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GST DISTRIBUTION REVIEW

VICTORIAN SUBMISSION

State Government Victoria

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CONTENTS

FOREWORD BY PREMIER AND TREASURER

The Victorian Government welcomes the GST Distribution Review.

The GST is Victoria's single biggest source of funding and represents almost a quarter of the State's total revenue. Given limited revenue raising powers, Victoria's share of GST and its interaction with our own tax policy is a crucial determinant of the standard of services and vital infrastructure which is delivered to Victorians. It is imperative that the approach to distributing the GST to the states and territories is fair, stable, predictable and transparent. It is also vital that the distribution provides incentives for the states to continually improve their own efficiency and effectiveness and that of the economies and societies they govern.

Victoria has supported fiscally weaker states every year since the introduction of horizontal fiscal equalisation. However, despite the growing fiscal maturity of Australia and each of its component jurisdictions, more redistribution is occurring now than at any other time since Federation. We consider that the current method of distribution is failing.

The best outcome to work towards is one where GST is distributed on an equal per capita basis, with specific policy challenges dealt with separately in a transparent and accountable manner. This would result in a simpler, more transparent, more predictable and fairer system of GST distribution. It would be consistent with the circumstances of the modern Australian Federation. This represents a significant change, and there are likely to be a number of transitional or intermediate options which move closer towards an equal per capita distribution.

To the extent that some form of equalisation remains, there is a case for significant refinement, as there are clear methodological shortcomings that need to be addressed. In particular, the methodology needs to support and reward increases in efficiency and productivity.

Our submission provides direction on both methodological changes and more substantive reforms to the GST distribution system.

The Review is an excellent opportunity for reform. We encourage the Review Panel to consider bold reform options that better meet the needs of the Australian Federation.

The Hon Ted Baillieu
Premier

The Hon Kim Wells
Treasurer

KEY MESSAGES

Australia's key challenges

- Australia faces a number of key economic challenges to increase productivity and workforce participation and make the most of the current resources boom while transitioning our economy to a higher value added and more competitive one.
- In this environment, we also face social challenges to provide a relatively consistent level of services to all Australians, maintain social cohesion and reduce the major gap in outcomes for disadvantaged Australians, particularly in the area of Indigenous disadvantage.
- To meet these challenges we must have a method of distributing the goods and services tax (GST) grants to the states which encourages efficiency and effectiveness while maintaining reasonably equitable outcomes across the Federation.

Horizontal Fiscal Equalisation's (HFE) evolution

- Victoria has contributed to HFE for many decades, and has been the only consistent donor state since 1933.
- Victoria recognises that historically some states have required fiscal support to balance budgets and provide minimum levels of service to their populations.
- The donor states of New South Wales (NSW), Victoria, Queensland and Western Australia (WA) now account for close to 90 per cent of Australia's population, meaning that the complex HFE methodology is redistributing revenue to a group that is much smaller and declining in number.

The needs of HFE have changed substantially since the system was created

- The HFE system has been in place in some form since early after Federation and was developed in a very different economic and social climate, in which some states had limited ability to deliver services and manage through periods of relative economic hardship.
- Australia is now a developed economy where all jurisdictions are relatively fiscally mature and deliver a high standard of basic services. The gap in average incomes across jurisdictions has narrowed over time. In addition, an advanced Commonwealth welfare system supports basic living standards for all. As such, while specific policy challenges remain across the Federation, the current system of HFE is badly in need of real reform.

The current HFE system in Australia is failing on a number of fronts

- The current approach to HFE has the effect of compensating states for underperformance, penalising reform and redistributing increasingly large amounts of the GST pool. This growth is occuring despite the lack of evidence of equivalent growth in the disparity of the costs of service provision among the states.
- Other significant problems with the current GST distribution system include the complex methodology, backcasting of data, selective choice of disability factors, and inconsistent treatment of infrastructure, all of which combine to increase volatility and reduce predictability.
- The equity objectives of the distribution of the GST are not being realised and there appear to be significant efficiency costs at a time when Australia's productivity is falling.
- The current approach promotes an 'aid mentality' among recipient states through compensating to average costs of services, rather than to a minimum standard level to encourage reform and increase efficiency.

The way forward

> Victoria considers that the current method of GST distribution is no longer appropriate for the modern Australian Federation.

> Ultimately, in a modern Australia, the GST should be distributed on an equal per capita (EPC) basis, with particular policy challenges dealt with separately through targeted and accountable means. This change could take time and would need to be implemented carefully through a staged transition.

> Should a form of equalisation remain, the current system should be made more simple, sustainable, predictable and transparent. It should meet the criteria of equity, efficiency, simplicity and predictability in a balanced way and should support broader economic and fiscal reforms.

> At a minimum, changes must be made to the current methodology to correct the present anomalies and unintended consequences.

> The transition to an EPC distribution can be facilitated through a number of reform options including one where donor states subsidise the (smaller) recipient states and receive an EPC share of the remainder of the pool, or a range of partial equalisation or revenue only equalisation models.

1 INTRODUCTION AND OPTIONS FOR REFORM

1.1 Introduction

Victoria has been a strong contributor to HFE, accepting that the fiscally stronger jurisdictions should support weaker ones so that all Australian states and territories (hereafter states) have the capacity to provide key services to their populations at roughly comparable standards. However, **Victoria is concerned that the current Australian arrangements are no longer fit for purpose, and are failing to deliver against their objectives in an efficient and effective manner**.

This submission discusses options for reform. It then outlines the context and history of HFE, and how it has evolved in Australia over time. This is followed by an evaluation of the current system against the Review's core criteria of efficiency, equity, simplicity and predictability. This allows an assessment of which aspects of the HFE system ought to be retained, and which aspects should be discarded on the basis that their underlying rationale is declining.

1.2 The gains from reform

Australia faces the challenge of declining productivity growth. **The current system of HFE promotes and rewards inefficiency,** and potentially exacerbates this decline.

Recent Australian history shows that policies based on positive incentives can promote and deliver productivity improvements. The best example of this was the national competition reforms of the mid to late 1990s.

Reform of the current HFE system to one that is simple, transparent and rewards efficiency has the potential to boost the productivity of the states, and contribute to improvements in national productivity.

1.3 Approaches to HFE reform

In keeping with the four key criteria of efficiency, equity, simplicity and predictability, there are three possible ways to consider reforms to the HFE system:

- methodological improvements to the current HFE system that bring greater simplicity, predictability and transparency;
- a substantive re-examination of HFE (along with the methodological improvements), resulting in a system that boosts productivity and facilitates a gradual move to an equal per capita (EPC) distribution of the GST pool in the long term; and
- combining HFE reform with broader federal financial relations reform aimed at reducing vertical fiscal imbalance (VFI) and improving our overall federal financial structure. This would seek reform beyond the Review's terms of reference.

If some form of HFE is to be retained for the time being, even in a progressive move towards EPC, then it should satisfy the following principles:

The HFE process should encourage measures to improve efficiency and effectiveness

Very few service costs are truly beyond a state's control over time. Improvements in infrastructure, transport, information technology and medical technology can assist in enabling cheaper delivery of services over long distances. State investment in these enablers should be recognised and rewarded, not punished.

The amount of redistribution should be limited to absolute, not relative disadvantage

The system should not perpetuate increasing levels of redistribution based on changes in relative disadvantage. Rather, it should focus on identifying and addressing the absolute level of disadvantage experienced.

Specific, large policy challenges and initiatives should be excluded from GST arrangements and addressed through separate tied and targeted programs

Specific, significant policy challenges and large, one-off infrastructure funds should be addressed outside the HFE process with tied funding. This will enable accountability and transparency against desired outcomes, and will ensure the full resources are applied to the targeted initiative (and not equalised to other states). It will also reduce the incentive for cost-shifting between the Commonwealth and the states.

The methodology should be predictable, transparent and simple to minimise volatility and discourage gaming

Given the limited fiscal levers available to states, it is crucial that states are able to accurately predict their share of GST and that the calculation process is transparent. This requires that the calculation of relativities occur on a basis which is stable and predictable from year to year.

In recommending changes to HFE processes, the Panel is encouraged to consider whether the changes are likely to be sustainable. Ideally, the Review process should achieve some consensus that whatever changes are made to the HFE methodology will remain in place until at least the next major Commonwealth Grants Commission (CGC) review, if not longer. If this proves unrealistic, sustainability requires changes to be principles-based, consistent with the Review's terms of reference.

All sources of revenue should continue to be included in HFE

The core principle of HFE is to equalise for disadvantages relative to a state's ability to raise revenue. This is most relevant to revenue arising from 'accidental endowments'. Since the adoption of HFE, all forms of states' own-source revenue have been part of the system, through a range of economic circumstances. Exclusion of specific revenue sources now is not justified, any more than excluding stamp duty during property booms. Nor is it appropriate to look at examples such as Canada to justify partial exclusion of mining revenue because, as noted throughout this submission, the Australian system is unique, and all aspects of the system need to be considered.

1.4 Methodological improvements to the current system

It is possible to make significant progress towards a better HFE system via principles-based methodological changes. These reforms would focus on bringing greater efficiency, simplicity, stability, consistency and transparency to the equalisation system.

1.4.1 Adopting minimum needs rather than total needs assessment

The current methodology could be redesigned to equalise for comparable, instead of identical, outcomes across jurisdictions. This would be consistent with the system's original goal of ensuring that recipient states were to be funded at a 'minimum' standard, as opposed to an 'average' standard achieved by non-recipient states. Compensating to a minimum standard would encourage reform and improvements in productivity. This was the original approach taken by the CGC, until after World War II, with 'minimum' allowances for social services (education, law, health) set from 6 to 10 per cent below the national average.

