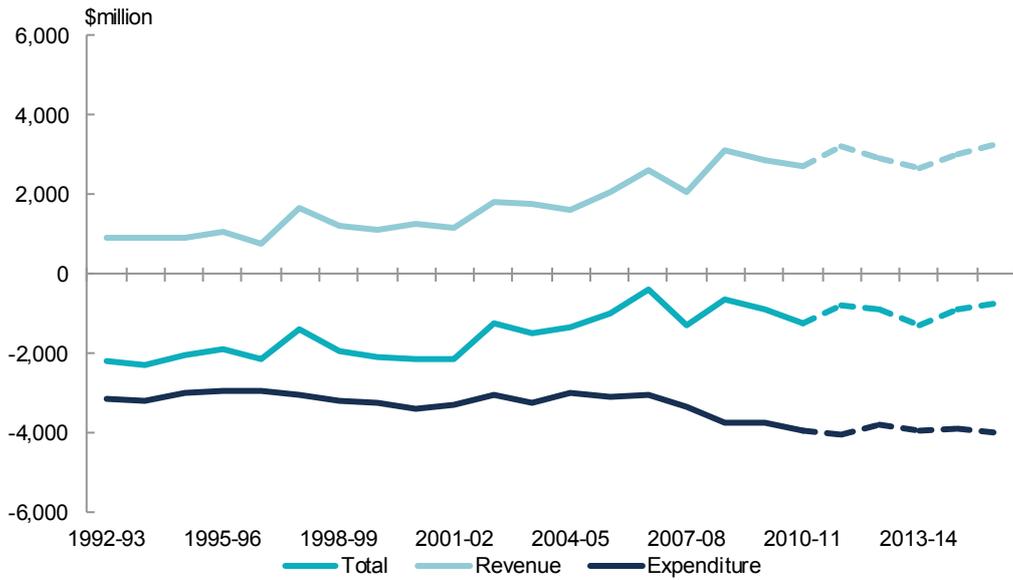
Figure F1: Assessment year needs, NSW, 1992-93 to 2015-16



Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

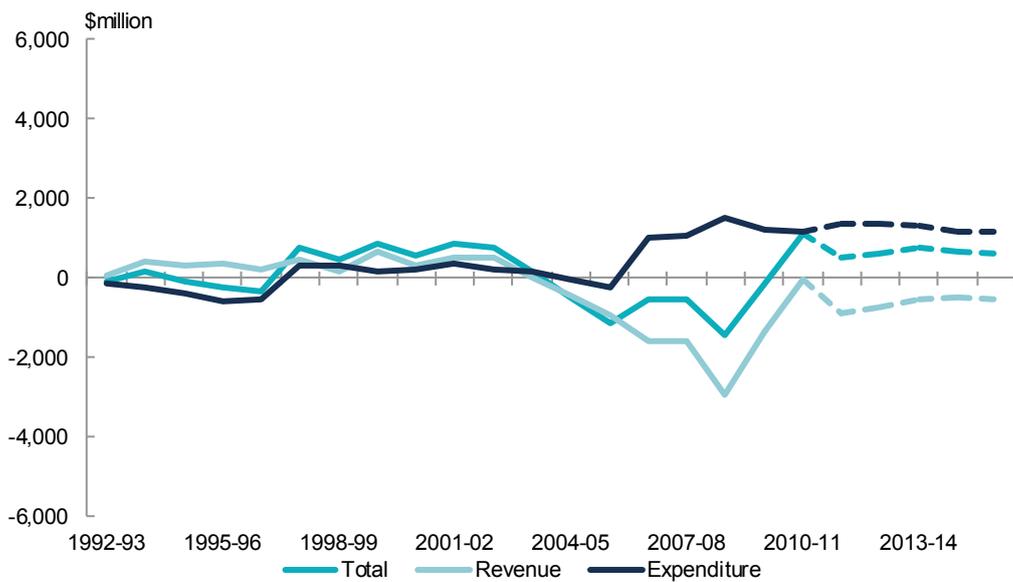
- 1 Estimates for the forward estimates period are based on data from the Secretariat's model agreed with Heads of Treasuries.
- 2 Redistributions due to expenditure assessments include population growth needs from 2006-07.

Figure F2: Assessment year needs, Victoria, 1992-93 to 2015-16



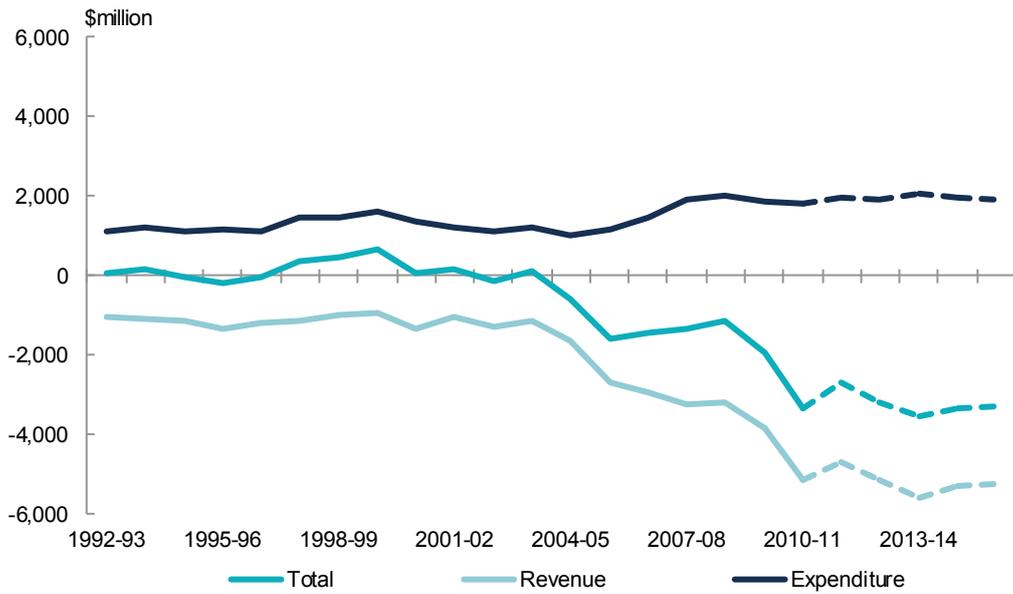
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F3: Assessment year needs, Queensland, 1992-93 to 2015-16



