## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Background</td>
<td>4</td>
</tr>
<tr>
<td>What is HFE?</td>
<td>6</td>
</tr>
<tr>
<td>What does HFE mean for Tasmania?</td>
<td>8</td>
</tr>
<tr>
<td>How does the CGC implement HFE?</td>
<td>10</td>
</tr>
<tr>
<td>What are assessed revenues and expenditures?</td>
<td>13</td>
</tr>
<tr>
<td>What is a relativity?</td>
<td>14</td>
</tr>
<tr>
<td>How is a State’s GST distribution calculated?</td>
<td>14</td>
</tr>
<tr>
<td>What are the current relativities between States?</td>
<td>14</td>
</tr>
<tr>
<td>How have relativities changed?</td>
<td>15</td>
</tr>
<tr>
<td>What causes relativities and GST shares to change?</td>
<td>16</td>
</tr>
<tr>
<td>What factors influence Tasmania’s relativity?</td>
<td>17</td>
</tr>
<tr>
<td>Dispelling the myths</td>
<td>19</td>
</tr>
<tr>
<td>Western Australia - a case study</td>
<td>28</td>
</tr>
<tr>
<td>Are there other options for distributing the GST?</td>
<td>30</td>
</tr>
<tr>
<td>Should Government become more involved in the HFE process?</td>
<td>35</td>
</tr>
<tr>
<td>Should HFE have other objectives?</td>
<td>35</td>
</tr>
<tr>
<td>Appendix A: Terms of Reference for Productivity Commission Review into Horizontal Fiscal Equalisation</td>
<td>37</td>
</tr>
<tr>
<td>Appendix B: How the Commission calculates assessed revenues and expenditures.</td>
<td>39</td>
</tr>
<tr>
<td>Appendix C: Alternative HFE models raised in the 2012 GST Distribution Review.</td>
<td>47</td>
</tr>
<tr>
<td>References</td>
<td>49</td>
</tr>
<tr>
<td>Glossary of terms</td>
<td>51</td>
</tr>
<tr>
<td>Acronyms</td>
<td>55</td>
</tr>
</tbody>
</table>
**Background**

Horizontal Fiscal Equalisation (HFE) is a fundamental principle that binds the Federation, and ensures that all States and Territories (States) have similar fiscal capacity to deliver services to their residents, and that the tax burden is similar on all taxpayers. This is particularly important for the States with smaller populations and economies (smaller States) that face higher service costs and/or weaker tax bases than the States with larger populations and economies (larger States).

HFE is therefore a critical feature of Commonwealth-State financial relations to ensure equity between the States and has been an integral part of Australian Government fiscal policy since Federation. This was confirmed in the 2011 Intergovernment Agreement on Federal Financial Relations between the Commonwealth and States, where it was unanimously agreed the Australian Government would continue to distribute revenue from the Goods and Services Tax (GST) among the States in accordance with the principle of HFE.

In Australia, over $60 billion in untied GST revenue is provided each year to the States to spend according to their own budget priorities. The distributions are designed to equalise the different fiscal capacities of the States in accordance with the methodologies recommended by the Commonwealth Grants Commission (CGC). The GST revenue transfers are the vehicle through which the Australian Government implements HFE.

The CGC, its work and the underlying aim of equalising the fiscal capacity of the States is sometimes contentious and often misunderstood. For example, when State shares of the GST changed markedly because of strong State revenue growth from the recent mining and housing booms. These changes have increased scrutiny in relation to the fundamental principles of HFE.

Such factors are generally beyond the control of governments and affect States in very different ways. Tasmania strongly believes that this reinforces, rather than diminishes, the importance of the current equalisation system which fully equalises diverging fiscal capacities and thus mitigates incentives for inefficient migration of labour and capital.

The decreasing State relativity of Western Australia has drawn considerable attention and raised ill-informed arguments that it is bearing an unfair equalisation burden. However, this ignores the fact that it has been a recipient State and was a significant beneficiary of the HFE system in the mid-2000s.

This paper aims to clarify the issues surrounding HFE and its important role in supporting the Federation in the context of two major reviews into HFE and the distribution of GST currently underway.

The paper will be updated from time to time as the debate on the issue of the GST and how it is distributed develops.

*Productivity Commission Review into Horizontal Fiscal Equalisation*

On 30 April 2017, the Australian Government asked the Productivity Commission (PC) to undertake an inquiry into Australia’s system of HFE, which underpins the distribution of GST revenue to the States.

The PC inquiry is to consider the influence the current system of HFE has on productivity, efficiency and economic growth.

The final report of the PC enquiry is expected to be delivered to the Australian Government by 31 January 2018.

The Terms of Reference for the PC inquiry are contained in Appendix A.
**CGC 2020 Methodology Review**

Concurrently with the PC inquiry, the CGC is undertaking its 2020 review of the methodological approach used to calculate the per capita relativities to distribute GST revenue to the States, from 2020-21 onwards. The CGC conducts periodic reviews of its methodology and principles for determining HFE approximately every five years. The previous review was completed in 2015.

While the two reviews are being conducted independently, the findings of the PC inquiry may impact on the CGC’s 2020 Review methodology.
What is HFE?

The objective of HFE is to equalise the capacity of governments to provide services taking into consideration individual State costs of providing those services and related infrastructure, and their revenue raising capacity. It reflects the belief that Australians should have access to a similar standard of service, regardless of the jurisdiction in which they live. This is a strong egalitarian principle, which is supported by the Australian community and has been reflected in the CGC’s approach, in one form or another, since its inception in the 1930s.

If States were not provided with the same capacity to provide services through HFE, inequality within the Australian community would increase over time, because disadvantaged States would not be provided with capacity to compensate for their disadvantages and strong States would have a greater capacity than required to meet their needs. This would give the latter an ability to provide above national average standards of services and/or lower taxes.

While there is no Constitutional reference to HFE, nor is it explicitly defined in current legislation or in any agreement with the Commonwealth, the principle of HFE has evolved over time, primarily as a result of the work of the CGC.

The CGC defines the principle of HFE as follows:

State governments should receive funding from the pool of GST 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.

In this way, the smaller jurisdictions such as South Australia, Tasmania and the Northern Territory, which on the whole, face higher than average per capita costs and/or lower than average revenue raising abilities, are granted a greater than proportional share of general revenue assistance. This enables them to discharge their standard functions without necessarily having to impose above average revenue raising measures on their communities.

Equalising the fiscal capacity of States is a central element of federation. It protects State autonomy and enables the provision of services to State communities, reflecting the specific and varied priorities of those communities. The nature of the GST revenue pool distribution is a "zero sum game" in that for a State to receive above population share, another has to receive below population share.

HFE provides each State and Territory with the same capacity to provide services. It does not "compensate" for differences attributable to policy, practice and relative inefficiency.

Differences in the economic, social and demographic characteristics of the States affect their expenditures and revenues and contribute to differences in GST distributions. As can be seen from Table 1, Western Australia’s above average revenue raising capacity drives its fiscal strength, despite the fact that it has higher than average costs of providing services - meaning that it needs significantly less than its population share of the GST pool.

1 For example, the Australian Constitutional Values Survey conducted by Newspoll for the Centre for Governance and Public Policy, October 2014, at Griffith University has consistently found that more than three-quarters of Australians believe that transfers from wealthy to poorer parts of Australia should be made so that all Australians can have similar levels of services. Across the States, 84.1% of Victorians (the highest) agreed with that principle. The lowest approval came from Western Australians, although nearly 70% of that State’s sample still agreed with the proposition.


The relative fiscal strength of New South Wales and Victoria (and to a lesser extent, the ACT) is their below average cost of providing services, although this is offset to some extent in Victoria (and completely in the ACT) by a below average strength in revenue raising. South Australia, Tasmania and the ACT have relatively low fiscal capacities as a result of their below average capacities to raise revenue.

Table 1: Difference from an equal per capita distribution of GST, 2017-18

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>Redist</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expense</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>requirement(a)</td>
<td>-2 583</td>
<td>-4 835</td>
<td>1 948</td>
<td>2 134</td>
<td>334</td>
<td>499</td>
<td>-190</td>
<td>2 693</td>
<td>7 608</td>
</tr>
<tr>
<td><strong>Investment</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>requirement(b)</td>
<td>45</td>
<td>586</td>
<td>-196</td>
<td>136</td>
<td>-262</td>
<td>-162</td>
<td>-52</td>
<td>-95</td>
<td>767</td>
</tr>
<tr>
<td><strong>Net</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>borrowing(c)</td>
<td>14</td>
<td>-86</td>
<td>10</td>
<td>-13</td>
<td>43</td>
<td>22</td>
<td>2</td>
<td>8</td>
<td>99</td>
</tr>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>raising capacity(d)</td>
<td>-10</td>
<td>3 031</td>
<td>879</td>
<td>-6 740</td>
<td>1 694</td>
<td>740</td>
<td>381</td>
<td>25</td>
<td>6 750</td>
</tr>
<tr>
<td><strong>Commonwealth</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>payments (e)</td>
<td>103</td>
<td>272</td>
<td>-242</td>
<td>17</td>
<td>146</td>
<td>-24</td>
<td>62</td>
<td>-335</td>
<td>601</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>-2 432</td>
<td>-1 032</td>
<td>2 399</td>
<td>-4 464</td>
<td>1 955</td>
<td>1 075</td>
<td>203</td>
<td>2 296</td>
<td>7 928</td>
</tr>
</tbody>
</table>

Notes:
(a) Expense requirement is the operating outlays of the States.
(b) Investment requirement refers to acquisition of new infrastructure.
(c) Net borrowing is the outcome of an operating budget calculated as expenses and expenditure on non-financial assets less State own source revenues and revenues received from the Australian Government.
(d) Revenue raising capacity is the capacity of a State to raise revenue relative to the average. It reflects the size of a State’s revenue base per capita relative to the average.
(e) Commonwealth payments are payments to States made by the Australian Government, including general revenue grants, National specific purpose payments (SPPs), National partnership payments (NPPs) and Commonwealth own purpose expenses. The Commission examines the purpose of each payment using established guidelines to decide whether the payment has an impact on State fiscal capacities.

In the OECD’s report on fiscal equalisation in OECD countries, it surveyed member countries to compare fiscal equalisation systems. The report showed that in 2004, of those countries surveyed, fiscal equalisation as a percentage of gross domestic product (GDP) was the lowest in Australia at 0.49 per cent. The highest was Japan at 4.04 per cent and the unweighted average was 2.26 per cent.

