GST Distribution Review

Submission by the Tasmanian Government in relation to the Issues Paper

October 2011

Tasmania
Explore the possibilities

TABLE OF CONTENTS

EXECUTIVE SUMMARY

KEY POINTS

It is Tasmania's strong view that:

- **The current HFE system is appropriately responsive to changing state circumstances, including the impact of global economic changes;**
- **Continuation of the current HFE system is essential, particularly in the current economic environment;**
- **The current HFE system has neither inhibited economic development in resource rich states, nor, has it acted as a barrier to the mobility of labour and capital;**
- **The current HFE system promotes co-operation between states, including economic reform, rather than being a barrier to such reform; and**
- **An examination of Tasmania's track record demonstrates that despite it being an HFE "recipient": it has a strong record in managing its budget and exercising the requisite fiscal discipline; and, it has been at the forefront of many economic reforms.**

All of these views are clearly and amply demonstrated in this submission.

Overview

Tasmania welcomes the opportunity to contribute to the GST Distribution Review (Review), as it has always been willing to argue the merits of the current principles and practice of Horizontal Fiscal Equalisation (HFE) against other alternatives. Tasmania firmly believes that:

- HFE, as practised in Australia, is the most effective and robust method to achieve equalisation according to the expectations of the Australian community; and
- any genuine deficiencies/methodological issues can and should be addressed within the existing equalisation system.

The principle of HFE is a cornerstone of the success of Australia's society. In this submission, empirical evidence is provided which supports this contention, and Tasmania's view, that the HFE system has served Australia well, particularly in the modern era.

Equalising the fiscal capacity of states[1] is a central element of our Federation. It protects states' autonomy and enables the provision of services to their communities, reflecting the

[1] Reference to "states" includes states and territories.

specific and varied priorities of those communities.

Tasmania strongly believes that the HFE system has:

- responded and adapted appropriately to changing state circumstances;
- facilitated and will continue to support agreement on major reforms (for example tax, health and education); and
- not impeded the mobility of labour or capital in response to the current patchwork Australian economy.

Many of the key questions being contemplated by the Review are the same or similar to questions considered in past reviews of HFE. In Tasmania's view, the answers to these questions continue to confirm the effectiveness of the current HFE system.

Terms of Reference Constraints

The Review Terms of Reference require that GST is to be distributed "consistent with the principle that jurisdictions should have *equal* capacity to provide infrastructure and services to their citizens". Tasmania asserts that this cannot be achieved with anything less than full equalisation (refer to Section 4).

Weighting the Review Principles

In seeking to promote all of the Review principles, it is possible to overburden the equalisation system and expect too much from HFE.

There are inherent trade-offs between the Review principles. As such, care needs to be exercised in weighting and balancing competing principles so as to ensure that the equalisation system is not compromised (refer to Section 5).

Equity

Tasmania strongly believes that equity must be the over-riding principle when examining the form of HFE. This is supported by the Review Terms of Reference which, as stated above, require that states should have *equal* capacity to provide infrastructure and services to their citizens.

Principles relating to efficiency, simplicity and predictability/stability are important aspects of a sound equalisation process. However, a lower weighting to one of them does not result in HFE ceasing to function adequately. By contrast, if the principle of equity is diluted, HFE will fail to achieve its stated aim (refer to Section 6).

Efficiency

Tasmania believes that the current equalisation system is predominately efficiency neutral, and that any "pro-efficiency" strategies should be pursued outside the HFE system.

Criticisms of HFE promoting inefficiency remain theoretical and have not been demonstrated in practice or accurately measured. Additionally, efficiency and performance objectives do not reconcile well with the requirement of the Review Terms of Reference that GST revenue must remain untied.

There is no evidence that fast growing states have actually limited their pursuit of economic development because of the GST redistribution consequences. Similarly, there is no evidence that states which are slow growing or have lower economic development potential are not pursuing economic development because it may reduce their GST share.

By way of example, whilst a relatively disadvantaged state, Tasmania's economic track record clearly shows it has been at the forefront of many economic reforms. Further, Tasmania has a strong record in managing its Budget and making difficult economic decisions. Neither of these facts are consistent with the argument that equalisation effectively "insulates" or "rewards" recipient states for under-performance (refer to Section 7 for specific examples).

In other Australian Government redistribution systems (for example, the welfare system) some reasonable inefficiencies are accepted in the pursuit of equity. The current HFE system has at best marginal inefficiency implications, which should be tolerated so as to ensure that equity prevails.

If it is agreed that stronger efficiency objectives are required in Commonwealth-state federal financial relations, these objectives should be specifically pursued outside of the HFE system. Augmenting the HFE system with a "pro-efficiency" agenda will in all likelihood overburden the system and lead to compromised outcomes. The recent National Health Reform Agreement provides an example of directly targeting mutually agreed efficiency objectives outside the HFE system, via imposing an efficient price for health services, and provides mechanisms to share the benefits of efficiency gains (refer to Section 3).

Simplicity

Simplicity will generally be preferred to complexity, however, there is a limit to which Tasmania is prepared to trade-off simplicity against other principles, such as equity (refer to Section 8).

Given the magnitude and importance of HFE, Tasmania does not believe the CGC methodology to be unnecessarily complex. In fact, the core concepts are straight-forward.

Simplification was a key theme of the *2010 Commonwealth Grants Commission Review of State Revenue Relativities* (2010 Review). The 2010 Review achieved significant improvements in simplifying the HFE system, and given the currency of this process there is little scope to achieve more without compromising the equalisation system and its outcomes.

It is not necessarily the case that further simplification will reduce the level of judgement in the current HFE system and result in greater consensus. Judgement will still be required, but at a higher level of materiality and potentially with more significant consequences.

Predictability and Stability

While all states value predictability and stability, changes in state circumstances will invariably lead to some degree of variability associated with GST revenue distribution, regardless of the form of HFE (refer to Section 9).

The extent of the trade-off between contemporaneity and stability can have a significant impact on state shares of GST revenue. This has been a strong focus of previous HFE reviews and resulted in the CGC recently moving from a five to a three year data averaging process. Tasmania supports the current three year approach.

1. HFE in Context

Australia's equalisation system, its processes and outcomes have been debated on many occasions and at varying levels of intensity over time. More recently, the mining boom and the Global Financial Crisis (GFC), in addition to demographic and other structural changes, have contributed to substantial changes in the distribution of GST revenue among the states[2].

These factors are all beyond the control of State Governments and affect states in very different ways. Tasmania strongly believes that this strengthens, rather than diminishes, the importance of the current equalisation system which fully equalises diverging fiscal capacities and thus mitigates incentives for inefficient migration of labour and capital.

Due to their impact upon relative state GST distributions, these factors have led to increased scrutiny of the current equalisation system. While this is understandable, the examination of the current equalisation system requires careful consideration to avoid any unjustified over-reaction. This is discussed further in Sections 1.1 to 1.3.

Whilst redistribution of GST revenue has been attributed to changes in state relativities, resulting in criticism of HFE, changes to state populations and the GST pool have also materially impacted relative state shares of GST revenues. As an illustrative example, Table 1 shows the extent that changes in these three variables have contributed to the changes in state shares of GST revenue in 2011-12. In all cases, the most significant contribution to changes in states' GST revenue is movements in the GST pool, rather than changes in state relativities or state populations. Further, Appendix 1 shows changes in these variables since 2000.

Table 1: Distribution of the 2010-11 GST and the Illustrative 2011-12 GST

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Estimated 2010-11	14 467.5	10 977.4	8 711.4	3 313.9	4 426.6	1 722.8	868.0	2 462.4	46 950.0
Illustrative 2011-12	15 439.9	11 257.4	9 475.8	3 728.2	4 630.6	1 795.2	894.1	2 778.9	50 000.0
Change	972.4	280.0	764.5	414.3	204.0	72.4	26.0	316.4	3 050.0
Change caused by new:									
Relativities	78.5	-417.1	141.7	164.4	-51.7	-23.8	-28.0	136.0	0.0
Population	-47.9	10.0	44.8	22.4	-26.8	-13.2	-0.5	11.0	0.0
Pool	941.8	686.7	578.0	227.4	282.5	109.5	54.5	169.5	3 050.0
Change ($m)	972.4	280.0	764.5	414.3	204.0	72.4	26.0	316.4	3 050.0

Source: Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities - 2011 Update, Table 3, page 5.*

[2] Reference to "states" includes states and territories.

To place the current HFE system in context, over the past decade around 8 per cent of the total GST pool has been redistributed away from an equal per capita (EPC) outcome (refer to Chart 1 on page 3 of the Review Issues Paper). While this could be considered immaterial at a national level, HFE results in very material outcomes for small states. This is demonstrated in Section 1.3.

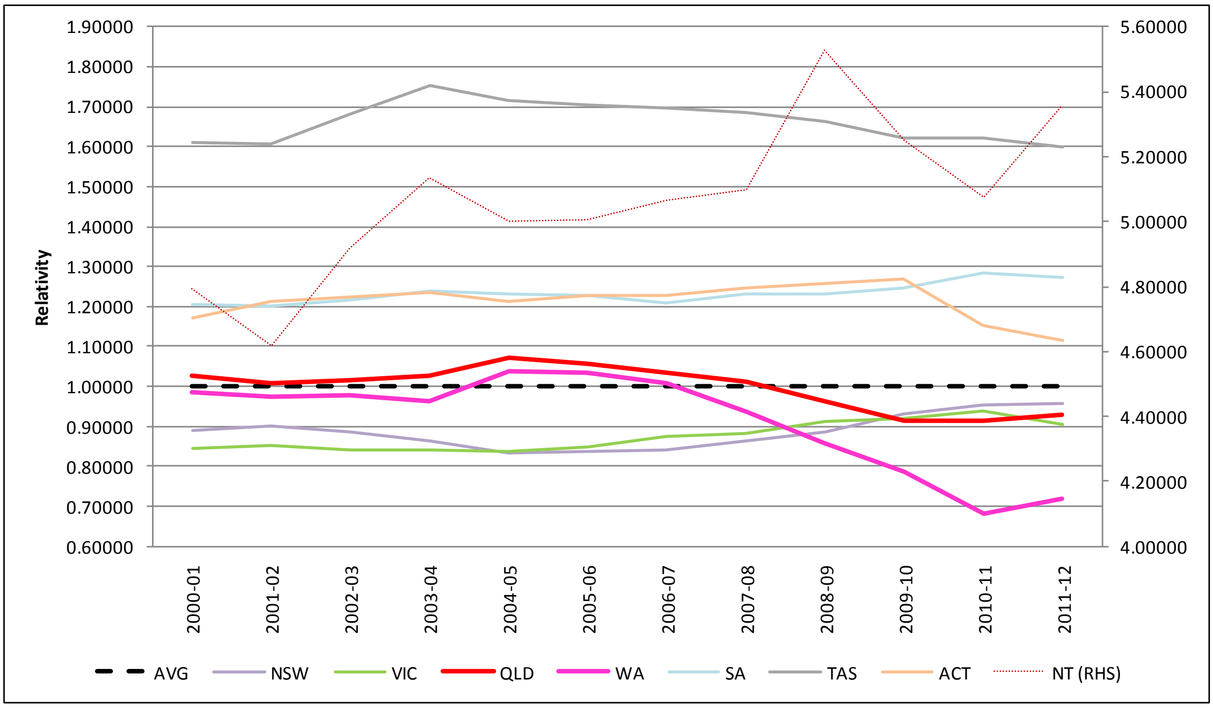
1.1 Relativities Appropriately Reflecting Change in State Circumstances

Tasmania strongly believes that variability in state relativities should not necessarily be of concern or warrant any particular attention. Rather, it is the direct correlation of state relativities to changes in state circumstances which matters.