The contemporary aim of achieving full equalisation necessitates extra complication in the HFE system, as the methodology is required to capture all the workings of each jurisdiction in minute detail. Rather than compromising the notion that Australia has a 'comprehensive' system of delivering HFE, **returning to a 'comparable' approach would more realistically recognise and treat the limitations of the data that is available for HFE calculations**.

One means of doing this could be to introduce more flexibility around the current interpretation of the 'what states do' principle, so that the CGC could consider what the majority of states do, rather than what all states do, in the assessment process. The present materiality regime established in the *2010 Review* requires that a category or disability be immaterial in all jurisdictions before it is removed. This has left many small disabilities clogging up the methodology that are material in just one jurisdiction. Considerable simplicity could be gained if the CGC had the flexibility to remove such components that have little impact across the system as a whole. There are presently 114 disabilities in use, most of which have only a very small impact on the GST's distribution. Many of these could be removed. For example, the *2010 Review* calculated that the urban traffic disability within the roads assessment category had a total redistributive impact of just $1.90 per capita nationally, but because it is material in the territories, this tiny disability remains.

If a 'comparable', rather than 'full' approach to equalisation is applied, there is likely to be further scope to remove detail from within the current assessments categories. Many current revenue and expense categories use multiple indicators in the assessment calculation. These categories could be streamlined, or have single indicators introduced, to reduce the number of calculations used across the HFE system.

For example, the lengthy assessment of payroll tax could be reduced by basing the assessment only on the ABS reported compensation of employees for each jurisdiction, and avoiding issues of thresholds or progressive rates. It may well be the case that less complex and easier to follow methods would yield similar results to the status quo.

1.4.2 Adopting absolute rather than relative needs assessment

To ensure GST redistribution is based on absolute levels of disadvantage, the redistribution required to achieve HFE should be decoupled from the size of the GST pool. The CGC currently calculates the amount that each state requires (in per capita terms) in order to have the fiscal capacity to provide services and the associated infrastructure of the same standard. If the CGC stopped here then the absolute amount of funding required by each state could be determined.[1] Any excess funds remaining from the GST pool could then be distributed on an EPC basis. Note, however, that Victoria would argue on efficiency grounds that compensation should only be to provide a minimum (not equal) fiscal capacity, to ensure incentives for recipient states to improve. This would result in smaller amounts needing to be redistributed.

Under this solution the impact of any growth in the pool above that required to achieve HFE would not affect relativities. This would ensure that the growth in the GST pool did not have an unwarranted impact on the amount being redistributed. Other possible reforms would include specifying that only a fixed proportion of the pool could be redistributed; these are considered further in Section 1.5.

1.4.3 Including all ongoing Commonwealth grants

The CGC methodology does not treat all Commonwealth payments equally. While this may reflect the different functions and/or purposes of Commonwealth payments, it also reflects arbitrary Commonwealth decisions to exclude funding from the assessment, as well as CGC judgement. To improve the predictability and transparency of the system **the default treatment for ongoing Commonwealth payments should be inclusion, with payments excluded only in extraordinary circumstances** (as outlined in the next sub-section)**.**

1.4.4 Appropriate treatment of infrastructure

The current system penalises states that receive a greater proportion of ongoing Commonwealth assistance for rail relative to road investment. Consistent treatment of infrastructure grants across transport modes would add transparency and consistency to the HFE process and remove potential distortions to infrastructure investment decisions. Consideration should be given to assessing 100 per cent of the value of ongoing Commonwealth payments for the construction of the National Network Roads (NNR) and the introduction of consistent treatment regarding impacts on states' net financial worth for both road and rail investment.

The inclusion of Building Australia Fund (BAF) projects within the equalisation methodology is an abnormality that heavily distorts annual relativities during years when BAF grants are paid, despite the BAF funding itself not impacting on a state's underlying fiscal capacity in the short term. **All BAF funding should be excluded from the equalisation formula.** Doing so would be more in keeping with both the purpose of the fund, to support investment in one-off, competitively-selected extraordinary projects.

1 The CGC uses the ratio of each state's per capita requirement to the national average to determine the per capita relativity which, after being averaged over three years, is used to distribute the entire GST pool.

1.4.5 Ending backcasting

The treatment of data revisions in the current methodology can be problematic. In the recent *2011 Update*, a large proportion of the change in Victoria's GST grant was caused purely by data adjustments, particularly in relation to interstate relative wage costs. The result was significant budgetary shock for Victoria's State Budget in 2011–12.

Current practice is for data revisions to be backcast across the previous two annual relativities that are used to calculate a new GST relativity. While this corrects errors in previous years' calculations, it also means that jurisdictions cannot rely on published annual relativities to remain constant, adding significant volatility to GST revenue forecasts.

This volatility could be eliminated from the system if data revisions were to be applied only prospectively, and previous annual relativities were 'set in stone' once published. For instance, should there be any significant revisions to data sources in the 2012 Update, then only the 2010-11 annual relativity should be impacted. The previously published annual relativities (2008-09 and 2009-10), that are also used to calculate the 2012 assessed relativity, should be left unaffected, thereby reducing the overall impact of the data revision. Previously published annual relativities would then only be re-examined during the CGC's periodic methodological reviews, to reflect changes in methodology rather than revisions to data.

Such a reform would increase certainty for all jurisdictions. As annual relativities would remain unchanged, there would be more fixed points to use in GST forecasts, leading to greater certainty in states' fiscal outlooks. This reform could be introduced very quickly, being relatively non-controversial, easy to implement, and having a minor systematic impact upon GST relativities.

1.4.6 Improving treatment of cost disabilities that are not policy neutral

In a robust methodology, cost disabilities should be used to make allowances for unavoidable factors that impact on state service delivery. Ideally they should be based on issues that are completely beyond a state's control, such as natural disadvantages or changes in age profiles. In other words, disabilities should be policy neutral. This is not the case where the underlying issues can be mitigated through successful policy or programs. The methodology should not create incentives for poor policy performance or act as a deterrent to good policy performance.

Disabilities that can be reduced through policy interventions should be handled through direct Commonwealth assistance – not through the HFE system. This approach would be an improvement on efficiency, equity, transparency and accountability grounds.

1.4.7 Considering the use of broader global indicators

The use of broad 'global' level assessments could be explored, as an alternative to attempting the measurement of all state activities through a large number of individual 'sector' level assessment categories. Provided appropriate and reliable proxy measures could be found, it could be possible to assess revenue and/or expenditure with just a few global indicators. One approach might be to base GST distribution on a simple global economic indicator of relative wealth, such as gross state product (GSP) per capita. This would be a proxy for the overall fiscal capacity differences of jurisdictions, adjusted for the net impact of revenue base and expenditure requirement differences.

Serious consideration of such an approach would be beneficial. It could significantly streamline HFE calculations, and reduce the role of judgement in GST distribution. Large gains in transparency would be made, and GST revenues would be much easier to forecast.

However, it needs to be acknowledged that GSP itself can be a volatile series and is subject to extensive revision over time. Nevertheless, the Panel is encouraged to consider what global indicators might be appropriate.

1.5 Possible options for substantive reform

1.5.1 Donor states supporting recipient states

At the moment, the four biggest states subsidise the four smaller states through the GST redistribution. In the near future, it is possible that South Australia (SA) will also become a donor state on the basis of future resource sector development.

Under this proposal, the four (or five) larger states would support the three (or two) smaller states, with the exception of the Australian Capital Territory (ACT) which would receive an equal per capita share of the GST pool. The ACT would be excluded as it has the highest per capita income in Australia in a small compact area without issues of remoteness, diseconomies of scale or significant disadvantaged population groups.**The GST pool would effectively be split, with a small amount equal to the needs of the smaller states being provided to them through an HFE system, and the remainder being distributed EPC among the donor states.** If undertaken in conjunction with other methodological reforms, this approach would reduce the volatility recently experienced in grant shares, and also increase the likely predictability of GST revenues. It would set in place the right incentives for improved performance from all states.

1.5.2 Using partial pool equalisation

This approach reflects the origins of the GST when it replaced Financial Assistance Grants and a number of state taxes that were outside the funding pool distributed via equalisation. It could be argued that the proportion of the GST pool that represents these taxes should not be equalised. Applying this logic, only 62 per cent of the GST pool should be equalised. This option would see, for example, 60-65 per cent of the GST pool distributed according to HFE with the remainder distributed on an EPC basis. To aid transition, it would be appropriate to start with 80 per cent of the pool subject to redistribution.

More generally, partial pool equalisation is consistent with past approaches to HFE, and along with the adoption of the methodological changes proposed, would be an appropriate transitional arrangement towards an EPC distribution of the GST pool.

1.5.3 Adopting revenue-only equalisation

The expense assessments conducted by the CGC are particularly complex and arguably create incentives for states not to reduce their sources of disadvantage.

Revenue assessments, on the other hand, tend to be less complex and easier to understand, although there is still the need for the CGC to apply judgement. **Assessing revenue only would improve efficiency, simplicity and transparency, while partially meeting the equity criterion by addressing differences in states' revenue raising capacities.**

Internationally, federal countries including Canada and Germany tend to concentrate on the equalisation of revenue capacities only, virtually ignoring cost disabilities in the provision of public services. These nations make achieving minimum standards rather than full equalisation their primary objective.