While more recent estimates for other countries are not available, for Australia the current amount of the total GST pool that is used for fiscal equalisation is $7 928 million or 12.6 per cent of the total GST pool as shown in the table below. Australia’s GDP is $1.684 trillion for the four quarters ending March 2017. Thus, as a proportion of GDP, fiscal transfers remain at a similar proportion of GDP (0.47%).

---

*Hansjörg Blöchliger, Olaf Merk, Claire Charbit, Lee Mizell Fiscal Equalisation in OECD Countries, OECD France September 2007*
Australia’s fiscal equalisation transfers are therefore not large by OECD standards, possibly because the differences in fiscal capacity within regions are not as great as in some other countries due to Australia’s long history of fiscal equalisation and community expectations. However, for the smaller States, equalisation is significant as their GST share represents a higher proportion of Gross State Product and General Government expenditure compared to the larger States.

As such, the way the GST is distributed has the potential to significantly impact small State economies and communities, while for the larger States it has a relatively smaller impact.

**Table 2: Amount of GST used to fiscally equalise the States**

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>VIC</th>
<th>QLD</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017-18 distribution</td>
<td>$17 680</td>
<td>$14 829</td>
<td>$14 963</td>
<td>$2 354</td>
<td>$6 360</td>
<td>$2 403</td>
<td>$1 230</td>
<td>$2 921</td>
<td>$62 740</td>
</tr>
<tr>
<td>Per capita distribution</td>
<td>$20 111</td>
<td>$15 862</td>
<td>$12 565</td>
<td>$6 818</td>
<td>$4 405</td>
<td>$1 328</td>
<td>$1 026</td>
<td>$625</td>
<td>$62 740</td>
</tr>
<tr>
<td>Difference</td>
<td>$-2 432</td>
<td>$-1 032</td>
<td>$2 399</td>
<td>$-4 464</td>
<td>$1 955</td>
<td>$1 075</td>
<td>$203</td>
<td>$2 296</td>
<td>$0</td>
</tr>
<tr>
<td>Total General Government revenue</td>
<td>$77 005</td>
<td>$60 370</td>
<td>$53 449</td>
<td>$25 681</td>
<td>$18 263</td>
<td>$5 573.7</td>
<td>$5 058</td>
<td>$5 891</td>
<td>$251 291</td>
</tr>
<tr>
<td>GSP/GDP</td>
<td>531 323</td>
<td>373 624</td>
<td>314 569</td>
<td>101 096</td>
<td>255 214</td>
<td>26 039</td>
<td>36 225</td>
<td>23 648</td>
<td>1 661 739</td>
</tr>
<tr>
<td>Share of GST as per cent of total revenue</td>
<td>23.0%</td>
<td>24.6%</td>
<td>28.0%</td>
<td>9.2%</td>
<td>34.8%</td>
<td>43.1%</td>
<td>24.3%</td>
<td>49.6%</td>
<td>25.0%</td>
</tr>
<tr>
<td>Share of GST as per cent of GSP/GDP</td>
<td>3.33%</td>
<td>3.97%</td>
<td>4.76%</td>
<td>2.33%</td>
<td>2.49%</td>
<td>9.23%</td>
<td>3.40%</td>
<td>12.35%</td>
<td>3.78%</td>
</tr>
</tbody>
</table>

Source: CGC 2017 Update Report and Treasury calculations

**What does HFE mean for Tasmania?**

HFE is important for Tasmania on a number of grounds, including fiscal adequacy, funding flexibility and the ability of the system to respond to changing financial and economic circumstances.

**Fiscal adequacy**

In 2017-18 Tasmania’s total revenue is expected to be approximately $5 874 million. The State’s largest source of revenue is GST revenue, estimated to be $2 387 million in 2017-18, or approximately 41 per cent of Tasmania’s total revenue.

Tasmania will receive $1.1 billion more than its population share of GST of $1.3 billion in 2017-18 because of HFE. This is 18 per cent of total revenue, 100 per cent of State own-source revenue and almost the same as the amount received from the Australian Government payments for specific purposes. Putting this into perspective, HFE distributions represents 64 per cent of Tasmania’s health expenditure, or 71 per cent of education expenditure.

Figure 1 shows the relative importance of each source of revenue for Tasmania.

---

6 Various State Budget Papers
7 ABS 5220.0 Australian National Accounts: State Accounts June 2016
Figure 1: Tasmanian Revenue Sources 2017-18

**Funding flexibility**

The introduction of the GST in 2000 provided the States with a more reliable and growing source of untied funding to replace Australian Government untied General Purpose Payments.

For Tasmania, untied funding from the GST is about 65 per cent of total Commonwealth funding. The remainder is provided by the Australian Government in the form of Specific Purpose Payments which are tied and must be spent in accordance with national agreements in such areas as health, education, roads, and environment.

If there were to be a change in the way the GST was to be distributed, and Tasmania received less funding from this source, an increase in other Commonwealth grant payments would be required in order to maintain total Commonwealth funding levels. This may be in the form of additional tied funding which would reduce Tasmania’s budget flexibility. Such a change would undermine the State’s sovereignty, because it would have less flexibility to provide services according to the needs and preferences of the community. It would also increase our fiscal risk and uncertainty, as the Commonwealth could unilaterally reduce or terminate these types of grants.

**Responsiveness to changing circumstances**

An important benefit of the current approach to HFE through the distribution of the GST is that it is able to respond to changes in States’ circumstances (albeit with a time lag). This means that if a State’s fiscal capacity is temporarily falling behind or surging ahead then the GST distribution will adjust to the change in fiscal capacity.

For example, where there are changes in revenue capacity such as growth in property taxation from property price escalation, the resulting improvement in fiscal capacity leads to a lesser GST share. If a State suffers abnormal natural disasters its GST share also adjusts accordingly, as can be seen in Figure 2. In Queensland when there were successive natural disasters its GST share increased, and when there has been rapid revenue growth from the resources sector other States received higher GST which...
helped alleviate the negative impacts of a rising exchange rate, inflation, and significant wage escalation. Rapid population growth would see the GST distribution adjust to provide the fiscal capacity for the additional infrastructure needed in areas such as schools, hospitals and roads.

**Figure 2: Queensland relativity since 2000**

![Graph showing Queensland relativity since 2000 with significant events labeled.](source: CGC history of general revenue assistance paid to States)

While Tasmania has experienced considerable economic and social improvement in recent years, it still remains well below national averages in a range of social and economic indicators. Many of these indicators reflect structural problems or characteristics, which can only be resolved over the long-term. Efforts to implement the structural changes necessary would be significantly undermined by any change to the objective of HFE which reduced Tasmania’s capacity to provide services.

**How does the CGC implement HFE?**

Established in 1933, the CGC is an independent Australian Government statutory body charged with the task of making recommendations to the Australian Treasurer, in the form of per capita relativity factors, on how GST Revenue should be distributed between the States each year to best achieve full fiscal equalisation.

During its early years, before the introduction of the GST, the CGC developed its principle for determining a special grant as being that amount necessary to make it possible for a State to function at a standard not appreciably below that of other States.\(^8\)

The role of the CGC was expanded in the 1970s under the New Federalism’ policies of the Fraser government. In 1978, the Commonwealth tasked the CGC with reviewing the States’ share of general revenue grants, specifying the principle it wanted the CGC to apply.\(^9\) This principle was expressed initially as follows:

\[
\text{The respective payments to which the States are entitled ... should enable each State to provide, without imposing taxes and charges at levels appreciably different from the levels of the taxes and charges imposed by the other States, government services at standards not appreciably different from the standards of the government services provided by the other States.}
\]


\(^9\) This principle was set out in section 13(3) of the States Personal Income Tax Sharing Amendment Act 1976.
This same principle was implemented by the CGC when the States signed the Intergovernmental Agreement on the Reform of Commonwealth-State Relations (the IGA) in 1999, as part of the implementation of the GST distribution process.

Under the current approach to HFE, the GST is distributed to the States on the basis of relativities recommended by the CGC. In calculating the relativities, the CGC assesses each State’s fiscal capacity, including its capacity to raise revenue and its costs of providing government services.

The CGC applies four key principles\(^\text{10}\) that ensure that HFE is implemented through methods that:

- reflect what the States actually do - this means that the CGC seeks to avoid making judgements on what the States could or should do;
- are policy neutral - this means that the CGC seeks to ensure that policy differences between the States do not affect the GST distribution, and that the distribution process does not provide the States with the incentive to vary their policies;
- are practical - this means that the assessments are based on sound and reliable data and methods; and
- are most appropriate to the application year - this means that the distribution should be up to date and should reflect State circumstances in the year the funds are used.

The rationale of HFE is that different States have different costs and capacities to raise revenue for reasons that are largely beyond their control. To accommodate these differences, the CGC consolidates the actual revenue and expenditure of the States to construct an ‘average’ State budget, based on the costs to provide the average level of services and the average revenue raised by State tax regimes.

While precise equalisation is the goal of the CGC, the reality is an approximate equalisation.

Relativities are calculated in a sequential way. The process includes:

- compiling the adjusted budget to obtain average State net lending, average expenses on State services and average State investment, average revenues for State own-source revenues and from other Australian Government payments for specific purposes (Australian Government payments);
- equalising State fiscal outcomes by calculating how much each State needs to save or borrow to give it the average stock of financial assets (assessed net lending); and
- equalising service delivery capacity and revenue effort by:
  - calculating, for each State expense, how much more or less than the average each State would need to spend to deliver the average service (assessed expense);
  - calculating how much each State would need to invest to give it the average stock of infrastructure, recognising differences between States in the quantity they require and its costs (assessed investment);
  - calculating, for each State revenue source, how much more or less than the average each State would raise if it adopted the average revenue raising policy of the States (assessed revenue); and

– taking account of the level of other Australian Government payments received by States.

A State’s GST requirement is then calculated as the difference between its assessed expenditure needs and the sum of its assessed own-source revenue capacity and its actual ‘tied’ Australian Government funding.

Figure 3A illustrates how the assessed revenues are built up from the own-State revenues and the ‘tied’ grants from the Commonwealth. The assessed expenditures generally exceed the sum of the assessed revenues. Figure 3B illustrates how much GST is required to meet the difference between assessed revenue and assessed expenditure, thus producing an outcome where States have (materially) the same capacity to fund their separate needs.

Figure 3A shows why States require differing levels of GST revenue - they have different costs of providing the average level of services and different capacities for raising revenues. If a State has a high capacity for raising revenue - like Western Australia - it will have high assessed revenue and will, therefore, require less GST. Similarly, if a State has a high cost of providing average service levels - like the Northern Territory - it will have high assessed expenses and will require more GST revenue.