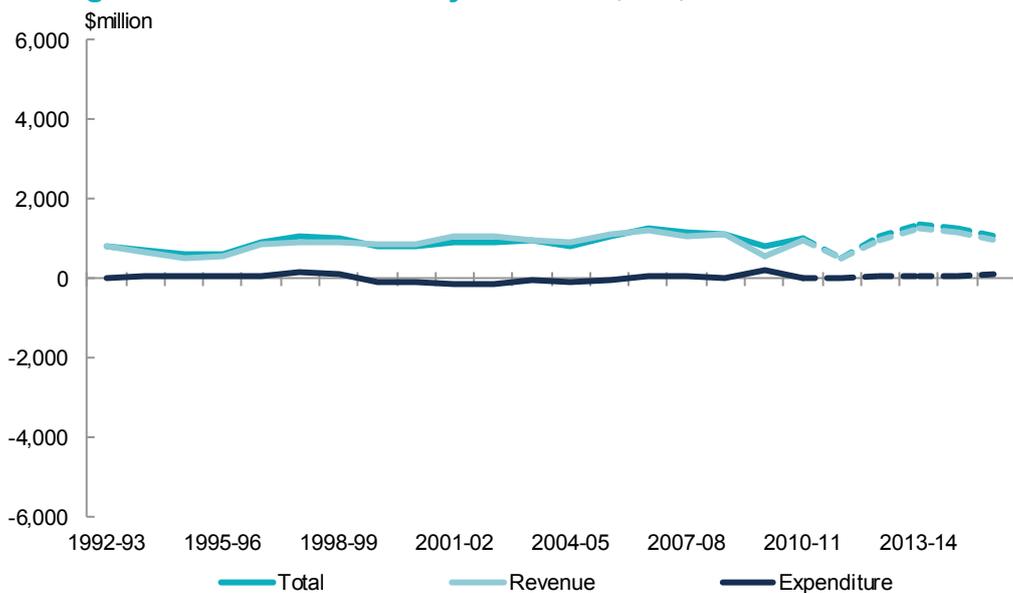
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F4: Assessment year needs, WA, 1992-93 to 2015-16



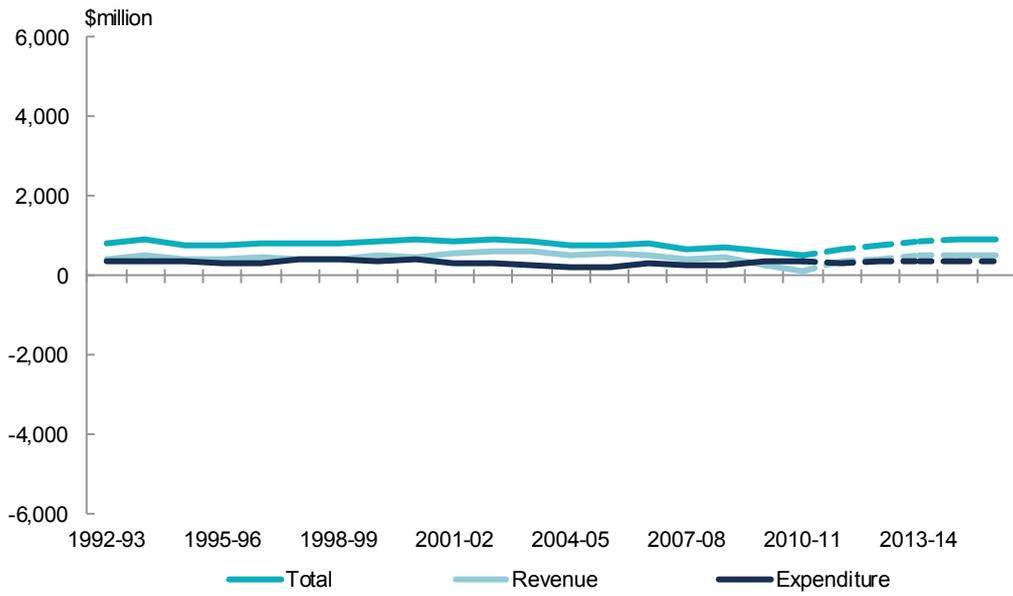
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F5: Assessment year needs, SA, 1992-93 to 2015-16



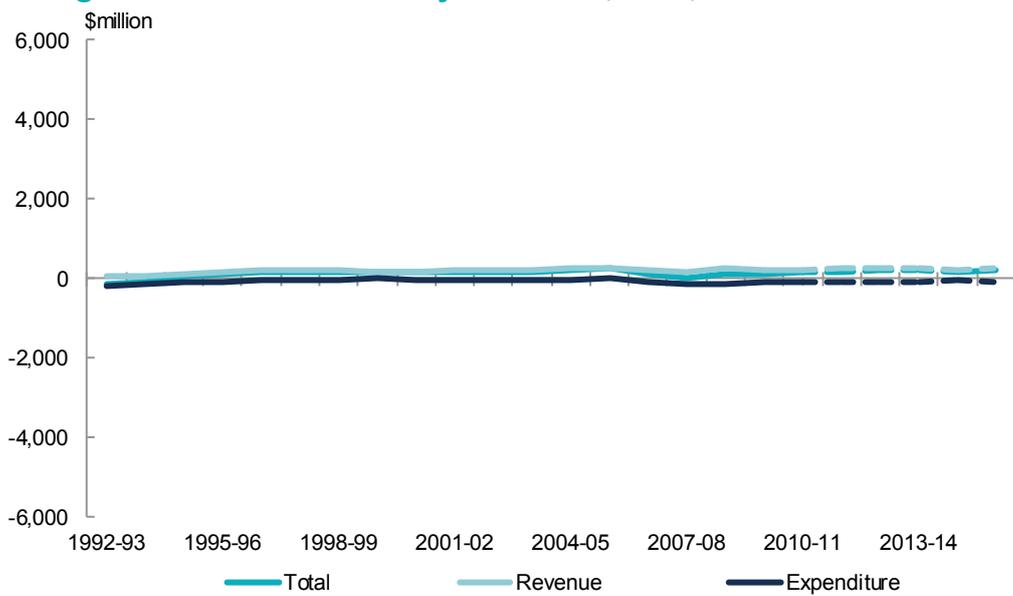
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F6: Assessment year needs, Tasmania, 1992-93 to 2015-16