1.6 The move to equal per capita distribution

There is a strong case for transitioning to an EPC distribution of the GST pool over the longer-term with significant policy challenges addressed through separate, targeted, accountable and transparent funding arrangements. Indeed, EPC can be seen as the end point for horizontal fiscal compensation, reflecting the convergence of all jurisdictions as their economies mature and their citizens reflect similar profiles in terms of service delivery requirements. EPC shares would be simple to calculate, thus negating the need for a complex CGC architecture to calculate relativities. The system would also be devoid of the type of perverse incentives for inefficiency that exist under the current system.

Victoria recognises that this is a long-term aspiration. While the Federation and its component parts have matured over the past century, and income levels have converged, there remain some differences in fiscal capacity across the states. Some assistance to redress fiscal shortfalls in recipient states would have to occur in any transition to an EPC distribution of the GST pool.

Appropriate transition strategies might involve adopting the reforms identified in section 1.5 as a starting point (for example, a partial pool equalisation approach, with the proportion of the pool subject to equalisation declining over time). These should be combined with the methodological improvements identified in section 1.4. Any funding to recipient states should be based on a minimum rather than average cost (thus encouraging improvements in efficiency), with absolute, rather than relative needs being assessed. It could be expected that such an approach could unlock long term efficiency improvements so that the amount of assistance per capita should reduce over time.

Victoria is confident that good governance and good policy can overcome many existing disadvantages in service delivery and revenue raising.

All of the proposals put forward in this submission will require careful evaluation. Victoria itself is still modelling the impacts of thse proposals. It is happy to provide the results of such modelling to the Review Panel and its staff over coming months as results become available.

2 CONTEXT

2.1 The challenges facing Australia

Australia is currently facing a range of dramatic economic events, driving the need for reform. The emergence of China and India as economic powerhouses has driven historic shifts in relative prices while large fiscal deficits and volatile financial markets are necessitating a process of readjustment in Europe and the United States.

As a producer of raw materials, Australia is directly benefiting from China and India's growth. The challenge is to ensure the benefits are sustained and widely shared. The strengthening of the Australian dollar is a symptom of the commodities boom, which is driving structural adjustment across the Australian economy.

In addition, there has been a decline in Australia's productivity growth, which must be turned around if we are to achieve sustained improvements to living standards, independent of natural resource endowments. Given the nature of Australia's Federation, economic and regulatory reform measures mean that states have their part to play in ensuring their own operations are focused on improving efficiency and productivity.

Australia also faces a range of social imperatives. These include: delivering access to essential services to all Australians; ensuring equitable development of the regions outside our major cities; and providing a cohesive, vibrant multicultural society.

Victoria is well aware that even during this period of relative economic prosperity, there remain entrenched pockets of disadvantage in every state, particularly among Indigenous Australians. It is appropriate that part of Australia's current high income be used to reduce underlying disparities. Those funds need to be well targeted and appropriate accountabilities and/or incentives put in place to ensure outcomes do improve.

By extension, it is essential that intergovernmental financial arrangements reinforce the drive for greater efficiency and improved outcomes, driving each taxpayer's dollar further. In aggregate, the GST now comprises around a quarter of the states' total budget revenue and is the single biggest revenue item for all jurisdictions, save WA. By implication, major changes to the distribution of GST revenue among jurisdictions can have significant flow-on effects to other state-based taxes such as stamp duty, which are regarded as inefficient taxes that hinder productivity.

A system that provides the best outcome for Australia, and is sustainable, should adhere to the criteria of efficiency, equity, simplicity and predictability outlined in the Review's terms of reference. It should not merely respond to recent events associated with the mining boom.

2.2 HFE is just one element of fiscal federalism

While welcoming the Review, it is unfortunate that its terms of reference have been restricted. GST payments are part of the much broader Federal-state financial arrangements, which include tied Commonwealth funding. **Real and sustainable reform of Federal-state finances requires a reduction in vertical fiscal imbalance (VFI) and an improved HFE system needs to be considered alongside reform of tied funding.** GST payments and tied funding both respond to the significant and increasing mismatch between the Commonwealth's dominance of revenue raising powers and the states' constitutional responsibility for service delivery.

It is widely acknowledged that Australian fiscal federalism concentrates excessive financial power with the Commonwealth. Indeed it is one of the most extreme forms of VFI among federal nations. In turn, the states' reliance on Commonwealth funding prevents the full benefits of a federation being achieved (particularly where the Commonwealth uses its financial powers to direct policy in areas of state responsibility).

Considering the complete system of central government transfers would allow the Review to investigate the most appropriate mix of tied and untied grants. The current system equalises GST revenue on an untied basis, which is vital to states' autonomy. Untied funding enables states to deliver services whose benefits are confined primarily to their geographic area and for which residents should have a choice over both the quantity and quality of service. However, **particular policy challenges are now driving a major part of the GST redistribution, while the HFE system fails to create incentives for those same entrenched policy problems to be overcome.**

In addressing Australia's VFI, state governments and the Commonwealth need to work together through this Review and the tax reform processes to provide states with access to efficient tax bases. When the GST was introduced, it was sold in part on the basis that it would give states access to a reliable and efficient growth tax. However, in recent years the growth in GST revenues has slowed, in part as a result of the impact of the global financial crisis as Australian households restructure their balance sheets and boost savings. Further, the portion of household consumption subject to the GST has grown by less than total consumption, putting further pressure on states' ability to fund growing service needs or to remove inefficient taxes. **Removing the states' most inefficient taxes and relying more on efficient taxes requires Commonwealth cooperation to establish a secure and efficient source of replacement revenue.**

3 HISTORY OF HFE IN AUSTRALIA

3.1 How the principles, methods and objectives of HFE have evolved

Prior to the establishment of the CGC in 1933, "special grants" (equalising to some degree) had been paid annually to WA beginning in 1910-11; to Tasmania beginning in 1912-13; and to SA beginning in 1926-27.

The position worsened for all three financially weaker states when world commodity prices collapsed during the Depression years, to the extent that some secessionist sentiment emerged as a consequence. In response, the Commonwealth accepted advice it received from an inquiry into the needs of WA, Tasmania and SA, and the CGC was established to inquire into and report on applications by 'claimant' states for special financial assistance.

From its inception, the CGC used as its criterion the budget balance of states. After appropriate adjustments, grants were recommended that would permit the claimant states to achieve the same per capita budget deficit as the stronger states. Use of the budget balance meant that all aspects of revenue and expenditure had to be evaluated. The tradition of full evaluation has continued until the present day, unlike in federations such as Germany and Canada which have a narrower focus on (partial) revenue equalisation.

Consideration of the full budget does not necessarily imply full horizontal fiscal equalisation. The early CGC used a needs-based approach in its determinations and recommended funding to enable the provision of a minimum standard of services, initially in the areas of health, education and law and order only. Revenue and expenses were not fully equalised and penalties were introduced for wasteful activity by claimant state governments. **Over time, the CGC methodology has evolved from this partial equalisation of claimant states to full equalisation across all states, and across a wide range of functions that we see today** (see Williams 2011).

In the 1981 CGC Report the methodology moved from an absolute dollar-requirements model to a relative model in which disadvantages and advantages in each state are expressed as relativities. The Northern Territory (NT) was added to the states' pool of Financial Assistance Grants from 1988-89, followed by the ACT from 1993–94.

From 2000-01, states received the proceeds of a dedicated tax base, the GST, replacing Financial Assistance Grants funded from the Commonwealth's own revenues and a range of inefficient state taxes. Implicitly, then, the compensation for disadvantages, through the GST, increases with rises in personal consumption expenditure.

With the introduction of the GST and the abolition of a number of state taxes, state governments, on average, are now dependent on CGC recommendations for around a quarter of their revenue. **A disadvantage of the current model is that forecasting this component of state revenue is difficult because it depends on a relative funding model in which the revenue accruing to one state depends on the fiscal performance of all states.**

3.2 The benefits of HFE

The original intention of HFE was to provide a safety net to weaker jurisdictions to ensure standards of service to citizens were not appreciably worse across Australia. To a large extent, that intent has been successfully achieved.

The independence of the CGC in its role as arbiter of the varying costs of providing services has also been valuable. Victoria maintains, however, that full equalisation may not have been essential to achieve this outcome.

The net result of this system is that Australia has a relatively homogeneous quality of services around the country and that the basic standards provided are of a generally high level. Evidence suggests that compared to Canada and the United States (US), Australia has the least amount of variation in output per capita across its member jurisdictions, and that incomes across Australia, with the exception of the ACT, are converging. As a result, Australians enjoy relative consistency in terms of living standards and quality of service throughout the country.