It is obvious from Figure 3B that if a State’s revenue raising capacity increases or its expenditure needs decline, the gap between its assessed expenditure and assessed revenue will narrow and the CGC will assess it as requiring less GST revenue to deliver the average level of services.

**Figure 3A: Revenue available to meet expenditure needs 2017-18 (per capita)**

Source: CGC Calculations
What are assessed revenues and expenditures?

To derive the assessed revenues and expenditures, the CGC identifies drivers (disabilities) that may cause a State’s revenue raising capacity or service delivery costs to diverge from the average State budget. From a revenue perspective, the CGC assessments cover 13 revenue assessments in eight categories of revenue. The assessed expenditure covers 93 expenditure assessments across 14 categories.

The major drivers of differences between States are:

- level of remoteness of population;
- distribution of indigenous people;
- wage costs;
- population growth;
- mining royalties;
- payrolls of large companies; and
- property sales and the value of property.

Relativities are calculated by expressing each State’s assessed GST revenue requirement per capita as a proportion of the average GST per capita for the year.

---

**Figure 3B: Resultant GST requirement 2017-18 (per capita)**

Source: CGC Calculations

11. Mining royalties, conveyance duties, payroll tax, insurance duty, motor vehicle tax, land tax, ‘other’ taxes and Commonwealth payments.
12. Schools, post-secondary education, admitted patients, community health, welfare and housing, community services, justice, roads, transport, services to industry, ‘other’ expenditure, depreciation and net lending.
Appendix B illustrates the method used by the CGC to undertake revenue and expenditure assessments. The Appendix uses the example of Insurance Taxes from the revenue perspective, and the Rural Roads component of Roads Expenditure from the expenditure point of view.

What is a relativity?

Relativities measure how a State’s calculated GST per capita differs from the average per capita GST.

If States had the same economic, social and demographic features and Commonwealth payments were distributed uniformly among them, the CGC would recommend that the GST be distributed equally per person. Each State would be allocated the same (average) amount per resident, and it would assess a relativity of one for each State.

However, some States are fiscally stronger than others - they have stronger tax bases, lower service delivery costs or receive above average Commonwealth payments. They need less GST revenue than other States if all States are to be fiscally equal.

That relative strength (or weakness) is measured by the State’s need for GST revenue, compared to the average, and is summarised in its relativity.

If the State had a weaker than average tax base, the CGC would recommend the State receive more than the average GST per resident, giving it a relativity above one. If the State had a stronger than average tax base, the CGC would recommend the State receive less than the average GST per resident, thereby assessing the State to have a relativity below one.

The recommended relativities are derived by averaging the relativities calculated for the most recent three years for which data are available. Three year averaging captures the differences in capacities among the States, which mostly change only slowly over time. The averaging also reduces year to year volatility in the GST revenue distribution, particularly if there are exceptional circumstances in any particular assessment year.

The recommended relativities are used, in conjunction with State populations in the application year, to determine a GST distribution for that year. The per capita relativities recommended for use in 2017-18, for example, are the average of the annual relativities for the three assessment years 2013-14 to 2015-16.

How is a State’s GST distribution calculated?

Each State’s GST revenue is a function of its relativity, population share, and the GST pool. The following equation is a simplified illustration of this calculation.

\[
\text{GST to Tasmania} = \text{Tasmania’s relativity} \times \frac{\text{Tasmania’s population}}{\text{National population}} \times \text{Total GST pool}
\]

In 2017-18, Tasmania’s relativity of 1.80477 and population share results in a 3.83 per cent share of the total GST pool.

What are the current relativities between States?

Table 3 below sets out the relativities derived for 2016-17 and 2017-18, together with the resultant GST shares and distributions for those two years. Table 3 indicates that five States - Northern Territory, the ACT, South Australia, Queensland and Tasmania - are assessed as having revenue or expenditure disabilities that require them to receive more than the per capita share of the GST distribution.
Table 3: Relativities, shares and illustrative GST distribution, 2016-17 and 2017-18

<table>
<thead>
<tr>
<th></th>
<th>Relativities</th>
<th>GST shares</th>
<th>GST distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2016-17</td>
<td>2017-18</td>
<td>%</td>
</tr>
<tr>
<td>New South Wales</td>
<td>0.90464</td>
<td>0.87672</td>
<td>29.1</td>
</tr>
<tr>
<td>Victoria</td>
<td>0.90967</td>
<td>0.93239</td>
<td>23.0</td>
</tr>
<tr>
<td>Queensland</td>
<td>1.17109</td>
<td>1.18769</td>
<td>23.6</td>
</tr>
<tr>
<td>Western Australia</td>
<td>0.30330</td>
<td>0.34434</td>
<td>3.3</td>
</tr>
<tr>
<td>South Australia</td>
<td>1.41695</td>
<td>1.43997</td>
<td>10.0</td>
</tr>
<tr>
<td>Tasmania</td>
<td>1.77693</td>
<td>1.80477</td>
<td>3.8</td>
</tr>
<tr>
<td>Australian Capital Territory</td>
<td>1.15648</td>
<td>1.19496</td>
<td>1.9</td>
</tr>
<tr>
<td>Northern Territory</td>
<td>5.28450</td>
<td>4.66024</td>
<td>5.3</td>
</tr>
<tr>
<td>Total</td>
<td>1.00000</td>
<td>1.00000</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: CGC 2017 Update

How have relativities changed?

State relativities will fluctuate over time, and sometimes significantly when relative State economic or demographic circumstances change.

Figure 4 illustrates the change in State relativities since 2000-01\(^\text{13}\). With the possible exception of the ACT, whose relativity reduced as a result of methodology changes in the 2010 Review, the relativities have adjusted to reflect changes in relative fiscal capacity, as they are designed to do.

The decreasing State relativity of Western Australia from 2007-08 has drawn considerable attention and raised arguments that it is bearing an unfair equalisation burden. However, these ill-informed arguments ignore the fact that in every year since 1978, New South Wales and Victoria have been significant donor States (receiving less than an EPC share of GST revenue). Furthermore, while Western Australia is a donor State, it was a recipient State and a significant beneficiary of the HFE system in the mid-2000s. Queensland has become a recipient State since 2013-14.

The Northern Territory’s relativity has declined sharply in the last two years, primarily as a result of reductions in its assessed expenses. The Northern Territory’s share of national population growth has been lower in the 2016 and 2017 CGC Updates, resulting in a reduced infrastructure investment requirement. There has also been a national decline in remote service use in the past two Updates, reducing the Northern Territory’s assessed community health spending; remote schools are considered to be less expensive to operate than in the past; and States are spending less on rural and local roads, both of which the Northern Territory has a higher than average length. Compounding the reduction in the Northern Territory’s assessed expenses, it also received a greater share of Commonwealth payments than in the 2016 Update.

\(^{13}\) The Northern Territory relativities are presented separately, as they distort the scale when included with the other States.
While Western Australia’s relativity has declined, the growth of its mining sector is evidence that HFE has not prevented, or discouraged States from improving their economic and fiscal capacities. Importantly, HFE responds to the changing relative circumstances of the States. This demonstrates that HFE operates as it was designed to.

What causes relativities and GST shares to change?

Factors that can influence changes in a State’s relativity include:

- the CGC’s methodology - the next CGC methodology review is already underway and will first have an impact on relativities from 2020-21;
- the CGC’s data sources - for example, the use of a new dataset to estimate comparative interstate public sector wages cost Tasmania approximately $30 million in the 2017 Update; and
- States’ own source revenue raising capacity. Western Australia’s mining royalties are the most visible example of this. However, New South Wales is currently experiencing rapid growth in conveyance duty revenue as a result of its strong property market. If NSW’s property market were to weaken this would, in time, result in less GST being distributed away from NSW and therefore less GST being distributed to Tasmania.

A State’s GST distribution is its population share of the national GST pool multiplied by its relativity factor.

---

14 Prior to 2009-10, GST relativities were also used to distribute health care grants. The pool was a combined pool of GST revenue and health care grants. The relativities in Figure 4 have been recalculated by the Commission with health care grants treated by inclusion (affecting the relativities, rather than being distributed in accordance with the relativities). Thus the relativities are “consistent” for illustrative purposes.
Whilst large changes in State relativities have drawn criticism of HFE, changes to State populations and the GST pool can also materially impact on relative State shares of GST revenues. As an illustrative example, Table 4 shows the extent that changes in these three variables have contributed to the changes in State shares of GST revenue in 2017-18. In all cases, except for Western Australia and the Northern Territory, the most significant contribution to changes in States’ GST revenue is movements in the GST pool, rather than changes in State relativities or State populations.

Table 4: Distribution of the 2016-17 GST and the Illustrative 2017-18 GST

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td>Estimated 2016-17</td>
<td>17 369</td>
<td>13 717</td>
<td>14 075</td>
<td>1 976</td>
<td>6 000</td>
<td>2 278</td>
<td>1 136</td>
<td>3 190</td>
<td>59 740</td>
</tr>
<tr>
<td>Illustrative 2017-18 (a)</td>
<td>17 680</td>
<td>14 829</td>
<td>14 963</td>
<td>2 354</td>
<td>6 360</td>
<td>2 403</td>
<td>1 230</td>
<td>2 921</td>
<td>62 740</td>
</tr>
<tr>
<td>Change</td>
<td>311</td>
<td>1 112</td>
<td>889</td>
<td>378</td>
<td>360</td>
<td>125</td>
<td>94</td>
<td>- 269</td>
<td>3 000</td>
</tr>
<tr>
<td>Change caused by new:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Population</td>
<td>22</td>
<td>75</td>
<td>- 9</td>
<td>1</td>
<td>- 33</td>
<td>- 23</td>
<td>- 1</td>
<td>- 32</td>
<td>0</td>
</tr>
<tr>
<td>Pool</td>
<td>873</td>
<td>693</td>
<td>706</td>
<td>99</td>
<td>300</td>
<td>113</td>
<td>57</td>
<td>159</td>
<td>3 000</td>
</tr>
<tr>
<td>Fiscal capacities</td>
<td>- 585</td>
<td>344</td>
<td>191</td>
<td>278</td>
<td>94</td>
<td>34</td>
<td>38</td>
<td>395</td>
<td>0</td>
</tr>
<tr>
<td>Change ($m)</td>
<td>311</td>
<td>1 112</td>
<td>889</td>
<td>378</td>
<td>360</td>
<td>125</td>
<td>94</td>
<td>- 269</td>
<td>3 000</td>
</tr>
<tr>
<td>Change ($pc)</td>
<td>39</td>
<td>178</td>
<td>180</td>
<td>141</td>
<td>208</td>
<td>239</td>
<td>233</td>
<td>- 1 094</td>
<td>122</td>
</tr>
</tbody>
</table>

Source: CGC Staff Paper
Notes: (a) The illustrative 2017-18 distribution is the likely GST available for distribution in 2017-18 as forecast by the Australian Government.