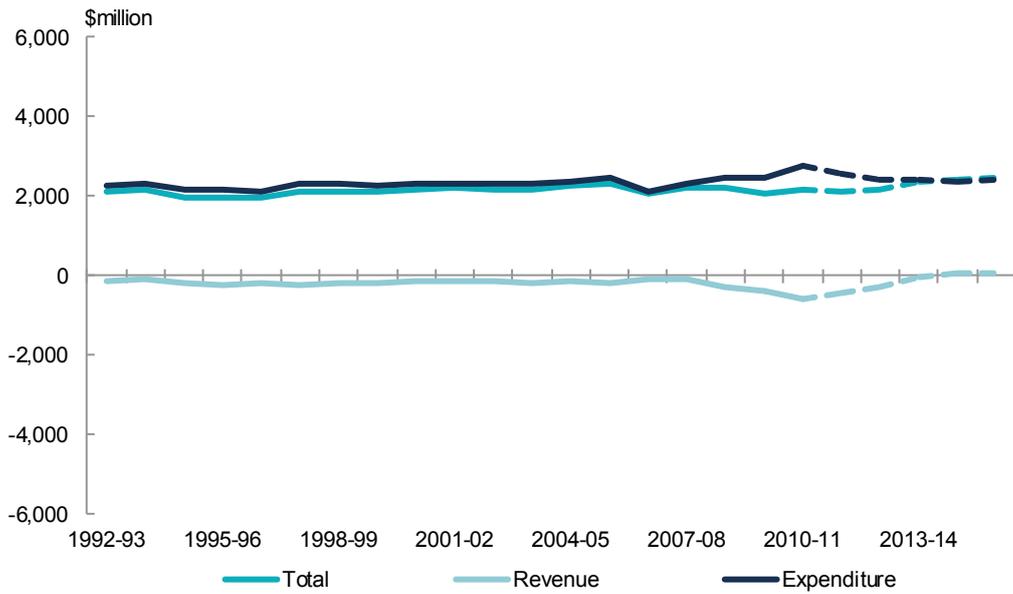
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F7: Assessment year needs, ACT, 1992-93 to 2015-16



Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

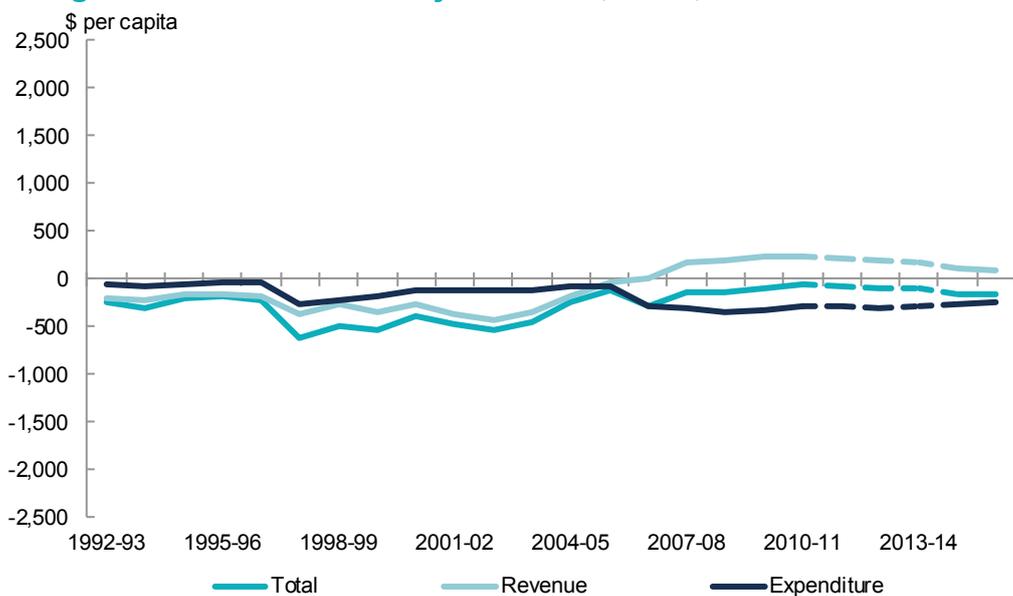
Figure F8: Assessment year needs, NT, 1992-93 to 2015-16



Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

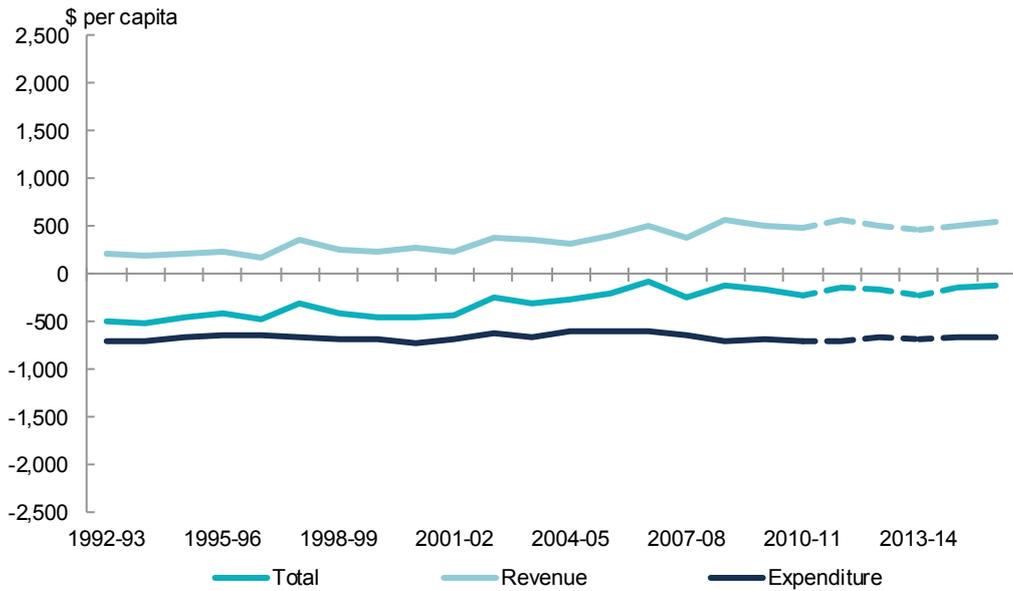
The following Figures show the same information expressed as dollars per capita.

Figure F9: Assessment year needs, NSW, 1992-93 to 2015-16



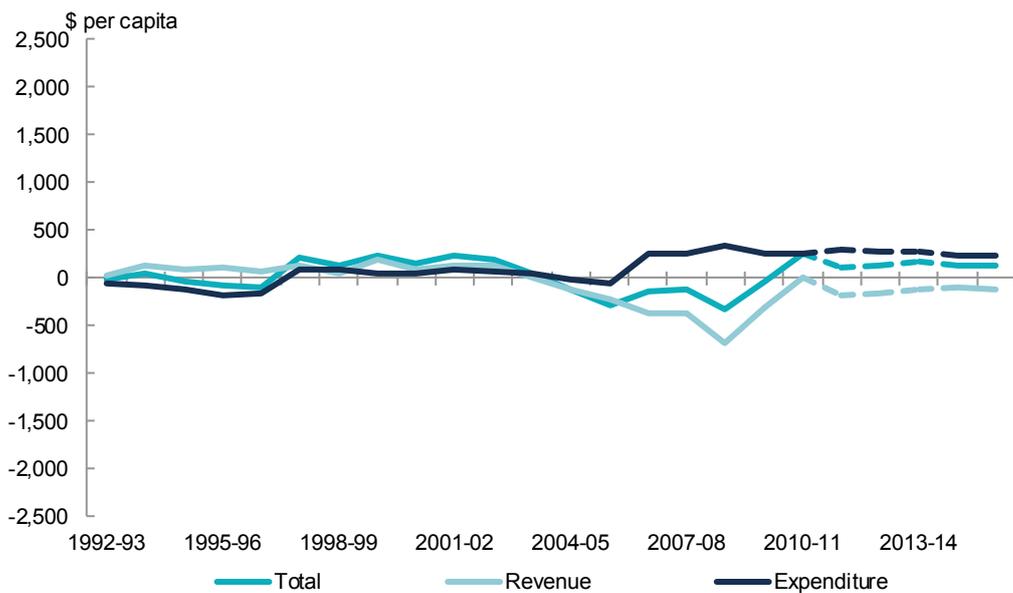
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F10: Assessment year needs, Victoria, 1992-93 to 2015-16