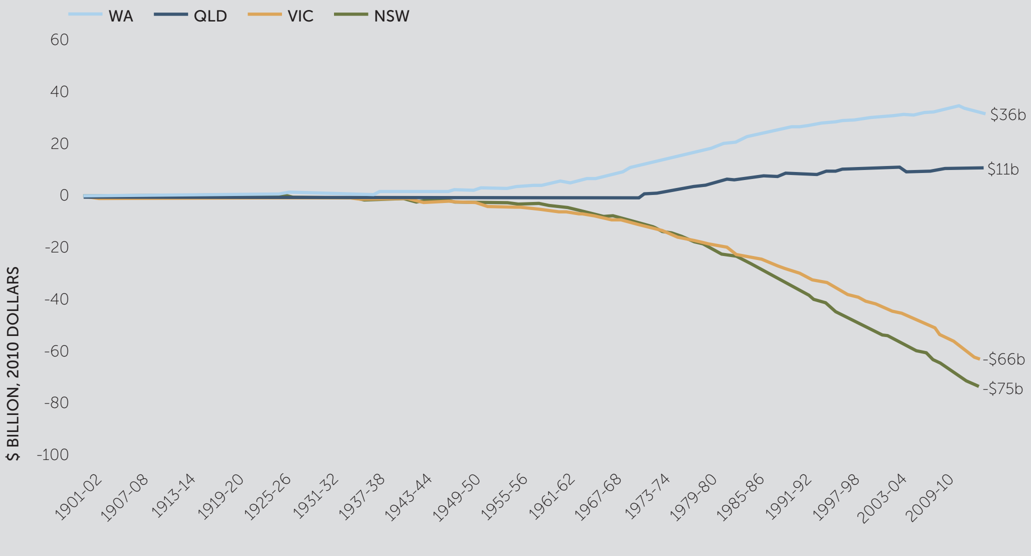
There is a real question now as to whether the existing system of full equalisation is relevant to the future needs of Australia's federation given the high quality of services and their comparability across jurisdictions.

3.3 Victoria's contribution to HFE

Victoria has been a major contributor to the Federation over the years and indeed the only jurisdiction to have been a donor state every year since HFE came into place in 1933.

Chart 3.1 illustrates that **since Federation, Victoria has contributed $66 billion to other states. In contrast, WA and Queensland are $36 billion and $11 billion ahead respectively** (having only recently become donor states). Victoria's long-term contribution to the Federation has been substantial, as it was perceived as having the "capacity to pay". Arguably the experience of WA and Queensland reflects the fact that HFE has acted to equalise outcomes both across jurisdictions and through time. When both States were in need of additional support from fiscally stronger states, this was provided through the HFE process – in effect helping to develop both states. Both states have become donor states at the time when those developmental 'investments' have yielded returns.

Chart 3.1: Cumulative redistribution, general revenue and specific purpose Commonwealth assistance, Federation to 2010-11

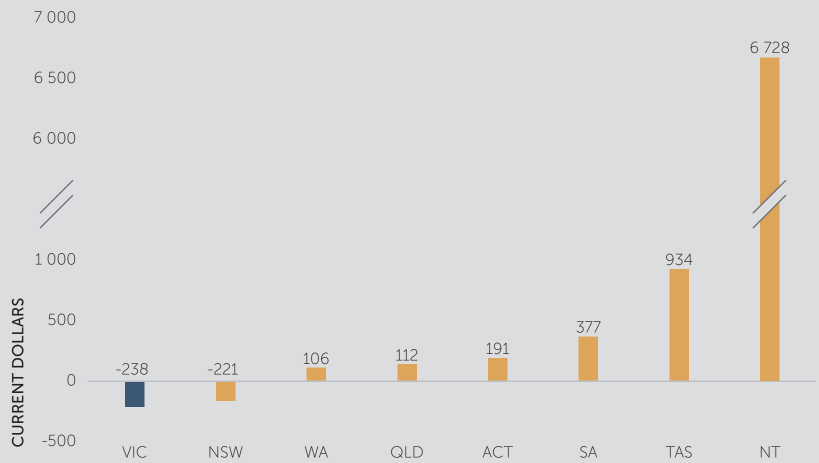


Source: Commonwealth Budget Papers, DTF calculations

Chart 3.2 depicts how **over the last thirty years since the adoption of a system of assessing all states' relative needs, Victoria has remained the largest contributor to HFE, contributing on average $238 per capita a year to other jurisdictions. In contrast, the mining states of WA and Queensland have received $106 and $112 per person respectively,** while the NT has received $6,728 per person a year since it joined the equalisation process in 1988-89.

Victoria therefore remains a significant donor state, despite having lower economic growth than the country as a whole over the last decade (2.6 per cent compared with 2.8 per cent per annum).

Chart 3.2: Average annual per capita redistribution of Commonwealth general revenue assistance, 1981-82 to 2010-11



Source: Commonwealth Budget Papers, DTF calculations

4 ASSESSING HFE IN TODAY'S AUSTRALIA

4.1 The criteria against which HFE should perform

Victoria's aims are consistent with the Review's terms of reference, which seek to deliver a more efficient, equitable, simple, predictable and stable system. This section examines why each of these criteria are desirable and help to boost public acceptance of HFE outcomes.

4.1.1 Efficiency

Economic efficiency matters for Australia's material wellbeing. In everyday terms, it boosts productivity and income and results in faster growth. As applied to the government sector it results in improved public services, lower taxes and a reduced 'red tape' burden for Australian business and households. In other words, an efficient government sector improves the competitiveness of Australia's private sector and increases household welfare.

Additionally, more efficient state governments and economies enhance fiscal capacity, which reduces the need to redistribute GST funds as states' fiscal capacities converge. **Efficiency should be at the forefront of HFE reform considerations, because a more efficient system enables the objective of HFE to be achieved with less need for redistribution.**

HFE has various efficiency dimensions, which are considered below.

Efficient government sector

A well designed system must create incentives for states to embrace cost-reducing or growth-enhancing reforms. It must not create an 'aid mentality' among recipient states, which discourages them from addressing current cost disabilities or providing services more efficiently.

First, **service costs should be compensated to an efficient standard, rather than an 'average cost' standard** in order to encourage reform and improvements in productivity. It is acknowledged that determining the 'efficient' cost of service delivery may be data intensive. This could be addressed by the CGC adopting a process of applying some efficient cost where such data is available and widely accepted. Alternatively, the CGC could provide compensation of 90 or 94 per cent of the assessed need. This was the original approach taken by the CGC until after World War II. Providing full compensation to meet the average cost of service delivery removes any incentive for recipient jurisdictions to improve the way they undertake service delivery.

Second, **the system must be policy neutral, ie. it must not enable states to influence the GST distribution via changes in policy settings.** While it is difficult to identify specific examples of this deliberately occurring, jurisdictions often take into account the impact of future CGC treatment when assessing the impact of any proposed policy change on both the revenue and expense sides.

Finally, the current form of HFE may have implications for the dynamic efficiency of state governments. Where states are large enough to influence the average, there is an incentive for them to boost expenses in those areas where they are assessed to have needs *above* the Australian average or to increase revenues in areas where they have *below* average revenue-raising capacity.

Spatial efficiency

A well designed HFE system should also not compromise spatial efficiency. It is important that labour and capital are applied to their most productive use. This means that any interstate migration of labour and capital should flow to more productive uses, and that any local tax system does not impede this flow. **'Accidents of natural and human endowments' that allow states to levy lower tax rates will induce non-productive migration and lead to spatial inefficiencies.** In Ergas and Pincus's words (2011, p7), interstate immigrants "join a fiscal 'club' with no entry fee... [and] this fiscal advantage will tend to distort decisions about where to settle".

If this inefficient migration were not prevented, the nation's productivity would decline further. Natural resource endowments are the clearest example of such an 'accident'.

The ability to tax economic rents allows a state to provide high-quality public services with relatively low taxes on the mobile factors of production, ie. capital and labour. By giving all states capacity to set similar tax rates on mobile factors, equalising the income from *immobile* factors improves efficiency. In contrast, equalising *mobile* factor incomes may have negative efficiency impacts (Freebairn 2011, pp 5-8).

In summary, not all revenue sources are equal in terms of efficiency impacts. Mining revenue equalisation serves an important efficiency role, while equalisation of other categories may stymie efficient factor movements. If a comprehensive approach to revenue capacity assessment is to be abandoned, efficiency considerations would suggest neither mining revenue nor land tax should be excluded.

Equal outcomes versus equal capacity

Turning to a less technical understanding of "efficiency", the current system of equalisation focuses on providing states with equal financial capacity to provide services at Australian average levels, should their governments choose to do so. It therefore ignores whether or not the resources redistributed are applied to the relevant services or, when applied, produce the outcomes that are linked to the original assessment category.

This is an important element of current federal fiscal arrangements – providing untied grants and maintaining a degree of policy autonomy at the state level. This system works best when governments vary the level of service delivery only marginally from the Australian average, reflecting local preferences. This may not always be the case, and significant resources can be redirected to alternative uses. From a layman's perspective (especially those in donor states) **it is arguable whether the resources that are redistributed toward recipient states are being "efficiently" used to address the cost disability in respect of which the money is being redistributed.**

This issue is linked to the following section and its shortcomings will be explored further in the following chapter.

4.1.2 Equity

HFE should be designed to ensure that individuals have access to comparable government services, regardless of the state in which they reside. This stems from the implied compact embodied by federation: just as individuals and households in a unitary state are treated similarly by government policies, *some* degree of horizontal equity should exist in the treatment of otherwise identical individuals located in different states of a federation.

Over time, Australia's system of HFE has moved from one based on broad equity to one based on specific equality. These concepts are distinct. **The goal of equity can be met without the provision of equal standards of service.** This stems in part from the general acceptance – reflected in social policy generally – that some degree of inequality can be reasonably equitable. Within states it is generally accepted that not all services can be provided equally in all areas – for example some complex medical procedures are conducted only at major urban hospitals.

Just as governments pursue only partial equalisation of budget capacities of private persons within jurisdictions, **HFE's equity goals can be fulfilled by a system that acts as a 'safety net' to enable jurisdictions to provide an adequate (or minimum) level of services, as was the original rationale of the CGC's processes.**

Partial equalisation of service standards is justified because of the inevitable trade-offs between the degree of equality pursued and the adverse incentive effects which can follow, reducing the level of efficiency achievable. A system which enables states to achieve *identical* service standards (rather than *comparable standards* or a *minimum standard*) can create efficiency costs without commensurate equity benefits.