State relativities will fluctuate over time, and significantly so where relative state economic or demographic circumstances change. This should come as no surprise to states or HFE commentators.

Chart 1 illustrates change in state relativities since 2000. With the possible exception of the ACT, whose relativity reduced as a result of methodology changes in the 2010 Review, the relativities have adjusted to reflect changes in relative fiscal capacity, as they are designed to do.

Chart 1: State Relativities Since 2000



Source: Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities - 2011 Update.*

Structural change in the economy has contributed to increased trend divergence in state relativities as state fiscal capacities diverge. For example, the rise of China has created stronger global demand for Australia's mineral resources.

The value of mining production and associated investment has increased significantly, with investment in the mining sector projected to equal the combined total of investment of all other sectors by 2012. High mineral and other commodity prices have driven Australia's terms of trade to historic record high levels.

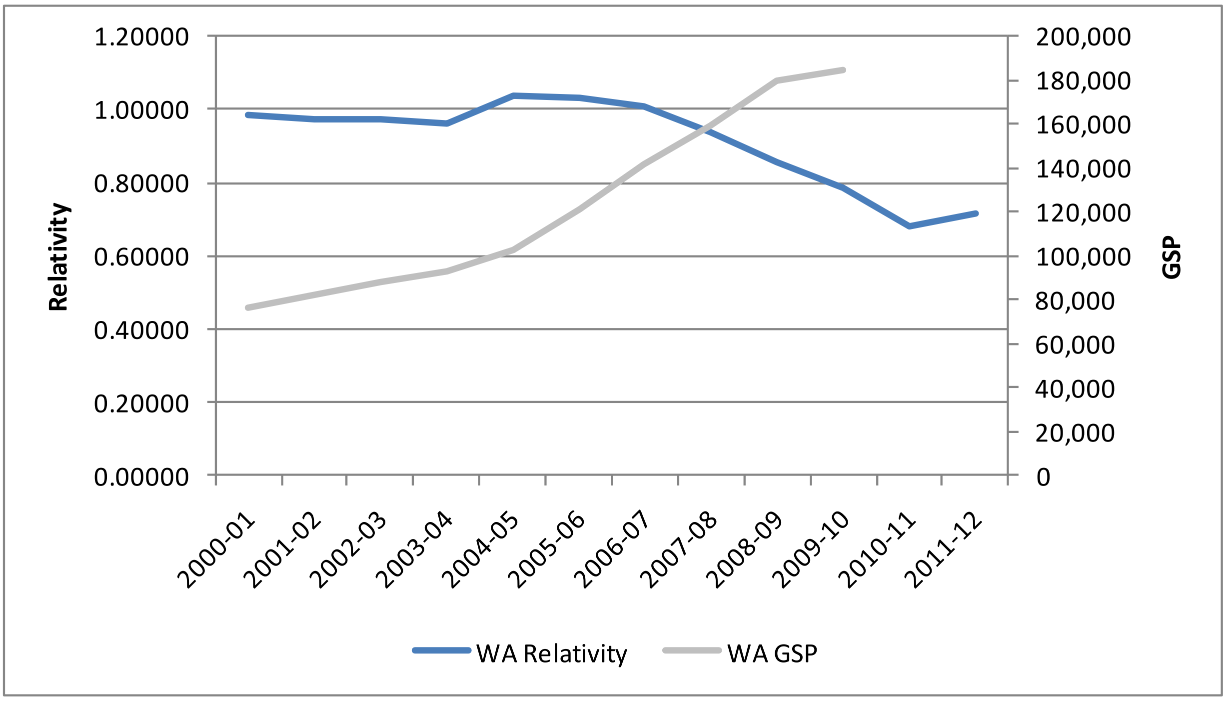
As a result of this mining boom, iron ore exports from Western Australia and black coal exports from Queensland have grown dramatically in recent years. As revenues increase from state mining royalties, GST revenue to those states has, appropriately, decreased reflecting the fact that they have become more self-sufficient.

The decreasing state relativities of Western Australia and Queensland has drawn considerable attention and raised arguments that these resource rich states are bearing an unfair equalisation burden. However, these narrow arguments ignore the fact that in every year since 1978, New South Wales and Victoria have been significant donor states (receiving less than an EPC share of GST revenue). Furthermore, while Western Australia and Queensland are currently donor states, they were recipient states and significant beneficiaries of the HFE system in the mid-2000s.

The experience of Western Australia and Queensland provides evidence that the current equalisation system does not prevent, or necessarily discourage, states from improving their economic and fiscal capacities. Importantly, the equalisation system does respond, albeit with a lag, to the changing relative circumstances of the states. This demonstrates that the equalisation system does, in fact, operate as it was designed to.

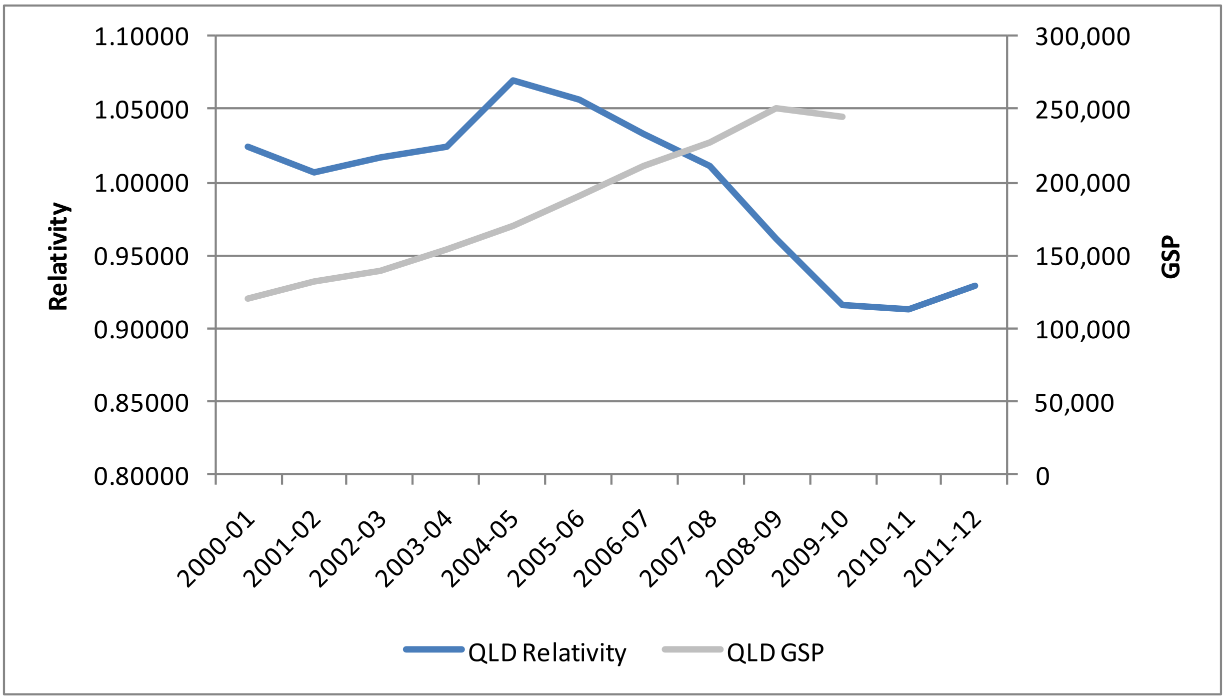
The following charts show change in state relativities and GSP of Western Australia and Queensland, in addition to Tasmania. These charts clearly demonstrate that as state economic circumstances improve, state relativities decline (albeit with a lagged timeframe).

Chart 2: Western Australia State Relativity vs. GSP (2000-01 to 2011-12)



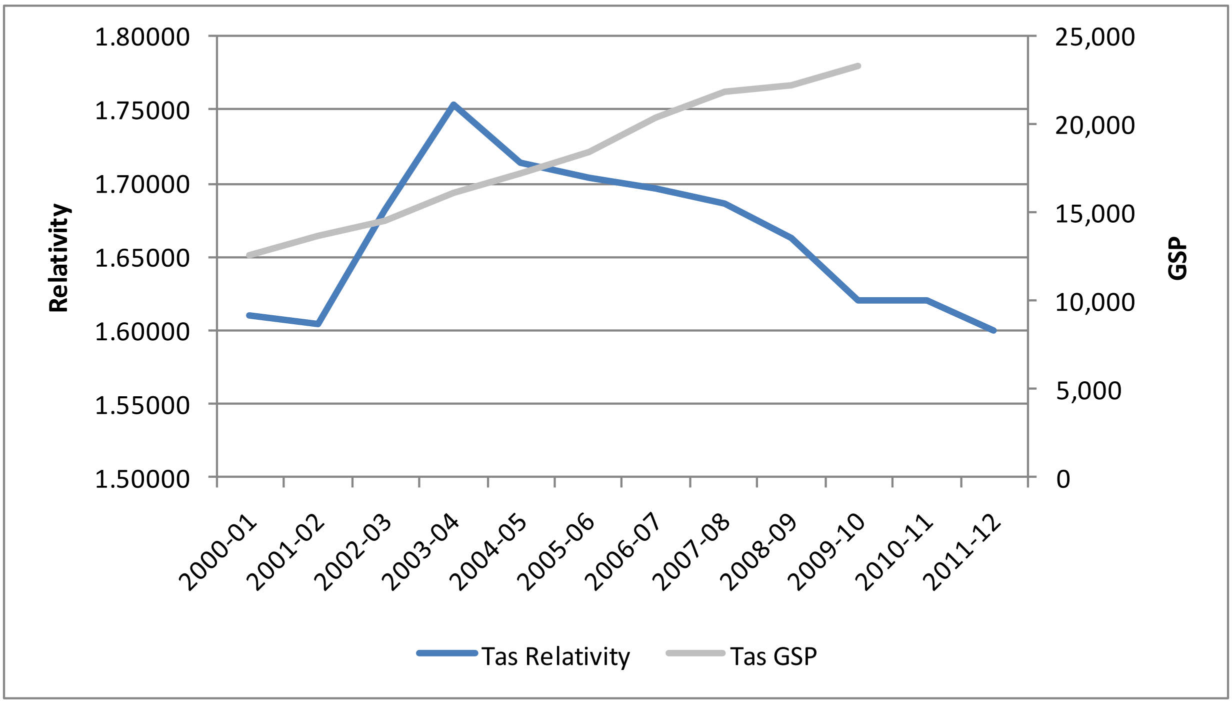
Source: Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities - 2011 Update* and Western Australian Budget Papers.

Chart 3: Queensland State Relativity vs. GSP (2000-01 to 2011-12)



Source: Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities - 2011 Update* and Queensland Budget Papers.

Chart 4: Tasmania State Relativity vs. GSP (2000-01 to 2011-12)



Source: Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities - 2011 Update* and Tasmanian Budget Papers.

In the case of the commodities boom, the large changes in production in the resource rich states (Western Australia and Queensland) were possible because of the relatively high mobility of labour and capital in the Australian Federation. The HFE system has not prevented these changes occurring, but instead supports those states which have not directly benefited from the commodities boom and have suffered a relative decline in fiscal capacity as a result of the broader economic consequences.

For example, Tasmania has a relatively small mining sector, accounting for 2 per cent of GSP compared to the national average of 9.5 per cent. Additionally, the sustained higher exchange rate has created difficult conditions for Tasmania's exporters, as the State relies heavily on international trade and faces strong competition in most of our export and import-competing markets. HFE compensates Tasmania for the impact that these economic conditions have on its revenue raising capacity.