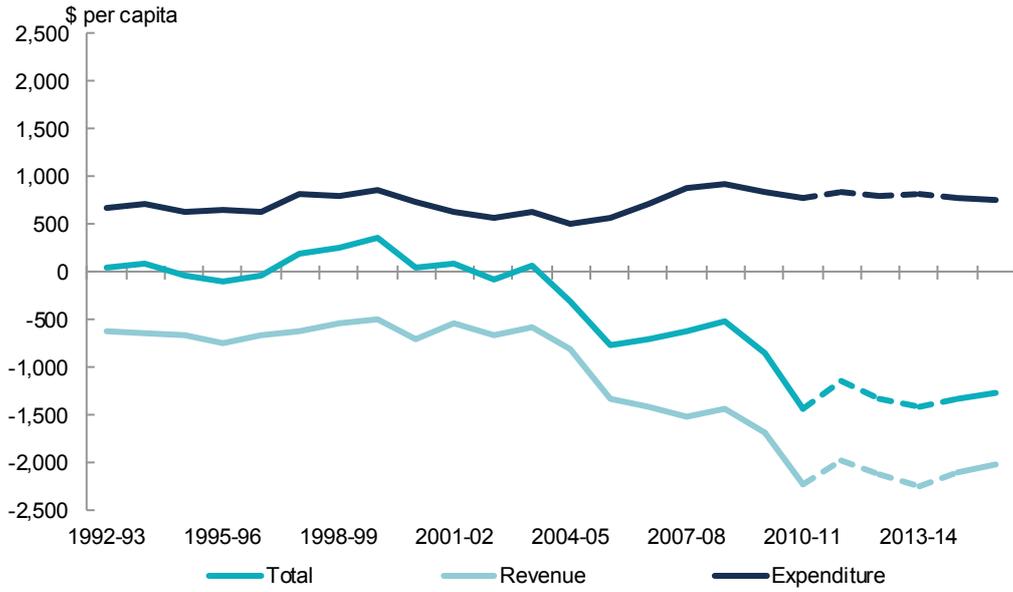
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F11: Assessment year needs, Queensland, 1992-93 to 2015-16



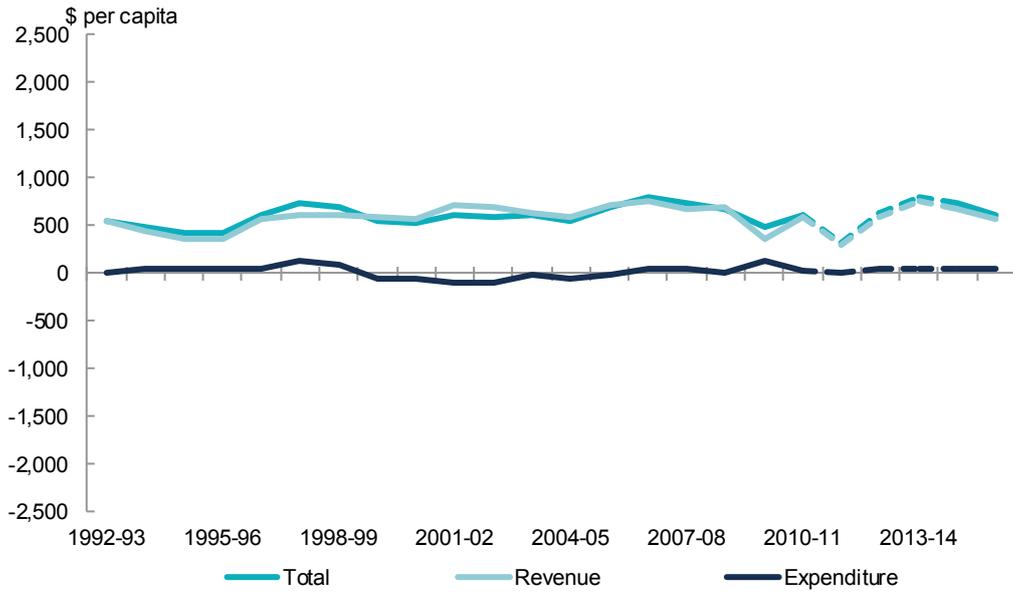
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F12: Assessment year needs, WA, 1992-93 to 2015-16



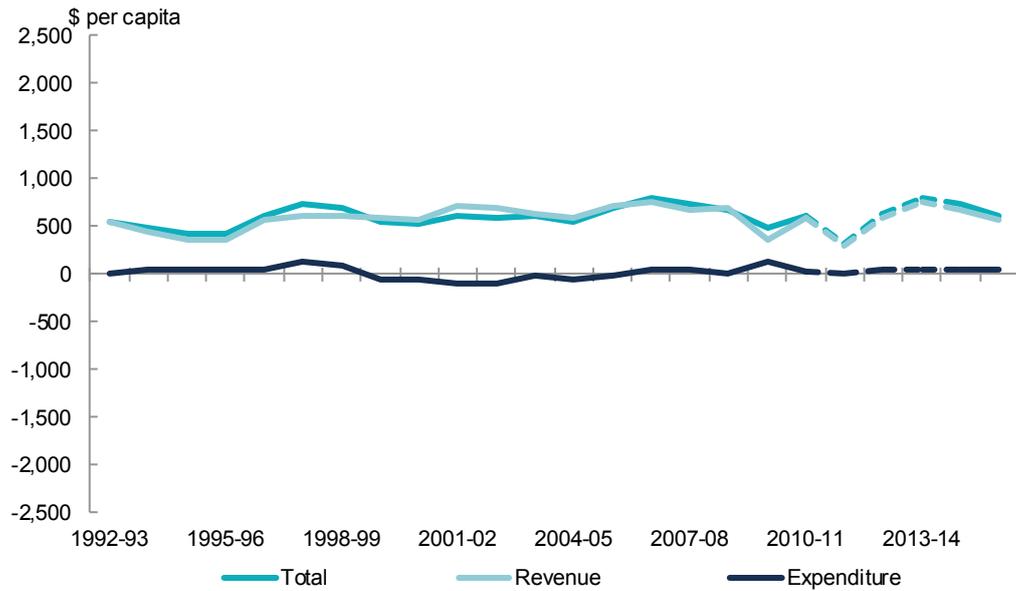
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F13: Assessment year needs, SA, 1992-93 to 2015-16



