Submission to the Productivity Commission Inquiry into Australia's system of Horizontal Fiscal Equalisation

July 2017

Contents

1 INTRODUCTION AND CONTEXT

Key points

- GST revenues are critical for state and territory governments (the states) to provide health, education, infrastructure and other public services which have a direct impact on Australia's productivity and wellbeing.
- The current system of GST revenue allocation penalises successful states, and redistributes the benefits of their success to other states. This acts as a significant disincentive to reform.
- The methodology for GST distribution is opaque and difficult for citizens to understand. Governance arrangements effectively sit with unelected officials and accountability is low.
- The system requires fundamental reform: New South Wales proposes a move towards a fair, efficiency-enhancing, simple and accountable system which will meet community expectations for service delivery and boost the wellbeing of all Australians.

1.1 Introduction

New South Wales welcomes the Australian Government's request for the Productivity Commission to undertake an inquiry into Australia's system of horizontal fiscal equalisation (HFE), which is the method by which GST revenue is allocated amongst the states and territories (states).

The current HFE system is broken. Reform is long overdue.

The key outcome of this inquiry should be to restore Australians' faith in the fairness of the GST distribution. Indeed, as one submission to this inquiry phrased it:

> "…this very inquiry has been **precipitated by public perceptions of fairness** around the shares of individual jurisdictions, Western Australia's in particular." *(bold added)*[1]

A fairer system can be achieved through sensible redesign which creates a simple, transparent and accountable system. Any new method to distribute GST should also have the additional and important benefit of encouraging states to undertake reform which will drive greater economic growth and improve the wellbeing of all Australians – regardless of where they live.

As well as driving unintended outcomes and acting as a disincentive to reform, the current system of HFE is complex and lacks transparency. Further, the Commonwealth

[1] NSW Business Chamber, 2017, NSW Business Chamber Submission to the Productivity Commission's public inquiry, Productivity Commission Inquiry into Horizontal Fiscal Equalisation, p. 9.

Grants Commission (CGC) makes distribution decisions that are overly complex and can, at times, rely on questionable data. It also relies on the use of extensive judgement and at times produces unpredictable outcomes.

These issues can create significant budgetary and planning difficulties for states. Revisions to data and changes in methodology often contribute to significant and unexpected year-to-year movements in state GST revenue, which can have large effects on state finances.

The failings of the CGC methodology have been strongly argued and well-documented since its introduction. This reflects an enduring lack of public acceptance and support for the system, as well as the absence of incentives for the Commonwealth to lead reform to change current arrangements.

The Commonwealth has made some provision of untied funding to states for the purposes of HFE since the time of federation. However, the interpretation of HFE and method of application has changed over time. The costs and benefits of this change have not been adequately accepted by the community.

It is time now to change how GST is distributed between states.

1.2 Principles of reform

A new well designed and carefully targeted system of HFE must be consistent with the following principles:

- **Fairness** – the distribution of GST revenue should be fair in the eyes of Australians. The system should provide sufficient revenue for states to provide minimum levels of selected critical services – health, education, law and order and infrastructure. No single state should bear an unreasonable burden that would detract from their responsibilities towards their own constituents.
- **Efficiency** – the distribution of GST should not create disincentives for economic adjustment and reform relating to expenditures or taxes. The benefits of pursuing equity should be greater than the efficiency cost.
- **Simplicity** – the mechanism should be simple to understand and administer. It should be easy to replicate.
- **Accountability** – should apply to both the body making the calculations of GST distribution and to the Commonwealth and state governments who must be responsible to their citizens for the spending and revenue choices they make.
- **Stability** – GST revenue distribution needs to be more predictable so that state governments can confidently budget to provide essential services.

Australia is not the only country to have a system in place to support fiscal federalism. Different models for fiscal equalisation exist throughout the world. However, it would be fair to say that Australia's approach to fiscal equalisation is unique – no other federation seeks to achieve full fiscal equalisation on the basis of actual service delivery, or require a pre-determined pool to be fully equalised. Some of the lessons and insights to be drawn from these international examples are included at Appendix B.

1.3 A model for reform: equal per capita

Successful reform must be radical and comprehensive. It must address the objectives, design, and governance of the system used to distribute GST revenues. Simply tinkering around the edges will not do the job.

New South Wales considers that distributing GST revenue to the states in full on an untied and equal per capita (EPC) basis is the best way forward. As New South Wales has stated in previous submissions, an EPC distribution:

- Is **fair**, and importantly can be seen as fair.

  It provides an equal amount of funding from GST revenue to each Australian resident regardless of where they live.

- Is **simple** to understand, **transparent** and can be replicated.

  It would not have the intense data requirements or subjective judgements of the current system and is a transparent calculation. Any citizen could calculate the GST distribution share for his or her state.

- Is **predictable** and **relatively stable**.

  Greater stability of GST revenue would also be achieved as state population levels do not vary significantly on an annual basis. This will allow states to plan their budgets with greater certainty. This would allow more fiscal certainty for a major source of state government revenue used to fund essential services.

- Makes governments **more accountable** for their revenue and expense choices.

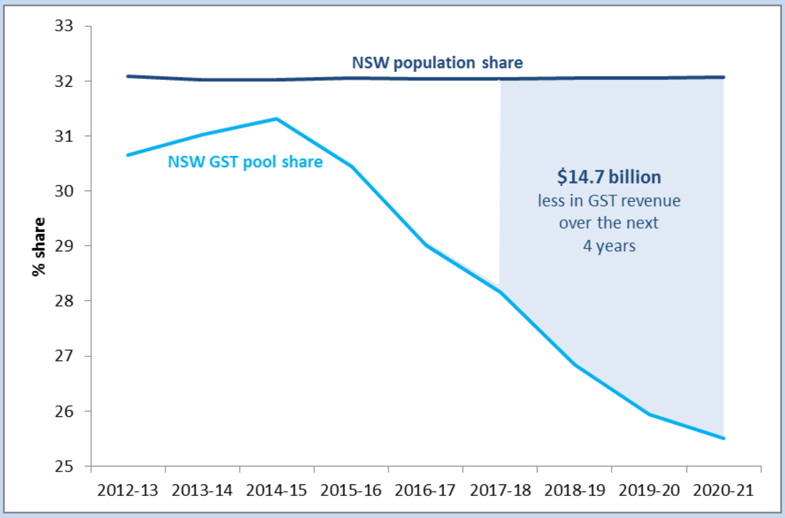
  Government spending and revenue raising choices will become more transparent to their voters.

- **Encourages good policy** and does not provide disincentives for reform.

  Greater efficiency and productivity growth would be supported by a system that encourages states to deliver service improvements and undertake other reforms that improve living standards and wellbeing across the nation.

The current system of GST distribution means New South Wales is effectively missing out on approximately $14.7 billion over the next four years to 2020-21 in comparison to a model where GST is distributed based on our population share.

Chart 1.1: NSW share of GST pool 2012-13 to 2020-21



Source: NSW Treasury modelling.

2 THE CASE FOR REFORM

Key points

- HFE creates a welfare mentality in GST recipient states.
  - In essence, it creates a perverse incentive not to change the delivery of government services as states are compensated for continued underinvestment in important areas linked to their assessed disabilities.
  - In addition, the incentive for governments to innovate, drive increased efficiency and cost savings in the delivery of government services is often subdued under HFE.
- The current system of GST revenue allocation penalises successful states, and redistributes the benefits of their success to other states.
  - Under the current system for HFE there is little incentive for states to undertake reforms to improve economic growth, productivity, or the efficient delivery of government services. This is because the economic benefits of undertaking such difficult reforms are ultimately subject to equalisation.
- Consecutive Commonwealth Treasurers have had little incentive to engage with CGC and its decision making, or drive HFE reform to improve national outcomes.
  - Difficulties in reaching a consensus between donor and recipient states means there are few benefits for the Commonwealth government in engaging with CGC decision making. At the same time, states have no meaningful role over important decisions that determine their GST shares.
- CGC bureaucrats overrule decisions of elected officials.
  - The inclusion of Commonwealth-state funding agreements in the CGC’s calculations negates the decisions of elected governments to allocate funding, through National Agreements and National Partnership Agreements.
- Australia’s HFE is one of the, if not the, most complex systems of equalisation in the world.
  - Poor transparency, combined with a high degree of complexity and subjective decision making means credibility and confidence in the CGC and HFE is undermined. Instead, a simple methodology for HFE in line with community wants and expectations of fairness needs to be introduced.
- Outcomes under HFE should be predictable and stable. This is essential to minimise interference with how states manage their budgets.

2.1 Introduction

Under HFE the incentive to pursue economic growth, productivity enhancing reform or more efficient delivery of government services is diluted. This is not consistent with community expectations for service delivery or the role of governments. Instead, the current system for distributing GST revenues between states results in the following, undesirable outcomes:

- incentives for economic reform are subdued
- states are locked into focusing on securing a greater share of GST revenues – states are not rewarded for achieving beneficial economic and social reform
- rewards for states to achieve increased efficiency or adopt innovative approaches in the delivery of government services are subdued.

These factors have a significant, detrimental impact on national productivity and economic growth. These impacts should not be understated or overlooked.

This chapter will outline some of the perverse incentives and unintended consequences that are key characteristics of the current system of fiscal equalisation.

Note: Hypothetical examples included in this section are based on various assumptions relating to likely CGC methodological approaches. There is some uncertainty associated with all scenarios included, as it is unknown how the CGC may approach such fact-based scenarios in practice.

2.2 The current HFE system distorts expenditure choices

The provision of untied general revenue assistance in the form of GST revenue recognises the importance of budgetary support for state governments. This is essential due to the high levels of vertical fiscal imbalance (VFI) that underpin the Australian federation. As untied revenue, all states exercise discretion in the allocation of GST revenues to deliver services in response to community preferences and needs.

At the same time, the primary rationale for HFE is that states are given the fiscal capacity so that individuals and households across Australia have access to a reasonably similar suite of government services if they pay comparable tax rates.

States are, in effect, compensated for continued underinvestment in important areas linked to their assessed disabilities, as defined by the CGC[2]. Further, the incentive for

[2] The CGC defines disabilities as circumstances beyond the control of individual states that require a state to spend more (or allow it to spend less) per capita than other states to provide the average level of service. Disabilities can be broadly classified into two types – use and cost disabilities. Use disabilities reflect differences between states in the use of services arising mainly from population characteristics. Cost disabilities affect the cost per unit of service provided to particular groups of people or regions. For example, higher costs might be incurred providing services in large cities or in remote areas. CGC, 2010, *2010 Review: Assessment of State Fiscal Capacities*, Volume 2, p. 562.

governments to innovate, drive increased efficiency and cost savings in the delivery of government services is often dampened by the GST distribution. Whereas states like New South Wales that introduce new innovative service delivery models or take other efficiency enhancing reforms may also be penalised.

Box 2.1: Rewarding underinvestment in essential services

The current HFE system provides a greater share of GST funding to a state that is affected by higher or lower differences in the cost of providing the average range of services because of factors beyond its control (that is, not influenced by government policy). This can include, for example, population characteristics within the state (including Indigeneity and socioeconomic status) and a state's geography and physical environment (remoteness).

In reality, variations in the cost of providing services in any given state cannot be purely disentangled from the past and present policy decisions of state governments. The current HFE system fails to fully recognise this.

In broad terms, GST distributions arising from state expenditure disabilities are driven by:

- a state's share of a particular social group, or geographic attribute
- the increased costs of providing services to that social group, or particular geographical setting.

As additional GST revenues are tied to both of these factors, the current HFE system provides perverse incentives for states with these disabilities to:

- Address disadvantages faced by particular social groups that qualify that state for a greater share of GST, as this would sustain (or increase) that state's national share of that group.
- Underinvest in infrastructure, or other efficiency-enhancing initiatives, that lower the cost of providing services to a remote area or particular group. For example, if it costs 35 per cent more to provide schooling to remote Indigenous communities, the incentive to invest in better roads or new technologies that might reduce this cost over the long run is reduced.

For example, in 2015-16 the national average expense for housing per capita was $119. Due to its disabilities, South Australia was assessed to require $131 per capita in order to provide the same service levels in housing as the national average, however its actual expenditure was only $42 per capita (i.e. 32 per cent of its assessed expense). Ongoing underinvestment risks widening this dispersion.

Similarly, Table 2.1 shows instances of underspending relative to assessed expenditure by Tasmania across a range of expenditure categories. It shows for example, that Tasmania was allocated $2,956 per person on an assessed expense basis for health expenditure – but in actual fact it only spent $2,575 per Tasmanian.

Table 2.1: Tasmania underspend per capita in 2015-16

		National average expense	Assessed expense	Actual expense	Difference
Health	($ per capita)	2,387	2,956	2,575	(381)
Welfare	($ per capita)	703	853	745	(108)
Services to communities	($ per capita)	250	268	93	(175)
Justice	($ per capita)	764	798	651	(147)
Roads	($ per capita)	267	244	180	(65)
Transport	($ per capita)	530	228	153	(75)

Source: CGC, 2017, *Report on GST Revenue Sharing Relativities – 2017 Update*, Attachment 4 (The Assessed Budget Category Tables).

Tasmania appears to use the dollars from spending less than average on health, welfare, services to communities and other services on services to industry instead. (In 2015-16, Tasmania spent $189 million – or $366 per capita, on services to industry.) This underinvestment relative to the national average expense is likely to widen the dispersion between Tasmania and the national average over time.

Similarly, Table 2.2 shows instances of underspending relative to assessed expenditure by Queensland across a range of expenditure categories. It shows that Queensland not only spent less than its assessed expense requirement for welfare and justice but also spent less than the national average.

Table 2.2: Queensland underspend per capita in 2015-16

		National average expense	Assessed expense	Actual expense	Difference
Post-secondary education	($ per capita)	188	191	174	(17)
Welfare	($ per capita)	703	756	637	(119)
Services to communities	($ per capita)	250	271	200	(71)
Justice	($ per capita)	764	811	646	(165)
Transport	($ per capita)	530	478	402	(76)

Queensland appears to use the dollars from spending less than average on welfare, justice and other services on roads instead. For example, Queensland spent 167 per cent of its assessed roads expense in 2012-13 – this amounted to $1,472 million (or $306 per capita) while in 2013-14 and 2014-15 they spent approximately 140 per cent of their assessed expense on roads, before returning to a level closer to the national average assessed expense of 105 per cent.

Source: CGC, 2017, *Report on GST Revenue Sharing Relativities – 2017 Update*, Attachment 4 (The Assessed Budget Category Tables).

A challenge to the efficacy of the HFE system and the outcomes it delivers is presented by long-standing and entrenched levels of disadvantage facing the Northern Territory associated with Indigeneity and remoteness.

Box 2.2: Underfunding of welfare services in the Northern Territory

The Northern Territory's level of assessed need is based on a recognition of significant cost disabilities arising from:

- the greater cost to deliver services to rural and remote communities across the territory
- the high cost of providing welfare services to Indigenous communities.

Indigenous peoples comprise 29.8 per cent of the Northern Territory's population, compared to 2.8 per cent for the whole of Australia.[3]

Despite high level of funding in 2012-13 and 2015-16 at levels significantly above the national average, the Northern Territory Government provided funding to deliver housing and welfare services to a standard well below their assessed level.

Table 2.3 below shows the Northern Territory's consistent underspending on housing and welfare services relative to their assessed expenditure.

Table 2.3: Northern Territory housing and welfare spending per capita compared to assessed expense

		Actual	Assessed	Difference	Average assessed
2013-14	($ per capita)	1,736	2,054	(318)	791
2014-15	($ per capita)	1,651	2,119	(468)	806
2015-16	($ per capita)	1,805	2,146	(341)	822

Source: CGC, 2017, *Report on GST Revenue Sharing Relativities – 2017 Update*, Attachment 4 (The Assessed Budget Category Tables).

In this way, other states are required to forgo GST revenue in order to provide ongoing funding to support the provision of assessed services that are underfunded by the Northern Territory and, therefore fail to deliver access to services or outcomes in line with community expectations.

More broadly, the experience of the Northern Territory under HFE raises questions regarding whether in fact HFE is the most appropriate policy instrument or distribution mechanism to address a historical legacy of deeply entrenched, structural disadvantage. See section 3.4 below.

[3] Australian Bureau of Statistics, 2017, *Census of Population and Housing Reflecting Australia – Stories from the Census,* 2016, ABS Cat. No. 2071.

2.3 Distortions to Commonwealth-state negotiated funding agreements

Commonwealth payments as a result of a National Agreement, National Partnership Agreement or Project Agreement are included by the CGC in the assessment of each state's fiscal capacity. This is because the CGC considers these payments are made available to support the provision of state government services.

This often results in agreements that are negotiated between the Commonwealth and state ministers being equalised under HFE.

This approach fails to give appropriate recognition that Commonwealth payments to states may be made for a range of purposes. These purposes are usually closely analysed as part of intensive and detailed negotiations between the Commonwealth and state governments. Accordingly, payments may be differentially distributed amongst states to progress agreed policy priorities, for example funding under the National Health Reform Agreement (see Box 2.3).

In many instances, the CGC exercises its discretion concerning which Commonwealth payments are subject to fiscal equalisation. This creates uncertainty for governments in negotiating any funding agreement with the Commonwealth. It also creates a real and genuine risk that the policy intent of elected representatives and governments will sometimes be subsequently overridden by unelected CGC officials.

Australia appears to be the only federation where payments from the central government may be subject to equalisation in this way.

If the Productivity Commission recommends an approach other than EPC, New South Wales believes all tied grants should be excluded from any HFE assessment process.

Box 2.3: Redistribution of National Health Reform Agreement (NHRA) funding

The CGC's treatment of Commonwealth grant funding to states can be problematic.

There are many instances where Commonwealth payments to the states are not provided on an EPC basis. For example, under the NHRA states receive funding for public hospitals on an Activity Based Funding (ABF) basis.

The ABF model distributes public hospital funding based on the level of household activity within a state, recognising the different demands and pressures on the public hospital system nationally.

However, most of the funding received under the NHRA is assessed by the CGC as revenue to be included in each state's fiscal capacity, and is therefore subject to equalisation. This has the effect of unwinding the intent of ABF provisions in the NHRA.

The following table shows total health funding that is assessed by the CGC (of which 98.3 per cent is NHRA funding) and the redistribution outcomes for each state.