What factors influence Tasmania’s relativity?

As noted earlier, the CGC’s methodology assesses each State and Territory’s revenue raising capacity and expenditure needs based on the average revenue raising effort and average expenditure policy, and then adjusts for specific revenue raising and cost disabilities.

Tasmania is assessed as having lower revenue raising capacity and higher service costs for most assessments and overall this results in a higher relativity than other States.

The CGC’s assessments use various cost factors that determine the relative cost disability a State faces in providing the average service level. These factors include demographic factors, wage costs, indigeneity, remoteness, and urban density. The CGC has estimated the impact of these factors to isolate their effects in the redistribution of the GST.

For Tasmania, the major drivers that distribute GST to the State are lower company payrolls, property sales, land values and mining production (on the revenue side) and greater remoteness and regional costs, and diseconomies of scale (administrative scale) and indigeneity (on the expenditure side).

Drivers that move GST away from Tasmania are our lower wage costs, smaller urban size and lower population growth. Table 5 summarises the impact of these revenue and expenditure drivers.
<table>
<thead>
<tr>
<th>Effects of revenue raising capacity</th>
<th>Redistribution (above EPC)</th>
<th>Total Redistribution</th>
<th>Tax proportion of total redistributed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining production</td>
<td>191</td>
<td>5,758</td>
<td>3.3%</td>
</tr>
<tr>
<td>Payrolls paid</td>
<td>217</td>
<td>1,550</td>
<td>14.0%</td>
</tr>
<tr>
<td>Property sales (a)</td>
<td>236</td>
<td>1,929</td>
<td>12.3%</td>
</tr>
<tr>
<td>Land values</td>
<td>87</td>
<td>668</td>
<td>13.0%</td>
</tr>
<tr>
<td>Other revenue effects</td>
<td>10</td>
<td>368</td>
<td>2.6%</td>
</tr>
<tr>
<td><strong>Total revenue raising capacity</strong></td>
<td><strong>740</strong></td>
<td><strong>6,750</strong></td>
<td><strong>11.0%</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Effects of expenditure requirements</th>
<th>Redistribution (above EPC)</th>
<th>Total Redistribution</th>
<th>Tax proportion of total redistributed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Demographic features</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Remoteness and regional costs (b)</td>
<td>379</td>
<td>2,150</td>
<td>17.6%</td>
</tr>
<tr>
<td>Indigenous status (c)</td>
<td>101</td>
<td>1,729</td>
<td>5.9%</td>
</tr>
<tr>
<td>Socio-economic status (d)</td>
<td>39</td>
<td>764</td>
<td>5.1%</td>
</tr>
<tr>
<td>Other SDC (e)</td>
<td>32</td>
<td>689</td>
<td>4.7%</td>
</tr>
<tr>
<td>Total</td>
<td>552</td>
<td>4,249</td>
<td>13.0%</td>
</tr>
<tr>
<td>Wage costs (f)</td>
<td>-165</td>
<td>1,221</td>
<td>-13.5%</td>
</tr>
<tr>
<td>Urban centre size (g)</td>
<td>-196</td>
<td>894</td>
<td>-21.9%</td>
</tr>
<tr>
<td>Population growth (h)</td>
<td>-9</td>
<td>800</td>
<td>-1.2%</td>
</tr>
<tr>
<td>Administrative scale</td>
<td>232</td>
<td>898</td>
<td>25.8%</td>
</tr>
<tr>
<td>Natural disaster relief</td>
<td>-9</td>
<td>800</td>
<td>-1.2%</td>
</tr>
<tr>
<td>Small communities (i)</td>
<td>22</td>
<td>588</td>
<td>3.7%</td>
</tr>
<tr>
<td>Non-State sector (j)</td>
<td>42</td>
<td>288</td>
<td>14.6%</td>
</tr>
<tr>
<td>Other expense effects</td>
<td>-25</td>
<td>1,613</td>
<td>-1.6%</td>
</tr>
<tr>
<td><strong>Total expense and capital effects</strong></td>
<td><strong>359</strong></td>
<td><strong>7,099</strong></td>
<td><strong>5.1%</strong></td>
</tr>
<tr>
<td>Effects of Commonwealth payments</td>
<td>-24</td>
<td>601</td>
<td>-4.0%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>1,075</strong></td>
<td><strong>7,928</strong></td>
<td><strong>7.4%</strong></td>
</tr>
</tbody>
</table>

| Proportion of GST that is total redistributed | 45% | 23% |

Source: CGC 2017 Update

(a) Stamp duty on conveyances only. Excludes stamp duty on motor vehicles.
(b) The effects of remoteness on the use and cost of services.
(c) The effects of Indigenous status on the use and cost of services. It does not include the effects of socio-economic status and remoteness.
(d) The effects of socio-economic status on the use and cost of services. In most categories, CGC has used area based measures of socio-economic status specific to Indigenous and non-Indigenous people.
(e) Socio-demographic composition (SDC) includes the effects of interstate differences in age structure (including number of students in the Schools assessment), educational disadvantage (National Education Reform Agreement (NERA)), household size and people with disabilities.
(f) The effect of differences between States in wage costs on the cost of providing services across States.
(g) The effects of urban centre size on urban transport subsidies and investment in urban transport infrastructure. It excludes the impact of population growth.
(h) The effects of population growth on State investment in infrastructure including urban public transport, net borrowing and capital grants to local government for community amenities.
(i) The effects of concentrations of people living in small, remote and very remote communities on utility subsidies.
(j) The effect of the provision of services by the non-State sector on the demand for State education and health services.
Dispelling the myths

While HFE in Australia is a longstanding practice, it nonetheless continues to be a contentious area of federal financial relations. This is perhaps due to the ‘zero sum game’ nature of the system, where an increased share of the equalisation pool for one State or Territory reduces the share of other States and Territories.

This has led to criticism of HFE and the way the GST is distributed from various commentators including the larger States which receive less than a per capita share of the GST. The debate has been fueled by a number of myths about HFE including that it:

- discourages States from pursuing efficiency and cost reductions;
- discourages efficient resource and population migration;
- results in excessively large public sectors in recipient States;
- discourages the development of revenue raising sectors such as mining and resources;
- discourages economic, regulatory and tax reform;
- over-subsidises and overfunds certain States;
- is inherently unfair to resource-rich States such as Western Australia;
- ignores the impact of gambling taxes in calculating revenue assessments;
- causes a lack of accountability in government expenditure; and
- may imperil the cohesion of the federation.

These myths are considered in more detail in the following analysis.

**Does HFE discourage States from pursuing efficiency and cost reductions?**

It is important to note that the CGC does not equalise the GST based on the individual efficiency of State governments. Its methodology distributes the GST based on the average of what all States do.

The CGC bases its assessments on factors that are beyond the control of Governments – for example how many people are in age groups that are the heaviest users of hospital services, how many school students are in each jurisdiction etc.

One of the CGC key principles is to ensure that its assessments are policy neutral. States have full incentives to make their operations more efficient.

As a result of this principle, fiscal equalisation is also efficiency neutral. Under the current methodology, all States are assumed to incur the national standard (weighted average) level of expenditure to deliver a service. This is then adjusted for the disabilities faced by each State to deliver that service. No adjustment is made in relation to how efficiently a State delivers a service.

If a State is able to deliver the average level of service at a cost below the national average, its funding from the Commonwealth is not impacted and it would benefit from its greater efficiency.15

Therefore any reforms that States make to their service delivery systems will not materially affect those assessments or HFE transfers. If a State has above average efficiency in delivering a particular service then it will benefit from the difference between the national average and its actual expenditure. Conversely if it less efficient than the national average then it bears that cost.

---

15 A State would only be affected by the minimal impact it would have through the national standard, as it impacts all States not just the ‘efficient’ State as it changes the average.
States therefore continue to have the incentive to reduce costs as they will retain the benefit of greater budget flexibility and will not be discouraged from improving efficiency by the equalisation process.

It could be also be argued that fiscal equalisation has other efficiency impacts. For example, it could be argued that, by compensating States for disabilities such as scale and dispersion, equalisation encourages States to provide services to small, dispersed populations which would otherwise be uneconomic and it provides a barrier to the rationalisation of these services. This is where there is a fundamental trade-off between the notions of equity and efficiency.

It could be also be argued that fiscal equalisation has other efficiency impacts. For example, it could be argued that, by compensating States for disabilities such as scale and dispersion, equalisation encourages States to provide services to small, dispersed populations which would otherwise be uneconomic and it provides a barrier to the rationalisation of these services. This is where there is a fundamental trade-off between the notions of equity and efficiency.

Efficiency is said to occur when a society as a whole obtains the largest possible amount of output (such as goods and services) from its limited economic resources. Equity occurs when a society distributes its economic resources fairly among its people.

These two goals can, at times be in conflict when efficiency is increased at the expense of equity. For example, the introduction of a flat tax rate or user pays charge may enhance efficiency, but will have adverse distributional effects and be inequitable to those on low incomes.

Research commissioned for the Garnaut-Fitzgerald Review of Commonwealth-State funding demonstrated that any theoretical efficiency losses arising from the application of HFE are minimal. The research found that, theoretically the welfare gains from moving to a per capita distribution were between $150 million and $250 million a year. This is insignificant when compared to Australian GDP of around $708 billion per year at that time.

Modelling, commissioned by the Queensland Government in response to a CGC staff paper in 2006 and undertaken by Monash University’s Centre for Policy Studies (which also undertook the Garnaut-Fitzgerald modelling), yielded strikingly different results. Based on slightly modified – though more realistic – assumptions, the Queensland modelling suggested that moving to an equal per capita (EPC) distribution would result in losses of up to $620 million in national economic welfare, compared to a no-change situation.

More recently, the 2015 study undertaken by Independent Economics on behalf of the South Australian Government found that the moving to a modified equal per capita distribution of GST revenues (indigenous expenditure remains equalized), would lead to a permanent loss in national living standards of about $520 million (in 2015-16 terms)

**Does HFE discourage efficient resource and people migration?**

It has been asserted that HFE leads to resource misallocation across Australia because it discourages employment-related interstate migration. It is argued that the fiscal transfers from the application of HFE enable people to remain in less productive regions and that this counteracts market incentives for individuals to move to where there are employment opportunities in higher productivity jobs. This, it is argued, would have the effect of lower overall productivity, which is the equivalent of a loss of potential output for the nation as a whole.