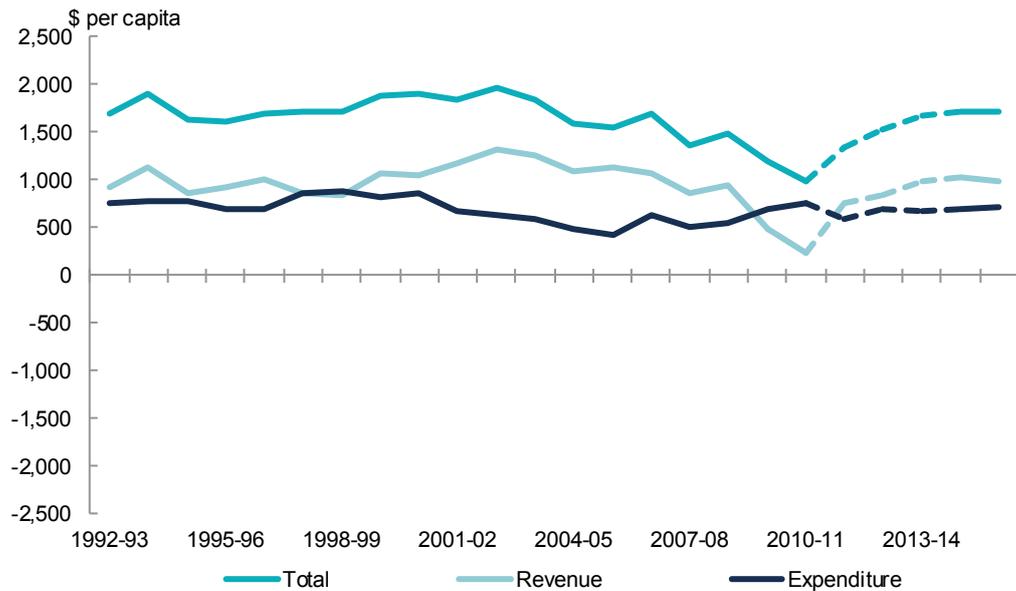
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F14: Assessment year needs, Tasmania, 1992-93 to 2015-16



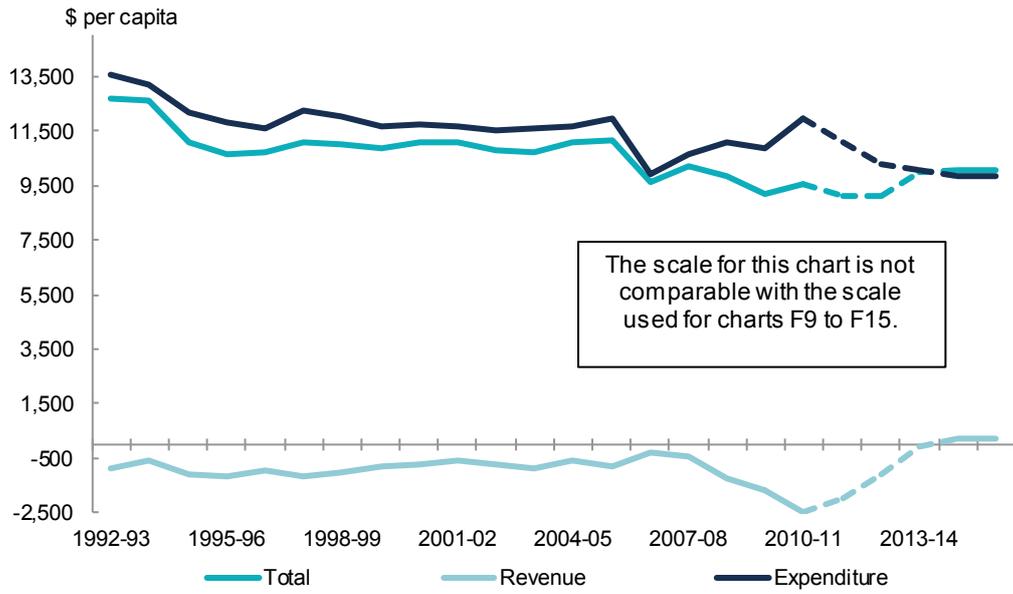
Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F15: Assessment year needs, ACT, 1992-93 to 2015-16



Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Figure F16: Assessment year needs, NT, 1992-93 to 2015-16



Source: Commonwealth Grants Commission and Secretariat calculation. Figures based on data available at 5 July 2012.

Appendix G: OECD VAT rates

The following table shows the rate for national consumption taxes (Value Added Tax or VAT) applied in OECD countries.

Table G.1: VAT rates in OECD member countries, as at January 2012

	2000	2001	2002	2003	2004	2005	2006	2008	2009	2010	2011	2012
Australia	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Austria	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Belgium	21.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0
Canada	7.0	7.0	7.0	7.0	7.0	7.0	7.0	5.0	5.0	5.0	5.0	5.0
Chile	18.0	18.0	18.0	18.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Czech Republic	22.0	22.0	22.0	22.0	22.0	19.0	19.0	19.0	19.0	20.0	20.0	20.0
Denmark	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Estonia	18.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0	20.0	20.0	20.0	20.0
Finland	22.0	22.0	22.0	22.0	22.0	22.0	22.0	22.0	22.0	22.0	23.0	23.0
France	20.6	19.6	19.6	19.6	19.6	19.6	19.6	19.6	19.6	19.6	19.6	19.6
Germany	16.0	16.0	16.0	16.0	16.0	16.0	16.0	19.0	19.0	19.0	19.0	19.0
Greece	18.0	18.0	18.0	18.0	18.0	18.0	19.0	19.0	19.0	19.0	23.0	23.0
Hungary	25.0	25.0	25.0	25.0	25.0	25.0	20.0	20.0	20.0	25.0	25.0	27.0
Iceland	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5	25.5	25.5	25.5
Ireland	21.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0	21.5	21.0	21.0	23.0
Israel	17.0	17.0	17.0	18.0	18.0	17.0	16.5	15.5	15.5	16.0	16.0	16.0
Italy	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	21.0
Japan	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Korea	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Luxembourg	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Mexico	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	16.0	16.0	16.0
Netherlands	17.5	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
New Zealand	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	15.0	15.0
Norway	23.0	24.0	24.0	24.0	24.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Poland	22.0	22.0	22.0	22.0	22.0	22.0	22.0	22.0	22.0	22.0	23.0	23.0
Portugal	17.0	17.0	17.0	19.0	19.0	19.0	21.0	21.0	20.0	20.0	23.0	23.0
Slovak Republic	23.0	23.0	23.0	20.0	19.0	19.0	19.0	19.0	19.0	19.0	20.0	20.0
Slovenia	19.0	19.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Spain	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0	18.0	18.0
Sweden	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Switzerland	7.5	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	8.0	8.0
Turkey	17.0	17.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0
United Kingdom	17.5	17.5	17.5	17.5	17.5	17.5	17.5	17.5	15.0	17.5	20.0	20.0

All OECD countries except the US levy a national VAT.