Table 2.4: Actual Commonwealth health funding by state 2015-16

		NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUS
NHRA	($m)	5,688	4,193	3,557	1,875	1,236	395	267	266	17,481
Redistributed	($m)	(86)	187	(47)	25	7	(17)	19	(88)	0

As funding is provided on an activity basis, HFE penalises states with hospital activity greater than the national average. This would mean New South Wales will lose $86 million in GST revenues as a consequence of the CGC including this agreement as part of their assessment approach. In this way HFE in effect reverses the policy intent of ABF funding and ultimately the policy decisions of elected officials to achieve set policy objectives.

This comes at the cost of untied GST revenues, which could have been spent on other important services such as education or justice.

The current GST distribution creates incentives for strategic behaviour amongst states in the negotiation and adoption of National Agreements and National Partnerships.

Box 2.4: Negotiating Commonwealth-state financial agreements and strategic behaviour

The following example references a hypothetical scenario for the development of a National Partnership Agreement relating to early childhood education and care. Further information is set out in Appendix C.

Under a new National Partnership Agreement relating to early childhood education and care (the ECEC NPA), Commonwealth funding is provided to states for the delivery of early childhood education and care related services. The total quantum of this funding for one year is $240 million. Distributed on an EPC basis between states, this is equal to $10 per capita.

Table 2.5: Funding allocations under the ECEC NPA

		NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUS
Population	(m)	7.7	6.1	4.8	2.6	1.7	0.5	0.4	0.2	24
Per capita	($)	10	10	10	10	10	10	10	10	10
Total	($m)	77	61	48	26	17	5	4	2	240

Scenario 1: Bilateral funding – New South Wales and the Commonwealth

New South Wales signs the agreement. All other jurisdictions abstain. New South Wales receives $77 million – the Commonwealth requires this to be spent on early childhood education and care.

Under HFE, Commonwealth payments are treated on an actual per capita basis.

The CGC now considers New South Wales to have greater fiscal capacity to provide these services in comparison to other states. The funding received by New South Wales of $77 million is divided by the national population to determine a national average level of assessed need. This equals $3.21 per capita.

Following equalisation, New South Wales retains $3.21 per capita for the provision of these services. The balance ($6.79 = $10 – $3.21) is distributed to all other states. All states receive

$3.21 per capita from GST revenues so that all states have the same fiscal capacity.

On this basis, $52.28 million of the original tied funding of $77 million provided to New South Wales is redistributed as untied general revenue assistance by the CGC under HFE. New South Wales will retain a net benefit of $24.72 million from being the only state that signs the agreement. Despite this, the Commonwealth still requires New South Wales to spend $77 million in New South Wales on ECEC.

In this way states are discouraged from entering into bilateral agreements. This is because in accepting any amount greater than its per capita share of available Commonwealth funding will result in a loss of untied GST revenues.

HFE can in this way deny states, as well as the Commonwealth, from realising potential benefits attached to bilateral funding agreements that may be specifically tailored to address social and economic priorities and needs that may offer a greater social benefit for that state.

Scenario 2: ***Multilateral funding – all states except Victoria***

Victoria abstains from the agreement and rejects the $61 million it would have received. All other states sign the agreement. The total amount of Commonwealth funding distributed is $179 million and each state receives $10 per capita for the delivery of these services.

All states are now considered to have a greater fiscal capacity than Victoria to deliver ECEC services.

Under HFE, the CGC considers that all states must have a fiscal capacity of $7.46 per capita to deliver these services. All signatory states forgo $2.54 per capita which is redistributed away under fiscal equalisation.

Under the ECEC NPA, Victoria received no funding. As a consequence of fiscal equalisation Victoria subsequently receives $7.46 per capita (or $46 million) in untied general revenue assistance to ensure it has the fiscal capacity to deliver these services even though there is no such obligation.

In this way, HFE provides a state such as Victoria strong incentives to increase its share of untied revenues. This is because Victoria may consider it preferable to forego tied funding of $61 million to secure a lesser amount of untied funding of $46 million that leaves it with a broad discretion to use these funds in ways that better meets the needs and expectations of its own citizens. This is ultimately a question of social choice, whereby the Victorian Government makes a decision in favour of those services that are more highly valued by its citizens.

It is also possible small states have an even greater disincentive than large states like New South Wales and Victoria to pursue bilateral agreements, or to abstain from multilateral agreements. For example:

- if Tasmania is the only jurisdiction to sign the ECEC NPA (and receives $5 million), it would receive a net benefit of just over $100,000 post-equalisation
- if Tasmania is the only jurisdiction to abstain from the ECEC NPA, it would forgo $5 million under the agreement, but after equalisation would receive $4.89 million from untied GST revenues.

The existence of such perverse incentives through HFE and its interaction with the broader federal financial relations framework should not lead to costs and benefits that extend beyond the intent of negotiated agreements.

Scenario 3: Commonwealth policy – distribution according to need

The Commonwealth determines that the level of need for ECEC in South Australia is significantly greater than other states. South Australia receives double the per capita amount for ECEC but this additional need is not recognised by the CGC.

Under HFE, the CGC would reverse this decision through a corresponding decrease in GST revenues. This means South Australia's interests would be better served by abstaining from the ECEC NPA, otherwise it risks losing a commensurate amount of untied general revenue assistance that can be applied for any purpose.

The Commonwealth can play an important role in tackling national social and economic reform priorities by spending its own source revenue to address possible issues and opportunities. HFE should not operate in such a way that it may dilute the efficacy of Commonwealth action in partnership with states.

The Commonwealth and states require flexibility to develop well-targeted solutions to address national social and economic priorities and needs. These needs may be unique to an individual state or more broadly dispersed across state borders.

The GST system should not negate the decisions of elected governments to allocate funding, through National Agreements and National Partnership Agreements. These agreements should not be included in CGC calculations.

2.4 Distortions to the taxation choices of state governments

2.4.1 Altering the tax mix

The CGC seeks to equalise revenue capacity on an individual assessment of various taxation bases including payroll tax, land tax, conveyancing duty, insurance taxes, motor vehicle taxes, mining taxes, and other revenues.

This approach can distort state decisions to alter their tax mix to enhance economic efficiency and minimise deadweight losses. In particular, it discourages states from making adjustments to its tax mix in ways that:

- extract the greatest value from its available tax bases
- leverages value from its economic assets
- drives substitution between revenue bases to better align with the structural features and resource endowments of the local economy.

Box 2.5: Substituting land tax for conveyancing duties

Conveyancing duties represent a significant and highly valuable revenue source for many Australian states.

As a tax on transactions, the design and application of conveyancing duties leads to widespread economic costs on a national level. This can be best demonstrated by the ways in which these transaction taxes may distort the behaviours of households and businesses. For example:

- a homeowner may prefer to travel long distances to their place of work due to the transaction cost of selling their existing property to move to a more a convenient location
- homeowners may undertake costly renovations rather than buy a larger house
- empty nesters continue to reside in the family home, even though it no longer meets their current needs.

In comparison, a broad land tax is regarded as an efficient tax. It provides a stable and reliable tax base that does not distort household or business behaviour. It is also immobile – so taxation on it is difficult to avoid. For these reasons the Australian Capital Territory Government has initiated a 20-year reform process to replace conveyancing duty with broad-based land taxes.

If hypothetically New South Wales or Victoria were to undertake a similar reform the CGC's approach to assessing revenue capacity could mean either of these states could forgo many hundreds of millions in GST revenues.

Under such a scenario, for example, if New South Wales were to undertake a revenue neutral reform like that of the Australian Capital Territory (phasing down conveyance duty by, say, half while phasing up land tax by an equivalent amount), it could potentially lose hundreds of millions of dollars per annum in GST revenue. This is in a scenario where the CGC treats New South Wales' new land tax revenues as part of the current land tax base assessment. As a result, while the revenue reform on own source tax revenue would be budget neutral the potential adverse budgetary impact on how GST is distributed could be significant.

An alternative scenario is where the CGC treats New South Wales' new land tax revenue on an EPC basis, as they do currently for the Australian Capital Territory. In this instance the only impact to New South Wales' GST share may be from the greater number of transfer duty transactions likely to occur from the lower transfer duty rate (potentially shifting significant sums of GST away from New South Wales). However, it is unclear if this is how the CGC would treat this in future.

Finally, the CGC may treat this as effectively a new tax base, in which case it would deem the same tax base for all other states. In this scenario New South Wales would lose GST revenue as a consequence of having an advantage in this new base. It could also lose GST as a consequence of the higher number of transfer duty transactions.

The CGC treatment of a potential policy change is uncertain. State governments must necessarily consult with the CGC and Commonwealth to secure a determination on a proposed treatment before initiating any such reform with confidence regarding its fiscal outcomes – and even then the final outcome will only be known once all other states' policy approaches are known.

2.4.2 Improving economic and social outcomes – addressing market failure

Taxation can also play an important role in improving economic outcomes that deliver widespread social benefits to households and businesses.

Taxation may be used to address negative externalities associated with different social and economic activities. In this way, taxation acts as a price signal designed to change behaviours by making households and businesses bear the full economic costs (as well as benefits) of their decision making. In this way such taxes foster an efficient level of consumption on an economy-wide basis

However, implementing these taxes will often have distributional consequences requiring compensation by governments. In addition because of HFE states often do not receive the full benefits of these reforms and may indeed incur a budgetary cost despite an immediate increase in revenue.

Take for example a congestion charge – it is likely that affected citizens in that state would expect all revenue from that charge to be hypothecated to public transport investment. But the example below shows that under HFE, not only the state introducing the reform in this case Victoria, but indeed New South Wales would be worse off as a result.

Box 2.6: Congestion pricing in Melbourne

The Henry Tax Review recommended governments introduce congestion pricing to assist individuals to make economically efficient decisions by aligning the private and social costs of road use. [4]

Congestion pricing is used to address the externalities that arise due to:

- congestion – each additional road user imposes a social cost on all other road users. Social costs arising from congestion can include: travel delays, higher fuel consumption and increased accident risks.
- road wear – higher levels of road use leads to faster and more significant depreciation and higher levels of capital investment is needed to maintain the road network.
- pollution – noise, exhaust and dust pollution resulting from increased road use.[5]

The Bureau of Instructure, Transport and Regional Economics estimates that congestion costs in Melbourne totalled approximately $4.62 billion in 2015.This is forecast to rise over time – reaching an estimated $10.19 billion by 2030 under an upper baseline scenario.[6]

[4] Australia's Future Tax System, 2009, *Report to the Treasurer – Detailed Analysis, Volume 2, Chapter E3-1 Road Transport Taxes*.
[5] Australia's Future Tax System, 2009, *Report to the Treasurer – Detailed Analysis, Volume 2, Chapter E3-3 Road Transport Taxes*.
[6] Bureau of Infrastructure, Transport and Regional Economics (BITRE), 2015, *Traffic and congestion cost trends for Australian capital cities*, Information Sheet 74.

If Victoria decided to act unilaterally to introduce congestion pricing, for example by raising $900 million in new time of day tolling on major congested roads, it would lose $22 million in GST.

New South Wales would lose $47 million in GST in favour of Queensland despite having made no change.

Table 1.5: Introduction of congestion charges in Melbourne

		NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUS
Revenue	($m)	…	900	…	…	…	…	…	…	900
Change in distribution	($)	(47)	(22)	53	(13)	2	15	4	7	0

This scenario is based on the following assumptions:

- BITRE estimates of the upper baseline projections of avoidable social costs of congestion are adopted by the CGC to establish the assessable revenue base
- Victoria, New South Wales and Western Australia are assumed to have a greater than average advantage in relation to this newly established tax base
- the CGC does not combine these revenues with any other, existing revenue category and it is therefore treated on a differential basis.

2.5 The current system does not encourage accountability

2.5.1 Accountability – Commonwealth government

The Commonwealth has few incentives to take accountability for the operation and application of HFE – at least since the introduction of the GST. As a result, the CGC has very much been left to operate as an independent body with limited guidance from the Commonwealth. For example, it is not possible to identify any instance, at least from 1988 onwards where the Commonwealth Government has rejected the CGC's recommendations regarding the distribution of GST revenues.[7]

There are times however when the Commonwealth has supplemented the total amount of assistance provided to states. This was seen most recently in the 2017-18 Commonwealth Budget which included a payment of $226 million to Western Australia. This suggests that at least implicitly, the Commonwealth agreed the GST distribution outcome was unfair.

The accountability model for the CGC has some of the standard elements associated with a Commonwealth Government agency under the Westminster model.

[7] Review outcomes and annual updates have been accepted and implemented for the following years: 1985, 1988, 1993, 1999, 2004, CGC, *The Commonwealth Grants Commission: The Last 25 years*, 2008, p. 32. Review outcomes for 2010 and 2015 were also accepted and implemented.

The CGC claims to be “open and accountable to the Australian community under the law and within the framework of Ministerial responsibility”.[8] Ministerial accountability is through their portfolio Minister, currently the Commonwealth Treasurer.

There is a strong norm for Commonwealth Treasurers to accept the CGC’s recommendations without demur. However, automatic acceptance of CGC decision making and recommendations is not indicative of the superiority of current arrangements. In fact, it suggests that the CGC’s assessment has not been subject to any real scrutiny at the Commonwealth level. In turn, this has foreclosed any possible opportunity for state Treasurers to engage with CGC assessments.

Further there has been no real benefit for the Commonwealth to engage with CGC decision making. This has meant, in practice, the CGC has had a broad remit to make its own policy decisions on the interpretation of fiscal equalisation, impacting on the allocation of $60 billion of taxpayer funding each year. In practice, there is no evidence that Commonwealth Treasurers or Treasury have challenged CGC’s policy making, or the layering on of complexity and scope creep by the CGC, or properly considered the false precision and trade-offs involved.

In their 2015-16 Annual Report the CGC notes:

> “In this year, as in the past, the Commission has satisfied its performance criteria. The Commission has never missed a deadline set in terms of reference and its recommendations on GST sharing relativities have always been accepted by the Treasurer. The high quality analytical work underlying its reports and the input of interested parties to that work are essential to give the Commonwealth and State Governments confidence in the outcomes and to have them accepted.
>
> A high degree of acceptance by governments was achieved. While all States would likely have preferred the Commission to make different decisions in relation to its methods and to have received larger shares of the GST revenue, nevertheless the Commission’s recommendations, based on the principle of HFE, have been applied in determining the distribution.”[9]

There has been no regular merit review process of the CGC’s determinations. There has been no independent third party reviewing policy decisions, testing the robustness of modelling, reviewing inertia in the application of judgement, and examining possible sources of game playing. In no other area of government has the allocation of such a huge sum of money received so little scrutiny or oversight.

The CGC should be a federal institution accountable to all state jurisdictions. This would give better practical recognition of the fiscal importance of CGC decision making directly upon states. Ultimately, the Commonwealth Treasurer will still have to be the

[8] CGC, *CGC Governance – Corporate Plan 2015-2020*, p. 3.

[9] CGC, 2016, *Annual Report 2015-16*, p. 4.

decision-maker, because the CGC and GST revenues are subject to Commonwealth legislation. But this should at a minimum be on the basis of advice from state representatives with appropriate voting powers. This will encourage the Commonwealth to be engaged on policy relating to one of the major funding allocation decisions in the Australian federation.

2.5.2 Accountability – CGC and state governments

States currently are unable to genuinely influence the definition and application of HFE, the overall direction, methodological approaches and decision making of the CGC. This accountability deficit represents a significant concern for states given the important budgetary support provided through the distribution of general revenue assistance under HFE and the high level of vertical fiscal imbalance that defines Australia's federal financial relations.

The role of the CGC is markedly different from an independent statutory body responsible for exercising regulatory functions or performing investigative functions. Instead, the CGC makes decisions that determine the allocation of Australian taxpayer monies between states to support the provision of important government services. Without question, this responsibility is better placed under the oversight and scrutiny of elected representatives. This would deliver an outcome that better meets citizens' expectations.

The CGC is distinguishable from international models for fiscal federalism which are also characterised by high levels of accountability.

Box 2.7: Fiscal federalism and accountability – international approaches

Germany – equalisation for all taxes requires the central government to pass legislation detailing the HFE process through the German federal parliamentary system. The Budensrat is the German equivalent of the Australian Senate or state's house and is composed of appointed delegations of each Lander government. This means Lander governments have a direct voice in the development, and scrutiny of, Germany's national equalisation system.

Switzerland – the Constitution defines the purpose of HFE. Decisions on the administration of HFE are subject to judicial oversight. In 2004, the Swiss definition was approved by popular vote thus facilitating clear, direct and democratic engagement with the principle and practice of HFE.

The federal government has direct accountability and responsibility for fiscal equalisation across a number of jurisdictions, including Canada, Mexico and Belgium. In these countries, a federal government department is responsibility for administering fiscal equalisation.

The absence of strong and robust accountability mechanisms within an Australian context has resulted in an outcome where the CGC engages in de facto policy making through its decision making – this includes how the CGC defines HFE and determines its methodological approaches. Significantly, this means the CGC makes decisions that fail to meet the expectations of the Australian community.

The CGC is also responsible for conducting reviews over its own methodology, and is the final arbiter of disputes concerning its own approach to HFE. The result is an increasingly complex system that successfully eludes states' efforts to hold the CGC to account. Similarly, the CGC has not been the subject of a performance audit by the Australian National Audit Office.[10]

Changes to the treatment of capital expenditure in the CGC's 2010 Review highlights the lack of accountability associated with CGC decision making processes.

Box 2.8: Treatment of infrastructure capital expenditure

In the lead up to the 2010 Review, some states and territories argued that past CGC assessments did not sufficiently address state infrastructure needs resulting from changing state and territory circumstances and population growth.

To address these concerns, the CGC considered two new approaches to the assessment of infrastructure capital expenditure:

- a direct approach (which recognises the financial consequences in the year the new assessed infrastructure needs arise)
- a holding cost approach (which recognises the financial consequences over the life of infrastructure).

The CGC preferred and ultimately decided on the direct approach.

The Australian Capital Territory and Tasmania disagreed, stating that equalisation is improved when it focuses on use or consumption of capital, rather than its acquisition.

New South Wales raised concerns that the CGC had gone beyond its terms of reference in making this methodological change, by extending the definition of equalisation.