This assertion ignores the fact that individuals and households face two sets of factors that influence living standards and, in turn, where they choose to live. Living standards are influenced by individual and household income, primarily determined by employment. They are also influenced by the net fiscal

---

16 Dixon et al, Effects of changes in Commonwealth Grants to the States: an applied equilibrium analysis. 2002
18 Queensland Treasury Response to Commonwealth Grants Commission Issues Paper 2006/03, June 2006;
benefit arising from living in their jurisdiction, determined by factors such as the level of State taxes and the level of public services and infrastructure.

Households will, according to economic theory, only move from one region to another if they make a judgement that they will enjoy a higher standard of living (utility or welfare) by doing so. If there are significant differences in the net fiscal benefit between States over time, this can affect migration decisions, which would be wholly unrelated to employment opportunities and therefore to productivity. In some cases, it could result in migration to States with a more favourable net fiscal benefit. In other cases, it could result in individuals or households choosing not to migrate even though there are superior employment opportunities, due to the poorer net fiscal benefit in other States.

It therefore follows that the greater the uniformity in the net fiscal benefit across States, the more migration decisions will be influenced by employment-related factors, which leads to higher national productivity.

Buchanan20, in his seminal study for the United States, found that HFE was beneficial not only from an equity perspective but also because it was consistent with economic efficiency principles. His work showed that HFE prevents the migration decisions of households from being influenced by the fact that State boundaries exist, where different States have different levels of net fiscal benefit.

If Australia were a unitary government with no State borders (or differences in the net fiscal benefit between States) and one part of the country experienced strong economic growth from its natural endowments, the associated increase in national government revenue would be distributed across the nation through lower personal and business taxation and increased welfare and other benefits. The net fiscal benefit would alter, but it would be the same across the country. However, as Australia is a federation of States and Territories, the State that benefits from the economic growth would be able to offer a superior net fiscal benefit, which would distort migration flows.

Independent Economics21 examined this theory from the perspective of one State experiencing a mining boom. Under that environment, an increased demand for mining industry labour leads to higher wages, and it would be efficient for households to move to that State to take advantage of that outcome. However, there comes a point in the migration process where average labour productivity begins to decline as more households migrate to the mining boom State.

Under normal conditions, migration would cease once there are no more marginal gains to be achieved from moving to that State. At this point, national welfare is at its highest and the migration that has occurred would be classed as ‘efficient’ because it has responded to the underlying economic conditions in the State.

However, in the absence of HFE, the State will now have a larger revenue base and therefore would be able to provide a higher standard of services, or charge lower taxes, or both, and so the migration would continue. At this stage, the migration becomes inefficient because it is responding to the differences in the net fiscal benefits between that State and other States. National welfare will therefore fall because the higher supply of labour reduces labour productivity, real wages and the amenity of the State.

Commonwealth Treasury, in its submission to the 2012 GST Distribution Review suggested that, because the amount of funding redistributed by the HFE system is only small from a national perspective, it would only have a small impact on the decision by individuals to migrate. In any event, it argued, there

---

are other drivers of location decisions that are taken into account - cultural factors, friends and family and climate to name a few - that would balance a migration decision.

Treasury therefore concluded that\textsuperscript{22}:

\begin{quote}
\textit{…there does not appear to be a need for reform of the system on the basis of location decisions.}
\end{quote}

**Does HFE result in excessively large public sectors in recipient States?**

Critics of HFE also argue that the increase in revenue from fiscal transfers from the GST tend to stick with State Governments - resulting in an inefficiently large public sector in so-called recipient States - and that little of this additional revenue is passed on to individuals in the form of tax cuts (the so called “flypaper effect”\textsuperscript{23}).

A contrary argument is that additional government spending as a result of HFE transfers could boost investment in areas such as health and education, thereby increasing the level of human capital. As Commonwealth Treasury suggested, this argument can be extended to suggest that a State with below average fiscal capacity could have below average education and health outcomes that would serve to further push down economic performance, revenues and services generally\textsuperscript{24}.

While there has been much written about the “flypaper effect”, the GST Distribution Panel found that\textsuperscript{25}:

\begin{quote}
There is ongoing debate about whether the flypaper effect really exists and, if it does, the extent to which it is undesirable. The key argument is that many transfers are made with the explicit purpose of increasing public spending by local or State government so you would expect to see an increase in their spending (potentially at the expense of spending by other levels of government). The related idea is that it would be inefficient for State or local governments to finance these expenditures themselves because they have access to less efficient tax bases, including because of potential interstate competition.
\end{quote}

Commonwealth Treasury conceded that the fact that some States need more resources to deliver average services than other makes it difficult to determine whether the HFE system is resulting in inefficiently large public sectors in so-called recipient States\textsuperscript{26}. There is no demonstrable evidence that it does.

**Does HFE discourage the development of revenue raising sectors such as mining and resources?**

Critics of HFE claim that equalisation reduces incentive for States to promote economic growth or improve the efficiency of service delivery because the benefits of economic reform and development, through higher revenue, may be equalised away. This simplistic argument overlooks that there is a range of incentives for State governments to pursue economic reform and development, the most significant of which is the desire to improve the welfare of their communities through the increased employment and higher incomes that are generated by economic development.

In its response to the GST Distribution Review Paper 2012, Tasmania noted that there is no evidence that fast growing States have actually limited their economic development activities because of the GST redistribution consequences. By way of example, Western Australia and Queensland moved from being recipient to donor States from the mid-2000s (Queensland subsequently returned to being a recipient

\begin{itemize}
\item \textsuperscript{22} Commonwealth Treasury submission to the 2012 GST Distribution Review, page 33.
\item \textsuperscript{23} Hines, J.R. and Thaler, R. *The Flypaper Effect* Journal of Economic Perspectives – Volume 9, Number 4, Fall 1995
\item \textsuperscript{24} Commonwealth Treasury submission to the 2012 GST Distribution Review, page 33.
\item \textsuperscript{25} GST Distribution Review, Final Report. Page 32.
\item \textsuperscript{26} Commonwealth Treasury submission to the 2012 GST Distribution Review, page 33.
\end{itemize}
State since 2013-14) which in large part is explained by the pursuit of economic development associated with the mining boom.

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

A major example of this type of land use decision is the Tasmanian Wilderness World Heritage Area (TWWHA) which occupies almost a quarter of Tasmania’s land base and is one of the largest temperate natural areas in the southern hemisphere. The area is formally recognised as a World Heritage property through the World Heritage Convention on the basis of three cultural heritage and four natural heritage criteria and is one of only two properties listed under the Convention satisfying this many criteria. The property was first inscribed on the World Heritage List in 1982 and has been subsequently expanded several times with a major extension in 1989 and minor boundary modifications in 2010, 2012 and 2013.

It is noted that Western Australia has publicly argued that the CGC’s asymmetrical approach to economic development expenditure (in particular the provision of infrastructure which underpins the generation of mining royalties) is a disincentive to the pursuit of economic growth.Whilst, it is arguable whether the provision of infrastructure to support economic development is a private or public responsibility, in relation to the question of whether HFE discourages policies to promote economic development, the GST Distribution Panel found:

…no clear evidence of any instance when GST share effects have changed a State’s decisions.27

It is worth considering whether resource rich States that complain that their revenue from resources is being ‘equalised away’ have stopped putting significant effort into supporting resource industries? The answer is clearly no. No government would expect to be returned to office, nor opposition expect to win government, if it did not actively propose and implement policies which are designed to increase economic development.

**Does HFE discourage economic, regulatory and tax reform?**

It has been suggested that HFE acts as a disincentive to tax reform.

As discussed, HFE ensures that States have the capacity to deliver an average level of service, on the assumption of an average level of revenue raising effort. If there is a change in the tax mix from a tax in which a State has a relative revenue raising advantage to one in which it has a relative disadvantage, HFE ensures that States receive sufficient funding in order to provide an average standard of services.

In this way, HFE actually supports tax reform by removing this disincentive for change. In reality, in considering tax reform, States are concerned with broader economic development issues, rather than temporal direct fiscal consequences. If this were not the case, no State would ever provide tax relief.

---

Further, HFE would never be the determinant consideration in any such decision. It would be weighed up against a number of other policy implications and outcomes. Commonwealth Treasury suggests that it is unlikely that HFE would be a marginal factor that would dissuade governments from pursuing reform agendas.

An examination of Tasmania’s track record demonstrates that it has been successful in implementing economic reform, despite fiscal equalisation being of central importance. Examples of this include Tasmania’s commitment to implementing the National Competition Policy reforms in the period from 1997 to 2005, included wide ranging reforms to the electricity sector, reforms to water pricing, governance arrangements related to the commercial activities of Government businesses and implementing competitive neutrality policies. There has also been a range of regulatory reforms including the more difficult areas such as shop trading hours in 2002 and the taxi industry in 2003. Tasmania was one of only two jurisdictions that received all NCP-related payments.

It was also one of the first jurisdictions to implement the 1999 Intergovernmental Agreement on Federal State Financial Relations to abolish a range of inefficient State taxes on the introduction of the GST. There are still a number of States, including NSW that are yet to abolish all taxes agreed under the IGA. Tasmania was also one of the first States to commit to the development of harmonised payroll tax arrangements, and its Service Tasmania concept as a single point of contact for all government services was nation leading and the subject of considerable discussion by mainland and New Zealand officials.

Experience with implementing NCP reforms and IGA tax reforms suggest that there is no relationship between willingness to undertake economic reform and HFE. Tasmania, a “recipient” State, was one of two jurisdictions to receive all of its NCP payments, the other being Victoria which is a “donor” State.

In the absence of HFE a State would either have a revenue shortfall from the tax reform or would have to impose a higher tax burden than other States. But HFE ensures that this is not the case – the loss of revenue is made up for through adjustments to GST grants.

The Henry Review stated that (because of HFE):

\[
\text{…no State would have a financial incentive to resist or favour a revenue neutral reform of State tax base composition on the basis of the local strength or weakness of particular tax bases.}
\]

The 2012 GST Distribution Review found:

\[
\text{Ultimately, there is no hard evidence on whether GST share effects influence State tax reform decisions. The Panel doubts that GST share effects are a very powerful factor when States are considering tax reform.}
\]

While the 2012 Review found that national reform to State taxes would result in changes in States’ GST shares, if such reform were to be a barrier to future tax reform any reform issues should be addressed in the context of the specific tax changes that are being proposed. It is also possible to address these issues through multilateral and bilateral agreements between the Commonwealth and the States with the Commonwealth providing compensation for GST share effects.