Equalising for minimum standards is also justified because modern HFE's role in securing interpersonal equity is much more limited today than it was at the beginning of Federation. As noted above, this is primarily because of the development of the Commonwealth taxation and social security system, and also because increased technological advancements and population mobility have reduced interstate income divergences.[2]

Finally, HFE's interpersonal equity goal is necessarily constrained by the requirement that GST funds are provided to states on an untied basis. Pursuing full horizontal interpersonal equity would necessitate over-riding state autonomy and the democratic choices of their residents; this would be undesirable as both the spirit of federalism and the benefits of 'competitive federalism' would be undermined.

HFE, in this view, is a compromise which recognises the tension between horizontal equity and state autonomy. It can only ever secure a relatively narrow form of equity, in which differences in public sector treatment of residents should arise only from democratically supported decisions, not from fiscal capacity differences (Walsh 2011, p7). Further, studies have shown that HFE redistribution subsidies do little to reduce the inequity of income between rich and poor individuals and families; in other words, the HFE model has a negligible, or in some instances an adverse, effect on income equity. [3]

In summary, equity is an important element of a strong and stable federation. However, it is arguable that the current system of HFE over-reaches in its quest for equality and thus, it is questionable if the system is successful in achieving its goals.

4.1.3 Simplicity

A simple HFE system provides transparency and accountability and reduces the administrative costs of implementation. **Reducing reliance on poor quality data and having fewer perverse outcomes, a simple system can better capture the underlying intent of HFE.** More complex HFE systems, as in Australia's case, require more and higher quality data — more detailed, timely and accurate information is needed to perform the equalisation system's many assessment calculations. In practice, this requires a greater use of judgement to retrofit imperfect data into the methodology's detailed workings, making the HFE system more subjective and less intuitive.

Simplicity also provides predictability and stability. A simple system enables states to build models that reflect the HFE methodology and so obtain more reliable projections of relativities.

Finally a simple system boosts accountability to citizens. The current system's complexity frustrates this goal as it is only understood by a narrow range of experts within the CGC and jurisdictions' public services. This contrasts with other federations, such as Switzerland, which have far fewer assessment categories and, in the Swiss case, a methodology approved by citizens' referendum.

4.1.4 Predictability and stability

States' ability to develop their short to medium-term fiscal strategies requires stability and predictability to be a clear priority. Indeed, these were key selling points for the introduction of the GST. GST revenue is now the largest revenue line for all jurisdictions, save for WA (23 per cent in Victoria's case in 2010-11, compared with just 16 per cent when Financial Assistance Grants were last used in 1999-00). Consequently even small changes in per capita relativities can have significant impacts on states' budgetary capacities. **The HFE methodology needs to ensure that changes to GST revenue are gradual and manageable. Above all, they should be easily understood and foreseeable by the parties affected.**

4.2 What are the problems with the current system?

Recent developments have highlighted a range of problems with the current system of HFE. Some of these problems could be overcome with relatively modest changes to the current methodology; others would require more substantive change.

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2 There is a risk that by offsetting the population movements that would otherwise occur, the long-run effect of equity-motivated transfers may ultimately be to support the owners of fixed resources (eg. land) in recipient states at the expense of owners in donor states, which is inconsistent with HFE's equity rationale (Ergas and Pincus 2011).

3 See the NATSEM Study referred to in Novak (2011, p10).

4.2.1 The lack of focus on efficiency

A major concern with the current system stems from the dramatic increase in the extent of equalisation that now occurs. While some form of fiscal equalisation is a part of many federations, Australia is an outlier in striving for *full* equalisation. As well as being inconsistent with the original goals and practice of HFE, there are real doubts about whether full equalisation is necessary given Australia's relatively small and falling interstate income disparities. Further, we have an extremely comprehensive and at times unpredictable and time-consuming HFE process that now assists four recipient states comprising 12 per cent of Australia's total population. With the anticipated increase in mining revenues flowing to SA, this proportion could drop even lower soon.

Full equalisation is also inconsistent with modern HFE's limited role in securing interpersonal equity, which today is primarily left to the Commonwealth's tax and welfare system. Accordingly, **a new approach is now required, which places greater weight on efficiency goals and which is premised on states being able to reduce high service costs and disabilities (at least over the medium to long term) via technology and sound policy.**

The current system impedes efficiency by undermining good policy and reducing incentives to reform as efficient jurisdictions (like Victoria) subsidise inefficient jurisdictions. This results from:

> the current system's focus on average service costs and standards neither recognising nor driving efficiency gains; no incentive is provided for improvement;

> providing *full* compensation to average service standards for recipient states, which reduces incentives for them to improve their operations and/or reduce relative disadvantages;

> treating high service costs as completely 'beyond a state's control' (even over the long-term) when, in practice, technology and good policy should be assisting to reduce relative disabilities;[4] and

> the system's failure to create incentives for states making investments with national economic benefits.[5]

The CGC's treatment of the impact of wages costs on service delivery is an example that illustrates clearly the disincentive to improve the economic efficiency of states. In 2011-12 around $500 million will be redistributed from Victoria to other states on the basis of interstate wage differences. This assessment is based on private sector wages as these wages are regarded by the CGC as not being influenced by government policy. However, the economic policies pursued by states do have an influence on private sector wages through policies which encourage competition in product and factor markets, and foster flexibility across the economy. These act to constrain wages growth, and link wages to productivity. Similarly, state fiscal policy can play a role by avoiding spending patterns which contribute to wages growth in already tight labour markets. An efficient, internationally competitive private sector is a key requirement to improve economic welfare and states that pursue such policies should be encouraged.

A significant cause of Victoria's relative economic performance since the 1990s is the substantial regulatory, competition, fiscal and Government Business Enterprise (GBE) reforms which occurred in Victoria in the 1990s. These reforms were largely absent in most other states over the same period. The current methodology therefore penalises Victoria for past reform efforts aimed at encouraging a more efficient private sector than some of the other states.

All the factors above can compromise the goal of 'policy neutrality', defined as the inability of states to influence the GST distribution via changes in policy settings. Policy neutrality can fail on (at least) four counts, as described:

> **'Average state policy' effects:** the 'adjusted budget' which determines states' fiscal capacities and GST relativities is based on average state policy settings. This can be substantially affected by policy choices of NSW and Victoria (and other states in particular spending or revenue areas). States can raise their grant share by increasing expenditure or taxation in categories where they have above-average per capita expenditure requirements or below-average revenue capacity, respectively.

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4 Indeed, under the current system, HFE compensates states for many disadvantages that they can reduce through policy changes (or are endogenous), but excludes some disadvantages which are genuinely exogenous (like climate).

5 For instance, expenditures which enhance the ability of Australia's internationally connected cities to compete in attracting internationally mobile capital and skilled labour, and to absorb migration flows (see Garnaut and FitzGerald 2002, p149).

- **'Revenue base' effects:** the sizes of some tax bases will be affected by the rates applying to that base. For instance, higher land tax rates reduce land values and higher stamp duties reduce the number of transactions and hence measured fiscal capacity (see Dahlby and Warren 2003). Basing mining revenue capacity on actual production values introduces similar non-neutrality to policy decisions about allowing mine development (Pincus 2011, p17).
- **Long-run revenue base growth:** economic development-oriented policies that grow tax bases will ultimately be reflected in higher assessed revenue capacity and a smaller grant share (Garnaut and Fitzgerald 2002, pp150-153).
- **Long-run reassessment of expenditure disabilities:** policy reforms that reduce the impacts of locational factors, service delivery scale, and socio-demographic factors on delivery costs may lead to CGC judgements about disability factors changing over time.

In addition, the redistributive effects of particular policy changes may be significant enough to distort policy decisions, particularly in the tax reform area.

Attachment 1 provides a more detailed summary of the existing literature on the efficiency impacts of HFE.

4.2.2 Complexity overrides simplicity

The high degree of complexity of the current system is well known. Its immense detail is illustrated by the sheer size of the final report of the *2010 Review*, which runs for over one thousand pages across three volumes.

Indeed, Australia can be characterised as having a 'Rolls Royce' HFE methodology. It attempts to accurately capture 'what states do' at a remarkable level of detail, and then equalise for identical outcomes across all major spheres of state government expenditure and revenue. However, in many cases Australia only has access to a 'horse and cart' level of data (which can be both inadequate and inaccurate) with which to perform HFE calculations. But, **by trying to do too much with limited data, there is a risk that Australia's complex HFE system produces results that are 'precisely wrong' rather than 'roughly right'.**

Some examples of data complexity include:

- the derivation of the socio-demographic composition disability factor applied to admitted patient expenses requires data from at least five different sources (with some data sources providing multiple forms of data). The population is split into four classifications that result in 350 different population types. All this complexity is required to redistribute just $21 per capita or around two per cent of total expenses;
- the regional costs component in the assessment of location costs. Limited data related to school education and police services has been applied to other expense categories;
- the valuation of the tax base for mining revenue assumes that all states provided valuations on a 'mine gate' basis. However, some states are only able to provide valuations on a 'free on board' basis. To have the revenue base valued on a consistent basis (either mine gate or free on board) will require some states to estimate transport and port charges;
- the 1981 CGC *Annual Report* considered whether disabilities should be compound or additive, and concluded in favour of adding effects. It noted, for example, that scale was not usually independent of dispersion. The CGC now takes a different approach to combining disability factors in a multiplicative manner, but has not explained why. However, it does suggest that expense factors are being over-compensated; and
- a total of 14 components of expense assessments were discounted (either by 12.5 per cent, 25 per cent or 50 per cent) in the *2010 Review* and *2011 Update*. This frequent application of discounts by the Commission and the need to rely upon suspect data suggests that the current 'comprehensive' methodology may not produce a better equalisation outcome than an alternative, simpler methodology.