Aside from economic circumstances, specific methodological decisions in the *2010 Commonwealth Grants Commission Review of State Revenue Relativities* (2010 Review) have also contributed to the recent volatility of state relativities. This has raised criticism from some states, particularly in relation to the mining revenue assessment. Such criticism, however, is only a problem where the new methodology is proven to be flawed. Where this is proven to be the case, Tasmania firmly believes that such methodological issues should be resolved within the current equalisation system.

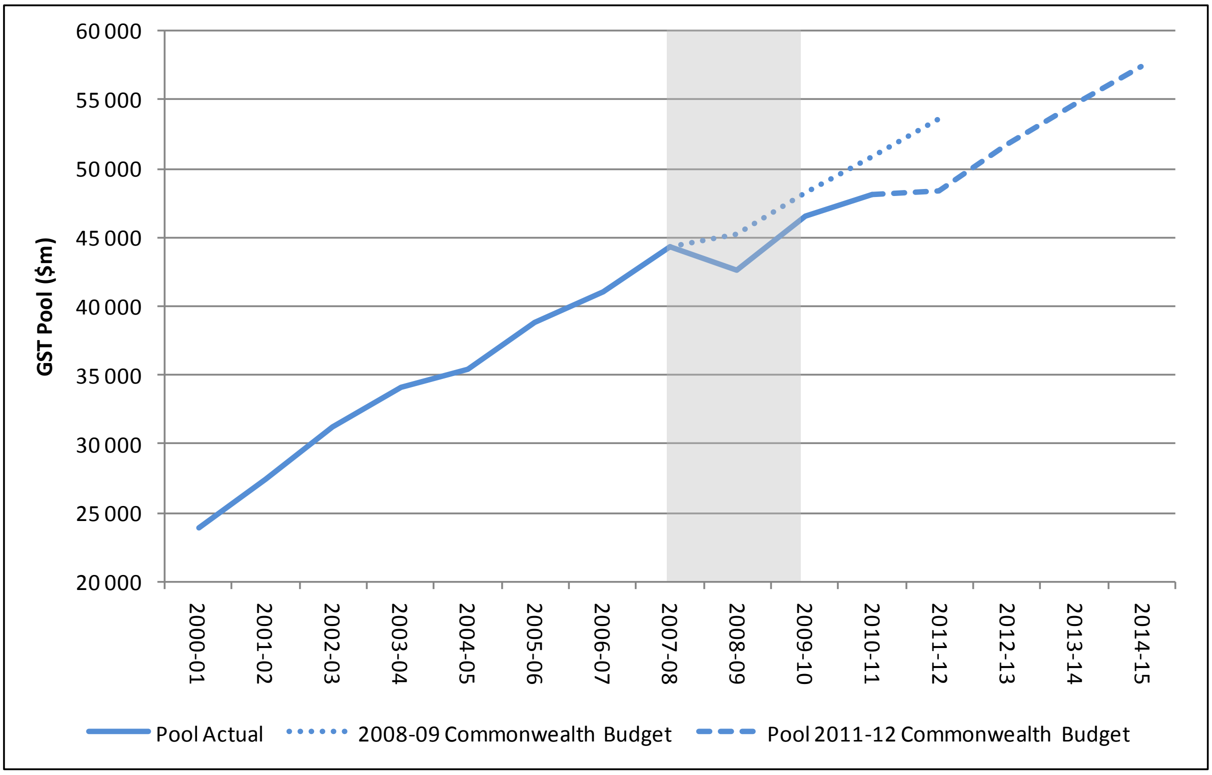
1.2 Growth in the GST Pool – Taking a Long-Term View

Changes in the GST pool have been a significant contributor to overall changes in state GST revenue shares. This is illustrated in Table 1 in relation to 2011-12. Analysis of all years since 1999 would produce the same result.

Prior to the GFC, the annual growth rate of the GST pool was around 9 per cent. Due to its wide-ranging economic implications, the GFC caused a major interruption in the long-term growth profile of the GST pool resulting in a 4 per cent decrease in the size of the pool in 2008-09.

This attracted significant attention, and raised concern among the states with regard to the volatility/predictability of the growth in the GST pool. Nevertheless, as illustrated in Chart 5, growth in the GST pool is forecast to return to a stable long-term growth rate, albeit lower than its pre-GFC level. From 2008-09, annual growth in the GST pool is forecast to be around 5 per cent.

Chart 5: Growth in the GST Pool Since 2000



Source: Various Commonwealth Budget papers.

The major (but hopefully temporary) interruption to the forecast long-term growth profile of the GST pool caused by the GFC should not result in undue attention being given to the current "tried and tested" approach to equalisation. While it is not possible to predict the magnitude or extent of future global economic down-turns, experience has shown that such events typically result in short to medium term volatility, with the GST pool forecast to return to a stable long-term growth profile, albeit at a lower level than previously.

1.3 Disproportionate Impact of HFE upon Smaller States

The HFE system is designed to address the unavoidable disadvantages faced by states compared with the national average.

HFE, however, has a disproportionate financial impact on smaller states. This can be illustrated by considering the impacts on General Government revenues of an extreme example of moving from an HFE to an EPC distribution of GST revenue.

Table 2 demonstrates that if GST revenue were distributed on an EPC basis in 2011-12, instead of under HFE, an extremely negative impact on smaller states' General Government revenue would occur. At the same time, there would be correspondingly smaller positive impacts for the larger states.

This example shows that an EPC distribution would reduce Tasmania's General Government revenues by 14.4 per cent and the Northern Territory's revenues by 46.8 per cent. In contrast, the percentage increase for Western Australia is much less significant at 5.6 per cent and for Victoria, Queensland and New South Wales only 2.4 per cent, or less.

Table 2: 2011-12 GST Distribution Comparison: HFE vs. EPC

	HFE (1)	% Share	EPC (2)	% Share	Difference (1)-(2)	GG Revenue (2011-12) (3)	Diff as a % of Revenue (1)-(2)/(3)	Population (31 Dec 2011) (4)	Per Capita Distribution (1)-(2)/(4)
	$m	%	$m	%	$m	$m	%	m	$
NSW	14 949.8	30.9	15 587.2	32.2	**- 637.4**	60 030.0	**-1.06**	7.36	- 86.60
VIC	10 888.5	22.5	12 008.1	24.8	-1 119.6	47 439.0	-2.36	5.67	- 197.45
QLD	9 138.9	18.9	9 826.7	20.3	**- 687.8**	43 007.0	**-1.60**	4.64	- 148.23
WA	3 598.5	7.4	5 019.2	10.4	-1 420.7	25 233.0	-5.63	2.37	- 599.47
SA	4 492.6	9.3	3 536.8	7.3	955.8	15 727.0	6.08	1.67	572.36
TAS	**1 743.0**	**3.6**	**1 080.1**	**2.2**	**662.9**	**4 618.0**	**14.36**	**0.51**	**1 299.84**
ACT	866.5	1.8	783.6	1.6	82.9	3 982.0	2.08	0.37	224.09
NT	2 672.1	5.5	508.3	1.1	2 163.8	4 622.0	46.82	0.24	9 015.97
TOTAL	48 350.0	100.0	48 350.0	100.0	0.0	204 658.0	na	22.83	na

Sources: Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities - 2011 Update*; 2011-12 Australian Government Budget – Budget Paper No. 3; various 2011-12 Budget Papers and NSW Half Yearly Review 2010-11 Report.

It is acknowledged that this is an extreme example. However, the example clearly illustrates the relative sensitivity to smaller states of any change in the distribution of the GST revenue and the resultant impact that this would have on state service delivery.

To put this sensitivity into a service provision context, if Tasmania were to experience half of this reduction in General Government revenue (i.e. approx $330 million) it would equate to either:

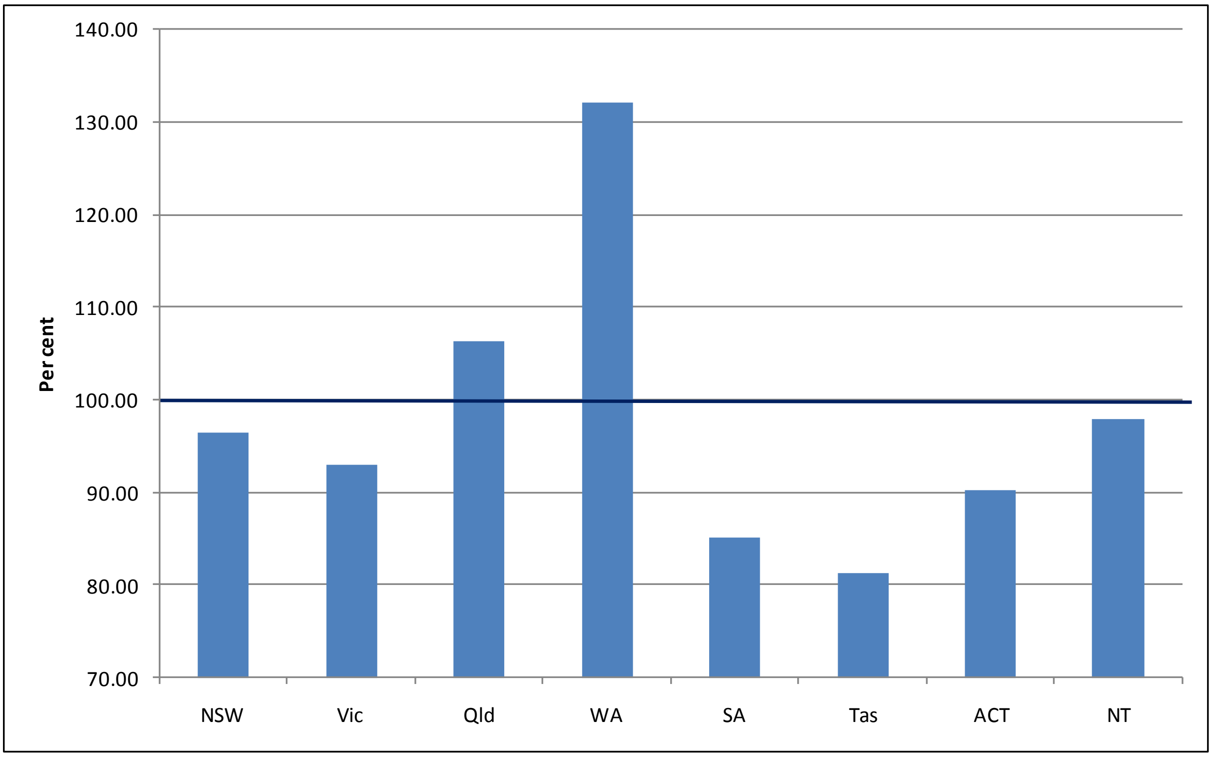
- more than the entire Tasmanian police budget;
- over one quarter of the Tasmanian education budget; or
- over one-third of the Tasmanian hospitals budget.

2. Tasmania's Social and Economic Characteristics

Tasmania has a higher per capita need than most other states and receives approximately one and a half times its population share of GST revenue via the equalisation process. This is due to some of the unavoidable disadvantages that Tasmania faces compared with the national average. Examples of such disadvantages include the following:

(i) Tasmania's lower capacity to raise many types of revenue (both a lower per capita GSP and smaller tax bases). This illustrated in Chart 6.