In response, the CGC stated that it: "consider[s] it appropriate for all States to have the same per capita capacity to hold the infrastructure they require to provide the average level of service… and to assess State infrastructure needs upfront when State circumstances change and new assets are required."[11]

This example demonstrates that – while it is true that current CGC processes allow for states to provide input on questions of methodology, and the CGC addresses this input and provides rationale for its final decision – the CGC makes decisions unilaterally without any effective

[10] In March 2005, the Australian National Audit Office conducted an audit: *Payment of Goods and Services Tax to the States and Territories*. Its purpose was to assess the adequacy and effectiveness of processes and procedures used by treasury in making payments of GST revenues and associated amounts to the states. The main focus for this audit related to the Guaranteed Minimum Amount – that is, an assurance provided to states that during a transitional period following the introduction of the GST, no state would receive any less under the new arrangements than it did under the old arrangements. Australian National Audit Office (ANAO), 2005, *Payment of Goods and Services Tax to the States and Territories*, Audit Report No. 38, 2004-05.

[11] CGC, 2010, *2010 Review Final Report*, Volume 2, p. 438.

mechanism for the elected representatives from states and territories to challenge or appeal these decisions. This ultimately reduces accountability and public trust in the HFE process.

The administrative scale assessment highlights a range of systemic issues that arise from a lack of accountability of the CGC.

Box 2.9: Assessment of administrative scale

The administrative scale assessment aims to recognise costs that some states face due to diseconomies of small scale in central administration, namely those costs incurred by a state in delivering services which are independent of the size of the service population. These costs are associated with:

- core head office functions of departments (including corporate services, policy and planning functions, but not all staffing and other resources delivering these)
- services provided for the whole of the state (including a legislature, judiciary, treasury, revenue office, and a state museum, but not all staffing and other resources delivering these).[12]

The CGC justifies this assessment by reference to a conceptual case whereby those states with small populations have intrinsically higher per capita costs. This is because the minimum functions of government are borne by a smaller number of residents.

A history of the methodologies used to assess administrative scale is provided at Appendix D. A brief summary of data issues associated with this assessment is also included.

On an annual basis, approximately $900 million is distributed across states based on this disability.

Donor states have consistently questioned the integrity of this assessment, based on:

- minimum function of government – this is dependent on the ideologies and judgments of elected representatives who are accountable to their voters.
- poor data and reliance on judgment – there is a lack of data that reliably captures diseconomies of small scale for states. Judgment is used drawing upon the selective use of data where data quality is poor.
- inconsistent discounting – CGC assessment guidelines provide for the discounting of equalisation outcomes where data is poor. No discounting is applied to this assessment despite significant data gaps and reliance on judgment.
- policy neutrality – this assessment is heavily influenced by state policy decisions relating to staffing levels, what functions a state performs and how they are discharged.

Efforts to challenge the administrative scale assessment have proven futile. The CGC considers that this assessment remains robust.

[12] CGC, 2015, *Report on GST Revenue Sharing Relativities - 2015 Review*, Volume 2, p. 401.

The inability for states to hold the CGC to account has, at times, led to outcomes extremely detrimental to states. The transport assessment is one example where the CGC has potentially made significant data errors to the detriment of New South Wales and cost hundreds of millions of dollars in GST revenues.

Box 2.10 Inconsistent treatment of transport data penalising New South Wales

New South Wales is assessed to need to spend more than the average amount per capita in order to deliver average quality transport services (i.e. it has a disability in providing transport relative to the national average). This is, in part because as cities grow larger, more public transport expenditure per capita is required, and it becomes more expensive to provide each unit of transport. However, even with this disability adjustment, New South Wales continues to spend significantly more on transport than it is assessed to need. In the 2017 Update, New South Wales received an extra $266 million of GST to fund its transport needs, but actually spent an additional $1 billion on providing these services.

New South Wales believe that there are both methodological and data flaws to the current assessment resulting in such an unfair outcome.

The CGC is aware that New South Wales has high ratios of actual to assessed spending. This could be caused by data reliability issues but New South Wales is not aware of any action being taken to investigate the issue further, despite the materiality of the issue. This has led to the CGC materially underestimating the cost of providing transport in New South Wales. While on average, the HFE system leads to New South Wales funding the needs of other states, this particular assessment may have led to New South Wales receiving hundreds of millions of dollars less in GST than it needs to provide transport services to the same standard as other states.

See Appendix E for detailed analysis.

These features are fundamentally inconsistent with a well designed and robust institutional framework. Problems with CGC governance and accountability will not be solved by a simple change to the definition of fiscal equalisation

Box 2.11: The CGC and the principal-agent problem

Poor governance means there are few safeguards in place to address agency issues associated with the CGC.

Shah considers that the theoretical advantages of having an independent agency to manage the equalisation task, including reduced politicisation of equalisation payments through the independent and transparent advice, are rarely achieved in practice.[13]

[13] Shah, A. 2005, “A Framework for Evaluating Alternate Institutional Arrangements for Fiscal Equalisation Transfers”, Policy Research Working Paper Series 3785, The World Bank, p.12.

On this basis, Shah considers that where an independent agency is wholly responsible for determining its role and function, principal-agent issues will typically arise. These include:

- mission creep – independent agencies face “continuous imperatives reinterpreting its terms of reference to enlarge the scope of its activities”
- incentives for complexity – that independent agencies “face power incentives to seek ever more complex solutions to simple questions”.

In 2016-17, the CGC received $6.2 million in Commonwealth appropriations. This is in direct contrast to other federations where the relative simplicity of their HFE systems allows for the administration of HFE through central finance departments (and costed on a business as usual basis).[14]

The current system also inhibits, to some degree, state government being made accountable for the revenue and expenditure choices they make. This makes it difficult for citizens to hold governments to account for their revenue and expenditure choices when a government, such as in Western Australia, seeks to shift the blame for their current fiscal position onto the CGC and the Commonwealth for a fall in their GST relativities.

Simplification and transparency of the system used to distribute GST revenues will improve the accountability of all state governments.

2.6 Mission creep and need for simplification

A simple methodology for HFE, that is easily replicable, represents international best practice to support fiscal federalism.

A failing associated with current approaches to HFE is that the CGC tends to perceive any addition or change in the methodological approaches it adopts to assess revenues or expenditures, or disabilities, as a move closer to a perfect or ideal redistribution. This frequently results in an expanded scope for revenues and expenditures to be assessed as part of the equalisation task and more complex methodology

At its simplest, the complexity in Australia’s current HFE system is demonstrated by the number of assessment and sub-assessments (or components) undertaken by the CGC.

[14] The South African Financial and Fiscal Commission received approximately A$4.1 million in government grants to support its operations. This is an independent body that advises on fiscal equalisation as well as the entire South African intergovernmental fiscal relations system. South Africa Financial and Fiscal Commission, 2016, *205/2016 Annual Report,* p. 46. (Total operating expenses at AUD-ZAR exchange rate July 2017).

Table 2.7: Total number of HFE assessments and disabilities

Review	Expense assessments			Revenue assessments	
	Assessments	Components	Disabilities	Assessments	Components
1999	39	157	321	31	33
2004	38	168	347	21	29
2010	14	30	78	8	13
2015	12	43	63	8	25

A review in 2010 did result in fewer assessment categories and disabilities. However, the HFE system retains an unacceptable degree of complexity. No evidence exists to suggest that the relativities resulting from a move towards simplification as part of the 2010 CGC methodology review have produced an inferior equalisation outcome.

However efforts to simplify HFE have proven to be short-lived. A fall in the number of revenue and expenditure assessments has been offset by a dramatic increase in the number of components for each assessment category.

This increase in the number of components reflects a trend for the CGC to investigate a wider range of data sources in the pursuit of moving closer to a true or perfect distribution. This is demonstrated in the box below.

Box 2.12: Methodological approach to assessing secondary education expenditure

The CGC's approach to assessing post-secondary education services (PSES) demonstrates the level of complexity used to measure one component within the expenditure assessment category.

Overall, the secondary education expenditure assessment involves four components. The other components relate to: Commonwealth funded government schools, Commonwealth funded non-government schools and student transport.

Usage of PSES is determined using data on government subsidised training hours. To make expenses data compatible with usage data, the fee-for-service revenue is deducted from government post-secondary education services. Government provision of commercial vocational education and training services has no impact on state fiscal capacities (as the revenue offsets the expense).

All revenue is deducted, including student fees and charges for government subsidised courses, because deducting only fee-for-service revenue does not produce a materially different outcome. In this way, the CGC avoids splitting revenue data.

Three disabilities are applied to the total expense.

Cross-border impact – For most states, cross-border provision is not material, but for the Australian Capital Territory over 17 per cent of Australian Capital Territory's contact hours were provided to New South Wales residents (according to the National Centre for Vocational Education Research (NCVER). The assessment makes an adjustment to New South Wales and

Australian Capital Territory expenses to recognise this.

Location – Differences in wage costs between the states are recognised by using the CGC's standard adjustment for differences in wage costs between states and territories, with assessed expenses adjusted to account for this. This entails a separate methodology with its own detailed data requirements in order to measure the wage differences between states.

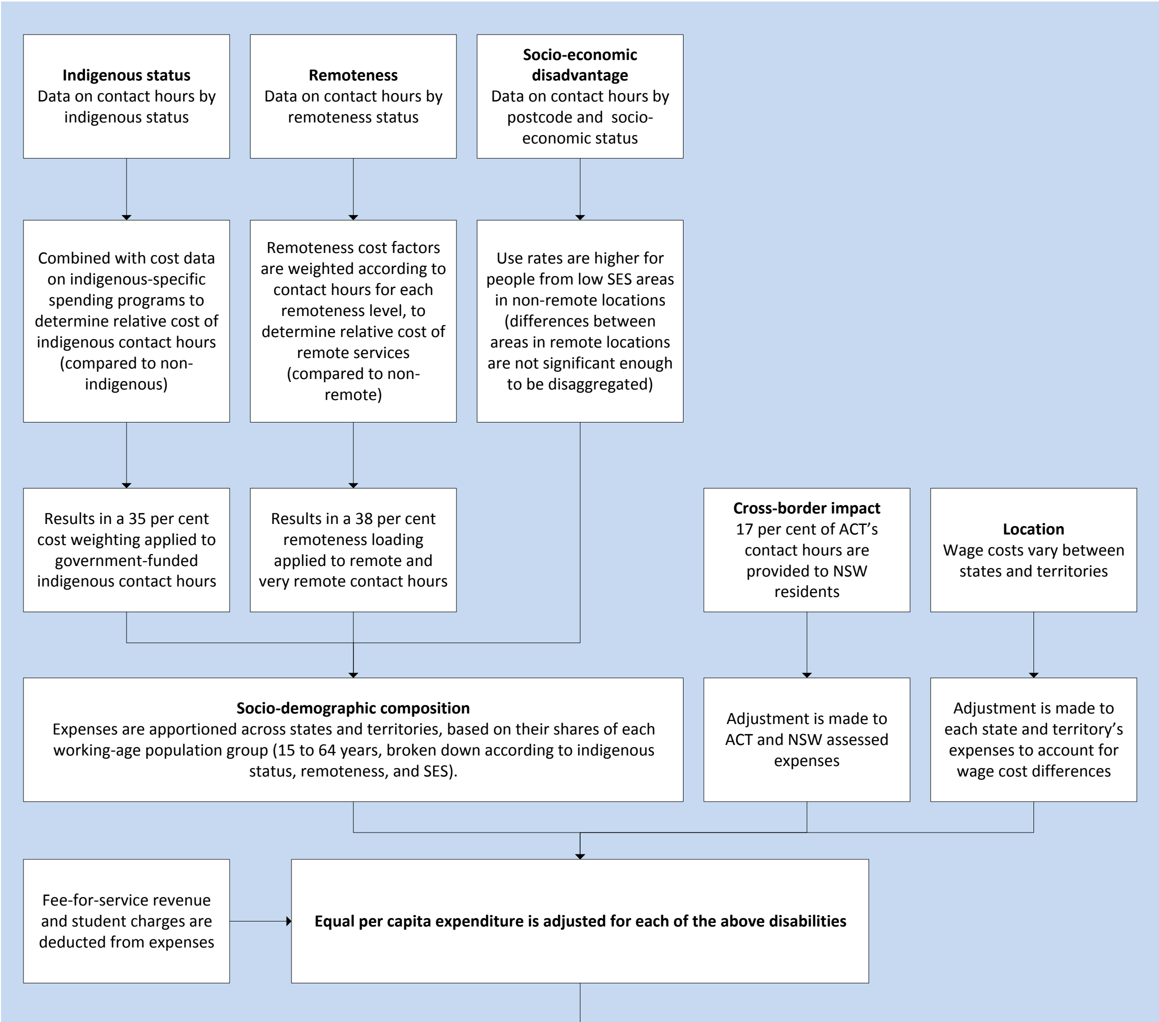
Sociodemographic composition – Certain characteristics of the working age population are recognised that can impact use and cost of PSES. These include:

- *Indigenous status*: Data from the NCVER shows that Indigenous students use PSES at twice the rate of non-Indigenous people, and that the cost per student is higher because most states and territories offer Indigenous-specific programs. Therefore, the CGC applies a 35 per cent cost weighting to government-funded Indigenous contact hours.

- *Remoteness*: Data shows that students in non-remote areas use PSES at a higher rate, but that it is more costly to deliver services to students attending remote institutes. Therefore, the assessment applies a 38 per cent remoteness loading to remote and very remote hours. This reflects the relative cost of remote and non-remote services.

- *Socioeconomic disadvantage*: Use rates are higher for people from low socioeconomic status (SES) areas in non-remote locations (but not in remote locations). NCVER provides data on government-funded contact hours by postcode and indigenous status. Socioeconomic data on each location is obtained from the non-Indigenous Socio-Economic Index for Areas (SEIFA) and Indigenous Relative Socioeconomic Outcomes (IRSO) index. Using the above data and loadings, expenses are apportioned across states, based on their shares of each working age population group (15 to 64 years, broken down according to indigenous status, remoteness, and SES), to obtain total assessed spending.

The following flowchart illustrates how data and disabilities are applied in this assessment. It demonstrates how a highly complex expenditure assessment has no real, direct and measurable improvement in outcomes for individuals and households across states.



Assessed expenses for each state and territory (example from 2013-14)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc
Equal per capita	246	246	246	246	246	246	246	246	246
SDC	0	-5	3	-1	4	11	-26	61	0
Cross-border	-2	0	0	0	0	0	41	0	0
Location	1	-3	-3	10	-2	-7	6	11	0
Total	245	238	246	254	247	250	263	321	246

The significant complexity of how disabilities are calculated poses a concerning issue for state's resource allocation decisions.

Under the current approach to HFE, states are unable to assess the GST consequences of their own spending decisions. This is a direct result of the complexity of how disabilities are calculated. There are too many moving parts driven, in part, by the spending decisions of other states, and the underlying sociodemographic changes that drive disabilities.

The level of complexity associated with the HFE methodology is also highlighted by the scope of the redistribution task (see Appendix F). In gross terms, approximately one-third of total GST revenues may be redistributed between states. But in net terms, only one tenth of GST revenues are redistributed between states[15].

Shah states that it is better to:

> "Keep it simple. In the design of fiscal transfer, rough justice maybe better than full justice, if it achieves wider acceptability and sustainability."[16]

The level and value of gross redistribution amounts demonstrates that significant complexity by the CGC, in determining GST relativities, does not drive final outcomes and is therefore unwarranted.

2.6.1 Subjective decision making and the use of judgment

The CGC has developed complex methodological approaches to assess revenues, expenditures and disabilities that require it to rely on extensive judgment. In particular, judgment is used to compensate for poor data and to fill data gaps. The CGC also relies upon judgment to build the conceptual cases that permeate disability assessments.

As the CGC has noted:

> "…Judgments on what constitute the best equalisation outcomes must continue to be made. Making these judgments is the task of the Commission."[17]

The following table lists some areas where the CGC has to depend on judgment as a consequence of its highly complex assessment methodologies and poor data. The use of these assumptions also undermines transparency and accountability.

[15] This has increased up to 12 per cent more recently due to strong mining revenues from Western Australia but from 2004-05 (when the CGC began estimating the level of GST redistribution) to 2013-14 it has typically ranged from 7.9 to 9.4.

[16] Shah, 2007, "A Practitioner's Guide to Intergovernmental Fiscal Transfers", pp. 1-54, in: Broadway, R., and Shah, A., (eds.), 2007, *Intergovernmental fiscal transfers; principles and practice*, p. 48.

[17] CGC staff paper, 2017,The principle of HFE and its implantation, 2020 Methodology Review, p.8.

Table 2.8: CGC assumptions – some examples

Assessment	Assumption
Post-secondary education	Subsidy per hour for all courses is the same
Education	The cost difference per student between non-government and government schools applies equally between primary and secondary school students
Health	No Indigenous people living in remote and very remote areas are insured.
Welfare	For child welfare, an individual family's SES is assumed to be the same as the SES of all families living in their postcode area
Roads	Vehicles travelling over a two kilometre stretch of road causes the same pavement damage as the same vehicle travelling over a one kilometre stretch of road twice An approximation of average policy for developing a rural road network is for states to build roads between adjacent towns of 400 people
Interstate travel assessment	Staff travelling interstate on government business do so on Qantas (or fly other airlines that charge the same prices as Qantas). Overnight accommodation is required when state personnel fly the morning after a meeting/conference because they cannot depart the host capital between 6:00pm and 9:00pm

The arbitrary and inconsistent use of discounting is another area where subjectivity and use of judgment by the CGC is evident.

New South Wales believes that judgements which have substantial impacts on GST distribution should be made by the elected officials of the states – not the CGC.

2.6.2 Lack of transparency

The key outcome of this inquiry should be to restore faith in the fairness of the GST distribution. Simplicity and transparency of process are essential.

The complexity of the current approach for HFE is complicated by a lack of transparency in the methodological approaches adopted by the CGC.

Each revenue, expenditure and disability assessment is underpinned by numerous and complex calculations that are difficult to understand. The interaction between each detailed calculation leads to further complexity (as highlighted in Box 2.12 above). This means it is extremely difficult for states to envisage how each detailed calculation interact to drive overall relativities.

Beyond the CGC, few staff across the Commonwealth, state treasuries and a small cohort of academic economists properly understands CGC processes and assessment methodologies.

Poor transparency, combined with a high degree of complexity means credibility and confidence in the CGC and HFE is undermined.