The CGC considered a range of simplifications to its assessments as part of the *2010 Review*. The result was a limited simplification in revenue assessments, but with more significant changes in expense assessments. The CGC concluded that it had obtained the right balance between equalisation and simplification. It also considered that further aggregation of categories and broader indicators of revenue bases and expense disabilities would be unlikely to equalise state fiscal capacities in terms of 'what states do'.

However, the methodology remains extremely complex with a large number of highly detailed moving parts. It is very difficult for anyone other than HFE technical experts to understand these elements of the system. While the system's complexity creates the impression of rigour, it may be the case that the current outcomes are actually less reliable than they seem. The need for frequent CGC judgement can undermine the acceptance of the system's outcomes among states. As the number of recipient states continues to contract, it is pertinent to question whether the complexity of the current equalisation system is still warranted.

The complexity of the system raises questions about the accuracy of the process. Given the shortcomings of data and the need for judgement, it must be accepted that some inevitable error must be present in the existing formula (though it is impossible to specifically identify and quantify). It is likely that the potential size and impact of these inevitable errors become more salient as the relativities widen. Nor is it the case that such errors apply only to the outliers: it calls into question the viability of all the relativities calculated across all jurisdictions. When relativities are fairly tightly grouped, there are fewer concerns about potential inaccuracies, and fewer gains (or losses) arise from questioning their veracity.

The system's complexity also produces large administrative overheads, including the need for state Treasuries to maintain specialist resources to support the HFE process. The complexity of the assessment methodology also means that the CGC has a relatively high resource requirement. It is not apparent that the process is cost effective; a similar outcome could be achieved through a simpler process that is less resource intensive.

Victoria considers that measures taken to improve simplicity should aim to achieve the following outcomes:

> easier to undertake assessments (increased reliability);

> easier to maintain data requirements (increased stability);

> easier to understand assessments (increased transparency); and

> much less reliance on the application of judgement.

4.2.3 Lack of predictability and stability

Unpredictability in projecting state shares of the GST pool currently arises in part because of the use of a relative funding model in which the revenue accruing to one state depends on the fiscal performance of all states as well as the level of domestic private consumption (GST pool). **The sheer size of the GST pool and the 'zero sum' nature of the redistribution mean that small changes in relativities translate to large amounts of redistribution.** This complicates revenue forecasting for a state, and is a serious problem because around a quarter of state government revenues on average (and a much larger share for the recipient states) are determined in this manner. In Victoria's case, incorporating the relativities from the CGC's *2011 Update Report* meant its forward estimates of GST revenue were revised down by $2.5 billion. The redistributive nature of Australia's HFE methodology has been further exacerbated by (a) the increase in the size of the GST pool; and (b) the Commonwealth directing the CGC to take into consideration other Commonwealth/state financial flows (eg. roads, capital and other tied grants to the states).

Further unpredictability arises both as a result of data revisions, especially when data is backcast (eg. wages), and as a result of the ad hoc and inconsistent treatment of items such as infrastructure.

4.2.4 Selective choice of disability factors

The equity shortcomings of HFE are compounded by the current methodology's selective views on the legitimate cost drivers of service delivery. In particular, **the system fails to consider cost pressures on larger states due to high migrant populations, urban congestion and diseconomies of large scale.**

It is uncontroversial that the costs of delivering government services can increase with heavy urbanisation. Higher wages are needed to entice people to work in urban locations, and more expensive inputs are required to provide services. Urban congestion increases public sector business costs, as do poorer environmental conditions.

Few of these effects are currently recognised outside the transport assessment; they should be assessed in more areas of government service delivery including infrastructure maintenance and policing.

It appears the CGC is taking an asymmetric approach, taking into account the geographical impact of remoteness and population dispersion in some parts of Australia while excluding the impacts of geography as seen in congestion and population concentration in others.

4.2.5 Inconsistent treatment of ongoing transport funding

The current CGC methodology treats Commonwealth funding of road and rail investment inconsistently in two significant respects:

- The CGC only includes 50 per cent of Commonwealth payments for the construction of National Network Roads (NNR) projects in the calculation of a state's infrastructure relativity. In contrast, 100 per cent of Commonwealth support for rail construction impacts on the GST distribution.[6]
- The CGC treats the impact of road and rail investment on a state's net financial worth differently. In particular, capital grants paid to the states for the purchase of rail assets, which are owned by state Public Trading Enterprises (PTEs), are considered to increase a state's net financial worth.[7] Accordingly, some of their value is redistributed away. In contrast, Commonwealth payments for road construction are simply treated as an expense in the infrastructure investment category. Accordingly, they are not treated as increasing a state's net financial worth, and thus a portion of their value is not equalised away.

These inconsistencies significantly impact on equalisation outcomes and potentially distort transport investment decisions by penalising rail investment over road investment. They disadvantage states like Victoria, which receives the bulk of its Commonwealth transport funding for rail projects. For example, in the 2011-12 Commonwealth Budget, Victoria only received 40 per cent of its major transport infrastructure grants for road projects, in contrast to WA (81 per cent), NSW (88 per cent) and Queensland (100 per cent).[8]

There is no valid conceptual basis for the current approach. The CGC has claimed that NNR projects reflect the broader transport needs of the nation by developing "...an efficient national transport network to facilitate national economic growth and productivity gains" (*2010 Review*, Vol.2 p444). However, this assumes that many of the benefits from NNR projects are national in nature. While there may be some broader benefits from NNR funded projects, they, like major rail projects, play a key role in servicing local state needs. Project allocation is based upon state submissions for NNR funding, which means that states in fact play a major role in shaping where and how NNR capital grants are spent.

Equally there is no clear basis for the inconsistent impacts on road and rail investment on a state's net financial worth. A major Commonwealth investment in a new rail project may well impact on a state's net financial worth, but the same would apply to Commonwealth investments in new roads. **Victoria considers that HFE would be better achieved if all ongoing infrastructure payments were fully included and assessed as investment.**

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6 In contrast, matching state funding for NNR projects (generally 20-50 per cent of the project cost) and expenditure to maintain NNR roads is assessed at 100 per cent of its value (CGC *2010 Review* Vol.2, p435,444).

7 Net financial worth is another aspect of state government activity that the methodology seeks to equalise.

8 Based on a comparison of road and rail investment funding from the Nation Building Program and the Major Cities and Building Australia Fund components of the Nation Building Plan for the Future (see Commonwealth Budget Paper No.3).

4.2.6 Inefficient and arbitrary treatment of 'one-off' Commonwealth infrastructure funds

In the Commonwealth's 2008–09 Budget the Treasurer announced a number of funds that would use the Commonwealth's budget surplus to invest in Australia's long-term future needs. These funds were the Building Australia Fund (BAF), the Health and Hospitals Fund, the Education Investment Fund, and the COAG Reform Fund. These funds were used to finance capital projects with the states.

The CGC treatment of the payments to the states from these funds means that they have an impact on GST relativities. **Including one-off Commonwealth funding for extraordinary projects within the HFE assessments creates a substantial anomaly.** In particular, equalisation would seem to be inconsistent with the purpose of these funds and significantly distorts equalisation calculations. However, the Commonwealth chose not to direct the CGC to treat these funds by exclusion.

Including project payments from these funds within the equalisation methodology causes large impacts on the annual relativities of years when the payments are made, despite the project funding itself not impacting on a state's underlying fiscal capacity in the short term. It causes the Commonwealth to give with one hand, and take away with the other via GST redistribution, thus appearing inconsistent with the objective of the agreed investment decisions.

A notable illustration of the impact of the CGC's assessment of BAF projects is the case of Victoria's Regional Rail Link (RRL) project. Victoria will receive a total of $3.2 billion of Commonwealth BAF funding towards this $4.3 billion project. The inclusion of the RRL grants in the assessment of GST relativities is estimated to result in Victoria receiving $1.4 billion less in GST revenue over the period 2012–13 to 2018–19.

The decision to include payments from the funds in the calculation of annual GST relativities could risk the delivery of the projects themselves. The possibility of losing hundreds of millions of dollars in GST funding could force states to delay or reduce the scope of large infrastructure projects. Funding from the BAF was subject to a competitive bidding process. States (including Victoria) may have varied their decisions to apply for funds from the BAF, or may have revised the scope of projects, if it was clear that any gains would be subject to subsequent equalisation processes. In Victoria's case this results in a loss of around one-third of the funding, with the shortfall only able to be met by reallocating funds from other budget priorities.

This could easily be addressed by the Commonwealth instructing the CGC to treat the one-off grants for infrastructure projects by exclusion.

4.2.7 The impact of expense requirements is increasing

The total GST pool has grown by 86 per cent over the past decade. Over that same period, the amount redistributed to the four small states has grown by 133 per cent.

While sources of revenue and expenses may have both grown, **the increase in the amount being distributed to a smaller share of the population could suggest some of this is due to the current methodology rather than any real increase in expense requirements.**

To illustrate this point, Chart 4.1 shows a large growth in the redistribution of the GST due to the four largest expense categories in 2011 – Indigeneity, population dispersion, interstate wage levels and socio-economic status.