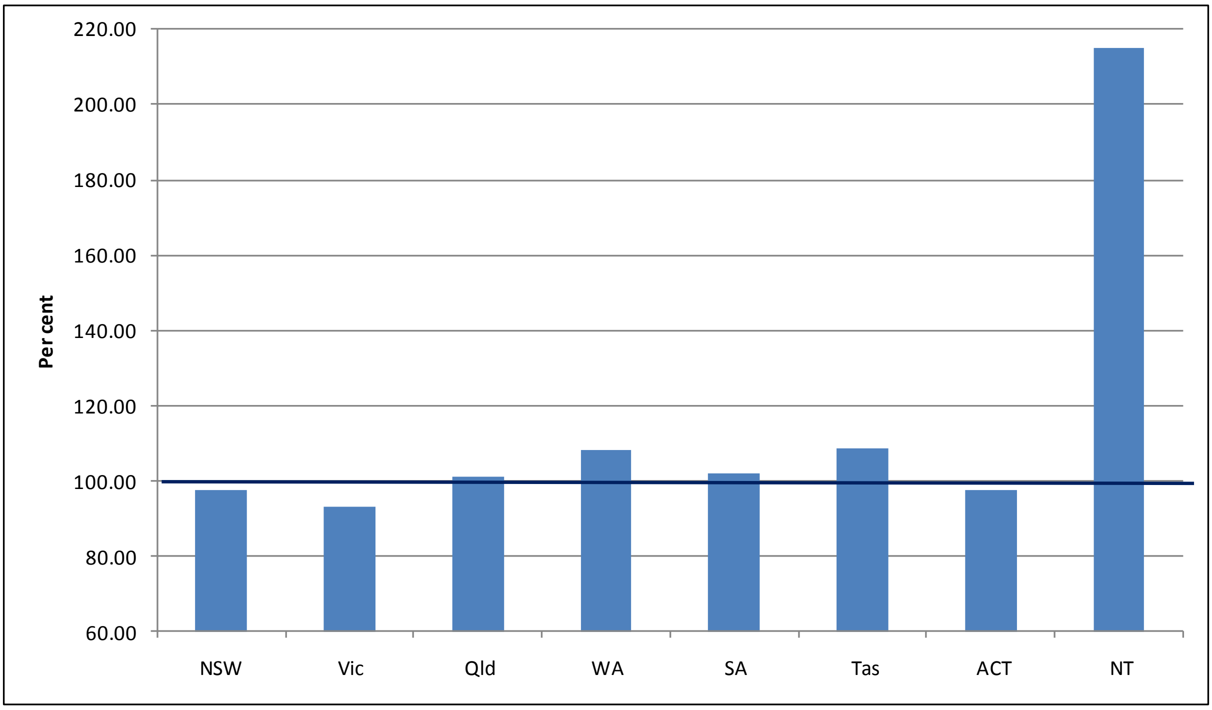
Chart 6: Relative Revenue Raising Capacities of States (2007-08 to 2009-10)



Source: CGC Table S3-1 Assessed Revenue Raising Capacity and Effort Ratio, based on a three year average.

(ii) Tasmania's increased cost of delivering services per person as a result of being a regional island economy with a decentralised population. This is illustrated in Chart 7.

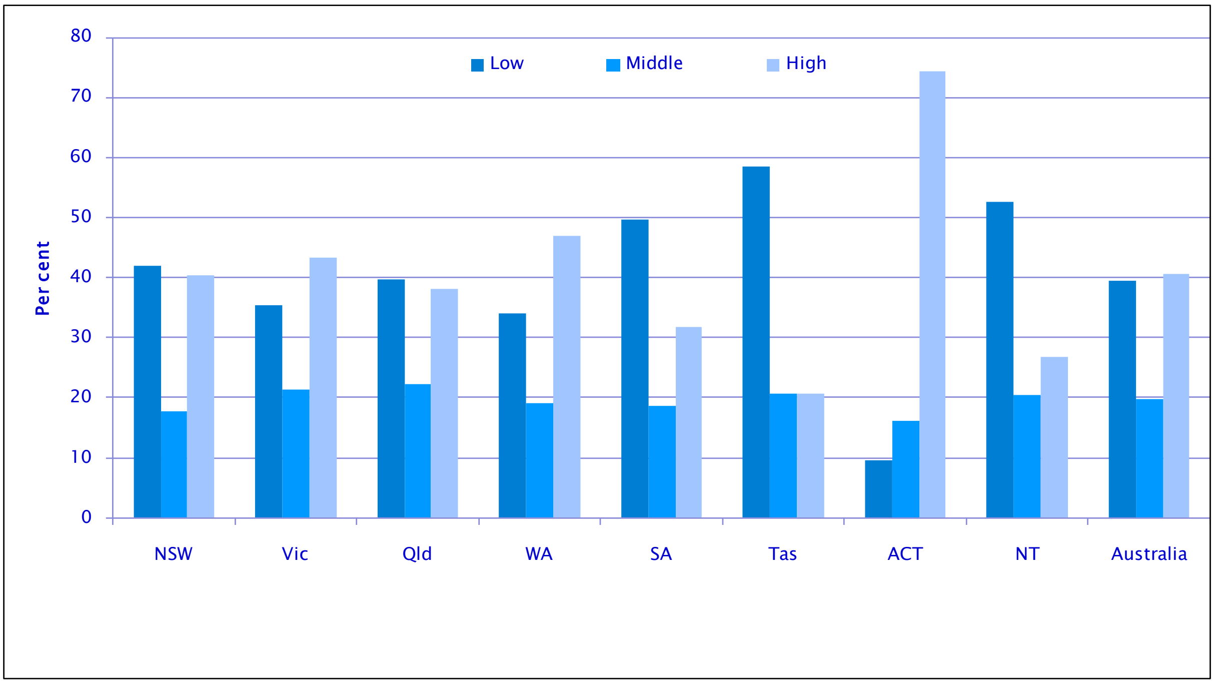
Chart 7: Relative Costs of Services (2007-08 to 2009-10)



Source: CGC Table S3-2 Assessed Cost of Providing Service and Level of Service Ratio, based on a three year average.

(iii) Tasmania has a greater demand for government services due to the socio-demographic composition of Tasmanians (due mainly to an older population and lower socio-economic status). This is illustrated in Chart 8.

Chart 8: Socio-economic Profiles of States



Source: ABS SEIFA index, 2009-10 (Census district data). Extract from the CGC presentation to the Review Panel, 6 May 2011.

Tasmania's revenue raising capacity issues have been exacerbated by historical Australian Government policy decisions. For example, Tasmania is intrinsically resource rich (i.e. it is highly mineralised and possesses major hydro and other renewable resources, which are currently in demand) but the majority of these resources have been locked away through land-use decisions of successive national governments over the past 30 years. This has successively constrained Tasmania's revenue raising capacity and there has been no direct fiscal compensation, as the equalisation process is supposed to provide that compensation.

Despite its disadvantages, Tasmania has experienced economic growth and social improvement over the past decade, most notably from early 2000 to 2008. Chart 4 illustrates a lagged decline in Tasmania's relativity associated with a continual increase in GSP over this period.

From a relative perspective, however, Tasmania still remains well below national averages across a range of social and economic indicators (refer to Appendix 2). Many of these indicators reflect structural or inherent characteristics, which can only be resolved over the longer-term (some specific characteristics may never be overcome).

While critics of HFE are keen to highlight Tasmania's more recent relative economic under-performance, it should be acknowledged that a state's economic performance is a result of a range of factors, of which government policy is only one. As stated above, in more recent times, higher interest rates and a high exchange rate have adversely impacted the Tasmanian economy, which cannot be influenced by State Government policy.

3. The Fiscal Equalisation System and Governance

The objective of HFE, as practised in Australia, is equalising the financial capacity of governments to provide similar services. The definition of HFE, as articulated in the 2010 Review, states that:

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

Decisions on how individual state fiscal capacities are used (what the funds are used for and where they are spent) are made by each State Government.

The HFE system is designed to ensure that GST revenue is distributed between the states as untied grants, in a manner which ensures that, over time, all states have an equal capacity to deliver services for which states are constitutionally responsible to their citizens. The system is therefore driven by the primary objective of equity and by the secondary or consequential objective of avoiding divergent standards of living based on geographic location.

In applying the current principle of HFE, the CGC has adopted "three pillars" of equalisation, being:

- the financial capacities of the states, not their performance or outcomes, are equalised;
- states are equalised to the standard that reflects what they all do on average; and
- a state's own policies or choices should not directly influence its GST grant.

These pillars ensure that the equalisation system is transparent, objective and preserves states' sovereignty.

It has been suggested that the HFE system could become a more active and dynamic policy tool. However, this would fundamentally change the HFE system from equalising state fiscal capacities to equalising states on the basis of the achievement of outcomes. Tasmania does not support such an approach, as it would:

- undermine state sovereignty by reducing State Government's flexibility in delivering services according to their respective communities' preferences;
- result in GST revenue being distributed on a de-facto tied funding basis, rather than on a genuine untied general purpose payment basis. Such an outcome is considered to be contrary to the Review Terms of Reference;
- lead to increased complexity; and

- create greater opportunity for grant seeking behaviour by the states.

It has also been suggested that there could be more government involvement in the governance of the HFE system. Such an approach, where governments determine aims, objectives and definitions of the HFE system, leaving the administrative body (the CGC) to deal strictly with data and mechanical issues, would politicise the GST distribution process and reduce the independence, transparency and integrity of the equalisation system.

Tasmania supports the current governance arrangements underpinning the HFE system. The CGC is the appropriate, independent body, with responsibility for recommending to the Commonwealth Treasurer state GST relativities. The CGC's processes are analytical and data driven. Such processes rely on historical, empirical data on what states do and the circumstances in which they operate.

The CGC is transparent, consults with the states, and discharges its responsibility with the highest integrity and expertise.

Tasmania believes that it is appropriate that the CGC is an Australian Government body rather than a joint state or joint state/Australian Government body. This is because the Australian Government has an interest in securing arrangements that are the best interest of the nation as a whole, and does not have a vested interest in the outcome, in the way that states do.

4. Scope of Fiscal Equalisation

The current form of HFE, based on full equalisation, has not caused states that receive above per capita distributions to become relatively wealthier than states that receive less than per capita distributions[3].

Further, service provision in these states is not significantly better compared to states with below per capita shares[4]. This suggests that the principle of HFE is generally operating soundly. That is, it is not designed to overcome disadvantages; it is only designed to compensate states for disadvantage.

The Review Terms of Reference require full equalisation – i.e. GST is to be distributed "consistent with the principle that jurisdictions should have *equal* capacity to provide infrastructure and services to their citizens". Tasmania asserts that this cannot be achieved with anything less than full equalisation.

---

[3] In 2009-10, GSP per capita in Tasmania was $46,185, significantly lower than GSP per capita in the donor states of Western Australia at $81,159, New South Wales at $56,591, Victoria at $54,793 and Queensland at $54,999.

[4] In the 2011 Update, the CGC assessed level of service provision for total expenses demonstrates that the vast majority of states provide services to the same level.

Tasmania is strongly of the view that full equalisation is essential to achieving the current principle of HFE. Any form of partial equalisation (revenue or expenditure only or parts thereof) or proximate equalisation (less than 100 per cent of an agreed standard) would not result in states being provided with the same capacity to provide services and would result in greater regional disparities.

While the fundamental principle of equalisation remains unchanged, the system has evolved significantly since the 1930s to adapt to changing circumstances and needs over time. The current comprehensive "all states" approach has served Australia well, with significant and regular refinement to the CGC's methodology, as necessary. The refinements have typically been achieved through modifications to the CGC terms of reference at the start of major relativity reviews. This process, which involves consultation between the Commonwealth and the states, ensures the HFE system remains current.

It is acknowledged that some other federations, such as Canada and Germany, equalise revenue raising capacity only. However, such partial equalisation will not result in equitable treatment across Australian jurisdictions. This is because some states have a relatively greater revenue raising disadvantage, others have a relatively greater expenditure disadvantage, and some have both. This is illustrated in Table 3.