---

Does HFE cause States to “game” the system?

Critics of HFE claim that equalisation creates incentives for grant-seeking behaviour by States, such that their revenue raising and expenditure policies are designed to maximise their GST distribution potentially at the expense of efficient/effective service delivery or taxation.

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

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

The CGC noted in its submission31 to the GST Distribution Review that in relation to applying the equalisation standard of “what States do” to determine GST distribution:

While it is not totally policy neutral, because States can influence it through their population, revenue and service delivery policies, there is little evidence that States do this deliberately. In most cases, they would need to make big changes to their policies for small uncertain gains, several years in the future. Experience suggests their budgetary policies are determined on the basis of their State circumstances, rather than attempts to ‘game’ the GST distribution process. For example, Western Australia recently increased the concessional royalty rate on iron ore fines even though it expected to lose more than it raised through the GST sharing process.

While it is theoretically possible for grant gaming to occur, in reality, State Governments are highly unlikely to make policy decisions based on anticipated GST impacts. State Governments are more concerned with direct budgetary impacts than the delayed, uncertain and indirect GST implications. The reasons for this include:

- the uncertain outcome of one State’s actions compared to similar or contradicting actions of other States; and
- the lagged GST impact associated with data averaging being considerably longer than the political timeframe of a given government.

Does HFE over-subsidise and over-fund certain States?

Whilst Australia’s definition of the HFE principle and the equalisation approaches it uses are broadly consistent with those of other federations, it is recognized as having the most comprehensive form of horizontal fiscal equalisation (HFE) of any federation in the world as it assesses both the revenue raising capacity and the expense needs of each State (other federations generally do one or the other).

In line with the HFE principle, it seeks to give all States essentially the same capacity to provide the range of standard State government services to their residents (a level fiscal playing field).

To give effect to the HFE principle, the CGC makes a comprehensive comparative assessment of each State’s fiscal circumstances taking into account the revenue that would be available to a State if it were to apply the notional average tax policy (as calculated by the CGC) to its own source revenue base; the non-policy related challenges/advantages (geographical, demographic) it would face in delivering the notional average level of services to its State population; and the support it receives through tied Australian Government revenue which offsets the GST funding needs that would otherwise be funded.

The range of relativity factors recommended in a given year therefore directly reflects the interjurisdictional distribution of GST required to deliver this level fiscal playing field at that given point in time (albeit lagged).

On an associated issue, there is no evidence to suggest that recipient States become dependent on grant funding and are, therefore, less likely to pursue policies to improve their circumstances.

On this matter, the GST Distribution panel found that:

…there seems to be little firm evidence to support these concerns. State shares of Commonwealth support are much closer together when all Commonwealth payments are considered and State performance on economic and social indicators is often much closer than differences in fiscal capacity. Differences in fiscal capacity (or other indicators) can largely be traced to geographic, demographic and economic factors outside a State’s control. While State governments sometimes make poor decisions, this is surely true of both donor and recipient States.32

Is HFE unfair to Western Australia?

Through the Intergovernmental Agreement that came into effect on commencement of the GST on 1 July 2000 and subsequently reiterated in the Intergovernmental Agreement for Federal Financial Relations that replaced it from 1 January 2009, all States and the Commonwealth agreed that the GST pool would be distributed between the States on the basis of HFE. As a signatory to these IGAs and as a member of the Australian Federation, Western Australia has both committed to and benefitted from the HFE distribution of GST (and the prior financial assistance grants).

Through the fortunate abundance of natural resources within its State boundaries Western Australia was able to take advantage of world demand for these minerals and reap the unprecedented economic benefits of the recent mining boom. As a result Western Australia has had, and will continue to have extremely high mining royalty revenues compared to other States. HFE balances this out by allocating it a smaller share of GST grants.

It is incorrect to claim that the other States and territories have profited from the GST redistribution that the mining boom generated while incurring none of the costs. Western Australia’s boom came at the expense of a number of other State economies. Tasmania, and other State economies, experienced

the down side effects of the very high exchange rates driven by world supply and demand mineral imbalances. In addition, the mining boom drove unprecedented wage increases in the public sector, impacting on service delivery costs in some, if not most, jurisdictions.

Even as Western Australia’s GST share has fallen sharply to around 0.3 of an equal per capita share as a result of its large increase in mining royalties, when taking into consideration all other income it has remained at above per capita total revenue compared to the national average.

Western Australia’s above average total and own source revenue from 2010-11 to 2013-14 is shown in Figure 5A and 5B below. Despite the decline in GST its total revenue per capita remained higher than Tasmania until 2015-16. However, its total per capita revenue is forecast to once again exceed Tasmania’s in 2018-19 and 2019-20 largely due to the lagged effect of GST distribution. The CGC has estimated that Western Australia benefited by about $7 billion in additional GST from 2010-11 to 2013-14 because the mining revenue assessment is lagged compared to a fully contemporaneous assessment.

**Figure 5A: Total revenue per capita, Tasmania, Western Australia and an average of all States (excluding WA)**

![Figure 5A: Total revenue per capita, Tasmania, Western Australia and an average of all States (excluding WA)](image)

**Figure 5B: Total own-source revenue per capita, Tasmania, Western Australia and an average of all States (excluding WA)**

![Figure 5B: Total own-source revenue per capita, Tasmania, Western Australia and an average of all States (excluding WA)](image)

Source: State Budgets and Treasury calculations.

---

33 Own-source revenue for Western Australia and Northern Territory (included in average) includes the Grants in Lieu of Royalties provided by the Australian Government.
Further detail on the issues impacting on Western Australia is provided in the following case study.

Western Australia - a case study

The recent debates about the integrity of the current HFE system has in large part been generated by the sharp decline in Western Australia’s GST share. This decline followed the rapid increase in its iron ore royalties from the mining boom.

The sharp decline in Western Australia’s relativity has coincided with the subsequent decline on its iron royalties post the mining boom. This is because the CGC determines States relativities for the coming financial year (the application year) based in the average of three assessment years up to the previous financial year for which final budget outcomes (and other relevant data) are available. For example, for the application year 2017-18, the relativity is based on the average assessments for the years 2013-14, 2014-15, and 2015-16.

While Western Australia has recently been experiencing both a decline in its GST share and falling iron ore royalties, it benefited from the lagged assessments when iron ore royalties were rising rapidly and its GST had yet to fully adjust downwards to reflect its higher royalty income. The CGC has estimated that Western Australia benefited by about $7bn in additional GST from 2010-11 to 2013-14 because the mining revenue assessment is lagged compared to a fully contemporaneous assessment.

The period when Western Australia was experiencing rapid increases in its royalty revenue and its GST had yet to adjust, meant that the State had significant cash surpluses over the period. Much of this was spent on higher recurrent expenditure on wages and salaries, services and infrastructure.

The fact that Western Australia now finds itself in a difficult financial situation is not the fault of HFE or the GST distribution method. When downgrading Western Australia’s Aa1 credit rating outlook from stable to negative in June 2015, Moody’s noted that as iron ore and other commodity prices spiked to record highs in 2013, along with adjustments to the royalty rate, Western Australia’s reliance on this volatile source of revenue grew from 8.4 per cent of income in 2006-07 to 21.6 per cent in 2013-14. Moody’s noted that, at the same time, these windfalls fueled a rapid rise in current expenditures, with significant enhancements to healthcare, education and justice services resulting in deficit operations during a period of strong economic growth.

Contrary to assertions by some States, wealth is not being taken away from resource rich States’ residents. The equalisation system is redistributing national GST collected by the Australian Government, so that essential State Government services can be provided to the average national standard to residents in recipient States. Western Australia’s falling share of GST is a direct result of the exceptional revenue growth it received from mining royalties resulting in greater own-source revenue. This means it is less reliant on the GST than other States to provide these services.

The lagged GST assessment and the decline in Western Australia’s share were predictable and well known by the Western Australian Government. In its 2011-12 Budget, the Western Australian Government forecast that its relativity would reduce from 0.72 in 2011-12 to 0.33 in 2014-15, with a corresponding significant decline in GST revenue. Despite this, the Government announced in its budget unprecedented levels of expenditure on infrastructure funded through borrowings. As stated by the Hon Christian Porter in his 2011-12 Budget Speech to Parliament:

“What we reasonably anticipate is that in 2013-14 the CGC will have brought in a new GST system. We expect it will produce a floor of around 75 per cent of our population share of the GST. Therefore we expect revenue of $1.8 billion in 2013-14 and $2.5 billion in 2014 15. These amounts will allow for reduced borrowings and will be used to progressively reduce existing debt to less than $18 billion while maintaining strong infrastructure spending.

If that change does not occur in that year, the State Government will then have no choice but to wind back infrastructure investment to decrease debt.”

However, the GST distribution was not changed (for sound reasons) and so as a result of those unrealistic assumptions, and its failure to respond to known changing circumstances, the Western Australia government’s financial position has deteriorated significantly.

Nonetheless in response to Western Australia’s falling GST share the Australian Government provided the State with additional funding of $499 million in 2015-16, $490 million in 2016-17, and $226 million in 2017-18 to effectively maintain its GST share at 2014-15 levels (relativity of 0.38). In its 2017-18 Budget, the Australian Government is providing $1.6 billion towards Western Australia’s $2.3 billion expenditure on new road and rail infrastructure.

---

34 CGC Response to the Commonwealth Treasurer on GST shares in the Presence of Large and Volatile State Revenues - April 2015
**Does HFE ignore gambling taxes, thereby disadvantaging Western Australia?**

In its assessment of the various sources of revenue, the CGC does not ignore gambling taxation, as some commentators have suggested. However, gambling taxation is different to the other revenue bases because different States have significantly different policies which impact on gambling activity. Western Australia, for example, prohibits gaming machines outside its casino, thereby impacting on the amount of gambling revenue that it could collect. Other States have different policy settings regulating the access that their communities have to gambling. The CGC is therefore unable to reliably estimate the revenue that each State could raise because gambling is significantly impacted upon by government policy.

Because of these difficulties, the CGC takes account of how much revenue is raised by the States from gambling and then assesses each State on an equal per capita basis. No State is advantaged or disadvantaged in terms of the GST outcome. The fact that Western Australia opts to limit gambling revenue has no bearing on its treatment as this is a policy choice that Western Australia has made. Were the Commission to allow States individual policy choices to impact its assessment approach it would rightly be accused of allowing individual States to “game” their GST outcomes. The only other alternative for the CGC would be for it to impose its own views on how much gambling revenue a State could raise if it applied a set regime of gambling policies. Such an approach would be considered unacceptable by the States.