Box 2.13: Transparency and the Net Balancing Transaction

The HFE system is a closed system. This means that, in effect, the sum of each assessment category for each state should be determined on the following basis:

GST revenue =	Expenses +	Net Investment +	Net Lending -	Own source revenue –	Cth payments

A separate adjustment is made by the CGC – the Net Balancing Transaction. This is intended to correct discrepancies and ensure that the adjusted budget identity holds. This is done by taking the total residual across all states, and adjusting this adjusted budget identity on an EPC basis.

Table 2.9 shows the per capita discrepancy for each state in 2013-14, and the Net Balancing Transaction conducted by the CGC to eliminate any imbalance in the adjusted budget identity.

Table 2.9: Per capita assessment values 2013-14

		NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUS
Expenses	($)	8,512	8,096	9,367	9,625	9,108	9,661	8,482	18,718	8,876
Net investment	($)	383	455	408	585	266	89	265	646	414
Net lending	($)	(435)	(446)	(441)	(457)	(421)	(406)	(436)	(437)	(440)
Own source revenue	($)	(4,620)	(4,227)	(4,671)	(7,690)	(3,914)	(3,446)	(3,882)	(4,687)	(4,779)
Cth payments	($)	(1,597)	(1,752)	(1,622)	(1,556)	(1,563)	(1,674)	(1,584)	(2,649)	(1,646)
Deficit	($)	2,243	2,127	3,040	506	3,477	4,224	2,846	11,591	2,425
Net Balancing Transaction	($)	(231)	(231)	(231)	(231)	(231)	(231)	(231)	(231)	(231)
Final deficit	($)	2,012	1,896	2,809	275	3,246	3,993	2,615	11,360	2,194

Source: Treasury analysis of CGC system data.

In 2013-14 the discrepancy in the adjusted budget identity was valued at $5.38 billion. This was equal in value of over 10 per cent of the total GST revenues in that year. On a per capita basis this equalled $231. The following table shows the equivalent distribution for each state as a consequence of the Net Balancing Transaction.

Table 2.10: State assessment values 2013-14

		NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUS
Expenses	($m)	8,512	8,096	9,367	9,625	9,108	9,661	8,482	18,718	8,876
Net investment	($m)	383	455	408	585	266	89	265	646	414
Net lending	($m)	(435)	(446)	(441)	(457)	(421)	(406)	(436)	(437)	(440)
Own source revenue	($m)	(4,620)	(4,227)	(4,671)	(7,690)	(3,914)	(3,446)	(3,882)	(4,687)	(4,779)
Cth payments	($m)	(1,597)	(1,752)	(1,622)	(1,556)	(1,563)	(1,674)	(1,584)	(2,649)	(1,646)
Deficit	($m)	2,243	2,127	3,040	506	3,477	4,224	2,846	11,591	2,425
Net Balancing Transaction	($m)	(231)	(231)	(231)	(231)	(231)	(231)	(231)	(231)	(231)
Final deficit	($m)	2,012	1,896	2,809	275	3,246	3,993	2,615	11,360	2,194

Source: CGC, Treasury analysis of CGC system data.

This effects 10 per cent of the GST pool (in 2013-14) and distributes $1.76 million away from New South Wales. But the CGC has not published any document that:

- explains the operation, role or purpose of the Net Balancing Transaction

- discloses the magnitude of the Net Balancing Transaction
- outlines the method applied by the CGC to offset the Net Balancing Transaction, or further, how offsets may be distributed amongst states.

The CGC has not publicly disclosed this methodology or conducted consultation with states regarding the Net Balancing Transaction. Reference to the Net Balancing Transaction is included in a footnote reference in the 2015 Review.[18]

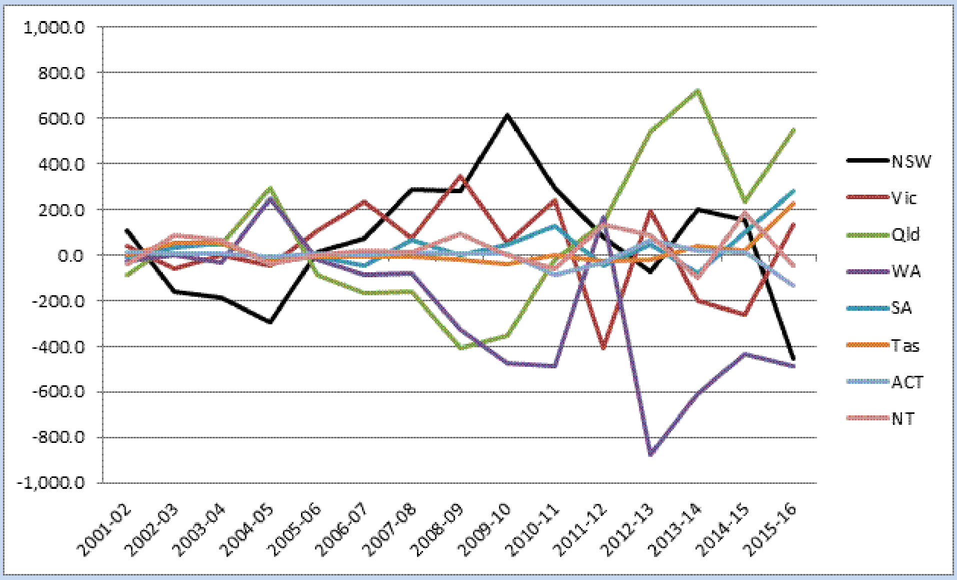
2.7 The current system leads to instability in budgets for state governments

The HFE system and its outcomes should be predictable and stable. This is essential to minimise interference with how states manage the budgets from year to year and over the business cycle.

Current approaches to HFE result in significant and unexpected movements in the annual distribution of GST revenues amongst states. In most instances, such outcomes will be the result of large, and/or potentially unanticipated changes in relativities.

Volatility in GST payments from year to year may be experienced by all states, driven by changes in GST relativities. This may be due to data revisions, a change in the circumstances of an individual state with the rolling forward by a year of the assessment period, or changes to methodological approaches. These changes can be large. Chart 2.1 shows changes in each state's GST allocation due changes in relativities over time.

Chart 2.1: Changes in GST allocation due to change in relativity



Source: NSW Treasury modelling based on Commonwealth Final Budget outcomes 2001-02 to 2015-16.

[18] CGC, 2015, *Report on GST Revenue Sharing Relativities – 2015 Review*, Volume 1, p. 77.

2.7.1 Data revisions

The pursuit of full or perfect equalisation has resulted in highly data intensive assessment methodologies by the CGC. The CGC seeks to use new data as it becomes available and where if offers a potentially more reliable or accurate basis for analysis. However, data revisions can also lead to significant shifts in distributional outcomes for states. This can amplify the unpredictability of final GST distribution outcomes.

Box 2.14 – Data revisions and volatility

The CGC requires data on state land values in order to conduct the land tax assessment.

In the 2010 Review, the CGC estimated land values for Queensland. This was different to the approach adopted by the CGC for other states. This was due to differences in the data collection methods employed in Queensland in comparison with other states.

New data on land values was released by the Queensland Valuer-General in time for the 2017 Update. These new land values became available as a result of a system update that aligned Queensland's data collection approach with other states.

The following table shows the impact of this data revision on states' GST revenues.

Table 2.11: Impact of new land data

Total change	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Redist
($m)	(257)	(27)	281	3	2	(2)	(1)	0	286
(per capita)	(32)	(4)	57	1	1	(4)	(2)	(2)	12

Source: CGC, *2017 Update: Land Tax Assessment Discussion Paper*, p. 7.

In total, this data revision led to a redistribution of $286 million of GST revenue amongst states in 2017 alone.

Stability and predictability is negated and the fiscal management task for states is made more challenging when unanticipated data adjustments can result in significant redistribution consequences for states in any given year.

3 RECOMMENDED MODEL AND APPROACH

Key points

- Any new approach to the distribution of GST revenues must comply with the principles of fairness, efficiency, simplicity, accountability and stability.
- An EPC distribution best achieves these objectives for Australia. It would strike a better balance between equity and efficiency.
- An EPC model would encourage every state to focus on building stronger economies and better outcomes service for their citizens.
- Any transitional model toward an EPC distribution approach must include reform of the current governance arrangements of the GST distribution.

3.1 Principles for a new model of HFE

New South Wales has demonstrated wide ranging and significant failings of the current approach to HFE, both in terms of its stated objectives, its governance, and its implementation.

New South Wales has developed a set of principles that should form the basis of a reformed HFE system.

These principles are not dissimilar to many of the supporting principles currently applied by the CGC. However the CGC uses these principles merely as guides to HFE outcomes:

> "However, the principles remain subsidiary to the Commission's primary objective of achieving HFE and they should not override HFE."[19]

New South Wales believes that compliance with these principles is essential for any future HFE system.

HFE principles:

- **Fairness** – the distribution of GST revenue should be fair in the eyes of Australians. It should provide enough revenue for minimum levels of services that are fundamental to the wellbeing of Australians – health, education, law and order and infrastructure across all states. In addition, a distribution of GST revenue is fair when no one state bears an unreasonable burden that would detract from their responsibility towards their own constituents.

[19] CGC, 2015, *Report on GST Revenue Sharing Relativities – 2015 Review*, Volume 1, p. 29.

- **Efficiency** – the distribution of GST should not provide disincentives for economic reform or moderate potential benefits of tax reform.
- **Simplicity** – the mechanism should be simple to understand and administer. It should also be easy to replicate.
- **Accountability** – this relates to both the body making the calculations of GST distribution and to the Commonwealth and state governments who should be responsible to their citizens for the spending and revenue choices they make after receiving GST revenues.
- **Stability** – GST revenue needs to be more stable than is currently the case to allow state governments to budget and forecast to provide essential services over time.

3.2 The way forward – equal per capita

New South Wales considers that distributing GST revenue to the states on an EPC basis is the best way forward.

Distribution of GST revenue on an EPC basis would achieve a better balance between equity and efficiency. Moreover, it would not interfere with payments tied to Commonwealth state funding agreements aimed at nationally significant policy issues.

An EPC distribution would remove the incentive for states to focus on securing a greater GST share, relative to other states inherent in the current system of HFE. This would shift states' focus towards growing the wellbeing of the nation, rather than only their own share of the pie.

Overall, moving from the current system of HFE to an EPC model would benefit the Australian economy and the Australian community.

An EPC distribution:

- is fair, and importantly can be seen as fair
- is easily understood and can be replicated (it's simple and transparent)
- it allows states to plan budgets with greater certainty (it's predictable and relatively stable)
- it would make governments more accountable for their revenue and expense choices
- it does not encourage bad policy or discourage good policy (it's efficient).

The following discusses each of these points in more detail.

Fairness

An EPC distribution of revenue will be seen as fundamentally fair by the Australian people.

An EPC distribution recognises that there are already other mechanisms of equalisation from stronger to weaker states. This includes through personal income taxes, where New South Wales pay more than its per capita share, and GST revenues more broadly. Even under an EPC approach New South Wales would still receive less than its consumption share.

It would, however, involve some compromise in terms of states having the capacity to deliver the same standard of services. Where some weaker states are unable to deliver a minimum or adequate standard of services to their residents, the Commonwealth could meet these needs through targeted grants.

As Pincus notes:

> "We should not exaggerate the degree of inequality in fiscal capacities that the Australian states would exhibit if the GST grants were made on some basis other than full horizontal fiscal equalisation including specifically equal per capita."[20]

Efficiency

Moving to an EPC model would remove the distortions inherent in the current system and so remove disincentives for states to undertake efficiency-enhancing revenue and expenditure reform. By increasing states' responsibility for improving their own fiscal capacities, it would encourage states to consider ways to improve their own tax bases and achieve greater levels of efficiency and better outcomes in service delivery.

As the OECD has noted:

> "…the more generous equalisation is the less incentive there is for poor regions to catch up or for households and firms to migrate to more prosperous jurisdictions. As a result, disparities widen rather than narrow."[21]

In effect, the CGC is entrenching disadvantage rather than addressing it.

Simplicity

An EPC model would be easy to understand and administer. It would not have the data requirements of the current system. The amount of resources dedicated to the system would be greatly reduced. An EPC model would be easily replicated making it

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[20] Pincus J. 2011, "Examining Horizontal Fiscal Equalisation in Australia", Research Paper No. 2011-25, p. 3.

[21] OECD Publishing, 2013, *Fiscal Federalism 2014: Making Decentralisation Work*, p. 111.

transparent and aiding citizens hold their state governments accountable for the revenues and spending choices they make.

Accountability

The simplicity and transparency of an EPC system would improve accountability of the CGC and of governments. It would be objective: calculation would be based on publicly available and timely data, with no need for judgment by the CGC. This would remove the ability for states to game the system, remove political influences or judgment.

Pincus notes:

> “A more pragmatic recommendation would be a system of equal per capita grants, which would internalise the fiscal effects of marginal spending and taxing decisions of the states: they would be forced to finance their additional spending; and could cut taxes and charges or reduce deficits if they cut back on spending. In addition, EPC grants would be simple to understand and transparent.”[22]

Improved accountability would restore confidence in the system.

Stability

An EPC model would produce stable outcomes, as the population of states does not vary significantly on an annual basis. This would allow more fiscal certainty for a major source of state government revenue used to fund essential services. Moreover, an EPC distribution would be contemporaneous. This removes the pro-cyclical nature of the current system, allowing states to appropriately manage their budgets in response to changing circumstances.

3.3 Transitioning to an EPC approach

3.3.1 Governance reform

Any transitional model toward an EPC distribution should include reform to the current governance arrangements of the GST distribution.

As noted by Warren, moving to a relative approach to HFE in the 1980s effectively transferred full responsibility for the HFE process to the CGC, significantly reducing the roles of state and Commonwealth governments in decision making:

> “The move from an absolute to a relative measure of need has acted to remove symmetry of responsibility that should necessarily go with good federation design, instead leaving subnational governments to negotiate with an

[22] Pincus J. 2011, “Examining Horizontal Fiscal Equalisation in Australia”, Research Paper No. 2011-25, p. 21.

independent agency which has neither responsibility for the quantum of grants nor normative judgements about what ought to be in relation to those grants."[23]

The system underpinning GST revenue distribution needs the support of the states, not just their acquiescence. If confidence in the system is to be re-established and maintained, a key element for good governance going forward is the full involvement of the states. Governments should have the responsibility of setting the objectives of HFE and ensuring that the HFE process is meeting those objectives in an appropriate way.

The CGC should not be the primary decision-maker or final arbiter responsible for:

- defining what HFE means and its policy objectives
- determining methodological approaches
- reviewing and assessing any challenge or critique of its assessments, methodological approaches
- final approval of outcomes and conclusions of its five-yearly methodological reviews.

3.3.2 A new governance approach

Under any transition path, governance reform must address oversight of the CGC and strengthen democratic engagement with the principle of HFE and its application.

A states only body comprising government representatives drawn from across states should take direct responsibility for overseeing the CGC. This oversight role could also extend to the assumption of responsibility for key decisions. This could help ensure an appropriate degree of scrutiny is applied to CGC decision making.

The Commonwealth should not be a member of this body.

Importantly, this group must include responsibility for defining HFE and its objectives. The significance of this definition means it would also be appropriate to be endorsed by the Council of Federal Financial Relations, which would also facilitate appropriate Commonwealth engagement with the policy framework for determining how GST revenues are allocated between states.

To be successful, it is necessary that any decision making body be capable of reaching a decision. Voting rules may be needed so that any impasse is resolved. The importance of such a body being able to reach a decision has a broader, systemic significance – it is necessary to help shift away from the zero sum game nature of the current arrangements.

A new HFE Board should be established charged with overseeing the distribution of GST. This board should comprise state treasurers with voting powers reflecting

[23] Warren, N., 2017, "Submission to Inquiry into Horizontal Fiscal Equalisation", Productivity Commission Inquiry into Australia's system of Horizontal Fiscal Equalisation, p. 2.

population share or the number of seats each state has been allocated in the Commonwealth Parliament (combining House of Representatives and the Senate). This would achieve a greater measure of fairness by better recognising the relative sizes of populations across states.

The New South Wales Premier has highlighted this same point, arguing that for our federation to modernise itself, a small jurisdiction, such as the Australian Capital Territory with a population of 400,000 should not be given equal weight in federal state relations and national decision making processes such that it can overrule or displace the needs and preferences of a state with a broad, diverse and substantially greater population of 7.7 million such as New South Wales.[24]

Any option for governance reform must have a clear role for elected representatives. Creating an oversight body that comprises unelected officials risks replicating, and potentially compounding, many of the problems that characterise current arrangements.

A failure to address governance reform and the accountability deficit that underpins these current arrangements means public confidence in HFE and its role in Australia's federation and the credibility of the CGC will remain at risk.

3.4 HFE, the Northern Territory, and addressing structural disadvantage

The Northern Territory represents a special case and occupies a unique position within the Australian federation with significant levels of widespread, entrenched disadvantage that has persisted since federation.

By many social and economic indicators, the Northern Territory is very different from the other Australian states.

According to the latest Closing the Gap report[25] outcomes for Indigenous people in the Northern Territory are poor not just compared to non-Indigenous people in the Northern Territory but compared to Indigenous people elsewhere in Australia.

- The Indigenous child mortality rate is 333 per 100,000. In the other states it varies from 111 to 189 per 100,000.
- Indigenous student attendance is the lowest in Australia.
- The proportion of Indigenous students reaching National Minimum Standards for Year 3 reading is by far the lowest in Australia (42 per cent; the next lowest is Western Australia at 71 per cent).

[24] The Hon Premier Gladys Berejiklian, Speech to National Press Club, 3 May 2017.

[25] Department of the Prime Minister and Cabinet, 2017, *Closing the Gap: Prime Minister's Report 2017*.

- The proportion of Indigenous 20-24 year olds with Year 12 or equivalent attainment is by far the lowest in Australia (29.7 per cent, the next lowest is Western Australia at 58.4 per cent).

On some indicators, such as overall mortality rates, Indigenous people in the Northern Territory are at the national average.

These outcomes for Indigenous people in the Northern Territory, both in absolute terms and compared to Indigenous people in other states suggests HFE has failed to deliver improved economic and social outcomes to address this disadvantage.

In 2015-16 the Northern Territory's assessed total expenses of delivering services were more than double the national average per capita expense as shown in the table below.