Table 3: Causes of Differences in Fiscal Capacity, 2011-12 GST

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Effects on revenue raising capacity									
Mining production	1 325.4	1 845.4	-1 212.6	-2 520.4	379.0	127.0	125.1	- 68.9	3 801.9
Payrolls paid	- 439.9	- 98.9	446.8	- 340.3	271.5	126.7	- 2.2	36.2	881.3
Property sales	179.7	125.8	- 477.7	- 278.7	322.1	116.9	- 10.3	22.1	766.7
Land values	- 39.2	64.8	- 95.5	- 252.7	187.7	77.5	37.3	20.1	387.4
Motor taxes	327.2	- 44.2	- 84.8	- 224.9	8.2	- 6.7	17.2	7.9	360.6
Other effects on revenue	- 132.6	29.8	46.1	19.6	7.1	17.9	4.9	7.2	132.6
TOTAL	1 220.6	1 922.7	-1 377.7	-3 597.4	1 175.6	459.3	172.0	24.6	6 330.5
Effects on expense requirements									
Indigeneity	- 550.9	-1 695.5	526.9	521.0	- 231.1	16.1	- 87.3	1 500.7	2 564.7
Population dispersion	- 548.8	- 805.4	378.8	653.3	160.4	- 88.8	- 199.1	449.6	1 642.1
Interstate wage levels	500.0	- 500.0	- 461.8	508.8	- 128.3	- 97.2	89.2	89.3	1 187.3
Socio-economic status	381.2	10.4	- 272.9	- 525.4	537.8	201.9	- 233.1	- 99.8	1 131.2
Non-State service provision	- 767.1	- 279.3	223.7	564.7	- 67.6	34.8	26.4	264.4	1 114.0
Population growth	- 583.4	46.1	521.3	383.8	- 256.7	- 106.9	- 19.4	15.2	966.4
Diseconomies of scale	- 393.1	- 243.7	- 152.0	48.1	99.4	197.5	205.9	238.0	788.9
Other effects on expenses	- 127.3	- 237.9	238.9	- 30.6	- 70.3	159.6	61.4	6.1	466.1
TOTAL	-2 089.4	-3 705.3	1 002.9	2 123.7	43.6	317.0	- 156.0	2 463.5	9 860.7
Effects on Commonwealth payments									
Commonwealth payments	208.2	615.3	- 345.4	5.7	- 229.0	- 102.7	78.3	- 230.5	907.5
GRAND TOTAL	- 664.4	-1 172.3	- 718.1	-1 464.1	990.2	673.9	94.1	2 260.7	4 018.9

Source: Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities - 2011 Update*.

Additionally, it has been suggested that 75 per cent of the GST pool be distributed on an EPC basis, with the remaining 25 per cent on a disability basis. Such an approach would fail to equalise the fiscal capacities of the states and therefore breaches the principle of equity (in addition to simplicity).

5. Review Principles

Tasmania believes that it is possible to overburden the equalisation system and expect too much from HFE (i.e. where it seeks to promote all of the Review principles). There are inherent trade-offs between the Review principles.

It is possible that in balancing competing principles, the equalisation system becomes compromised and that none of the principles will be properly achieved.

Tasmania believes that it is inappropriate to use HFE to achieve other broader objectives. Equalising states' fiscal capacities is a large and sufficiently complex task without obscuring the process further with additional requirements. Hence it is more appropriate to pursue exogenous efficiency objectives through other mechanisms rather than through the equalisation system (which is focused on equity).

An example of achieving efficiency objectives outside of the HFE system is the recent National Health Reform Agreement where states have effectively agreed to establish an "efficient price" for health services, that allows for regional differences, which underpins Commonwealth funding. This national agreement has been structured to more directly target mutually agreed efficiency objectives and provides mechanisms to share the benefits of efficiency gains.

Additionally, efficiency and performance objectives do not reconcile well with the requirement of the Review Terms of Reference that GST revenue must remain untied. This is discussed further in Section 7.

6. Equity Issues

There is no evidence to support the assertion that the current practice of HFE materially impacts on efficiency. However, there is clear evidence of the importance of HFE to ensuring equity.

Table 2 shows the impact on Tasmania of the extreme example of moving from an HFE to an EPC distribution of GST revenue. Section 1.3 highlighted the specific impact of a significant reduction in GST revenue to Tasmania from a service provision perspective. Any reduction in the GST distribution to Tasmania would be disastrous given its current economic climate.

Equity is at the heart of HFE. Principles relating to efficiency, simplicity and predictability/stability are important aspects of a sound equalisation process. However, any dilution (or lower weighting) of these principles does not result in HFE ceasing to function adequately. By contrast, if the principle of equity is down-graded, the equalisation process will fail to achieve its major aim.

HFE reflects the principle that Australians should have access to a similar standard of service, regardless of the jurisdiction in which they live. This is strong egalitarian principle has been widely held by the Australian community and been reflected in the CGC's approach, in one form or another, since its inception in the 1930s. HFE is not about achieving equity between individuals. Any variations in actual service standards across jurisdictions reflect different preferences between jurisdictions rather than a failure of HFE to deliver equity.

HFE is focused on equalising the fiscal capacities of State Governments so as they are able to provide services to the same level. This does not require that State Governments provide equal services and impose comparable taxes and charges, reflecting the principle of sovereignty of State Governments to deliver services according to the preferences of their citizens. As such, HFE is concerned with inter-state equity rather than equity between individuals or intra-state equity. Different levels of service delivery naturally exist across regions within states, for example between Sydney and Broken Hill, and are widely accepted by the relevant citizens. However, in the absence of HFE, it is likely that such regional variations in State Government service provision would be greater. This is because HFE, in equalising states' service provision capacity, takes into account the cost of providing services to regional populations. If a State Government decided not to meet the preferences of its citizens in such regions it would not be re-elected.

The Issues Paper notes that equalisation provides for states to have the same capacity to deliver services, but it does not specify the standard of those services. There is no inherent reason why states should spend the amount of money allocated by the CGC in relation to a particular category assessment on responding to a particular population characteristic. States typically take a "program" approach to services where individual programs address a range of needs and characteristics, rather than address a single population group or category of need. Further, equity does not require that exactly the same level of service is provided. Rather, it means that services are designed to meet the delivery needs of different sectors of the population. Equity is usually regarded as requiring that a "minimum" rather than the "same" level of service is available to everyone.

The questions raised in the Issues Paper seem to imply, due to the fact that the standard of State Government services are not the same, either across states or within states, that HFE has failed to achieve its objectives. Tasmania considers that differences in service standards across and within states reflect different preferences for services across jurisdictions rather than a failure of HFE.

If there is a view that there ought to be a consistent standard of service across Australia, this objective is best met by other means outside the equalisation system. Section 5 highlights the recent National Health Reform Agreement as an example of targeting mutually agreed efficiency objectives through the establishment of an efficient price for health services outside the current HFE system.

If states are not provided with the relative equal fiscal capacities to provide services, inequality will compound over time, because disadvantaged states will not be provided with enough capacity to compensate for their relative disadvantage and strong states will be provided with greater capacity than required to meet their needs. Had GST revenue been distributed on an EPC rather than an HFE basis Tasmania would have received approximately $6 billion less revenue over the past 11 years and service levels would have been significantly less than they currently are. This would create a divisive Federation with clear winners and losers and promote inefficient migration to relatively advantaged states to the detriment and viability of disadvantaged states. Additionally, governments and societies would face even greater costs in the longer-term to remedy such regional fiscal problems. This includes, but is not limited to, major direct financial transfers to address the effects of prolonged fiscal inequity.

7. Efficiency Issues

Tasmania supports the pursuit of efficiency in government service provision. However, Tasmania firmly believes that efficiency should not be pursued within the HFE system if it detracts from the primacy of achieving equity.

If the HFE system were to be used to promote greater efficiency objectives, it is difficult to perceive how this would be achieved without compromising the Review Terms of Reference commitment to continued equality of access to state services and untied funding. This is because the greater promotion of efficiency objectives within the HFE system would require a move away from equalising states' fiscal capacities according to a national average, which would in turn:

- change the nature of GST revenue from an untied general purpose payment to de-facto tied funding; and
- compromise the ability of State Governments to deliver services to the same standard.

Where there is broad agreement across governments to pursue efficiency objectives, Tasmania considers that such objectives are more appropriately pursued outside the HFE system (refer to Section 7.2).

7.1 Efficiency Criticisms

Various efficiency critiques have been made of the Australian equalisation system, including that HFE: inhibits efficient resource allocation; reduces incentives for governments to pursue economic development; insulates recipient states and creates opportunities for states to engage in grant gaming behaviour.

These criticisms remain highly theoretical and have not been demonstrated in practice. Further, the associated modelling of such claimed efficiency impacts is problematic and inconclusive. Quantifying efficiency impacts of the current HFE system is problematic as it relies on estimation within a counter factual context without direct empirical data. In this context, empirical modelling cannot conclusively demonstrate the effect of HFE on policy choices while the simplifying assumptions that necessarily accompany such modelling leave the findings vulnerable to criticism.

While the empirical modelling undertaken to date has found that equalisation reduces national welfare, a common feature of all these studies is that the negative efficiency costs of HFE are very small, if not negligible (some fraction of a percentage point of GDP). In addition some studies have criticised such modelling as being flawed. For example:

- research commissioned for the Garnaut-Fitzgerald Review of 2002 demonstrated that any theoretical efficiency losses arising from the application of HFE were minimal. The research found that welfare gains from moving to a per capita distribution were between $150 million and $250 million a year. This is insignificant compared to Australian GDP of around $1 283 billion a year. The Garnaut-Fitzgerald finding is at the upper bound of the range of findings by other researchers using similar models in the same/similar time period;

- Dixon, Picton and Rimmer in their 2002 study found welfare changes relative to GDP ranging from $75 million per annum to $169 million per annum (0.006 per cent to 0.013 per cent of GDP); and

- in exploratory work undertaken for the CGC in 1990, the Institute of Applied Economic and Social Research (IAESR) in conjunction with the Tasmanian Centre for Regional and Economic Analysis (CREA)[5] noted that in academic discussions of the economic efficiency implications of HFE aspects of proposed policy changes and resource utilisation effects are often ignored, which compromise the conclusions.

7.1.1 Efficient Resource Allocation

Critics of HFE claim that equalisation:

- creates a system whereby individuals do not face the true cost of State Government services, and as such reduces their incentives to relocate to other states where their productivity is higher, resulting in lost output for the nation;

- leads to public sectors of lower capacity states being comparatively larger because the residents of those states demand a larger quantum of government services than would be the case if such services were fully costed; and

- uses resources in managing the equalisation system that could have been more productively employed elsewhere.

Tasmania firmly believes that HFE ensures that location decisions are independent of the fiscal effects that arise from variations in regional physical endowments. Mobile workers will follow economic fortune and HFE automatically adjusts for this.

By way of example, in the absence of HFE, due to the geographical location of Australia's useable national mineral resources, which are currently in world demand, resource rich states would grow rich and the remaining states poor. This would result in greater regional disparities, inefficient migration of labour and as such the demise of the remaining states and the Federation.

Contrary to public assertion, under HFE, wealth is not being taken away from resource rich states' residents. The equalisation system is only redistributing national GST collections so

---

[5] IAER/CREA, *Simulators of the Economic Effects of Changing the Distribution of General Revenue Assistance*, Peter B. Dixon, Matthew W. Peter and John R. Madden, September 1990.

that essential State Government services can be provided to existing residents in recipient states (i.e. reflecting the fact that resource rich states through the fortunate abundance of natural resources within state boundaries are able to raise a disproportionate amount of own source revenue and are more self sufficient). The welfare centric nature of the current HFE system is analogous to a pensioner who wins the lottery and, as a result forfeits pension entitlements and has to pay tax[6].