Chart 4.1 - Redistribution by selected expense requirements as a proportion of total GST pool, 2003-04 to 2011-12

Source: CGC Update and Reviews; 2009-10 figures calculated as an average of 2008-09 and 2010-11

Reasons for these anomalous results could include:

> the methodology rewarding relative rather than absolute needs; and/or

> the multiplicative interaction of disabilities in determining this relativity.

Given the imperative to make progress on current outcomes for these disability factors, Victoria believes this apparent anomaly is worthy of further investigation, and will be undertaking more detailed work in this area.

4.2.8 More constraints placed on the grants the Commonwealth gives to donor states than recipient states

One of the HFE system's perverse outcomes is that it results in the Commonwealth placing more constraints on the money given to donor states than to recipient states. This does not encourage recipient states to improve, and fails to reward reforms.

The pattern is one in which the higher a jurisdiction's productivity and per capita GSP, the greater has been the equalisation 'tax' and the larger the share of tied funding in its total revenues (Ergas and Pincus 2011, p 6). The extent to which those high levels of productivity also reflect relatively good governance, the effect is to increase central control in jurisdictions where it interferes with the quality of government, while reducing it in jurisdictions that have particular policy challenges that could be addressed through tied funding. In other words, **the Commonwealth places more constraints on the money it gives to donor states than the recipient states. In effect this punishes jurisdictions for pursuing reform and associated productivity improvements.**

5 HFE HAS OUTLIVED ITS ORIGINAL INTENT

5.1 How have our circumstances changed?

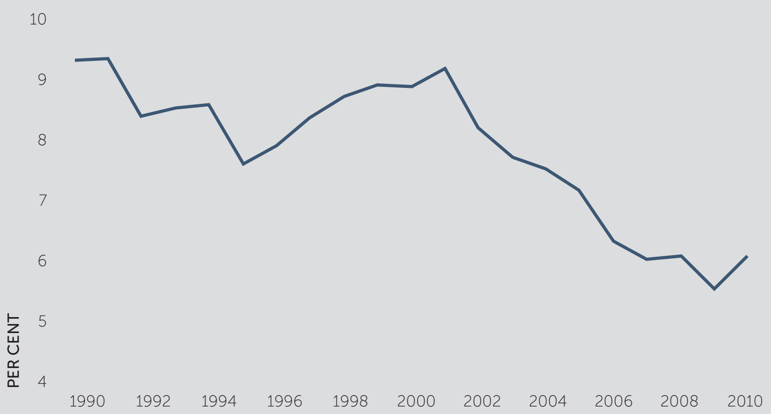
Individuals should have access to a reasonable level of government services regardless of the state in which they reside. Victoria acknowledges that some jurisdictions have inherent disadvantages, which are beyond their control at least in the short term. For instance, some jurisdictions have natural disadvantages or demographic profiles which increase the cost of providing services while others have natural advantages, such as mineral wealth, climate or geographic advantages that increase their ability to raise revenue. Over the history of our Federation, HFE has compensated jurisdictions for those disadvantages that would otherwise have rendered them incapable of providing, with reasonable levels of efficiency, a standard of public services comparable to that which other jurisdictions were able to provide.

Nonetheless, many of the circumstances of early Federation which provided both the original rationale for HFE and influenced the form that it should take – weak capital markets, relatively small Commonwealth payments, a poorly integrated domestic economy, policies that seriously disadvantaged some jurisdictions (creating a real risk of secession) and a weak sense of nationhood – no longer apply.

Similarly, HFE's role in securing interpersonal equity has largely disappeared. The burden of achieving interpersonal equity is now principally achieved through other policy instruments, such as the nationally-funded taxation, social security and primary health systems. Accordingly, the income tax system, combined with social security and welfare transfers, is far more effective in moderating the income distribution of individuals and households than the HFE system.

Substantial reductions in the costs of interstate migration and communications also mean that similar individuals and families enjoy similar living standards in every Australian jurisdiction.[9] This is illustrated by Chart 5.1, which shows the coefficient of variation across states' Gross Household Disposable Income (GHDI) over time. In general, disposable incomes have converged across Australian states over the past two decades. The notable exception is the ACT (excluded from the calculation), which (despite its high and sharply increasing incomes) has been a recipient state every year since its entry into the HFE system in 1988-89, except 1995-96 and 1996-97.

Chart 5.1: Gross Household Disposable Income per capita, states and territories (excl. ACT) coefficient of variation, 1990 to 2010

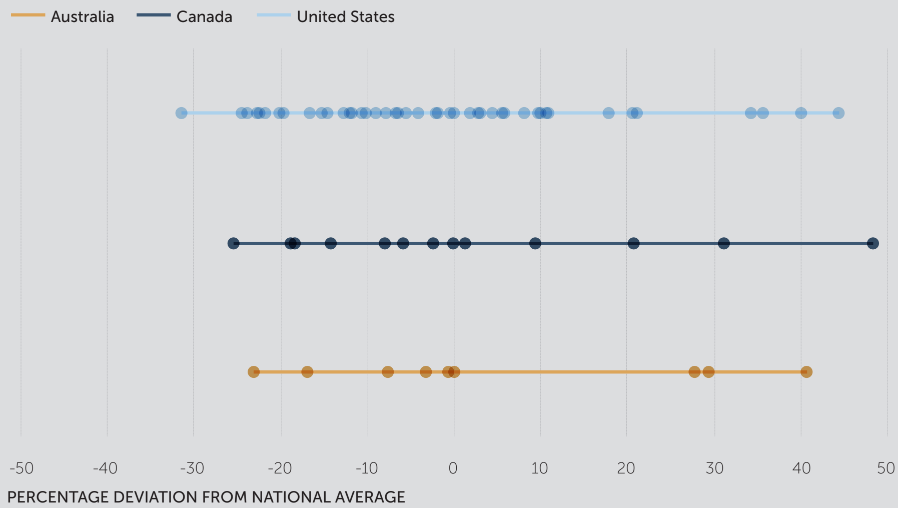


Source: ABS, Australian National Accounts (cat. no. 5220.0)

9 Abelson (2010) and Pincus (2011) argue that, by ignoring that some interstate differences in wage rates compensate for differences in costs of living (especially residential land rents and transit costs), the current Grants Commission methodology is unsound when it comes to estimating capacity to pay taxes and charges.

Australia also has relatively low interstate income disparities by international standards. This is illustrated by Chart 5.2, which presents a mark for each state (or territory or province) in Australia, Canada and the US, expressing each jurisdiction's percentage deviation in GSP per capita from the nation's average (ie. GDP per capita) in 2009. (The outliers of the Northwest Territories in Canada and the District of Columbia in the US are removed.) Broadly speaking each of three nations has comparable levels of regional GSP per capita disparity, but Australia's disparity is still moderately less than that of both Canada and the US.

Chart 5.2: GSP per capita, percentage deviation from national average, Australian, Canadian and US sub-national jurisdictions, 2009



Source: ABS, Statistics Canada, and US Census Bureau

Despite this fact, **Australia is the only one of these federations that seeks to comprehensively equalise the fiscal capacities of its sub-national governments.**

These developments, as well as all the issues raised in the previous sections, raise valid questions about the justification for the current system and whether its remaining objectives are better served by a different form of HFE including a move towards an EPC distribution.

HFE should be thought of as a dynamic arrangement, rather than a static principle to be applied for all time. Clearly, there are periods in a nation's development where significant disparities in service costs, demography and resource endowments may exist. HFE to an appropriate degree is necessary to maintain some sense of equity and nationhood. However, as time proceeds, many general disparities are likely to be overcome, as population growth generates economies of scale, as resource endowments (or the lack of them) can be offset by technological change and improvements in labour and capital productivity, and as the needs of particular disadvantaged segments of the population are addressed. Concurrently, specific disadvantages may become more apparent and need to be dealt with via separate, targeted and accountable interventions.

The long term effect of this process is that the nation becomes more homogeneous, reducing the need for HFE. In this event, the most efficient and equitable outcome will be to distribute Commonwealth funding on an EPC basis.

5.1.1 Full equalisation is a uniquely Australian concept

Unlike other comparable federations, the current system of HFE in Australia attempts to achieve 'full equalisation'. Equalisation in modern Australia now attempts to provide for the same standard of state services across seven revenue categories and eleven expense categories, as well as equalising infrastructure requirements and state net lending positions. This is reflected in the following definition of HFE, adopted by the CGC in its *2010 Review*:

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

This interpretation differs substantially from HFE's original purpose. In the early years of equalisation, recipient states were compensated to allow them to provide a minimum level of services in a small number of key areas like health and law and order. Since then, while the original justification for HFE has steadily diminished, its scope and magnitude have increased very substantially beyond the original remit.

5.1.2 Scope and magnitude of HFE has grown substantially beyond its original intent

From 1976, there have been progressive methodological changes that have increased both the scope and magnitude of HFE. These have:

> increased the areas of 'equalisation';

> introduced the concept of national averages;

> compensated to allow *equal* levels of average service delivery, rather than *comparable* or *minimum* levels of service delivery;

> redistributed a fixed pool (ie. zero sum game); and

> distributed the pool on the basis of relative rather than absolute disadvantage.

These changes have effectively shifted Australia from a system of partial to full equalisation. But the justification for doing so is far from clear, especially as the factors that created the need for HFE have substantially lessened, as noted above.