Table 3.1: Northern Territory expenditure per capita and national average assessed expense per capita 2015-16

		National average expense	Assessed expense	Actual expense	Difference
Post-secondary education	($ per capita)	188	257	541	283
Health	($ per capita)	2,387	4,106	5,124	1,018
Housing	($ per capita)	119	418	636	218
Welfare	($ per capita)	703	1,728	1,169	(559)
Justice	($ per capita)	764	2,407	2,461	54
Transport	($ per capita)	530	215	297	82
Services to industry	($ per capita)	227	334	1,050	716
Other expenses	($ per capita)	1,271	2,413	3,502	1,089
Total expenses	($ per capita)	9,372	19,248	21,657	2,409

Source: GC, 2017 Update – Supporting information (The Assessed Budget Category Tables).

The differential outcomes for the Northern Territory under HFE demonstrate that it is a significant outlier in comparison to other states. At the same time, continued poor outcomes for Indigenous peoples in the Northern Territory suggest that HFE may not be an appropriate policy instrument or distribution mechanism for the Northern Territory. It is on this basis Shah concludes:

> "A special grant for the Northern Territory would simplify the Australian program while achieving equalization objectives."[26]

The HFE methodology changed very little with the inclusion of the Northern Territory in 1988-89, despite it being an obvious outlier in terms of service needs, costs and

[26] Broadway, R. and Shah, A. (eds), 2007, Shah, A., "A Practitioner's Guide to Intergovernmental Fiscal Transfers" pp. 1-54, *Intergovernmental Fiscal Transfers: Principles and Practice*, p. 31.

revenue-raising capacities. In turn, the Northern Territory's unique circumstances distort the relativities for all other jurisdictions.

The Northern Territory (and arguably also the Australian Capital Territory for different reasons related to its status as the national capital and absence of disabilities) should be considered the responsibility of the Commonwealth Government and should not fall within the scope of HFE.

Such a change would give better practical recognition of the unique position and special financial circumstances of the Northern Territory. In 2017-18, for example, the Northern Territory will derive 75 per cent of its budget from Commonwealth revenues – through GST revenues and tied grant funding. This would also be consistent with section 122 of the Constitution.

As well as avoiding its Constitutional responsibilities, the Commonwealth is engaging in cost shifting through HFE – the costs of addressing Northern Territory's long-standing needs are being borne by the states.

Addressing the acute economic and social disadvantage of Indigenous peoples is a legitimate and important national priority and policy challenge.

In the 2017 Update, HFE will redistribute $762 million from other states to the Northern Territory on the basis of Indigeneity factors (this excludes the significant redistribution to the Northern Territory made based on remoteness costs of $662 million). At the same time, the Commonwealth Government's contribution through National Partnership payments targeted at Indigenous disadvantage will be $0.5 billion in 2015-16.

For the Commonwealth to assume responsibility for the Northern Territory outside HFE, it would cost $2.9 billion in 2017-18. This would also address a current anomaly whereby the jurisdiction with greatest need for financial assistance has fewer conditions imposed on the funding it receives from the Commonwealth than other states. Untied grants from the Commonwealth make up the greatest share of the Northern Territory's budget (47 per cent in 2017-18).

The Northern Territory faces challenges of national importance. These would be better addressed outside HFE. In addition, such alternate arrangements would provide greater transparency and accountability with the potential to deliver better outcomes.

APPENDIX A – ALTERNATIVE MODELS

New South Wales has examined and analysed a number of alternative GST distribution options. As this analysis shows, many of the alternatives suffer from the same flaws as the current model. Of the models analysed, the Swiss model and the expenses only models perform best against the principles for HFE reform.

SWISS MODEL – A RANK BASED APPROACH

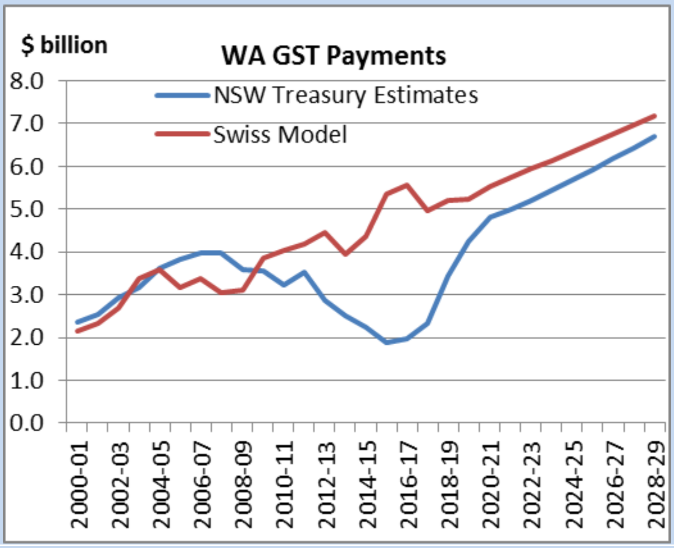
Key features:

- Global indicators used to determine a *potential revenue base* (e.g. real GSP per capita, mean house prices) from which states can potentially raise own-source revenue.
- Global indicators used to measure potential cost disadvantage in service delivery that is not tied to actual service delivery (e.g. population density, level of urbanisation, relative socio-economic status, indigeneity, age profile).
- Ranks states across all indicators to provide an overall rank of fiscal capacity – fiscally weaker states receive higher payments than fiscally stronger.

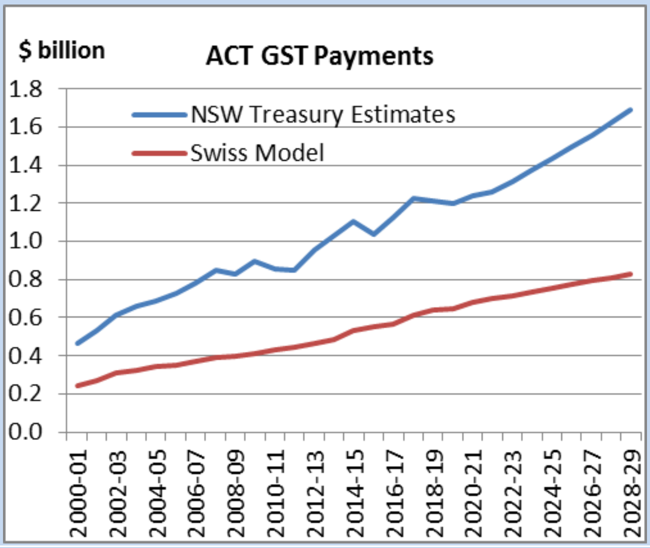
Analysis:

- Reliance on broad indicators, rather than actual state tax policies or service delivery, breaks the zero sum game dynamic. Rankings only change if state policies affect the underlying indicator (e.g. real GSP), and only if state policy moves the state to the bottom three.
- Model can be designed to achieve comparable final distribution outcomes as current HFE system – SA, Tas and NT still identified as fiscally weak under modelled scenario.
- States that have a strong potential resource base in which they can raise own-source revenue are not provided assistance by HFE for failing to exploit that base (e.g. ACT and Queensland).

Donor state



Recipient state



Fiscal impact:

This table shows the impact on all states' GST revenues of relativities based on a 'Swiss model' of HFE, compared to a business as usual scenario based on New South Wales Treasury projections. Negative values (in brackets) indicate a fall in revenue.

($ billion)	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2018-19	1.5	(0.6)	(3.7)	3.0	0.0	0.0	(0.2)	0.0
2019-20	2.2	(0.6)	(3.8)	2.4	0.0	0.0	(0.2)	0.0
2020-21	2.7	(0.7)	(4.0)	2.2	0.0	0.0	(0.2)	0.0
2021-22	2.7	(0.9)	(4.0)	2.3	0.0	0.0	(0.2)	0.0
2022-23	2.5	(0.8)	(3.9)	2.4	0.0	0.0	(0.2)	0.0
2023-24	2.2	(0.7)	(3.7)	2.4	0.0	0.0	(0.2)	0.0
2024-25	1.9	(0.5)	(3.6)	2.4	0.0	0.0	(0.2)	0.0
2025-26	1.6	(0.4)	(3.4)	2.4	0.0	0.0	(0.3)	0.0
2026-27	1.3	(0.2)	(3.2)	2.4	0.0	0.0	(0.3)	0.0
2027-28	1.0	(0.1)	(3.0)	2.4	0.0	0.0	(0.3)	0.0

Principle	*High level assessment of the model against individual principles.*
Efficiency	▪ Disincentives for reform, and perverse outcomes, are considerably removed due to the ranking system. GST distribution only affected if state policy changes rank (e.g. impairs real GSP or medium house prices)
Fairness	▪ Provides a more sensible indicator of which states require and deserve budgetary assistance. States with strong potential resources in which to raise own-source revenue (e.g. ACT) are not supported through HFE.
Simplicity	▪ Calculations are simpler than the current HFE system, based on a smaller range and more representative data set that requires little (if any) adjustment for use.
Accountability	▪ More transparent and easier to understand for policy-makers and the public. Once proxy indicators and weightings are agreed, there is limited (if any) scope for judgement.
Stability	▪ Once determined, payments mechanism delivers a predictable revenue stream for fiscally weak states (pre-determined equalisation payment) and fiscally strong states (EPC of remaining GST pool).

CGC role

- Reduced role with simplified calculations. Can easily be administered by Commonwealth Treasury.

Transition

- Transition arrangements can address short term losses by fiscally strong states that lose under the current model.

*In the above modelling, distribution of GST is assumed to follow a two stage process: (1) Fiscally weaker states (ranked in the bottom three) are assumed to be paid the exact same amount as they are forecast to receive under the current HFE system (i.e. no worst off) (2) The remainder of the GST pool is redistributed amongst fiscally stronger states (ranked in top five) on an EPC basis.

EXPENSES ONLY ASSESSMENT

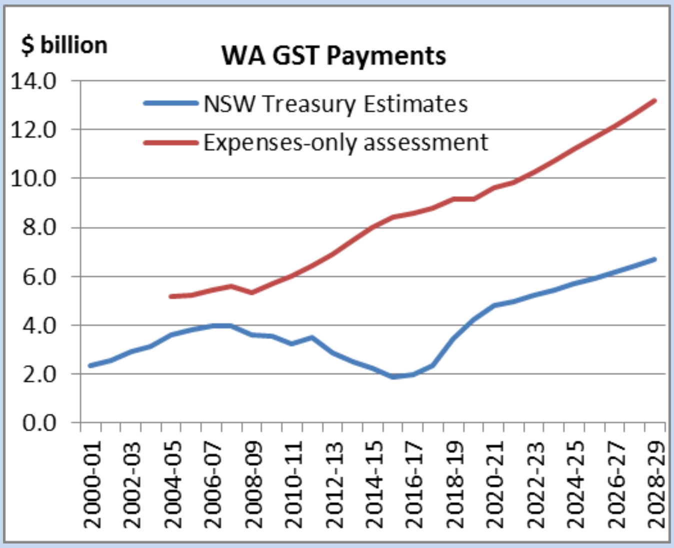
Key features:

- Relativities are assessed exclusively based on states' expenditure requirements.
- Could be limited to select core services – health, education, law and order and infrastructure to a minimum standard.

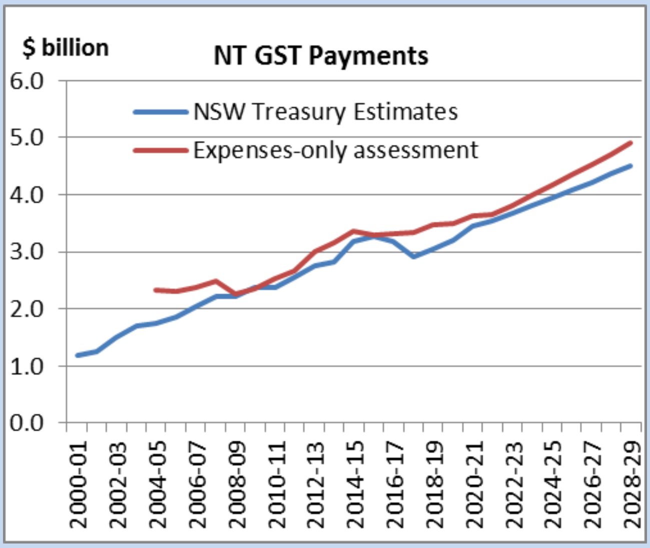
Analysis:

- Does not change underlying perverse incentives of HFE on the expense side (although could be partly addressed through a narrower range and more simplified assessments of expenses).
- Ignores significant inherent differences in revenue-raising capacity (eg. mining royalties).

Donor state



Recipient state



Fiscal impact:

This table shows the impact on all states' GST revenues of relativities based on an expenses only assessment, compared to a business as usual scenario based on New South Wales Treasury projections. Negative values (in brackets) indicate a fall in revenue.

($ billion)	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2018-19	1.7	(4.6)	(0.9)	5.7	(1.5)	(0.6)	(0.3)	0.4
2019-20	3.2	(5.4)	(1.0)	4.9	(1.3)	(0.5)	(0.2)	0.3
2020-21	4.5	(6.5)	(1.0)	4.8	(1.2)	(0.6)	(0.2)	0.2
2021-22	4.7	(6.8)	(0.8)	4.8	(1.2)	(0.6)	(0.2)	0.1
2022-23	4.2	(6.4)	(0.9)	5.1	(1.3)	(0.6)	(0.2)	0.1
2023-24	3.7	(6.0)	(1.0)	5.3	(1.3)	(0.6)	(0.2)	0.2
2024-25	3.1	(5.6)	(1.0)	5.5	(1.4)	(0.6)	(0.2)	0.2
2025-26	2.5	(5.1)	(1.1)	5.7	(1.4)	(0.6)	(0.2)	0.3
2026-27	1.8	(4.6)	(1.2)	6.0	(1.5)	(0.6)	(0.2)	0.3
2027-28	1.2	(4.0)	(1.3)	6.2	(1.5)	(0.7)	(0.2)	0.3

Principle	***High level assessment of the model against individual principles.***
Efficiency	▪ Eliminates scope for perverse incentives in revenue-raising activities, but depending on the scope of expenditure assessments and the level of equalisation could still impede efficiencies in expenditures.
Fairness	▪ Fairer but still recognises differences in cost of service provision.
Simplicity	▪ Reduces the complexity of HFE system as only expense assessments need to be undertaken – especially if scope of assessments were limited.
Accountability	▪ Some change on revenue side but limited change from status quo regarding funding for expenses. Could be improved – if states held accountable to raise revenues needed for services beyond some minimum.
Stability	▪ Would assist stability of GST revenues.

CGC role

- CGC's role would be to assess expenses only – ideally limited to assessing some selected categories of expenses only.

Transition

- Paradigm shift compared to current HFE process.
- Transitional arrangements needed.

LONG TERM AVERAGE RELATIVITIES FOR DONOR STATES

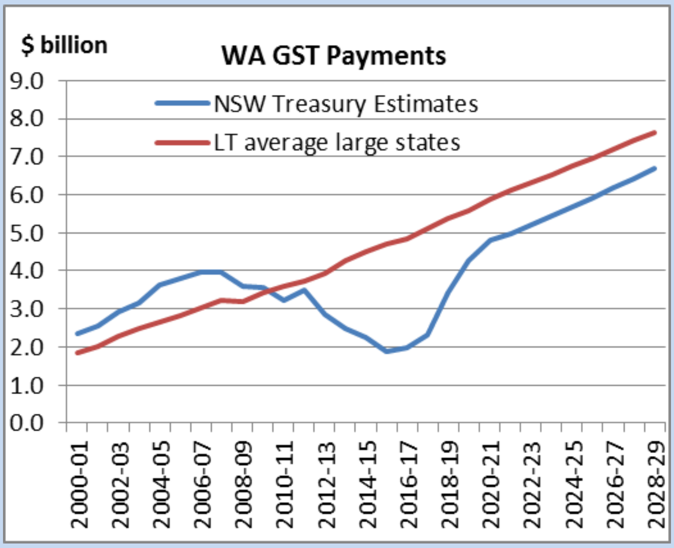
Key features:

- Relativities for donor states (NSW, VIC, WA) and QLD fixed at their individual long-term average (from 2000-01 to 2016-17).
- Over longer term, current system of HFE continues for recipient states (SA, TAS, ACT, NT, excluding QLD) but some periods of under and over compensation.
- Periodic review of long-term average relativity.

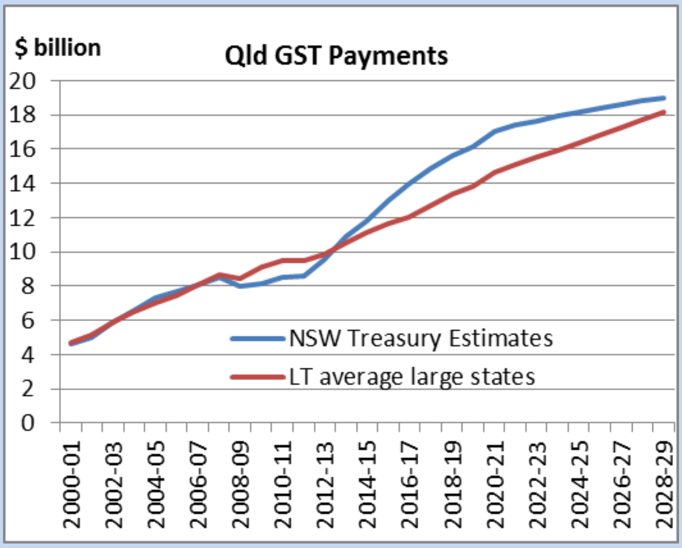
Analysis:

- Moderate fiscal impacts for donor states and QLD
- Provides some budget certainty for donor states and QLD.
- Recipient states retain their preferred distribution method (current HFE model) but current flaws to system still apply.

Donor state



Recipient state



Fiscal impact:

This table shows the impact on all states' GST revenues of a long-term average relativity for donor states and QLD compared to a business as usual scenario based on New South Wales Treasury projections. Negative values (in brackets) indicate a fall in revenue.