**Does HFE cause a lack of accountability in government expenditure?**

GST funding is untied general purpose funding. States are not required to spend GST it in accordance with its notional expense attribution nor to raise revenue in accordance with the notional average tax rates determined by the Grants Commission. Policy priorities are determined by each State and Territory in accordance with State sovereignty.

The CGC’s distribution methodology is based on a notional average level of service provision. The CGC calculates a State’s GST entitlement taking into account specific State demographic, geographical and other non-policy related influences to determine whether a State would need to spend more or less than the national average expenditure level to have the capacity to deliver the notional average service level. The CGC’s methodology does not take into account what a State actually spends, it is only interested in the differences in financial capacity to provide the average level of service.

The CGC’s notional average level of service provision is not an observable service or expenditure level, but rather a mathematical construct developed to give effect to the principle of horizontal fiscal equalisation.

For example, Tasmania is assessed as having greater than average costs for delivering health services because of its inherent cost disabilities (such as an aging population, and lower than average socio economic status), the CGC methodology therefore distributes GST towards Tasmania and away from other States, in respect of this disability.

However, for other assessments such as infrastructure, public transport and roads, GST is distributed away from Tasmania and towards other States because of Tasmania’s lower costs, due to it being less urbanised and having lower population growth. This does not mean that Tasmania should spend less on public transport or infrastructure and highlights why it is inappropriate to look at one assessment in isolation and to conclude that this is what the State should be spending.

There is no requirement or expectation that GST funds should be allocated in accordance with the CGC’s notional distribution formula – this is the very essence of GST as a general (untied) revenue source. To simplistically allocation GST funding on this basis would display a significant misunderstanding of the CGC methodology and intention.
Whilst the GST itself is not subject to direct reporting and accountability controls, increasingly, there are national reporting mechanisms which seek to report comparative performance measures across State government services. These measures do not distinguish between sources of funding but effectively are evaluations based on total expenditure in that area regardless of source. Examples of this in the key service delivery areas of schools and public hospital services include: NAPLAN reporting, elective surgery waiting lists; and emergency department waiting times.

**Does HFE imperil the cohesion of the Federation?**

The fundamental premise of this argument is that the HFE GST distribution method is inherently prejudicial and if allowed to continue will result in a breakdown of the federation. That is, it rewards the mendicant States, which have every incentive to remain permanently disadvantaged, and face no accountability, through the redistribution of GST revenue from the donor States, most specifically Western Australia.

The alternative, correct and diametrically opposing view, is that HFE is the glue which holds the federation together. It maintains social cohesion because it allows Australians living in similar circumstances, regardless of State of residence, access to similar government services, akin to what would also be expected of a central government if Australia was governed as a unitary State. In the absence of HFE, the smaller, fiscally weaker States would not be able to maintain services and over time disparities in levels of services provided in fiscally weaker States relative to fiscally stronger States, would lead to a break down in social cohesion and the kind of rich State/poor State divides seen in countries which do not have fiscal equalisation.

In contradiction to their position in regard to redistribution of the GST, States that are critical of equalising fiscal capacity between the States through the GST have no issue with equalising services within their own State borders. For example, the Western Australia Government has used some of its mining royalties to support its regions through the Royalties for Regions program.

**Are there other options for distributing the GST?**

Whilst alternative options for distributing the GST have been put forward from time to time by commentators and critics, these alternatives have generally been found to be inferior to the CGC methodology. These include:

**Review of Commonwealth-State Funding 2002**

A review of Commonwealth-State funding was independently commissioned by the Governments of New South Wales, Western Australia and Victoria to assess the Australian Government's methods of allocating grants to the States. The final report of the Review by Ross Garnaut and Vince Fitzgerald, recommended a new model for Commonwealth-State financial arrangements. As part of the recommendations it was proposed that existing untied general purpose revenue (primarily the GST) be distributed on an equal per capita basis with an element of HFE through the Australian Government providing guaranteed minimum untied payments to all States to cover the minimum overhead costs to State Governments. This minimum payment would favour the smaller States and ease their adjustment to the new funding arrangement.

---

The 2012 GST Distribution Review

In 2011 the Australian Government announced a review of the GST distribution system amongst the States to consider whether the current approach to distributing the GST using existing HFE principles would ensure that Australia was best placed to respond to the expected significant structural changes in the economy and would maintain public confidence in financial relationships within the Federation.

That inquiry examined a number of alternative proposals by the large States to modify the system either by doing less equalisation than under the present model or by performing equalisation in a less precise or more general way. These alternatives are summarized in Appendix D.

For the less precise options, it looked at a number of alternatives, including the use of Gross State Product or Household Disposable Income as broad indicators of State fiscal capacity.

The range of alternatives assessed by the Inquiry resulted in significant differences in the redistribution in aggregate and across States. It lead the Inquiry to the conclusion that it:

\[
\text{\ldots (was) not possible to use simple broad indicators and deliver States with the same, or very nearly the same, GST shares.}
\]

The Inquiry essentially concluded that, while there seemed to be an endless range of simpler methods by which to determine the distribution of GST to the States, the ‘natural rule’ appeared to be:

- the simpler the method, the less representative it was of current outcomes; and
- the less representative of current outcomes the method, the greater the differences in redistribution.

The Inquiry also gave some discussion to a proposal put forward by New South Wales, Victoria, Queensland and Western Australia that represented a fundamental move away from full equalisation. The four States proposed that HFE should be replaced with a per capita sharing of the GSP revenues between States, supplemented by additional payments from the Commonwealth to maintain a form of HFE for the fiscally weaker States.

In other words, the GST pool would cease to be the sole revenue source for equalisation. The cost of the ‘top up’ payments from the Commonwealth at the time were estimated at $4.6 billion per annum. Had this proposal operated since the GST’s introduction (in 2000-01), it would have cost the Commonwealth an additional $74 billion.

The difficulties of such an EPC model were also recognised by the GST Distribution Review panel which noted:

\[
\text{\ldots the Commonwealth has made it clear there is no additional money available to compensate States that would otherwise be worse off under an EPC model.}
\]

Essentially, the Review found that the criticisms of HFE were overstated and that there were no alternatives that were more simple or efficient. Their specific recommendations did not include any fundamental changes to HFE.

---

38 This is similar to a variation on the EPC option discussed by the CGC above.
Reform of the Federation White Paper Process 2014-15

Before this reform process was subsequently discontinued in late 2015, it canvassed alternative HFE models as part of a comprehensive examination of the federation. Models considered included the introduction of a GST relativity floor which was originally proposed by Western Australia, as well as the application of a discount to all revenue and expenditure assessments as a form of partial equalisation.

The relativity floor (proposed to be 75%) remains an active alternative being supported by the current Australian Government.

CGC 2020 Methodology Review

As part of its 2020 Methodology Review, the CGC has released a Staff Paper40 on other approaches to distributing the GST revenue to States. The CGC has compared three alternatives to the current distribution method to examine the likely effect on States using the 2017-18 application year as an example. The alternative methods include:

1. equal per capita (EPC) distribution;
2. partial EPC distribution; and
3. actual per capita (APC) distribution.

An EPC distribution

Under this option, all States receive their population share of GST. In effect, all States would have a relativity of one. An EPC share disproportionally impacts the smaller States such as the Northern Territory, Tasmania and South Australia, which would all be under-equalised, while the fiscally stronger States would be over-equalised.

The proportional loss in GST is far greater for the smaller States than the proportional gain to the largest States such as NSW and Victoria. Western Australia stands to gain the most in proportional terms given its decline in relativity over recent years due to the mining revenue boom. For example, in 2017-18, Tasmania would only receive an estimated $1.3 billion in GST revenue, a reduction of $1.1 billion or approximately 20 per cent of total State revenue.

If the GST was distributed on an EPC basis there would be a significant funding shortfall of around $7.9 billion in 2017-1841 for the recipient States that would require the Australian Government to provide if it were to maintain the current principle of equalising the capacity of States to provide services to their communities.

It raises the question of how, in the current economic climate, the Australian Government would fund the additional payments to the smaller States in order to leave no State or Territory worse off.

Supplementary Commonwealth funding would leave those States exposed to the funding priorities of the Government of the day. It would also increase their reliance on tied grants which as noted earlier, reduces budget flexibility.

There is also the issue as to why the stronger States should receive more GST on an EPC basis than they currently receive and in some cases, significantly more. This outcome will only exacerbate inequity in Australia.

---

40 Achieving HFE - Other Approaches to Distributing the GST. Commonwealth Grants Commission Staff Research Paper. May 2017.

41 Refer to Table 1 in this paper.
A partial EPC distribution

Under this option the additional amount of GST that recipient States receive under the current HFE distribution is removed from the GST pool (ie the pool is reduced). The reduced pool is then distributed on an EPC basis and the additional amounts are then added back to the recipient States.

With partial equalisation, a smaller proportion of the total GST pool is used to equalise the fiscal capacity of the States than under full HFE, with a greater proportion distributed on an equal per capita basis.

Under this option, the fiscally weaker States receive more than a population share of GST, but not as much as under the current equalisation distribution. Fiscally stronger States receive less than a population share of GST, but (in most cases) more than under the equalisation distribution.

Depending on the proportion distributed on an equal per capita basis, the implication of this distribution method for Tasmania, would be a decrease of $200 million in 2017-18 (approximately 8%) compared to what it would receive under HFE.

Actual Per Capita (APC) distribution

This option is an alternative to the EPC distribution. It is a simple distribution where the assessed expense or revenue for each State is set equal to its actual expense or revenue. It assumes that the policies of all States are the same and thus no State can influence the distribution outcome by its own policy choices, and any differences in expenses or revenue per capita are due to differences in State circumstances.

This option provides more GST per capita to States that have higher per capita spending and lower per capita revenue raising. The implication for Tasmania, in 2017-18, is similar to the partial EPC approach, with an expected decrease of $200 million in GST revenue (approximately 8%).

Quarantine of 25 per cent of Western Australia’s iron ore royalties

The Premier of Western Australia, the Hon Mark Gowan, proposed that the Productivity Commission review of the GST consider the option of quarantining 25 per cent of Western Australia’s iron ore royalties from the GST distribution to increase the State’s share of the GST pool.