It has been suggested that HFE acts as a disincentive to tax reform. HFE ensures that states have the capacity to deliver an average level of service, on the assumption of an average level of revenue raising effort. If there is a change in the tax mix from a tax in which a state has a relative revenue raising advantage to one in which it has a relative disadvantage, HFE ensures that states receive sufficient funding in order to provide an average standard of services. In this way, HFE actually supports tax reform by removing this disincentive for change. In any event, in considering tax reform, states are concerned with broader economic issues, rather than direct fiscal consequences. If this were not the case, no state would ever provide tax relief. In Tasmania's case, the Government has never considered the HFE consequences of a tax change as part of its decision making process.

It should be noted that HFE does not equalise the costs of non-government goods and services. Such costs would have an equal if not greater effect on an individual's decision about where to live and work than the standard of State Government services. As a result, any HFE effects on the incentives of people to locate to their most productive areas are much less than implied by HFE critics.

7.1.2 Economic Development

Critics of HFE claim that equalisation reduces incentive for states to promote economic growth or improve the efficiency of service delivery because the benefits of such actions will be equalised away.

There is no evidence that fast growing states have actually limited their economic development activities because of the GST redistributional consequences. By way of example, refer to Section 1.1 which illustrates how Western Australia and Queensland moved from recipient to donor states from the mid-2000s which in large part is explained by the pursuit of economic development associated with the mining boom.

Similarly there is no evidence that states which are slow growing or have lower economic development potential are not pursuing economic development because it may reduce their GST share. It has been suggested that Tasmania's above average share of GST revenue has made it easy for it to accede to pressure from environmental groups rather than to confront difficult economic development decisions. However, this presents a simplistic view of events. In addition to rich natural resources, Tasmania is also fortunate to have a unique and valuable natural environment, which is highly valued as an Australian, not just a Tasmanian asset. As a result, in a number of instances, Tasmania has had its economic development capacity restricted through land use decisions that have reflected national,

[6] Saul Eslake, "Australia's Tax Reform Challenge", Australian Parliamentary Library Lecture, Parliament House, Canberra, 21 September 2011.

rather than simply, Tasmanian preferences. Examples of this include:

- the recent and prior[7] Forestry Intergovernmental Agreement with the Commonwealth;
- the failed Wesley Vale Pulp Mill in the 1980s (where the Commonwealth did not issue environmental approval); and
- the introduction by the Commonwealth of the *World Heritage Properties Conservation Act 1983* (which gave the Commonwealth constitutional power to halt the Gordon Below Franklin Dam).

Limited, or no direct compensation, was received by Tasmania for such permanent economic development constraints, however, Tasmania's reduced revenue raising capacity is indirectly compensated through the HFE system.

It is noted that Western Australia has publicly argued that the CGC's asymmetrical approach to economic development expenditure (in particular the provision of infrastructure which underpins the generation of mining royalties) is a disincentive to the pursuit of economic growth. It is arguable whether the provision of infrastructure to support economic development is a private or public responsibility. The validity of the CGC recognising economic development expenses within its methodology has been debated in previous reviews. The CGC has concluded that economic development expenditure reflects a policy choice of governments and has decided not to include an assessment. On a practical level, it is difficult to see how such an assessment could be undertaken given the different reasons put forward for undertaking economic development. For example, while Western Australia argues that its abundance of natural resources requires it to incur costs to support their exploitation, Tasmania would argue that the absence of natural resources that it can exploit requires it to undertake expenditure to develop other opportunities.

It is noted that currently General Government infrastructure needs associated with economic development and population growth are reflected in the CGC assessments (for example via the roads, schools, health and other General Government infrastructure development requirements). Broader infrastructure requirements (for example, ports and electricity supply for new mining ventures), tend to operate on a commercial, user-pays basis, and as such, are not assessed under the HFE system.

7.1.3 HFE "Insulating" Recipient States

Critics of HFE claim that equalisation effectively "insulates" recipient states and avoids the need to make difficult economic and budgetary decisions.

Practical experience does not show this to be the case. For example, Tasmania as a recipient state has a strong record in managing its Budget. During the 1990s and early 2000s, successive governments exercised high degrees of fiscal discipline to achieve a sustainable Budget and reduce high levels of net debt. During 2004-05, Tasmania was one of the first states to be General Government Sector Net Debt free.

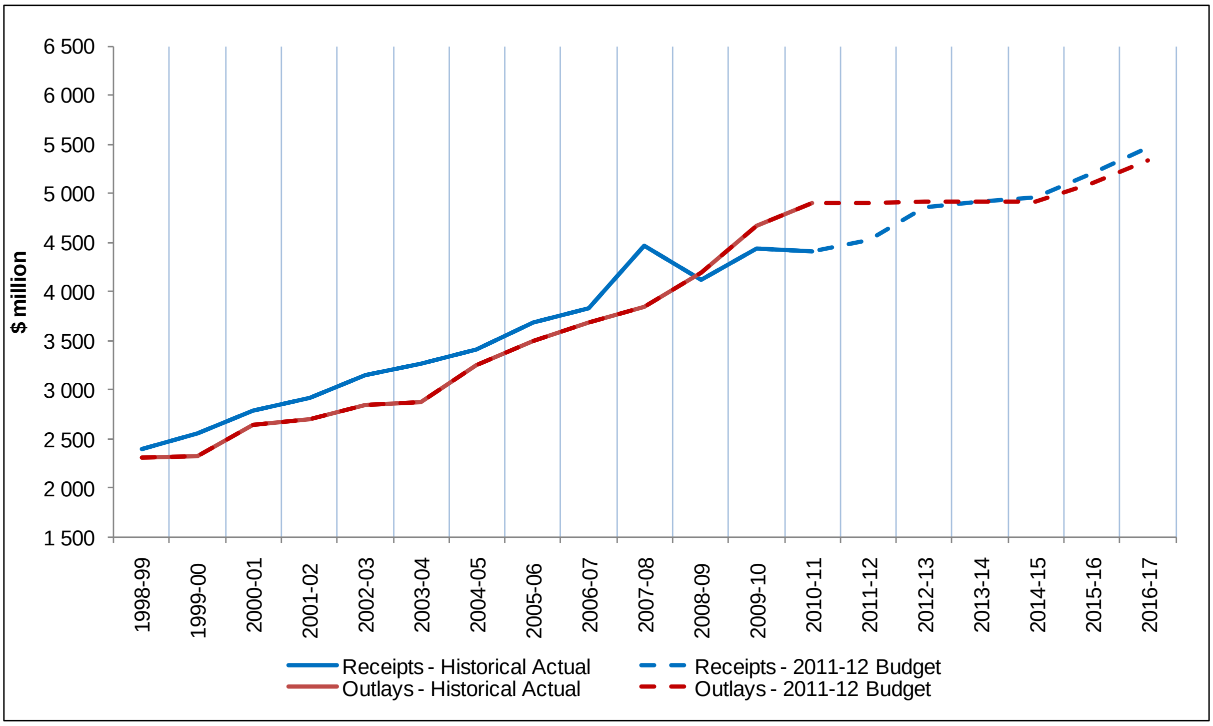
---

[7] For example, the Helsham Inquiry.

Now faced with the prospect of budget deficits, the State Government has demonstrated that it is again prepared to make tough decisions, rather than let the level of debt escalate unsustainably. The strategies contained in the recent 2011-12 Budget will guide the return of the Budget to a long-term sustainable position and Tasmania's General Government Sector is expected to remain Net Debt free.

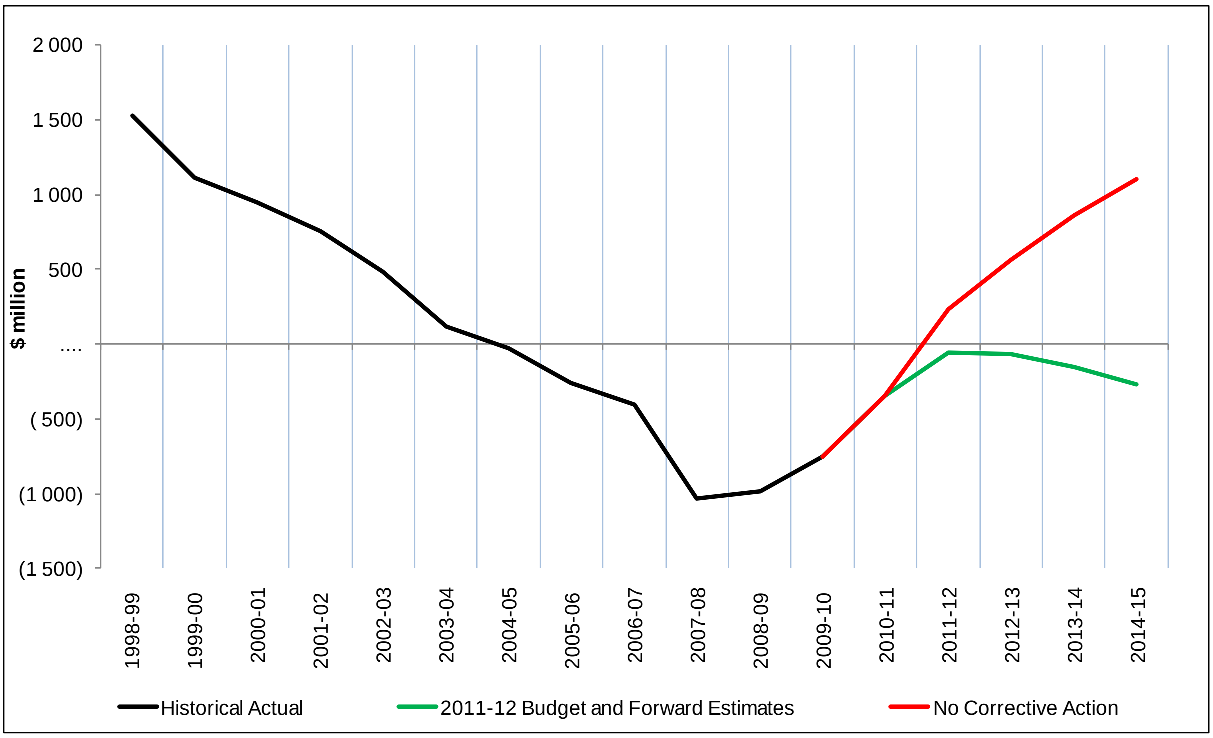
Charts 9 and 10 below clearly illustrate that Tasmania, faced with a major downturn in revenue growth (both GST and own source revenue) following the GFC, is addressing its fiscal challenges by putting in place the requisite Budget management strategies.

CHART 9 – Tasmania Receipts and Outlays
Achievement of Budget Savings Strategies



Source: Tasmanian Department of Treasury and Finance.

CHART 10– Tasmanian Net Debt



Source: Tasmanian Department of Treasury and Finance.

HFE actually incentivises State Governments, regardless of size, to pursue innovation in terms of economic growth and development in that HFE acts as a safety net where innovation fails to achieve its aim.

An examination of Tasmania's track record demonstrates that it has been at the forefront of economic reform, despite fiscal equalisation being of central importance. Examples of such reforms include the following:

- *National Competition Policy* (NCP): from 1997 to 2005, Tasmania was assessed by the Australian Government as fully complying with its NCP obligations and was one of only two jurisdictions within Australia to receive all NCP-related payments over this period.

- *Shop trading hours*: in 2002, Tasmania removed most of its restrictions on shop trading hours, making it one of the most liberalised jurisdictions in this regard.

- *Taxi industry*: in 2003, Tasmania amended the *Taxi and Luxury Hire Car Industry Act 1995* to require the annual release of new taxi licences in all taxi areas. Tasmania's model is regarded as the most pro-competitive in Australia.