($ billion)	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2018-19	1.4	(1.0)	(2.2)	1.9	0.0	0.0	0.0	0.0
2019-20	2.1	(1.1)	(2.3)	1.3	0.0	0.0	0.0	0.0
2020-21	2.6	(1.2)	(2.4)	1.1	0.0	0.0	0.0	0.0
2021-22	2.6	(1.4)	(2.3)	1.1	0.0	0.0	0.0	0.0
2022-23	2.3	(1.3)	(2.2)	1.1	0.0	0.0	0.0	0.0
2023-24	2.1	(1.2)	(2.0)	1.1	0.0	0.0	0.0	0.0
2024-25	1.8	(1.1)	(1.8)	1.1	0.0	0.0	0.0	0.0
2025-26	1.5	(1.0)	(1.6)	1.0	0.0	0.0	0.0	0.0
2026-27	1.2	(0.8)	(1.3)	1.0	0.0	0.0	0.0	0.0
2027-28	0.8	(0.7)	(1.1)	1.0	0.0	0.0	0.0	0.0

Principle	***High level assessment of the model against individual principles***
Efficiency	▪ For the donor states and QLD, inefficiencies or incentive distortions inherent in the existing system removed.
Fairness	▪ Recipient states (excluding QLD) retain existing HFE arrangements. ▪ Unfair model. Problems with fairness continue. Citizens in different states continue to be treated differently.
Simplicity	▪ Complexity remains– calculations for all donor and recipient would still need to be prepared to calculate recipient states relativity.
Accountability	▪ Government accountability for donor states and QLD enhanced – this is due to greater simplicity of the equalisation methodology and greater predictability and stability in the level of GST revenues over time.
Stability	▪ Stability enhanced, as relativities would be fixed for donor states and QLD.

CGC's role

- CGC continue to administer HFE for recipient states.
- Periodic review of long term average for donor states and QLD.

Transition

- Gradual transition needed to support donor states and QLD undergo adjustment.

CAP AND FLOOR OF 20 PER CENT OF AVERAGE

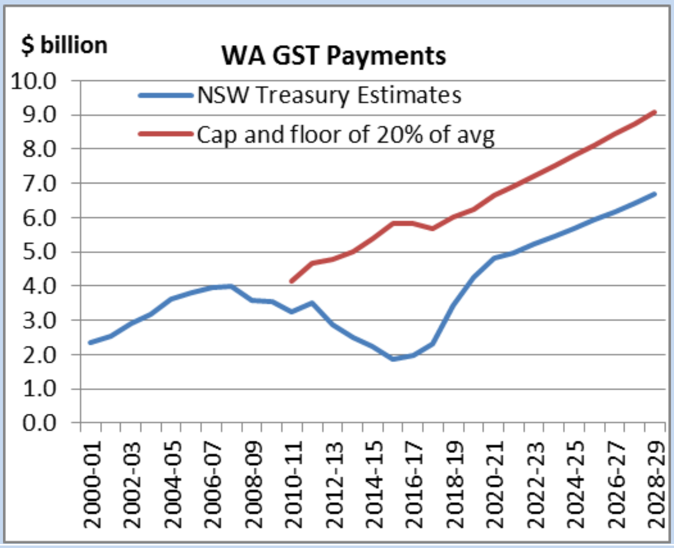
Key features:

- Cap and floor of 20 per cent from per capita average in a given year is applied to major assessment categories (i.e. number of expenses, revenue, Commonwealth payments etc.).
- An alternate methodological approach to assess revenues and expenses to deliver step-change improvements to states.

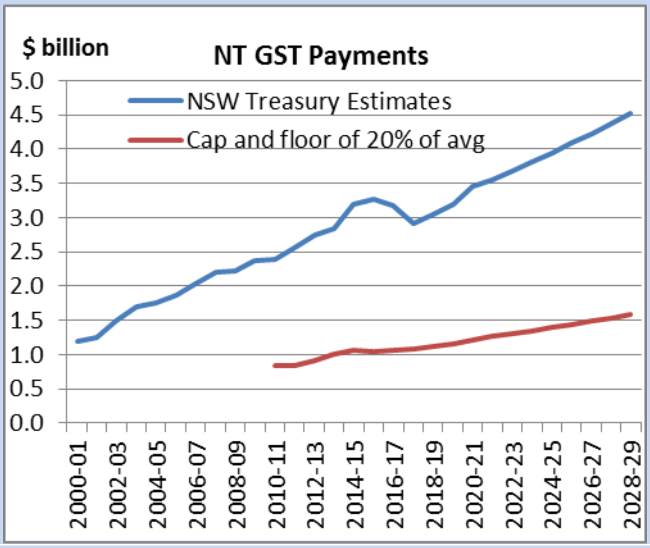
Analysis:

- 'HFE-lite' introduces incentives to shift around 20 per cent above the average on revenue and no more than 20 per cent below on expenses.
- Incentives to shift states towards the average position in each category.
- Does not significantly remove underlying perverse incentives of HFE.
- The 20 per cent limit is arbitrary.
- Funding of floor and distribution of cap would need to be resolved.

Donor state



Recipient state



Fiscal impact:

This table shows the impact on all states' GST revenues of relativities based on a cap and floor of 20 per cent model of HFE, compared to a business as usual scenario based on New South Wales Treasury projections. Negative values (in brackets) indicate a fall in revenue.

($ billion)	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2018-19	0.3	(0.9)	(0.4)	2.6	0.2	0.0	0.1	(1.9)
2019-20	1.1	(1.0)	(0.6)	2.0	0.3	0.1	0.1	(2.0)
2020-21	1.7	(1.1)	(0.8)	1.8	0.4	0.1	0.2	(2.2)
2021-22	1.9	(1.3)	(0.9)	1.9	0.4	0.1	0.2	(2.3)
2022-23	1.8	(1.2)	(0.9)	2.0	0.3	0.1	0.2	(2.4)
2023-24	1.7	(1.1)	(0.8)	2.1	0.3	0.1	0.1	(2.5)
2024-25	1.6	(1.0)	(0.8)	2.1	0.3	0.1	0.1	(2.5)
2025-26	1.6	(0.8)	(0.8)	2.2	0.3	0.1	0.1	(2.6)
2026-27	1.5	(0.7)	(0.7)	2.3	0.3	0.1	0.1	(2.7)
2027-28	1.4	(0.5)	(0.7)	2.3	0.3	0.1	0.0	(2.8)

Principle	***High level assessment of the model against individual principles.***
Efficiency	▪ Perverse incentives of current system still exist but are lessened. Encourages states to shift around 20 per cent above the average on revenue and no more than 20 per cent below on expenses.
Fairness	▪ Favours the donor states at the expense of the recipient states.
Simplicity	▪ No benefit.
Accountability	▪ Similar to status quo.
Stability	▪ More stable than status quo as it limits the extent of movements away from the average in a given category.

CGC role

- Similar to current role with same number of assessments to be undertaken.
- Additional calculations needed to establish per capita average.

Transition

- Some transitional arrangements required.

DONOR STATES – 0.9 RELATIVITY

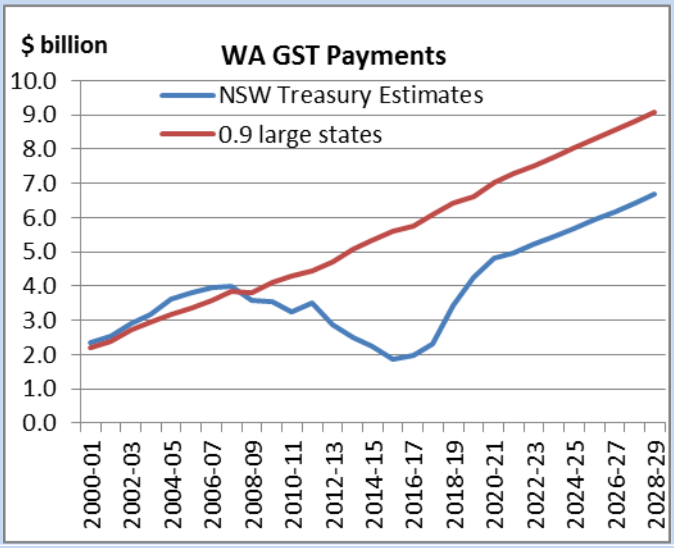
Key features:

- Donor states(NSW, VIC, WA) and QLD relativities fixed at 0.9
- Over the long term, current system of HFE continues to apply to recipient states (SA, TAS, ACT, NT) with some short term periods of over and under compensation.
- Main benefit to WA, with some loss for QLD. NSW and Vic largely unchanged.
- GST revenues would increase for donor states in line with national pool and relative population growth maintaining ability to deliver comparable services.

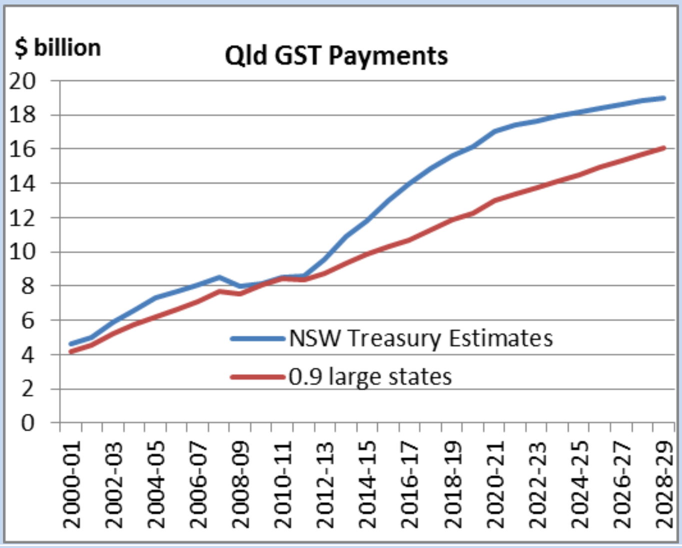
Analysis:

- Relativity of 0.9 for the donor states is based on historical redistribution to four recipient states. Locks in a fixed donor-recipient dynamic.
- Regular reviews needed to revisit relativities.
- Provides some budget certainty for donor states.
- Unfair to citizens in donor states and QLD – implies permanent donor-state status.
- Recipient states retain their preferred distribution method (current HFE model), though current flaws remain.
- Main adverse impact is on QLD, whose relativity is usually above 0.9 due to high costs of service delivery and natural disaster relief.

Donor state



Recipient state



Fiscal impact:

This table shows the impact on all states' GST revenues of a relativity of 0.9 for donor states and QLD compared to a business as usual scenario based on New South Wales Treasury projections. Negative values (in brackets) indicate a reduction in revenue.

($ billion)	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2018-19	1.4	(0.7)	(3.8)	3.0	0.0	0.0	0.0	0.0
2019-20	2.1	(0.7)	(3.9)	2.4	0.0	0.0	0.0	0.0
2020-21	2.6	(0.8)	(4.1)	2.2	0.0	0.0	0.0	0.0
2021-22	2.6	(1.0)	(4.0)	2.3	0.1	0.0	0.0	0.0
2022-23	2.4	(0.9)	(3.9)	2.3	0.1	0.0	0.0	0.0
2023-24	2.1	(0.8)	(3.8)	2.3	0.1	0.0	0.0	0.0
2024-25	1.8	(0.6)	(3.6)	2.4	0.1	0.0	0.0	0.0
2025-26	1.5	(0.5)	(3.5)	2.4	0.0	0.0	0.0	0.0
2026-27	1.2	(0.3)	(3.3)	2.4	0.0	0.0	0.0	0.0
2027-28	0.8	(0.2)	(3.1)	2.4	0.0	0.0	0.0	0.0

Principle	*High-level assessment of the model against individual principles.*
Efficiency	▪ For the donor states and QLD, inefficiencies or incentive distortions inherent in the existing system removed. Poor incentives and risk of perverse outcomes continue for recipient states (excluding QLD) – encourages OECD's "widening disparities" (see section 3.2 above).
Fairness	▪ Problems with fairness continue. Citizens in different states continue to be treated differently. ▪ Lack of fairness and continued complexity outweighs more modest efficiency benefits.
Simplicity	▪ No reduction in complexity – calculations for donor and recipient states would still need to be prepared to calculate recipient states relativity. Reform to simplify equalisation amongst recipient states still needed.
Accountability	▪ Government accountability for donor states and QLD is enhanced – this is due to a result of greater simplicity of the equalisation methodology and greater predictability and stability in the level of GST revenues over time.
Stability	▪ The fixed relativities for the donor states and QLD would result in more stable GST revenues, as fluctuations due to year-on-year changes in assessed relativities would be eliminated.

CGC role

- CGC continue to administer HFE for recipient states.

Transition

- A gradual transition may be needed for donor states and QLD to adjust.

REVENUE ONLY ASSESSMENT

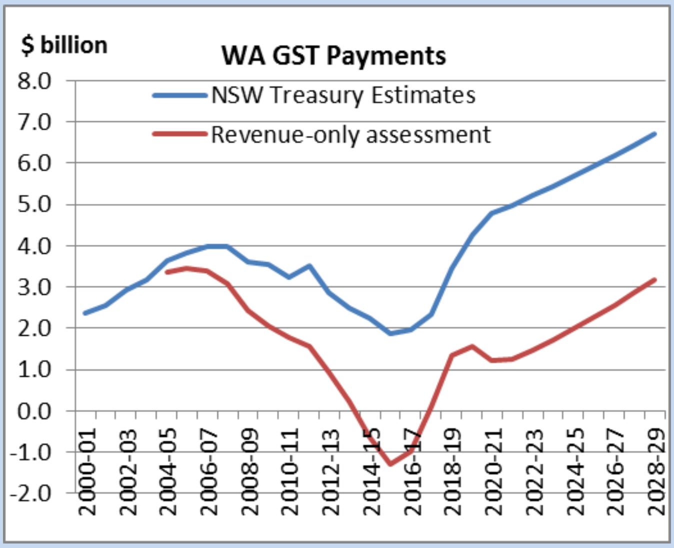
Key features:

- Relativities are assessed exclusively based on revenue-raising capacity of states.
- Similar to Canadian equalisation arrangements.

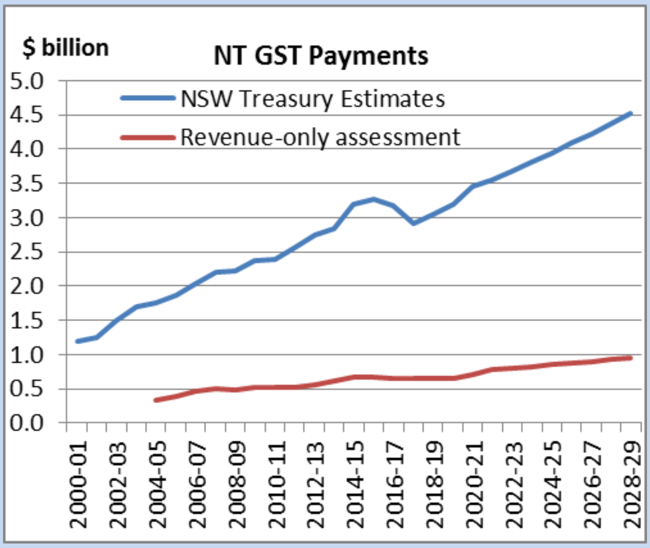
Analysis:

- Does not change underlying perverse incentives of HFE on the revenue side. Does encourage efficiency on expenses side.
- Ignores significant inherent expense disabilities.
- Potential for negative relativities based on historical analysis.

Donor state



Recipient state



Fiscal impact:

This table shows the impact on all states' GST revenues of relativities based on a revenue-only assessment, compared to a business as usual scenario based on New South Wales Treasury projections. Negative values (in brackets) indicate a fall in revenue.

($ billion)	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2018-19	2.2	3.7	(1.3)	(2.1)	0.0	(0.3)	0.2	(2.4)
2019-20	2.4	3.5	(1.0)	(2.7)	0.3	(0.3)	0.3	(2.5)
2020-21	3.0	3.3	(0.7)	(3.6)	0.5	(0.2)	0.4	(2.7)
2021-22	3.2	3.0	(0.4)	(3.7)	0.5	(0.2)	0.4	(2.8)
2022-23	3.4	3.4	(0.8)	(3.7)	0.4	(0.2)	0.3	(2.9)
2023-24	3.5	3.8	(1.1)	(3.7)	0.4	(0.2)	0.3	(3.0)
2024-25	3.7	4.3	(1.5)	(3.7)	0.3	(0.3)	0.3	(3.1)
2025-26	3.8	4.7	(1.8)	(3.7)	0.2	(0.3)	0.2	(3.2)
2026-27	4.0	5.2	(2.2)	(3.6)	0.2	(0.3)	0.2	(3.3)
2027-28	4.2	5.7	(2.7)	(3.6)	0.1	(0.4)	0.1	(3.4)

Principle	***High level assessment of the model against individual principles.***
Efficiency	▪ Eliminates scope for perverse incentives in expenditure.
Fairness	▪ Fairer but still recognises disabilities on revenue side. ▪ Ignores significant inherent disabilities in expenditure (e.g. remoteness). ▪ Would greatly impact the fiscal position of the NT and WA.
Simplicity	▪ Significantly reduces complexity of HFE system as only revenue assessments need to be undertaken.
Accountability	▪ Little change from status quo..
Stability	▪ Modelling indicates that the relativity could become more volatile and historical data indicates that WA's relativity would have been negative under this arrangement. ▪ Would make forecasting GST revenue for states marginally more certain.

CGC role

- The CGC's role would be reduced to assess revenue only.

Transition

- This model would be a paradigm shift compared to current HFE process (phase-in arrangements may be needed).

0.75 FLOOR; DONOR ONLY SUBSIDISATION

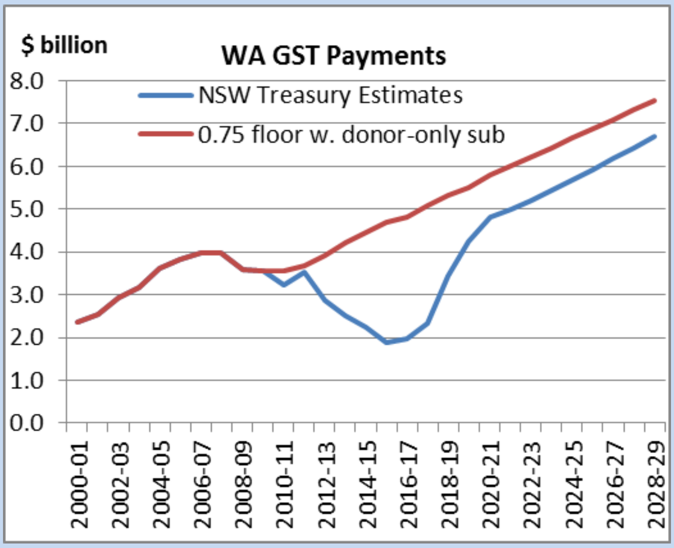
Key features:

- Relativities cannot fall below a floor of 0.75.
- Current donor states (i.e. with a relativity of less than 1) donate further relativity to support floor.