'Total' rather than 'minimum' financial needs:

The recipient states were initially funded at a 'minimum' standard. Between 1934 and 1941, **the CGC even introduced a penalty for claimancy such that allowances for social services (law, education, health) were set from 6 to 10 per cent below the national average** and the severity of taxation was set above the national average. This ensured that recipient states could not be better off than the weakest of the non-recipient or donor states.[10]

The principle of 'not appreciably below' in the CGC funding model was not formally adopted until the 1970s. This effectively encourages an aid mentality and significantly reduces incentives in the recipient states to become more efficient.

Equalisation as is it applied in Canada only seeks the goal of 'equalising up', not the Australian approach of both equalising up and equalising down. **The Australian approach penalises efficient states like Victoria while removing the incentive for other states to reform.**

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10 The concept of minimum needs was premised on the purpose of grants not being to lift a state "to the high standards of welfare of the most prosperous states, but to a minimum standard to enable it to carry on with reasonable efficiency" (CGC 1936 Report cited in Williams 2011, p13). It also incentivised states to improve their own performance.

'Absolute' rather than 'relative' payments

Prior to 1981, under the recipient state model, all disabilities were expressed as absolute dollars. Since then, the expense category assessment has been calculated in terms of states' relative need, not dollar amounts required to overcome disabilities. This method expresses expense disabilities in 'multiplicative' terms, increasing the complexity of the system. Essentially a range of disability factors are applied to expense items, including eligible population, service use, scale, dispersion of population, urbanisation and socio demographic variables. As noted earlier, **the net amount being redistributed to a contracting proportion of the population has also grown.**

National average rather than uniform minimum

The concept of 'national average' was introduced in 1981 (initially with just the six states, before the two territories were progressively added following the granting of self-government). **With only eight jurisdictions, the all-state average can be affected by the actions of one state.** Because the CGC applies this standard over many different and narrow areas of public expenditure, even a small state can dominate the standard in some areas - implying that states, if they wished, could alter their revenues and expenditures to affect the standard by which the CGC determines the 'national average', ie. average policy. This is consistent with the long-standing argument that the average policy can be influenced by state actions.

5.2 Next Steps

The difficult task of the Review Panel going forward cannot be underestimated. In this submission Victoria has articulated some of the problems associated with the current system of HFE in Australia, and some options on how to improve the system of HFE and move towards an EPC distribution of the GST pool among the states, including the identification of transitional or intermediate options.

Victoria encourages the Review Panel to be ambitious in its proposals to reform the distribution of the GST to serve the needs of a modern day Australia, and looks forward to the interim report. For its part, Victoria will seek to develop its proposals further in consultation with the Panel and in partnership with other jurisdictions, providing relevant details and undertaking further detailed modelling in relation to the key issues raised.

ATTACHMENT 1. EMPIRICAL WORK ON EFFICIENCY IMPACTS OF HFE

There is only a limited literature attempting to measure the welfare effects of Australia's HFE system. The most significant quantification has been from Monash University's Centre of Policy Studies (CoPS), which utilises Computable General Equilibrium (CGE) modelling to estimate the welfare impacts of changes to equalisation policy, from HFE to equal per capita (EPC). They come up with small to very small estimates of the efficiency effects, of about 0.3 per cent of the total amount distributed from the Commonwealth to the states.

However, it can be argued that the CGE approach has shortcomings that lead to an under-estimate of the size of the inefficiency caused by HFE. In particular, the Monash CGE work ignores all distortions to the incentives of state government decision-making, caused by HFE, except the 'flypaper' effect. This effect occurs when '… in a high-cost state, the Government may feel little pressure to use part of its Commonwealth grant to lower the level of state taxes, even though this would be of benefit to its citizens.' (Dixon *et al.* 2002, p308). Essentially, states with higher CGC grants are overspending relative to their citizens' preferences, as modelled by CoPS.

But there are many other distortions caused by HFE, affecting the decisions of state governments and of citizens. Although these have not been modelled in any quantitative way, they seem likely to have much greater efficiency effects than those captured by CoPS.

In an early attempt using stand-alone CGE models for the Northern Territory and Tasmania, Dixon *et al.* (1993) estimated that fiscal equalisation led to a national production loss of $30 million, based upon 1990 data.

With the more advanced Commonwealth-State Funding (CSF) CGE model, which incorporates all states and territories, Dixon *et al.* (2002) find that changing to an equal per capita distribution of all federal grants would produce an annual national welfare gain of $169 million.

The majority of this increase ($115 million) was attributed to a reduction in the 'flypaper' effect that accompanies fiscal equalisation. The remainder of the simulated gain arose from population shifts towards states with lower costs of service delivery.

In 2005, Dixon *et al.* updated their CSF analysis, again simulating the welfare effects of moving away from fiscal equalisation, once more using 2001 data. They concluded that a change to an EPC regime would increase national welfare somewhere in the order of $28 to $135 million per annum, depending on assumptions regarding population mobility, government preferences and externalities. Flypaper effects were again found to be the major source of welfare gains.

In summary, these CGE studies to measure the efficiency impacts of HFE generally found a welfare loss resulting from Australia's fiscal equalisation - but that is relatively modest in scale.

CGE models are necessarily very high level simplifications of reality, and their simulations miss much of the detail that is important to equalisation policy debates.

How much reliance should be placed on these estimates, given their shortcomings? One modelling choice probably led to an over-estimate of the efficiency losses; but most of the others led to an underestimate.

The over-estimate comes from the way that Dixon *et al.* model state spending, or the flypaper effect. They approvingly quote Hines and Thaler: "It is a rare community that treats a $2 million block grant and a collective $2 million tax cut as equivalent, regardless of the underlying equivalence in theory" (Dixon *et al.* 2005, p91). The assumption made by Dixon *et al.* is that a state government would not be acting in the interests of its citizens unless it gave additional tax relief equal to most of the redistributive part of the HFE grants. In their model, the state should spend only a portion, determined by the income elasticity of demand for publicly-supplied goods and services. But this ignores that, in the Australian federal system, federal grants are a component in a system of federal finance, and are meant to displace state own revenues (Brennan and Pincus 1996).

The GST was a change in federal-state financial relations, designed to make the states less reliant on their own sources of funds; and its introduction led to the complete abolition of some state taxes; but the same argument applied, prior to the GST.

However, the CGE model created by Dixon *et al.* has other shortcomings that arguably lead to an under-estimate of the size of the inefficiency. Garnaut and FitzGerald (2002) observe that the CoPS models treat capital as tools carried by workers; grossly simplify the production side of the economy; and adopt a simple treatment of expenditure externalities.

But the deeper criticism is that Dixon *et al.* hang too much on the flypaper effect, and ignore a range of ways in which HFE alters state government incentives described below. Thus, the greatest limitation of the CoPS model is perhaps its inability to capture the dynamic effects of government decisions that arise from equalisation methods that are not truly policy neutral. The long run cost of these and other aspects of the HFE system that may discourage efficiency-enhancing reforms could be very large, although hard to quantify. Such distortions reduce the long run rewards from implementing difficult economic development or cost reducing reforms, and the resulting efficiency losses may be significant: 1 to 2 percent of GDP, in the view of Garnaut and FitzGerald (2002, p151).

For example, state governments that (through various policy decisions) are able to increase their tax bases lose most of the revenue benefits to other states: through HFE, the initiating state retains merely its population share of the revenue benefits. The effective marginal 'HFE tax rate' ranges from 68 per cent for NSW, through 99 per cent for NT. This reduces the incentive to pursue policies that increase their tax bases; and encourages the states to prefer policies that create benefits to state budgets that are not 'taxed' by the CGC.

Moreover, although Dixon *et al.* model interstate migration, they do so in a way that does not capture how HFE distorts settlement patterns between states and within states.

As acknowledged by Dixon *et al.* (2002, p306), the CSF model is too high level in its treatment of taxes and expenditures to measure possible attempts by states to increase grant shares by altering their policies to game outcomes from the CGC formula. However, there is some econometric evidence (Dahlby and Warren 2003) that the equalisation system may have in fact impacted upon the fiscal decisions of state governments, including their choice of tax rates.

The theoretical economic literature has identified circumstances under which HFE can offset horizontal fiscal externalities, as well as fiscally-induced incentives for people to relocate (eg. to move to a resource-rich state, so as to become a part-owner of the mining tax revenues). However, the same theoretical literature also notes that HFE can cause damaging vertical fiscal externalities.

If a rise in one state's payroll tax causes some migration of taxable entities to another state, that would tend to cause the initiating state to moderate its rise in tax rate: this is a case of a horizontal fiscal externality, as one state's loss is another's gain. Australians form of HFE encourages states to impose higher payroll taxes than otherwise, by compensating the state that lost tax base, and reducing grants to the state that gained tax base.

But payroll taxes also impose a vertical externality on the national tax system, to the extent that payroll taxes reduces the Commonwealth's income tax base. The Henry tax review stated that the marginal economic cost of public revenue obtained through the payroll tax was high, relative to some existing state and federal alternatives; and, in response, recommended that it be replaced. Thus, on balance, it may be that HFE has encouraged states to impose payroll tax rates that are too high, from the point of view of tax efficiency. We could find no quantitative estimate of the overall loss or gain in tax-mediated efficiency that is induced by HFE.

In summary, these issues highlight how difficult it is to get a complete measure of the efficiency impacts of Australia's HFE system. Given the narrow scope of the empirical literature to date, policy makers should be wary of assuming that the costs resulting from HFE efficiency losses are relatively low and can be ignored when making decisions.

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