- *Water and sewerage sector*: in 2009, Tasmania introduced structural and pricing reform to its water and sewerage sector. An independent pricing model will be fully implemented in Tasmania by 1 July 2012, which will adhere to the National Water Initiative pricing principles. Tasmania's efforts have been recognised by the Productivity Commission, in its report, "Australia's Urban Water Sector" (volume one), 31 August 2011, as a leading jurisdiction in urban water reform.

- *National Reform Agenda (NRA)*: to date, Tasmania has continued to meet its obligations under the NRA and has implemented some reforms earlier than other states, including business names and consumer credit. Further, Tasmania was one of the first states to commit to the development of harmonised payroll tax arrangements.

- *Regulatory reform*: Tasmania introduced the *Subordinate Legislation Act 1992* to ensure that only effective, efficient and necessary subordinate legislation is made.

- *Abolition of 1999 IGA taxes*: Tasmania is one of the first jurisdictions to abolish the 1999 IGA state taxes. By 2008, Tasmania had abolished all its IGA state taxes ahead of all other Australian jurisdictions, with the exception of Victoria. This is illustrated in Table 4.

TABLE 4 – State Taxes Agreed To Be Abolished Under The IGA

State Tax/Duty	IGA cease date	VIC	TAS	ACT	NT	SA	NSW	WA	QLD
Accommodation tax	1/07/2000				2000		2000		
Financial institutions duty	1/07/2001	2001	**2001**	2001	2001	2001	2001	2001	
Stamp duty on marketable securities	1/07/2001	2001	**2001**	2001	2001	2001	2001	2001	2001
Debits tax	1/07/2005	2005	**2005**	2005	2005	2005	2002	2005	2005
Stamp duty on:									
non-real non-residential conveyances	1/07/2013		**2008**	2006	2012	2012	2012	2013	2013
non-quotable marketable securities	1/07/2013	2002	**2002**	2010	2006	1905	1905	2004	2007
leases	1/07/2013	2001	**2002**	2009	2006	2004	2008	2004	2006
mortgages and other loan securities	1/07/2013	2004	**2007**			2009	1905	2008	2009
credit arrangements and instalment purchase arrangements	1/07/2013		**2005**						2004
rental arrangements	1/07/2013	2007	**2002**	2007	2007	2009	2007	2007	2007
cheques, bills of exchange and promissory notes	1/07/2013				2005	2004		2004	

Sources: *Commonwealth Budget Paper No.3 2007–08,* Appendix E: Timetable for the abolition of State taxes
NSW Treasury, Interstate Comparison of Taxes 2010–11

Abolished | Never imposed | Partially abolished | Yet to be abolished

Experience with implementing NCP reforms and IGA tax reforms suggest that there is no relationship between willingness to undertake economic reform and HFE. As indicated Tasmania, a "recipient" state, was one of two jurisdictions to receive all of its NCP payments, the other being Victoria which is a "donor" state. In relation to tax reform, three of the five jurisdictions yet to complete their IGA obligations are "donor" states while two of the three states to have fully met their obligations are "recipient" states.

Table 5 shows that the states have broadly similar credit ratings and therefore broadly similar characteristics. This suggests that there is no relationship between whether a state is a "donor" or a "recipient" and its level of fiscal responsibility.

TABLE 5 –Comparison of State Credit Ratings

State/Territory	Moody's	Standard & Poors
New South Wales	Aaa	AAA
Victoria	Aaa	AAA
Queensland	Aa1	AA+
Western Australia	Aaa	AAA
South Australia	Aaa	AAA
Tasmania	**Aaa**	**AA+**
Australian Capital Territory	n.a.	AAA
Northern Territory	Aa1	n.a.

Source: Tasmanian Department of Treasury and Finance.

It is simply untrue that the current equalisation process rewards states for under-performance in service delivery and penalises them for investing in economic growth. The current practice of equalisation is efficiency neutral because the assessment benchmark is the national average efficiency of all states. A state's share of GST revenue provides it with the capacity to provide services to the national average level of service provision. If a state can deliver services more efficiently; at a cost below the national average, then it retains the benefit of that saving. The converse is also true.

7.1.4 Grant Design

Critics of HFE claim that equalisation incentivises grant-seeking behaviour by states, such that their policies are designed to maximise GST receipts potentially at the expense of efficient/effective service delivery.

Debate in this area tends to focus on claims and counter claims based on complicated or obscure scenarios, many of which are not supported by real world examples or empirical data.

The CGC structures its equalisation approach to maintain policy neutrality (based on the average of what states do) and avoid the possibility of states "gaming" their grant outcomes. As such a state's capacity to influence the national average spending or taxing level is limited to its contribution to the national average.

As part of the GST Review process, the CGC has prepared a number of presentations for the Review Secretariat in relation to HFE and responded to specific queries and scenarios raised by the Secretariat. This material is publicly available on the CGC's website. The CGC's analysis illustrates in extreme circumstances it is theoretically possible for grant gaming to occur. In reality, State Governments typically do not make policy decisions based on anticipated GST impacts. State Governments are more concerned with direct budgetary impacts than the delayed, uncertain and indirect GST implications. The reasons for this include:

- the uncertain outcome of one state's actions compared to similar or contradicting actions of other states; and

- the lagged GST impact associated with data averaging being considerably longer than the political timeframe of a given government.

As a topical example, the mining revenue assessment is argued to illustrate specific economic growth disincentives inherent within the current equalisation approach, where two states have dominant positions with respect to total revenue collections. Analysis undertaken by the CGC (in response to specific Review Secretariat queries) clearly illustrates that there continues to be financial incentive for such states to pursue mining economic development regardless of the GST redistributive effects. Even where this incentive becomes more marginalised, practical evidence shows that these states continue to pursue such economic development.

If such issues are proven and considered problematic, Tasmania strongly believes that such methodological shortcomings should be addressed within the current equalisation system rather than devising a new system, which would no doubt have its own issues and short-comings given the complexity of the equalisation task.

7.2 What States Do

The “what states do” benchmark, based on the national average of state governments’ actual revenues and expenditures, weights the standard services and tax bases of State Governments’ and provides an objective, policy-neutral, easy-to-measure, and broadly accepted benchmark.

Critics of the current HFE system have argued that equalisation should be based on an agreed efficiency standard or benchmark. This would effectively change the HFE system from equalising fiscal capacity to equalising the performance of states. There is a significant degree of ambiguity surrounding what, if and how this could be measured.

Selecting benchmarks to use as performance standards would require subjective judgements based on the concept of “what states *should* do” instead of currently “what states *actually* do”.

Any efficiency standard which is developed would need to take some account of the different service delivery characteristics of states in order to be fair. For example, in developing the efficient price for public hospital services, under the recent National Health Reform, allowances will be made for jurisdictional differences, such as scale, remoteness, etc. This results in circularity as the purpose of the CGC’s assessments is to determine a states’ expenditure needs given its specific service delivery characteristics, relative to a standard which in turn takes into account its specific service delivery characteristics.

An efficiency standard is not consistent with the Review Terms of Reference commitment to untied funding.

Attempting to incorporate efficiency standards or benchmarks into the current HFE system may overburden the system resulting in it failing to achieve any of its aims (refer to Section 5). If it is agreed that greater efficiency incentives are required, Tasmania strongly believes that these should be pursued outside the HFE system. These objectives could be pursued through:

- separate, but complementary COAG processes focused on efficiency, performance, accountability and state service provision (for example, National Health Reform and My

Schools reforms); and

- the broader national taxation and welfare system (for example, via the current review of the national tax system).

Properly structured these mechanisms should incentivise individuals, households and businesses to locate to their highest valued usages/areas of comparative advantage.

7.3 Other Issues

It has been argued that state disabilities should reduce over time through the application of policies. The fact that they are not is argued to imply that the equalisation process is not providing appropriate incentives. It is important to distinguish between:

- *cost disabilities* – key drivers that affect unit costs of services; and

- *use disabilities* – key drivers that affect use of services.

While it may be possible for State Governments to control certain aspects of cost disabilities, this is not the case for use disabilities. Moreover, some disabilities are fixed, such as geographical features. The current equalisation process provides states with GST revenue to deliver services to the national average *despite* their disabilities, not to *overcome* their disabilities. For states to overcome their disabilities (where this is possible) this would require significant additional funding that goes beyond simply equalising state capacities.

8. Simplicity Issues

8.1 General Observations

Simplicity will generally be preferred to complexity but there is a limit to which Tasmania is prepared to trade-off simplicity against other key principles (such as equity).

Tasmania has supported the simplification of the CGC's methodology to ensure a robust and sustainable equalisation system, at times, to the financial detriment of the State. The 2010 Review reduced the number of CGC assessment categories from 29 to 13, recognised fewer influences on costs and use of services (reducing the number of disabilities from 344 to 93), and placed greater reliance on nationally based and independently sourced data. The averaging period was also reduced from five to three years.

Tasmania believes that the 2010 Review achieved significant improvements in simplifying the HFE system. Given the currency of this process there is limited scope to achieve more without compromising the equalisation system and its outcomes.

More generally, Tasmania observes that:

- simplification will not necessarily result in greater acceptance of the equalisation outcome to the extent that stakeholders believe that a simpler assessment fails to capture all the appropriate impacts. It simply changes the focus of debate amongst stakeholders;

- trying to include exogenous efficiency objectives in HFE is also likely to add to complexity and therefore compromises the principle of simplicity; and

- simplicity will not necessarily lead to greater stability.

8.2 Necessary Complexity

The distribution of the GST revenue will by its very nature invariably involve certain levels of complexity. However, the core concepts of the CGC methodology are straight-forward. Importantly, the CGC's methodology must be complex enough to adequately reflect states' needs. It is useful to compare the HFE system with the income tax system, which directly affects individuals but relatively few understand the mechanical and technical complexity, as opposed to the overall aim of the system.

Given the magnitude and the importance of equalisation, Tasmania does not believe the CGC methodologies to be unnecessarily complex, particularly given the importance of HFE to state budgets. As demonstrated in section 1.3, while HFE only redistributes a small proportion of the GST pool, it has very significant financial impacts for state budgets.

Simplicity should not be an end in itself. Just because something may have associated complexity does not necessarily mean that it is not transparent. The CGC is highly transparent, all methodological review and annual update materials are in the public domain.

Most importantly, simplification should not be pursued to the detriment of the achievement of equity. That is, the CGC's assessments should not be over-simplified to the extent that they are no longer credible because they fail to capture the main drivers of material interstate variations in expenditure needs or revenue raising capacity.

8.3 CGC Process

The CGC is committed to ensuring that data used for its assessments are fit for purpose and of sufficient quality. Wherever possible, the CGC uses ABS data (as opposed to state provided data) as a means of ensuring comparability.

The 2010 Review introduced strict data reliability and materiality guidelines (as set out in Attachment A of the 2010 Review Report). These guidelines are aimed at ensuring that the CGC assessments allow only for those factors which have a material effect on the GST distribution and which are measured using conceptually rigorous methods and quality data fit for the purpose. The guidelines led to considerable simplification by reducing the detail in the assessments. They also provided greater confidence in the outcomes, as the assessments were more reliable[8].

---

[8] For example the CGC, in the 2010 Review, made significant methodological changes to way in which indigeneity and cultural and linguistic diversity is reflected in the various assessments.

Tasmania has consistently held the CGC in high regard and continues to do so. It considers the CGC has the necessary expertise for applying judgement within the equalisation process. The CGC is conservative in its use of judgement and does so with transparency. This provides a "reasonableness" test by ensuring that equalisation outcomes, which are based on the best available data and financial modelling, also take into account intuitive expectations in a consultative manner.