Source: OECD Tax Database.

Appendix H: Consultations

Consultation process

On 30 March 2011, the Commonwealth Government issued Terms of Reference¹ for this review of Australia's system of distributing the GST amongst the States and Territories (hereinafter collectively referred to as simply 'the States').

The Panel has consulted extensively during the course of the Review. Table H.1 outlines the main stages of the consultation process.

Table H.1 GST Distribution Review Consultation Process

Consultation	Date
Original Terms of Reference	March 2011
Initial consultations with each jurisdiction and the CGC	May — August 2011
Issues Paper released	July 2011
Symposium	October 2011
Supplementary Terms of Reference	November 2011
Supplementary Issues Paper released	December 2011
First Interim Report	March 2012
Second Interim Report	June 2012
Final consultations with each jurisdiction	June — July 2012
Final Report	October 2012

Following receipt of its Terms of Reference the Panel visited each jurisdiction to obtain initial views on particular issues of concern and met with the Chairman and staff from the Commonwealth Grants Commission (CGC). These consultations occurred between May and August 2011.

The Panel released several documents to help facilitate consultation:

- An issues paper, related to the initial Terms of Reference, was released in July 2011 providing some background on HFE in Australia, indicating some particular matters on which views were sought, and inviting formal public submissions.
- A second issues paper, related to the supplementary Terms of Reference, was released in December 2011.²
- Two interim reports were finalised in March 2012 and June 2012.

Lists of submissions responding to these papers are set out below.

¹ The full Terms of Reference for the Review are set out in Appendix A.

² The Supplementary Terms of Reference are contained in paragraphs 6A and 6B of Appendix A.

The Panel conducted a symposium in Sydney in October 2011 to provide an opportunity for academics to present their views. A list of individuals and organisations that attended the symposium is given below.

Following the release of the interim reports the Panel met with representatives from each jurisdiction in June and July 2012 to provide them with further opportunity to present their views directly to the Panel.

All public submissions have been placed on the Review website.³

The Panel thanks all those who contributed to this Review.

Submissions in response to the initial issues paper

Government submissions

Australian Capital Territory Government, *Submission to the GST Distribution Review Issues Paper of July 2011*, October 2011.

Australian Government, The Treasury, *Submission to the GST Distribution Review*, October 2011.

Commonwealth Grants Commission, *Submission to the GST Distribution Review*, August 2011.

New South Wales Government, *Submission to the GST Distribution Review*, November 2011.

Northern Territory Government, *Review of GST Distribution — Submission to Issues Paper*, October 2011.

Queensland Government, *Submission to the Review of GST Distribution*, October 2011.

South Australian Government, *Submission to the GST Distribution Review Panel*, September 2011.

South Australian Government, *Supplementary Submission to the GST Distribution Review Panel — Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects*, February 2012.

South Australian Government, *Response to comments from Jonathan Pincus and Henry Ergas on the Independent Economics Report on Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects*, April 2012.

Tasmanian Government, *GST Distribution Review — Submission by the Tasmanian Government in Relation to the Issues Paper*, October 2011.

Victorian Government, *Submission to the GST Distribution Review*, October 2011.

³ GST Distribution Review website — <http://www.gstdistributionreview.gov.au/content/Content.aspx?doc=home.htm>

Western Australian Government, *Submission to the GST Distribution Review*, October 2011.

Western Australian Government, *Submission to the GST Distribution Review — Response to the Australian Government Submission*, December 2011.

Other submissions

Association of Mining and Exploration Companies, *Submission to the Commonwealth Treasury — GST Distribution Review*, October 2011.

Business Council of Australia, *Submission to the GST Distribution Review*, December 2011.

Business SA, *Submission in relation to the GST Distribution Review Issues Paper*, October 2011.

Chamber of Commerce & Industry of Western Australia, *Submission to Review of GST Distribution*, October 2011.

Crook, Tony, MP, Member for O'Connor, *Submission to the Goods and Services Tax Distribution Review*, October 2011.

Emery, Peter, *Submission to GST Distribution Review*, September 2011.

Ergas, Henry and Pincus, Jonathan, *Reflections on Fiscal Equalisation in Australia*, 2011.

Institute of Chartered Accountants in Australia, *Submission in Response to the GST Distribution Review Issues Paper*, October 2011.

Institute of Public Affairs, *Beyond Its Use-by Date: Australia's System of Fiscal Equalisation, and How to Reform It*, Submission to the Federal GST Distribution Review, September 2011.

New South Wales Business Chamber, *Submission to the GST Distribution Review*, October 2011.

Pincus, Jonathan and Ergas, Henry, *Comments on Independent Economics report for the SA Government, entitled "Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects"*, March 2012.

Pincus, Jonathan, *Submission to the GST Distribution Review: Mining Revenues*, August 2011.

Queensland Treasury Corporation, *Submission to the GST Distribution Review*, July 2011.

Ripper, Eric MLA, *Submission to the GST Distribution Review*, October 2011.

Submissions in response to the supplementary issues paper

Government submissions

Australian Capital Territory Government, *Submission to the GST Distribution Review Supplementary Issues Paper of December 2011*, March 2012.

New South Wales Government, *Second Submission to the GST Distribution Review*, March 2012.

Northern Territory Government, *Review of GST Distribution – Northern Territory Government Submission to Supplementary Issues Paper*, March 2012.

Queensland Government, *Submission to the Review of GST Distribution*, August 2012.

South Australian Government, *Submission to the GST Distribution Review Panel – Response to Supplementary Issues Paper*, March 2012.

Tasmanian Government, *GST Distribution Review Submission to the Supplementary Issues Paper*, March 2012.

Victorian Government, *GST Distribution Review – Victorian Supplementary Submission*, March 2012.

Western Australian Government, *Submission to GST Distribution Review Supplementary Terms of Reference*, March 2012.

Other submissions

Business SA, *Submission in relation to the GST Distribution Review Supplementary Issues Paper*, March 2012.

Chamber of Commerce and Industry WA, *Submission to the GST Distribution Review Supplementary Issues Paper*, February 2012.