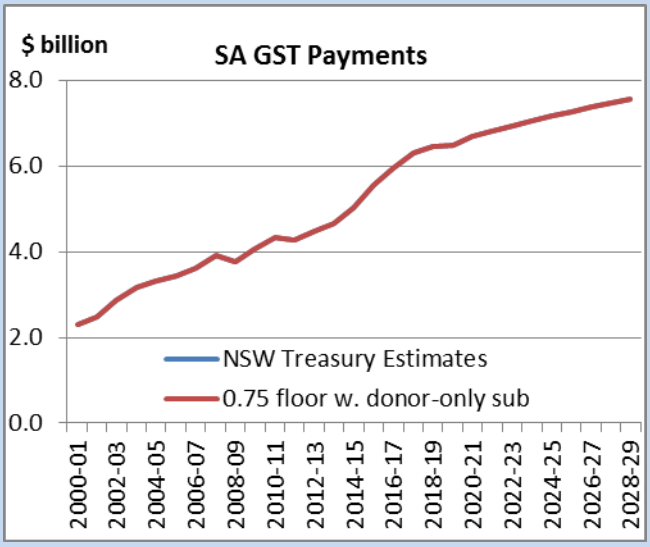
Analysis:

- Does not change the perverse incentives or unintended consequences from current HFE arrangements.
- Benefits one or a minority of states at the expense of other donor states.
- Unfair to donor states.
- Arbitrary.

Donor state



Recipient state



Fiscal impact:

This table shows the impact on all states' GST revenues of a 0.75 relativity floor with donor-only subsidisation, compared to a business as usual scenario based on New South Wales Treasury projections. Negative values (in brackets) indicate a fall in revenue.

($ billion)	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2018-19	(1.1)	(0.8)	0.0	1.9	0.0	0.0	0.0	0.0
2019-20	(0.7)	(0.5)	0.0	1.2	0.0	0.0	0.0	0.0
2020-21	(0.6)	(0.4)	0.0	1.0	0.0	0.0	0.0	0.0
2021-22	(0.6)	(0.5)	0.0	1.0	0.0	0.0	0.0	0.0
2022-23	(0.6)	(0.4)	0.0	1.0	0.0	0.0	0.0	0.0
2023-24	(0.5)	(0.4)	0.0	1.0	0.0	0.0	0.0	0.0
2024-25	(0.5)	(0.4)	0.0	1.0	0.0	0.0	0.0	0.0
2025-26	(0.5)	(0.4)	0.0	0.9	0.0	0.0	0.0	0.0
2026-27	(0.5)	(0.4)	0.0	0.9	0.0	0.0	0.0	0.0
2027-28	(0.5)	(0.4)	0.0	0.9	0.0	0.0	0.0	0.0

Principle	*High-level assessment of the model against individual principles.*
Efficiency	▪ No efficiency benefits.
Fairness	▪ Unfair. ▪ Arbitrary – no basis for a 0.75 floor.
Simplicity	▪ Greater complexity in comparison to status quo. ▪ Status quo remains plus additional calculations to implement the floor, which may be subject to contention.
Accountability	▪ This model risks further undermining credibility of HFE, as it would favour one or a small number of states based on an arbitrary judgement. ▪ No improvement in accountability.
Stability	▪ Poor. Provides short term benefit to WA. Stability for other states same as status quo or potentially worse. Stability outcome depends on value selected as the floor and states' future economic circumstances. ▪ Fiscal management worsened.

CGC role

- CGC continue to administer the HFE process with additional calculations needed to administer the floor.

Transition

- Commonwealth government prefers to wait until WA's relativity has recovered before introducing a floor.

APPENDIX B – INTERNATIONAL APPROACHES TO FISCAL EQUALISATION

Switzerland

Switzerland pursues a separate fiscal equalisation program for revenue and expenses, through the use of a ranking system based on broad macroeconomic indicators.

- *Revenue*: The revenue raising capacity of Cantons is ranked on the bases of each Canton's aggregate tax base (a measure of potential own-source tax revenue). This focuses on a Canton's potential revenue raising capacity, and not the revenues they choose to raise through their tax policy, encouraging Cantons to raise revenue themselves before resorting to the equalisation system.
- *Expenses*: Cost disadvantages are evaluated on the basis of the spatial distribution of objective factors (e.g. topography, distribution of socioeconomic groups) that is not tied to actual service delivery.

There is no zero sum game dynamic – equalisation does not directly respond to a Canton's tax policy or service delivery decisions.

The pool for distribution is also not pre-determined – fiscally weak Cantons receive only the amount of funds required to bring them within 85 per cent of the national average (financed through federal own-source revenue and direct contributions from fiscally strong Cantons).

Germany

Germany pursues a fiscal equalisation program based on an equalisation index focusing on the revenue capacity of the various Länder and local government authorities.

The use of an index that is tied to revenue raising capacity means that the zero sum game dynamic is minimal. Fiscally weaker Länder are equalised according to a linear-progressive schedule that increases on a marginal basis – with payments made to ensure the financial capacity index of Länder are within 44 per cent to 75 per cent of the equalisation index (a proxy for the average fiscal capacity across the German federation).

Although there is a defined pool for equalisation (the German VAT), only 25 per cent of the pool is available for equalisation, and then only to meet a maximum of 75 per cent of a Länder's gap in fiscal capacity from the average. For the remaining 25 per cent gap, any further equalisation not covered by VAT revenues is met through supplementary grants from the federal government. These grants are financed through own-source revenue.

Canada

Canada pursues a program of revenue equalisation across five tax bases only, with equalisation payments made only to those Provinces that are assessed as having low fiscal capacity. Equalisation on the basis of need (including cost disadvantages provinces face in actual service delivery) is not subject to equalisation.

Fiscally weaker provinces are equalised up to standard level of fiscal capacity across the ten Provinces – the equalisation system does not reduce the fiscal capacity of fiscally stronger states to achieve the equalisation objective.

There is also no pre-determined pool for equalisation that is required for full distribution – equalisation payments are made from federal own-source revenue, and only amounts needed to equalise fiscally weaker states up to the required standard.

APPENDIX C – EARLY CHILDHOOD EDUCATION AND CARE NPA

Table C.1: Distribution outcomes if funding pursued bilaterally

Commonwealth Grants Commission – $ 77 million subject to equalisation									
	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUS
Population (m)	7.7	6.1	4.8	2.6	1.7	0.5	0.4	0.2	24
Before equalisation – NSW is the only jurisdiction that accepts Commonwealth funding									
Offered per capita ($)	10	10	10	10	10	10	10	10	10
Accepted per capita ($)	10	0	0	0	0	0	0	0	3.21
Total funding ($m)	77	0	0	0	0	0	0	0	77
HFE process equalises $70 million received across all states and territories									
Actual per capita distribution ($)	10	0	0	0	0	0	0	0	-
Assessed per capita distribution ($)	3.21	3.21	3.21	3.21	3.21	3.21	3.21	3.21	-
Net redistribution per capita ($)	(6.79)	3.21	3.21	3.21	3.21	3.21	3.21	3.21	-
Net redistribution ($m)	(52.28)	19.58	15.41	8.25	5.46	1.61	1.28	0.64	0[27]

Table C.2: Distribution outcomes under a multilateral agreement

Commonwealth Grants Commission – $179 million subject to equalisation									
	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUS
Population (m)	7.7	6.1	4.8	2.6	1.7	0.5	0.4	0.2	24
Before equalisation – Victoria is the only jurisdiction that rejects Commonwealth funding									
Offered per capita ($)	10	10	10	10	10	10	10	10	10
Accepted per capita ($)	10	0	10	10	10	10	10	10	7.46
Total funding ($m)	77	0	48	26	17	5	4	2	179
HFE process equalises $179 million received by all states and territories (except Victoria)									
Actual per capita distribution ($)	10	0	0	0	0	0	0	0	
Assessed per capita distribution ($)	7.46	7.46	7.46	7.46	7.46	7.46	7.46	7.46	
Net redistribution per capita ($)	(2.54)	7.46	(2.54)	(2.54)	(2.54)	(2.54)	(2.54)	(2.54)	
Net redistribution ($m)	(19.56)	45.50	(12.19)	(6.60)	(4.32)	1.27	1.02	0.51	0[28]

[27] Numbers may not add due to rounding.

[28] Numbers may not add due to rounding.

APPENDIX D – ADMINISTRATIVE SCALE ASSESSMENT

The administrative scale assessment aims to recognise costs due to diseconomies of small scale in central administration. The CGC argues that administrative scale disability recognises the costs incurred by a state in delivering services, which are independent of the size of the service population. These costs are associated with:

- core head office functions of departments (for example, corporate services, policy and planning functions, but not all staffing and other resources delivering these)
- services that are provided for the whole of the state (for example, the legislature, the judiciary, the Treasury, the revenue office, and a state museum, but not all staffing and other resources delivering these).

The original data supporting the administrative scale assessment was the subject of work done by the CGC as part of the 1999 and 2004 Reviews.

A brief review of how those costs are derived indicates a considerable degree of assumption and judgement has been used. This cannot be ignored in an assessment which redistributes over $911 million each year.

Box D.1: Overview and history of the Administrative Scale Assessment – 1999 to 2015

1999 Review

The Commission calculated administrative scale disabilities for minimum fixed costs and scale affected variable costs. Minimum fixed costs were defined as the costs of the minimum amount of corporate services and basic head office structures required to provide policy and planning for state wide functions regardless of the size of the task. Scale affected variable costs were expenses on corporate services and policy and planning additional to minimum fixed costs, but still subject to some diseconomies of small scale.

The assessment involved identifying the disability factors which indicated how per capita fixed and scale affected variable costs varied across states and identifying the absolute level of fixed and scale affected variable costs for each service.

The minimum fixed costs factors were calculated as the inverse of state population shares assuming that each state needed to spend the same absolute amount to provide the minimum sized central office. The minimum sized central office was determined by reference to the lowest constructed cost at which any state could provide the function, without any reference to the volume of service delivery.

The variable cost factors were estimated by establishing a value for the Northern Territory using data on education departments; setting the factors for New South Wales, Victoria and Queensland to 1.0000; interpolating factors for the other states by reference to their population size and their actual expenses; and rescaling the factor so that the population weighted Australian average was 1.0000. Adjustments were made to reflect cross-border use of services for the Australian Capital Territory, and zero or low needs for certain spending categories in the Australian Capital Territory and Tasmania.

The estimates of fixed costs were based on “judgements about the size of the smallest central office unit required in the smaller states to provide basic administration.”

The variable scale affected expenditures were based on judgement, after consideration of the nature of the services in each category and analysis of annual reports and budget papers.”

The amounts estimated in the 1999 Review ($114 million for minimum fixed cost and $102.9 million for scale affected variable cost) formed the basis for the amounts estimated in the 2004 Review ($157.6 million). Further work for the 2004 Review suggested that the minimum fixed costs estimated in the 1999 Review “seemed reasonable in the context of the price levels and State government functions that existed at the time of the 1999 Review.”

2004 Review

The Commission was not convinced of the conceptual case for scale affected variable costs, since logically they varied with the size and complexity of the service being delivered. “The Commission considered that, on the basis of judgement, about 10 per cent of these costs were in effect fixed costs.” So the scale affected variable costs element was excluded, but 10 per cent of costs previously classified as scale affected variable costs were added to fixed costs.

To estimate the impact on minimum fixed costs from changes in government functions since the 1999 Review the Commission used data which suggested the extra costs of new functions added around $10 million for the Education and Treasury departments of one state. It then assumed that other State government departments had been affected by similar cost increases, minimum fixed costs represented about 10 per cent of state head office expenses and the education and treasury minimum fixed costs were about 10 per cent of total minimum fixed costs. So in the 2004 Review the total increase in minimum fixed costs across all categories owing to changes in government functions was estimated to be $10 million since the 1999 Review.

On the basis of movements since 1999 in public sector wages (estimated as 80 per cent of fixed costs) and the CPI (estimated as 20 per cent of fixed costs), the Commission inflated the 1999 review minimum fixed costs to 2004 levels.

2010 Review

The Commission accepted that there may have been changes in state responsibilities and in how services were delivered since the 2004 Review. However, the Commission decided that states were unable to provide reliable data to allow these changes to be measured.

As a result, the Commission decided to continue reliance on the quantum determined in the 1999 Review, and updated with indexation, switching to using the chain price index for state and local government final consumption expenditure from the ABS National Accounts to index the quantum of administrative scale expenses. No attempt was made to determine whether the administrative structure of states had since changed from 1999.

2015 Review

In 2010, revisiting the quantum of costs under the administrative scale assessment was identified as a priority issue. A Data Working Party was tasked with developing a method to quantify these costs. However, they were unable to develop a tractable methodology to reestimate this quantum. This resulted in a simple continuation of the indexation of data used in the 2010 Review (itself based on the data and assessment methodology used in the 1999 and 2004 Reviews).

As a result, states and territories are subject to an administrative scale assessment that relies on 1999 data that has since been subject to numerous methodology changes and scaled for inflation and price levels.

Despite the significant use of judgement and the reliance on outdated data, the CGC continues to claim that the results do not require discounting as they are robust. The uncertainties in the administrative scale assessment – in exactly what it is intended to measure, the lack of data to measure it, and the age, provenance and judgements associated with previously-used data – are among the highest in any of the CGC's assessments.

In summary, as there is no precise data on the extent of costs associated with diseconomies of small scale the current estimates are based on estimates originally made in the 1999 Review for minimum fixed costs and scale affected variable costs. These were subsequently modified in the 2004 Review by:

- excluding all but 10 per cent of scale affected costs
- adding an amount for changes in government functions between 1999 and 2004
- up-scaling for movements between 1999 and 2004 in public sector wages and the CPI.

In addition, the chain price index has been scaled up for state and local government final consumption expenditure from the national accounts for movements in these costs between the 2004, 2010 and 2015 Reviews.

APPENDIX E – TRANSPORT ASSESSMENT AND NEW SOUTH WALES

Inconsistent treatment of data penalising New South Wales on transport

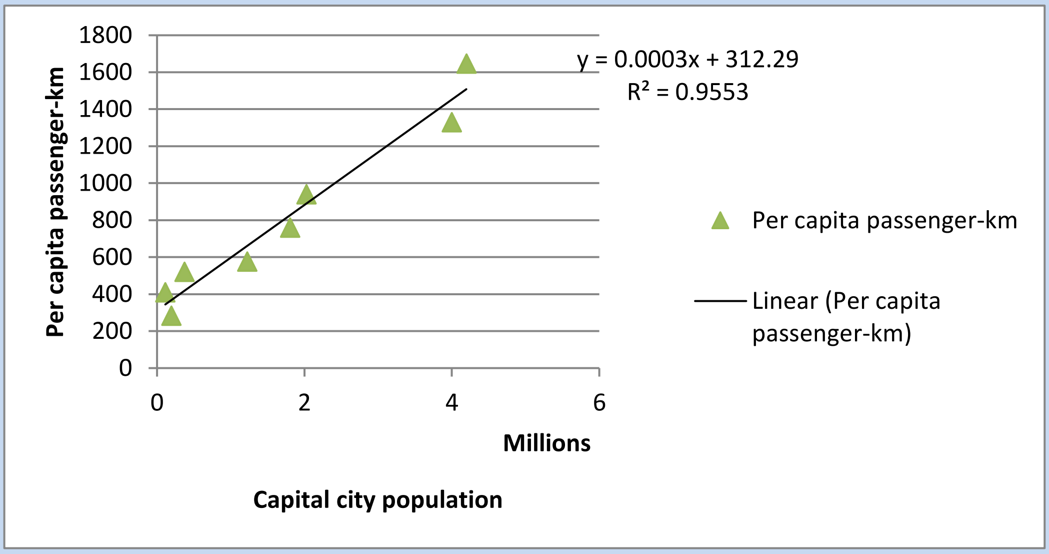
New South Wales spends significantly more on transport than it is assessed to need. In the 2017 Update this mean that New South Wales spent $1 billion more on actual transport expenses than its assessed expense and received an extra $266 million of GST to fund its increased transport needs. But there is prima facie evidence to suggest that there is a data flaw in the assessment that has not been clearly explained or addressed.

The transport assessment

For the 2015 Review, the CGC updated a regression analysis for the transport assessment that was used in the 2010 Review. The regression analysis compared the per capita transport task and the per capita net expenses to the population using data from 2009-10 to 2011-12.

The per capita transport task increased in line with capital city population as expected (see chart E.2).

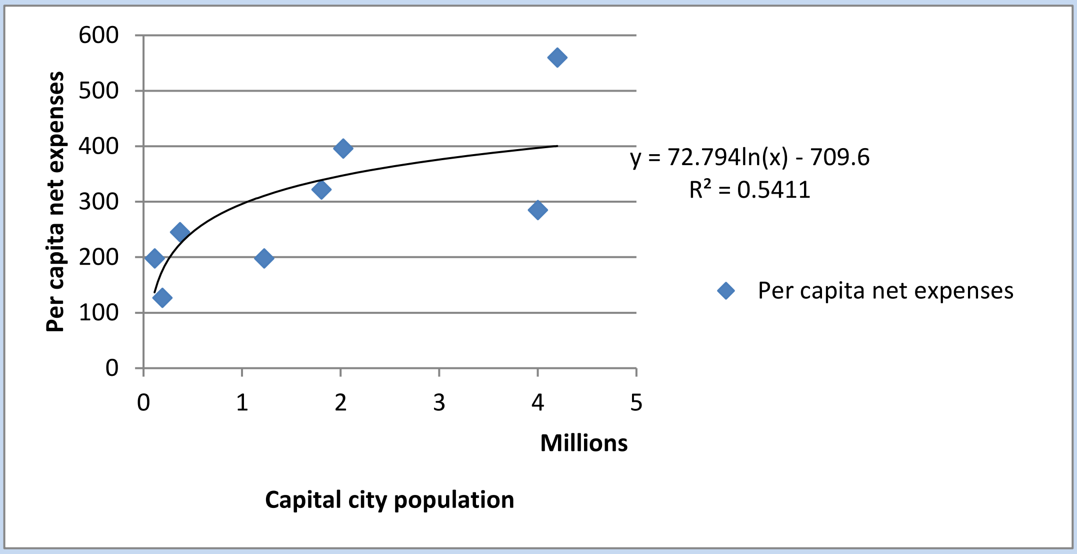
Chart E.1: Per capita transport task by capital city



Source: CGC, 2015, *Report on GST Revenue Sharing Relativities – 2015 Review*, Volume 2, p. 359, Table 6.