It is acknowledged, however, that maintaining recent simplification gains made with respect to the CGC's methodology will continue to be a challenge. This is because there are incentives in the HFE system to increase complexity as states seek to differentiate themselves, which invariably leads to arguments for more detailed assessments.

8.4 Simplicity Criticisms

There has been a strong focus on the likelihood that simplification will reduce the level of judgement (by the CGC) and result in greater consensus. Tasmania challenges this view, as judgement will still be required under a simplified system, but at a higher level and potentially with more material financial impacts.

Proponents of further simplification also point to data quality/availability being improved if the CGC's methodology is simplified. This is not necessarily the case. Data quality is a complex issue and dependent upon many factors. A simplified assessment may require data which does not exist or is of lower quality.

8.5 Proposals to Address Simplicity Issues

An example of extreme simplification on the revenue side is to have one global revenue assessment which is an indicator of the aggregate revenue base for each state. This could be based on state GSP or state household income. However, as states do not actually tax GSP or household income, the result of such an approach would depart from an equalisation outcome. Contrastingly, the link of the revenue assessments to state budgets is most readily achieved by a tax-by-tax approach according to the principle of "what states do". Arguments in favour of a tax-by-tax approach include:

- it focuses on measuring the capacity of the states to raise revenue from the taxes they impose and takes account of the practical constraints they face in doing so;
- states have limited access to tax bases due to constitutional constraints and in some areas face interstate competition with tax rates and bases; and
- it reflects interstate differences in industry size and structure (such as the percentage of highly profitable mining activity in some states), income distribution, wealth or the extent to which non-residents pay state taxes (all factors which affect state capacities to raise revenue).

Other simplification suggestions include removing outlier assessments (i.e. those that do not have a common base across all jurisdictions, such as mining royalties and indigeneity), and dealing with these outside the CGC assessment process.

Tasmania firmly believes that redistribution of mining revenue is a core component of HFE. It is widely acknowledged that mineral wealth is a national asset, but with a very uneven geographic distribution. As such, the mining revenue assessment is a critical component of HFE and its materiality only strengthens the argument for its inclusion.

In relation to the suggestion that indigenous influences be removed from the HFE system and addressed separately, it is not clear to Tasmania how this would actually result in greater simplification. This is because indigenous influences would still need to be assessed to determine the amount to be netted off the GST pool for each state (and subsequently addressed outside the HFE system). This approach may also result in dual service delivery models and/or overlap in responsibility of policy and service delivery between the Commonwealth and the states.

It has also been suggested that both territories could be taken outside of the CGC assessment process, with the Commonwealth assuming direct funding responsibility. Presumably, one option of achieving this would be to dedicate a proportion of the GST pool to the territories, which would raise question/judgement as to how much, indexation and how often it would be reviewed.

9. Predictability and Stability Issues

While all states value predictability and stability, changes in state circumstances will invariably lead to some degree of variability associated with the GST revenue distribution, regardless of the form of HFE. Movements in the distribution of GST revenue are driven by a range of factors, including changes in: state fiscal circumstances; methodology changes; the GST pool; and state populations. This is demonstrated in Table 1 in section 1.

The extent of the trade-off between contemporaneity and stability can have a significant impact on state GST revenue shares. This has been a focus of past HFE reviews. Arguably, HFE is given its full effect when assessments are made annually, with revenue adjusting to meet current circumstances. However, this would create significant volatility, which would make the management of state budgets very difficult. Delays in data availability also limit the ability of HFE to quickly and accurately reflect changes in state circumstances. Tasmania supports the current three year data averaging approach, adopted in the 2010 Review, as reflecting an appropriate balance between contemporaneity and stability.

The Issues Paper notes that the current equalisation process is inherently reliant on the provision of data from the states. The CGC uses GFS and ABS data (wherever available). Where state provided data is required, the CGC works with the states so as to improve the comparability and reliability of this data.

The mining revenue assessment (and associated changes in wages data) has been a particular source of variability in the GST distribution in recent years. However, historically, significant movements in GST revenue have been driven by circumstances in the non-mining states, such as the New South Wales property boom in the mid-2000s. This illustrates that factors, which are a particular source of variability in the GST distribution, evolve and change over time.

The use of limits (or floors and ceilings applied to state relativities) has been suggested as a potential solution to inherent variability in state relativities. If a floor or ceiling were introduced, GST revenue would not be fully equalised. A state on a floor would receive more than its full equalisation amount. A state on a ceiling would receive less than the amount required to achieve full equalisation.

This would be inconsistent with the Review Terms of Reference which requires that jurisdictions should have equal capacity to provide infrastructure and services to their citizens. In addition the introduction of limits is far from simplistic or transparent and would require significant judgement. Tasmania does not support these types of mechanisms.

CONCLUSION

In Tasmania's view, this submission clearly and amply demonstrates that:

- The current HFE system is appropriately responsive to changing state circumstances, including the impact of global economic changes;
- Continuation of the current HFE system is essential, particularly in the current economic environment;
- The current HFE system has neither inhibited economic development in resource rich states, nor, has it acted as a barrier to the mobility of labour and capital;
- The current HFE system promotes co-operation between states, including economic reform, rather than being a barrier to such reform; and
- An examination of Tasmania's track record demonstrates that despite it being an HFE "recipient": it has a strong record in managing its budget and exercising the requisite fiscal discipline; and, it has been at the forefront of many economic reforms.

APPENDIX 1 – STATE RELATIVITIES, POPULATIONS AND THE GST POOL SINCE 2000

	GST RELATIVITIES								POPULATION*									GST
	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total	POOL
									'000	'000	'000	'000	'000	'000	'000	'000	'000	$m
2000-01	0.88914	0.84510	1.02507	0.98692	1.20433	1.61016	1.17050	4.79406	6 527	4 770	3 592	1 888	1 508	471	317	196	19 273	23 854
2001-02	0.90228	0.85168	1.00625	0.97571	1.19971	1.60490	1.21100	4.61547	6 605	4 833	3 671	1 914	1 517	472	321	198	19 534	27 389
2002-03	0.88419	0.84227	1.01673	0.97612	1.21719	1.68200	1.22552	4.91642	6 649	4 892	3 765	1 938	1 526	475	324	199	19 771	31 257
2003-04	0.86533	0.84243	1.02495	0.96455	1.23997	1.75292	1.23351	5.13490	6 689	4 952	3 857	1 968	1 536	481	326	201	20 012	34 121
2004-05	0.83468	0.83641	1.06994	1.03811	1.23041	1.71466	1.21407	5.00304	6 729	5 014	3 946	1 999	1 546	485	328	204	20 252	35 655
2005-06	0.83571	0.84900	1.05700	1.03303	1.22712	1.70370	1.22837	5.00537	6 786	5 086	4 044	2 037	1 559	488	332	208	20 544	39 118
2006-07	0.84193	0.87451	1.03271	1.00778	1.20839	1.69599	1.22918	5.06502	6 859	5 171	4 140	2 085	1 576	492	337	212	20 871	41 208
2007-08	0.86380	0.88206	1.01143	0.93616	1.23141	1.68662	1.24724	5.09597	6 944	5 262	4 243	2 138	1 593	495	342	217	21 236	44 381
2008-09	0.88743	0.91347	0.96196	0.85797	1.23192	1.66348	1.25603	5.52758	7 041	5 365	4 350	2 204	1 612	500	348	222	21 642	42 626
2009-10	0.93186	0.91875	0.91556	0.78485	1.24724	1.62040	1.27051	5.25073	7 192	5 498	4 477	2 274	1 635	506	355	228	22 164	44 510
2010-11	0.95205	0.93995	0.91322	0.68298	1.28497	1.62091	1.15295	5.07383	7 277	5 587	4 552	2 316	1 652	510	361	231	22 486	45 450
2011-12	0.95776	0.90476	0.92861	0.71729	1.27070	1.59942	1.11647	5.35708	7 360	5 675	4 641	2 366	1 667	514	366	235	22 824	48 350

*As at 31 December.

Sources: Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities - 2011 Update*; *Australian Historical Population Statistics, 2008*, ABS Cat No. 3105.0.65.001; 2011-12 Australian Government Budget – Budget Paper No. 3

APPENDIX 2 - SPECIFIC TASMANIAN SOCIAL AND ECONOMIC STATISTICS

Social and Economic Statistics	Tasmania	Australia	Difference
Economic Indicators			
GSP per capita (real)[1]	$44 208	$57 925	-23.7%
Assessed revenue raising capacity (%)[2]	81.2	100.0	-18.8pp
Assessed cost of service provision (%)[2]	108.5	100.0	8.5pp
% of population in low socio-economic situation[3]	58.6	39.6	19.0pp
Health			
Persons with a disability (% of population)[4]	22.7	18.5	4.2pp
Causes of death – cancer (per 100 000 persons)[5]	197	176	11.9%
Causes of death – ischaemic heart disease (per 100 000 persons)[5]	113	98	15.3%
Education			
Persons who completed Year 12 (% of persons aged 15 and over)[6]	32.4	43.7	-11.3pp
Persons with a Bachelor degree or above (% of persons aged 25-64)[7]	19.6	26.9	-7.3pp
Income			
Government pension or allowance as principal source of income (% of households)[8]	34.1	23.2	10.9pp
Average weekly ordinary time earnings[9]	$1 152.40	$1 305.40	-11.7%
Median house price (capital city)[10]	$349 200	$464 300	-24.8%
Population			
Persons aged 65 years and above (% of total population)[11]	15.6	13.5	2.1pp
Dependency Ratio (%)[12]	53.4	47.9	5.5pp
Indigenous population (% of total population)[13]	4.0	2.5	1.5pp
Proportion of population in highly accessible location[14]	33.92	67.97	-34.05pp
Proportion of population in urban centres (over 40 000)[15]	34.75	71.87	-37.12pp
Labour Force			
Participation Rate (%)[16]	61.1	65.7	-4.6pp
Unemployment Rate (%)[16]	5.6	5.1	0.5pp
% of unemployed who are long term unemployed[17]	20.2	19.2	1.0pp
Average length of unemployment (weeks) [17]	43.6	36.7	18.8%
% of employed persons in part time employment[16]	34.9	29.6	5.3pp

Notes:

The data in the table is based on the most recent published information as at September 2011.

1. ABS Cat No 5220.0. Data for 2009–10.
2. CGC data average of the years 2006-07 to 2008-09
3. CGC Data for June 2009 sourced from ABS Cat No 3101.0. Index used is the SEIFA Index for Socio-economic Disadvantage.
4. ABS Cat No 4430.0. Data for 2009.
5. ABS Cat No 3303.0. Data are the average of the years 2006 to 2008.
6. ABS Cat No 2068.0. Census 2006 data.
7. ABS Cat No 4102.0. Data for May 2010.
8. ABS Cat No 6523.0. Data for 2007–2008.
9. ABS Cat No 6302.0. Data for May Quarter 2011.
10. REIT Quarterly Median House Sale Price Figures. Data for March Quarter 2011; Hobart compared to average of all other capital cities.
11. ABS Cat No 4102.0. Data as at June 2010.
12. ABS Cat No 3201.0. Data for 2009-10. Dependency ratio is defined as persons aged <15 and >64 years as a proportion of population aged between 15-64 years.
13. ABS Cat No 4102.0. Data as at June 2010.
14. CGC Data for June 2009 sourced from ABS by request. Based on State-based Accessibility and Remoteness Index of Australia developed for the CGC by National Centre for Social Applications of Geographic Data (GISCA).
15. CGC Data for June 2009 sourced from ABS Cat No 3101.0. Urban centres are classified according to their population in 2006. Population growth over a threshold does not result in a reclassification.
16. ABS Cat No 6202.0. Data for 2009-10 , in trend, year average terms
17. ABS Cat No 6291.0. Data for 2009-10, in original, year average terms