Insurance Council of Australia, *National Disability Insurance Scheme (NDIS): Funding the Unfunded Commitment*, material prepared by Deloitte for the Insurance Council of Australia, April 2012.

McDonald, James, *Submission to the GST Distribution Review: Separating Federal Public Goods and State Productivity Dividends*, NSW, March 2012.

McDonald, James, *A note on the efficiency of Horizontal Fiscal Equalization*, NSW, March 2012.

McGowan, Mark MLA, *Submission to the GST Distribution Review*, April 2012.

Submissions in response to the interim reports

Government submissions

Australian Capital Territory Government, *Response to the First and Second Interim Reports [of the GST Distribution Review]*, July 2012.

Commonwealth Grants Commission, *Submission to the GST Distribution Review on its Interim Reports*, July 2012.

Government of Norfolk Island, *Norfolk Island Government Submission to the GST Distribution Review Second Interim Report*, July 2012.

Joint Submission by the States of New South Wales, Victoria, Queensland and Western Australia to the GST Distribution Review, August 2012.

New South Wales Government, *Third Submission to the GST Distribution Review*, August 2012.

Northern Territory Government, *Review of GST Distribution — Northern Territory Government Submission to the First and Second Interim Reports*, July 2012.

Queensland Government, *Submission to the Review of GST Distribution — Supplementary Issues*, April 2012.

South Australian Government, *Response to the GST Distribution Review Interim Reports*, July 2012.

Tasmanian Government, *GST Distribution Review — Submission in Response to the First and Second Interim Reports*, July 2012.

Victorian Government, *Third Submission to the GST Distribution Review*, August 2012.

Western Australian Government, *GST Distribution Review — Submission in Response to the First and Second Interim Reports*, August 2012.

Other submissions

Brohier, Peter, *Reconnecting an isolated state*, article as it appeared in The Examiner newspaper, 7 July 2012. The article was provided as a submission to the GST Distribution Review.

Buckley, Brian, *Submission on Interim Reports of GST Distribution Review*, July 2012.

Business Council of Australia, *GST Distribution Review — Response to Interim Reports*, July 2012.

Chamber of Minerals & Energy of Western Australia, *Submission to Review of GST Distribution*, July 2012.

Emery, Peter, *Submission to the GST Distribution Review, Three Cheers for the Commonwealth Grants Commission*, July 2012.

Emery, Peter, Submission to the GST Distribution Review, *Some Questions of Consistency*, August 2012.

Emery, Peter, Submission to the GST Distribution Review, *Has Any Good Case Been Made For Substantial Change to the Current Arrangements*, August 2012.

Evans, Michael, *Submission on interim reports of GST Distribution Review*, July 2012.

FAQ Consulting, *Submission to the GST Distribution Review*, Darwin, July 2012.

Feng, Lintong, *Simpler and More Efficient GST Distribution*, July 2012.

Garnaut, Ross, *Submission to the GST Distribution Review*, July 2012.

Hill, John, *The Review Of Horizontal Fiscal Equalisation*, 2012.

New South Wales Mineral Council, *GST Distribution Review – Supplementary Issues Paper*, March 2012.

National Retail Association, *The Threshold Question: Economic impact of the low value threshold on the retail industry*, Report prepared by Ernst & Young for NRA, July 2012.

Pincus, Jonathan, *Summary of a Workshop on the GST Distribution held in Canberra 23 July 2012*.

Symposium — list of participants

The Panel conducted a symposium in Sydney in October 2011 to provide an additional opportunity for academics to present their views to the Panel. The Symposium was also attended by a number of observers.

Participants

Dr John Donovan
Mr Peter Emery
Dr Vince FitzGerald
Mr Chris Murphy
Prof Jonathan Pincus
Emeritus Prof Cliff Walsh
Prof Neil Warren
Prof Ross Williams

Observers

Mr Michael Barnes	Western Australia Treasury
Ms Kim Besharati	Tasmanian Treasury
Mr Roger Broughton	Australian Capital Territory Treasury
Mr Daniel Caruso	Commonwealth Treasury
Ms Mary Cavar	Victoria Treasury
Mr Damian Creedon	Chief of Staff, Treasurer, Western Australia
Mr Bruce Freeland	New South Wales Treasury
Mr Stuart Hocking	South Australian Treasury

Ms Catherine Hull	Commonwealth Grants Commission
Mr Brendan Smyth	Australian Capital Territory Shadow Treasurer
Mr Anhi Vong	Northern Territory Treasury
Mr Gary Ward	Queensland Treasury

Other visits and discussions

During the course of the Review the Panel met with all State Treasurers, several State premiers and the CGC and a number of academics. The Panel also had formal discussions with the following people:

Dr Bruce Cohen
Prof Ross Garnaut (AO)
Mr Ted Evans (AC)

In addition, the Secretary of the Review attended a number of Heads of Treasury meetings to discuss the progress of the Review.

Glossary

Actual per Capita assessment method (APC)

The assessed expense or revenue for each State is set equal to its actual expense or revenue. Typically, the CGC uses this assessment when the policies of all States are the same or and any differences in expenses or revenue are due to differences in State circumstances.

Ad valorem royalties

These are based on the value of the commodity being mined. The method of calculating value can be complicated and differ across jurisdictions.

Adjusted budget

A representation of State budgets used by the Commonwealth Grants Commission (CGC) to calculate the average per capita revenue and expenses.

Application year

The year in which relativities are applied. For example, in the 2012 Update, the application year is 2012-13.

Assessed differences (also known as needs)

The financial impact on a State of its disabilities. They are measured, for example, as the difference between assessed expenses and average expenses, average revenue and assessed revenue. Assessed differences can be either positive or negative.

Assessed expenses

The expenses a State would incur if it were to follow average expense policies, allowing for the disabilities it faces in providing services, and assuming it provides services at the average level of efficiency. Assessed expenses exclude differences from the average due to policy choices under the control of a State.

Assessed investment

The expenditure on new infrastructure a State would incur if it were to follow average policies, allowing for disabilities it faces in providing infrastructure, and assuming it requires the average level of infrastructure to deliver the average level of services. Assessed investment excludes differences from the average due to policy choices under the control of a State.

Assessed net lending

The transaction based change in net financial worth that a State would require to achieve the average net financial worth at the end of each year. The CGC's method for calculating assessed net lending assumes that each State has the average net financial worth at the start of each year.

Assessed revenue

The revenue a State would raise if it were to apply the average policies to its revenue base, and raised revenue at the average level of efficiency. Assessed revenue excludes differences from the average due to policy choices under the control of that State, for example a higher or lower tax rate applied by a State compared to the average.