The comparison of per capita net expenses presents some anomalous results – in practice we would expect this should be closely correlated to the per capita transport task, see Chart 1.3 below.

Chart E.2: Per capita net expenses by capital city



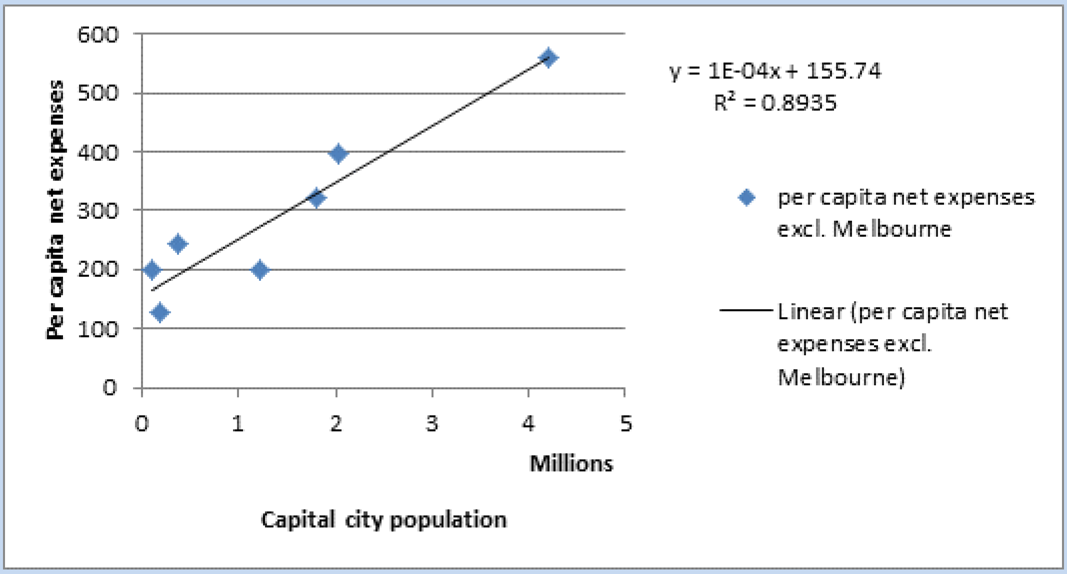
CGC, 2015, *Report on GST Revenue Sharing Relativities – 2015 Review*, Volume 2, p. 359, Table 6, and Treasury calculations.

The data showed a significant dispersion in data points between cities and the CGC decided to switch to a log linear regression with a significantly worse explanatory power.[29]

Normally when carrying out econometric analysis it is good practise to carry out visual inspections and test for outliers. A simple visual inspection indicates that Melbourne looks like an outlier. Excluding Melbourne produces a significantly improved scatter plot and a linear relationship with a higher explanatory power which is more consistent with the per capita transport task data and theory.

[29] It is not possible to exactly replicate the CGC's calculated regression curve without further information but the R^2 value is similar.

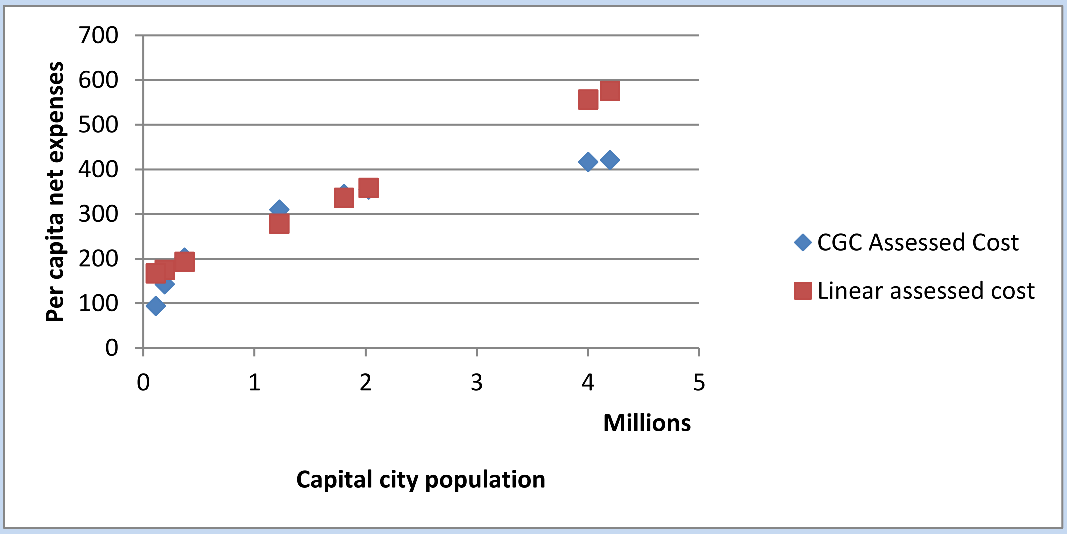
Chart E.3: Per capita net expenses by capital city excluding Melbourne



CGC, 2015, *Report on GST Revenue Sharing Relativities – 2015 Review*, Volume 2, p. 359, and Treasury calculations

The CGC did not provide any explanation of its regression analysis apart from the formula used to derive the assessed net urban operating expense, y = 90.17ln(x) + 291.29. Comparing this formula to the linear formula clearly shows a significant difference in per capita costs for Sydney and Melbourne in particular.

Chart E.4: Per capita assessed and calculated costs for Sydney and Melbourne



CGC, 2015, *Report on GST Revenue Sharing Relativities – 2015 Review*, Volume 2, p. 359, and Treasury calculations

The strangeness of the regression analysis has been reinforced by looking at the change in the ratio between actual per capita transport expenses to assessed expenses. Victoria has moved from having actual transport expenses significantly below their assessed level to above their assessed level, suggesting that the period used for the regression analysis may have contained erroneous data for Victoria.

Table E.1: Percentage of actual and assessed transport cost by state

		NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
2012-13	%	132.9	79.9	102.2	67.4	69.6	50.3	68.8	137.0	100.0
2013-14	%	132.7	95.6	82.7	65.2	63.6	57.0	59.0	140.1	100.0
2014-15	%	124.8	104.3	89.6	59.4	58.7	48.2	64.5	120.5	100.0
2015-16	%	121.9	106.8	84.2	68.3	61.2	67.1	54.8	138.4	100.0

Source: CGC, *Report on GST Revenue Sharing Relativities 2017 Update*, Supporting Documentation, Revenue and Expense ratios.

The CGC is aware that New South Wales has high ratios of actual to assessed spending and that could be caused by data reliability issues[30] but New South Wales is not aware of any action being taken to investigate the issue further despite the materiality of the issue.

[30] CGC, 2016, *What States Do – Transport*: *CGC Staff Research Paper*.

APPENDIX F – NET AND GROSS REDISTRIBUTION

Table F.1 and Chart F.1 detail the amounts involved in the gross and net redistributions of GST for the period 2004-05 – when the CGC began estimating the redistribution based on the GST relativities – to 2017-18. They reiterate Shah's point that 'rough justice, may be better than full justice'.

Table F.1: Net and gross distribution outcomes

Year	Pool	Net redistribution		Gross redistribution	
	($m)	($m)	% of pool	($m)	% of pool
2004-05	35,062	3,220	9.2	7,464	21.3
2005-06	37,442	3,354	9.0	8,215	21.9
2006-07	39,560	3,226	8.2	8,771	22.2
2007-08	42,399	3,339	7.9	9,113	21.5
2008-09	41,159	3,614	8.8	9,633	23.4
2009-10	44,510	3,513	7.9	8,683	19.5
2010-11	45,450	3,598	7.9	12,829	28.2
2011-12	45,600	4,019	8.8	14,856	32.6
2012-13	47,700	4,262	8.9	15,910	33.4
2013-14	50,720	4,744	9.4	16,473	32.5
2014-15	54,000	5,482	10.2	17,883	33.1
2015-16	57,450	6,858	11.9	20,525	35.7
2016-17	60,660	7,785	12.8	20,977	34.6
2017-18	62,340	7,928	12.7	21,247	34.1

Chart F.1: Net and gross distribution outcomes

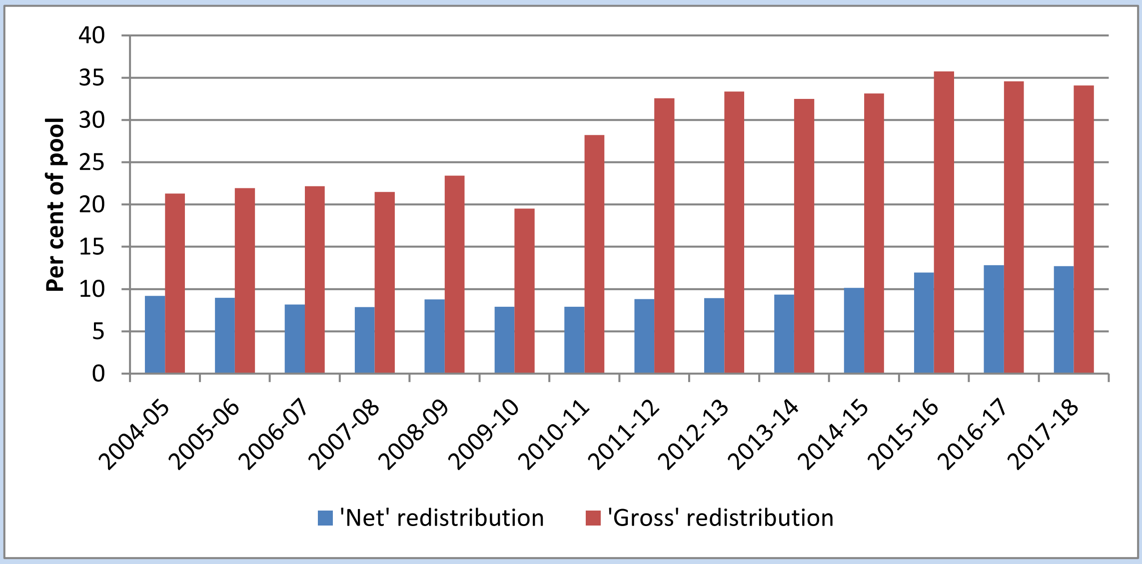


Table F.1 and Chart F.1 show that the gross redistribution is more than twice the net redistribution to 2009-10, and more than three times the net redistribution from 2010-11.

APPENDIX G – BRIEF SUMMARY OF HFE AND ITS HISTORY

Australia's unique approach to fiscal federalism is characterised by two main features: VFI and HFE. Over more than a century, both VFI and HFE have developed in ad hoc and incremental ways, expanding in scale and scope over time.

VFI is partly attributable to the centralist impulses of past Commonwealth governments seeking to aggregate tax raising and spending powers at a national level. Greater levels of control and fiscal intervention mean the Commonwealth has assumed an increasingly active role in traditional areas of state responsibility.

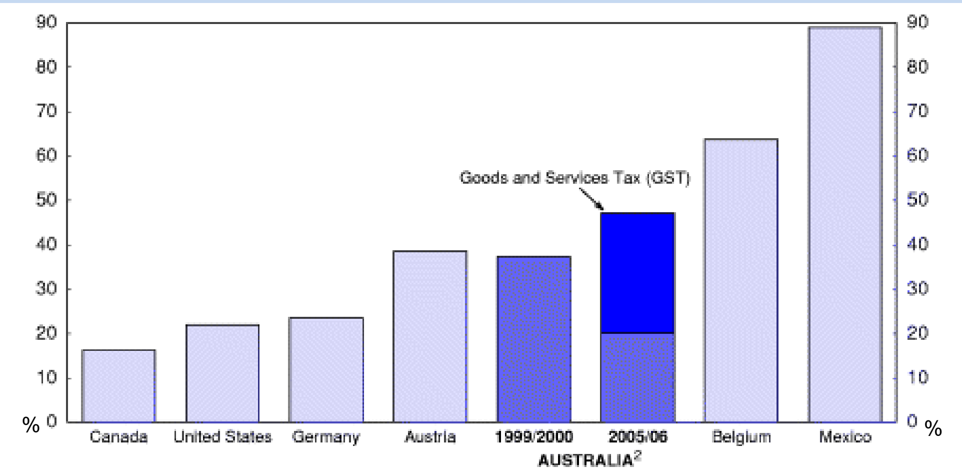
The impacts of VFI on states has compounded over time as different tax bases were forgone in exchange for Commonwealth grants and more recently, an equalised share of GST revenues. Consequently, general revenue assistance, through the allocation of GST revenues, provides significant budget support for states. Table G.1 shows the proportion of states' total revenue attributable to GST revenue, demonstrating its importance to states' budgets.

Table G.1: GST revenue as a share of total revenue 2015-16, by state

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
%	22.7	22.6	25.6	7.1	32.0	41.5	21.7	52.5

As a result of the mismatch between expenditure and revenue raising capacities at each level of government, Australia has become one of the federations with the highest incidence of VFI in the OECD (as shown in the following chart).

Chart 1.6 Vertical fiscal imbalance in selected OECD countries, per cent of sub-national revenue



Source: OECD 2006, Economic Survey of Australia, 2006, OECD, Paris. VFI is defined as the ratio of federal payments to total sub-national revenue. Data are for 2003, except Australia which uses data for 2005-06

The following sections address how the definition of HFE and the governance framework surrounding it have evolved since federation and the extent to which the current system aligns with principles of fairness and efficiency. These discussions provided the foundation for recommendations for future directions.

Fiscal equalisation and the Australian federation

Since federation, Commonwealth provision of untied funding to states has reflected some degree of fiscal equalisation to ensure that all citizens have access to a minimum level of service, regardless of the state in which they reside. This was consistent with a commitment to national cohesion within a federation.

However, interpretation of the principle of fiscal equalisation between states has changed over time.

The objective of equalising states' fiscal capacities has evolved since federation – originally limited to targeting financially weaker states, today it aims to achieve full horizontal fiscal equalisation across all states.

There have been four defining stages in this evolution:

- the first three decades of federation
- the establishment of the CGC in 1933
- the adoption of full equalisation in the early 1980s
- the introduction of the GST and the *Intergovernmental Agreement on the Reform of Commonwealth State Financial Relations 1999*.

From 1910, the Commonwealth provided special grants to financially weaker claimant states, recognising that the process of federalism disadvantaged some states and that temporary support was needed to ensure that each state could function as a viable member of the federation.

Demands from claimant states grew over the following two decades, along with dissatisfaction with the ad hoc nature of grant provision, and secessionist sentiment. The CGC was established in response, tasked with independently assessing the needs of claimant states and making recommendations on the provision of Financial Assistance Grants.

The CGC determined that grants should be provided based on a principle of need, to support a minimum standard of services. The amount to be given was determined on the following basis:

> "Special grants are justified when a State through financial stress from any cause if unable to efficiently discharge its functions as a member of the Federation and should be determined by the amount of help found necessary to

make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States."[31]

Grants were determined by assessing claimant states' needs against the average capacity of New South Wales and Victoria, the more populous states. The CGC, in making these assessments, was not concerned with achieving equal standards across states. Rather, the objective of these grants was limited to alleviating the financial difficulties of claimant states.

The objective of these special grants remained essentially unchanged over the following five decades – the same formulation as above was reflected in the *Commonwealth Grants Commission Act 1973.* Section 5(1) references the granting of financial assistance to a State for the purpose of making it possible for the state, by reasonable effort, to function at a standard not appreciably below the standard of other states.

A fundamental change took place in the 1980s, in the context of new revenue sharing arrangements introduced by the Commonwealth government in 1976.

The CGC was tasked with reviewing the relativities based on the principle that payments should enable each state to provide government services at standards "not appreciably different" from standards provided by other states[32]. This expanded the scope for equalisation to include all states, rather than just financially weaker states. A further key difference was that equalisation payments were funded within a fixed pool rather than our of the Commonwealth's own budget. Consequently, payments were allocated such that states doing better than the standard would be equalised down and those falling below the standard would be equalised up.

Linking fiscal equalisation to a fixed pool at this time also worked to introduce a zero sum game dynamic that shifted states focus shifted to securing a greater share of the pool, intensifying competition among states. It is worth noting that, at times, states had occasionally bargained with the Commonwealth to increase the total amount distributed among them as a means to mitigate the effects of a reduction in their share of financial assistance[33].

Under this new approach, the CGC began taking into account differences in capacities to raise revenues as well as differences in expenses required to provide minimum government services and the principle of full equalisation began.

Throughout the 1990s, the principle of full equalisation of fiscal capacities became more explicit in the CGC's terms of reference, as the objective changed from enabling states to provide minimum of government services to the same, average standard of services.

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[31] CGC, 1936, *Third Report*.

[32] *States (Personal Income Tax Sharing) Amendment Act 1978*

[33] CGC, 2008, T*he Commonwealth Grants Commission – the Last 25 Years*, p. 35.

The significance of the CGC's definition of HFE and its decisions for states' budgets increased dramatically in 2000, with the introduction of the GST and the *Intergovernmental Agreement on the Reform of Commonwealth State Financial Relations (IGA).* The IGA stated that GST revenue would be distributed among the states based on the principle of HFE, which was interpreted as referring to the CGC's definition of HFE.

Significantly, this reform represented a substantial increase in the amount of funds to be distributed by the CGC. The total pool rose by 32 per cent, from $22.9 billion in 1999-2000 to $30.2 billion in 2000-01[34]. In addition, the transition from applying HFE to financial assistance grants to total GST revenue locked in a zero sum game between states.

The CGC's concept of HFE was not adjusted in the course of these reforms.

[34] CGC, 2008, *The Commonwealth Grants Commission – the Last 25 Years*, p. 123.