Assessment years (period)

The financial years used in a review or an update to calculate relativities. The CGC uses data for three financial years. For example, the relativities recommended in the 2012 Update are based on the average of three annual relativities calculated for the most recent completed financial years at the time the relativities are released (2008-09 to 2010-11).

Average (or Australian average)

The benchmark against which the performance or characteristics of a State are assessed. It is an average derived from the policies or financial data of all States, and hence may be a financial average or a policy average.

Broader indicators

Indicators that could be used to assess State fiscal capacities at a level lower than a total budget level that is at a category and/or disability level.

Category

A classification of State general government transactions relating to distinct services or revenue sources, used for analytical purposes.

Commonwealth payments

Payments to States made by the Australian Government, including general revenue grants, National specific purpose payments, National partnership payments and Commonwealth own purpose expenses.

Current fiscal equalisation system

The process and methods adopted by the CGC in its 2010 Review to examine State fiscal capacities.

Disability

An influence beyond a State's control that requires it:

- to spend more (or less) per capita than the average to provide the average level of service
- to make a greater (or lesser) effort than the average to raise the average amount of revenue per capita.

Distribution

State shares of GST as determined by the relativities.

Equal per Capita assessment method (EPC)

Each State's assessed expense or assessed revenue in a category is set equal to the Australian average per capita amount. Such an assessment means that no 'needs' are assessed for any State and that there is no impact on the relativities.

Fiscal capacity

The fiscal capacity of a State is a measure of its ability to provide average services, including infrastructure, to its population if it raised revenue from its own revenue bases at average rates and received its actual Commonwealth payments, excluding the GST.

Fully contemporary GST distribution

A theoretical GST distribution, where States' fiscal capacities for the application year determine their GST distribution in the application year.

Global indicators

Indicators which could be used at the total budget level to assess States' fiscal capacities.

Goods and services tax (GST) revenue or pool

The funds made available by the Australian Government for transfer to the States as untied financial assistance.

Government Finance Statistics

Government Finance Statistics produced by the ABS that measure the financial activities of the governments. GFS statistics are used by the CGC to compile the adjusted budget.

Lag

Describes the impact of averaging State fiscal capacities over three years, and the two year delay in data availability. Alternatively, the lag can be described as the difference between the GST distribution in an application year based on historical data and a fully contemporary GST distribution.

Material, materiality test, materiality threshold

A test used to assist decisions on when a separate category of State activity or disability should be assessed or when data should be adjusted. The materiality levels are defined in terms of the amount of GST redistributed per capita for any State. Different thresholds are used for each. An assessment or data adjustment is said to be material if it exceeds the threshold set for it. See the Assessment Guidelines, Attachment A of the 2010 CGC Review Report, Volume 1.

National partnership payments (NPPs)

Commonwealth payments to States that support the delivery of specified projects, facilitate reforms, or reward those jurisdictions that deliver on nationally significant reforms. Some Specific purpose payments under the previous federal financial arrangements have become National partnership payments.

Payments for Specific Purposes (PSPs)

Payments made by the Commonwealth to States for specific purposes, namely National Specific Purpose Payments, National Partnership Payments and other general revenue assistance apart from the GST, see also Commonwealth payments.

Policy neutral assessment

An assessment unaffected by the policies of individual States other than through the influence of those policies on the averages.

Relativity

A per capita weight assessed by the CGC for use by Treasury in calculating the share of the GST revenue a State requires to achieve horizontal fiscal equalisation.

Revenue base

A measure of the transactions, activities, or assets that are taxed by the States. Differences between the revenue bases of each State are used by the CGC to determine the relative capacities of each State to raise a particular type of revenue.

Revenue effort

The difference between the actual rate of tax, exemptions, concessions and scope of the revenue base in a State, compared with the average rate of tax, exemptions, concessions and scope of the revenue base. It is measured as actual revenue, less assessed revenue.

Revenue raising capacity ratio

A ratio which indicates the capacity of a State to raise revenue, relative to the average. It is measured by dividing assessed revenue per capita by average revenue per capita.

Revenue raising effort ratio

A ratio which indicates the actual effort made by a State to raise revenue, relative to the average effort. It is measured by dividing actual revenue per capita by assessed revenue per capita.

Review of methodology

The process in which the CGC reconsiders the methods used to calculate State relativities, according to terms of reference given to it. From 1988 onwards, reviews have usually been done every five years. By contrast, an update is conducted every year other than a review year and updates the relativities using the methods determined in the last review and the latest financial data.

Royalties (mining)

Rent for the use of non-produced assets such as deposits of minerals or fossil fuels. It is also referred to as mining revenue.

Specific purpose payments (SPPs)

Commonwealth payments for specific purposes to the States which enable national policy objectives to be achieved in areas that may be administered by States.

State(s)

Unless the context indicates otherwise, the term 'State(s)' includes the Australian Capital Territory and the Northern Territory.

Tax elasticity effect

Where a State's tax changes affects its assessed capacity, for example where a tax increase causes assessed capacity to contract. The size of this effect depends on the elasticity of the tax base and is difficult to calculate with any certainty.

Untied payments

Untied payments to States from the Australian Government may be spent solely in accordance with State priorities. States receive the GST revenue as untied payments.

Update

The annual assessment of State relativities undertaken by the CGC between reviews. Update assessments incorporate new budgetary developments and the most recent available data. In general, the methods used to calculate the relativities are those adopted in the most recent review.

Acronyms

ABF	Activity Based Funding
ABS	Australian Bureau of Statistics
AFTS	Australia's Future Tax System
AIHW	Australian Institute of Health and Welfare
ANTS	A New Tax System
APC	Actual Per Capita
CGC	Commonwealth Grants Commission
COAG	Council of Australian Governments
DIDO	Drive in Drive out
EPC	Equal per capita
FAG	Financial Assistance Grant
FFR Act	<i>Federal Financial Relations Act 2009</i>
FHOS	First Home Owners Scheme
FIFO	Fly in Fly out
GBE	Government Business Enterprise
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GMA	Guaranteed Minimum Amount
GNI	Gross National Income
GNP	Gross National Product
GRA	General Revenue Assistance
GSP	Gross State Product
GST	Goods and services tax
HDI	Household Disposable Income

HFE	Horizontal Fiscal Equalisation
IGA	Intergovernmental Agreement
IGR	Intergenerational Report
LVPPT	Low Value Parcel Processing Taskforce
MRRT	Minerals Resource Rent Tax
NCP	National Competition Policy
NDIS	National Disability Insurance Scheme
NFB	Net Fiscal Benefit(s)
NPP	National Partnership Payment
PRRT	Petroleum Resource Rent Tax
PSP	Payments for Specific Purposes
SPP	Specific Purpose Payment
VDA	Value Distribution Adjustment
VFI	Vertical Fiscal Imbalance
WST	Wholesale Sales Tax

References

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