Mining revenue is one of the six categories of States’ own source revenue that the CGC considers when determining GST shares amongst the States. The value and type of mining production in each State and the associated royalty revenue is used to calculate two average royalty rates - one for low royalty rate minerals and another for high royalty rate minerals. These average rates, applied to the quantity of mining production each year in each State, produce an estimate of the amount of mining revenue that each State would raise, if it applied the average policy.

Western Australia’s assessed capacity to generate mining revenues is significantly higher than other States, although Queensland and the Northern Territory also have assessed capacity above the average. Western Australia generates about 97 per cent of Australia’s iron ore revenues.

When considering the issue of mining revenue, the 2012 GST Distribution Review made it clear that it did not consider it appropriate to remove or quarantine mining revenues, and that it should continue to

---

42 Table 6 showed fiscally weaker States receive less than the Commission’s recommended distribution because all States (including fiscally weaker States) share the cost of the amount removed from the pool on a population basis.

43 Actual per capita assessments have a history in Australian equalisation. In early reviews, before the Commission was able to collect data to support all its assessments, equal per capita and actual per capita assessments were prevalent.
be equalised through the HFE process in the same way as other own-source revenues\(^{44}\). Instead, the Review suggested that specific attention be given to developing a new two-tier mining revenue assessment and a method of dealing with mining-related expenses by applying a 3 per cent discount to the mining revenue assessment to compensate mining rich States for additional expenditures needed to support the industry.

However, the main conclusion of the Review on this issue is significant:

…the mere fact that the mining part of the HFE system is currently driving a large amount of redistribution is not, in our view, a reason to treat mining differently from other revenue.

Internal Treasury modelling of 25 per cent quarantining of Western Australia’s iron ore revenues suggests that there would be a significant impact on all other States as an estimated $1.043 billion is transferred to Western Australia. The modelling suggests that Tasmania would lose about $24 million each year from this change to the HFE distribution process.

Table 6: Average annual impact of quarantined royalties

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average annual impact</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td></td>
<td>-375</td>
<td>-299</td>
<td>-234</td>
<td>1 043</td>
<td>-81</td>
<td>-24</td>
<td>-19</td>
<td>-11</td>
</tr>
</tbody>
</table>

Source: Treasury Modelling

Table 7: GST redistribution alternatives and corresponding impacts, per capita, 2017-18

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>GST distribution</td>
<td>$pc</td>
<td>$pc</td>
<td>$pc</td>
<td>$pc</td>
<td>$pc</td>
<td>$pc</td>
<td>$pc</td>
<td>$pc</td>
<td>$pc</td>
</tr>
<tr>
<td>Equalisation</td>
<td>2.238</td>
<td>2.372</td>
<td>3.035</td>
<td>895</td>
<td>3.694</td>
<td>4.596</td>
<td>2.972</td>
<td>11.796</td>
<td>2.541</td>
</tr>
<tr>
<td>EPC</td>
<td>2.541</td>
<td>2.549</td>
<td>2.550</td>
<td>2.536</td>
<td>2.540</td>
<td>2.490</td>
<td>2.477</td>
<td>2.441</td>
<td>2.541</td>
</tr>
<tr>
<td>Partial EPC</td>
<td>2.225</td>
<td>2.228</td>
<td>2.712</td>
<td>2.238</td>
<td>3.348</td>
<td>4.213</td>
<td>2.725</td>
<td>11.389</td>
<td>2.541</td>
</tr>
</tbody>
</table>

| Difference | $pc | $pc | $pc | $pc | $pc | $pc | $pc | $pc | $pc |
| EPC        | 303 | 176 | -486| 1.641| -1.154| -2.107| -495 | -9.355| 0    |
| Partial EPC| -13 | -144| -324| 1.343| -346 | -383 | -248 | -407 | 0    |
| APC        | 126 | -160| -425| 671  | -519 | -383 | 1.734| 2.441| 0    |

Source: CGC calculation and Treasury calculation

As shown in Table 7, Tasmania would be significantly impacted by any of the proposed changes to GST distribution compared with the current HFE distribution. An EPC approach would result in Tasmania losing $1.1 billion in GST revenue in 2017-18, a decline of more than 19 per cent of total Tasmanian revenue. The partial EPC distribution and an APC distribution both result in a $200 million revenue reduction, or in per capita terms this would result in $383 being lost per Tasmanian in GST revenue. The CGC concluded that compared with the current equalization system, an EPC distribution takes no account of differences in State fiscal capacities and an APC assessment takes no account of differences in State policies.

Any reduction in revenue would have a significant impact on the State. Without any other funding from the Commonwealth this would mean either a 19 per cent reduction in expenditure on government services, or 19 per cent increase in State revenue from taxes, fees and dividends, or a combination of both. Clearly this would create an unsustainable budgetary position for the State.

The Government would have to decide how it would deal with the loss of revenue. Generally, there are three main options - a reduction in spending, an increase in own-source taxation revenue or an increase in State debt. The sale of State owned assets is an option which would only temporarily address the issue, given that it may potentially forsake dividends that would impact on revenue raising capacity.

Should Government become more involved in the HFE process?

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

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

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

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

Should HFE have other objectives?

As mentioned, HFE is primarily concerned with achieving equity between the States and Territories.

It has been suggested that the HFE system could be used to achieve other national objectives such as tax reform. However, this would fundamentally change the HFE system from equalising State fiscal capacities to achieving other national outcomes. Such an approach would substantially complicate HFE, overburden the system and lead to compromised outcomes. It would involve difficult judgements and debate about what is, or is not, desirable policy. It would significantly restrict the ability of a State’s residents to elect a government to deliver policy in line with their preferences, defeating the purpose of a federal system of government.

If the Commonwealth and all States agree that a particular policy objective is desirable, this can and should be pursued outside the HFE system. For example, the National Health Reform Agreement and the Intergovernmental Agreement on Federal Financial Relations demonstrate that the Commonwealth

---

45 For example in the additional terms of reference to the GST Distribution Review 2012.
and the States can cooperatively agree on, and pursue, shared policy objectives. At no stage has any party made a convincing case that HFE could be used to enhance this process or better achieve these objectives.

Likewise, if there is a demonstrated need for large scale State tax reform, this should be pursued cooperatively and as part of a separate process. Entangling tax reform with the HFE process would reduce transparency, making it much harder for the public, and even for governments, to understand proposed reforms or their expected outcomes.

The GST revenue was agreed to be provided to the States as untied revenue in recognition of the level of vertical fiscal imbalance (VFI) in Australia and the States agreeing to abolish a number of inefficient State taxes over time.
Appendix A: Terms of Reference for Productivity Commission Review into Horizontal Fiscal Equalisation

Terms of reference

I, Scott Morrison, Treasurer, pursuant to Parts 2 and 3 of the Productivity Commission Act 1998, hereby request that the Productivity Commission undertake an inquiry into Australia’s system of horizontal fiscal equalisation (HFE) which underpins the distribution of GST revenue to the States and Territories (States).

The inquiry should consider the influence the current system has on productivity, efficiency and economic growth, including the movement of capital and labour across State borders; the incentives for the States to undertake fiscal (expense and revenue) reforms that improve the operation of their own jurisdictions, and on the States’ abilities to prepare and deliver annual budgets.

Background

HFE has been a feature of Commonwealth-State financial relations since Federation and is Australian Government policy. HFE involves the distribution of Commonwealth financial support to the States so that each State has the capacity to provide its citizens with a comparable level of Government services.

Under the current approach to HFE, the GST is distributed to the States on the basis of relativities recommended by the independent Commonwealth Grants Commission (CGC). In calculating the relativities, the CGC assesses each State’s fiscal capacity, including its capacity to raise revenue and its costs of providing government services.

In recent years, some States and commentators have suggested Australia’s approach to HFE does not sufficiently recognise the differences between States’ individual circumstances nor States’ efforts to manage those circumstances thereby creating disincentives for reform, including reforms to enhance revenue raising capacities or drive efficiencies in spending.

In commissioning this inquiry, the Government seeks an examination of the issues underlying these claims and concerns that any gains from reform are effectively redistributed to other States.

Scope of the inquiry

The Commission should consider the effect of Australia’s system of HFE on productivity, economic growth and budget management for the States and for Australia as a whole. In doing so, the Commission should, in particular, consider:

- Whether the present adoption by the CGC of a HFE formula to equalise States’ revenue raising and service delivery capacities is in the best interests of national productivity; or whether there may be preferable alternatives. On this matter the Productivity Commission should enquire as to whether this aspect of the CGC formula or any other aspect of it may restrict the appropriate movement of capital and labour across State borders to more productive regions during times of high labour demand;

- Policies affecting energy and resources, noting the uneven distribution of natural resources across the nation; whether sufficient consideration is given to the different underlying and structural characteristics of different revenue bases;

- State laws and policies restricting the development of energy resources;

- Whether the present use by the CGC in its HFE formula of rolling three year averages provides the most appropriate estimate of real State revenue raising abilities, particularly for those States heavily reliant on large and volatile revenue streams. Particular analysis should be given to
whether the lagged fiscal impacts that result from averaging and non-contemporary data leads to GST relativities which accentuate rather than moderate peaks and troughs in State economic cycles;

- Whether the present HFE formula, may have the effect of producing a disincentive for a State to develop a potential industry or raise a royalty rate for an existing industry at an appropriate time; and

- Whether the present HFE formula in its stated aim of comprehensively equalising States’ fiscal capacities places too great a reliance on broad indicators and insufficient relevance on specific indicators which recognise States’ different circumstances.

The Commission should also take into account previous reviews of the HFE process, including the 2012 GST Distribution Review report as well as international approaches to fiscal equalisation within federations.

The Commission should also consider implications for equity across jurisdictions, efficiency and simplicity.

**Process**

The Commission should undertake appropriate public consultation, including holding hearings, inviting public submissions and releasing a draft report to the public. It should consult widely, including with State and Territory governments.

The final report should be provided to the Government by 31 January 2018.

Scott Morrison

Treasurer
Appendix B: How the Commission calculates assessed revenues and expenditures\textsuperscript{46}.

State revenue raising capacity and spending differs from the average because of differences in the economic, socio-demographic, environmental and geographic characteristics of the States.

**REVENUE ASSESSMENTS**

Revenue assessments aim to measure the revenue each State would raise if it applied the Australian average tax rates to its tax bases — that is, if it made the average effort to raise revenue.

A State has a revenue raising advantage if the per capita value of its tax base exceeds the national value. In that case, making the average tax effort will yield above average per capita revenue.

**Measures of revenue bases**

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>Tax base and source of data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll tax</td>
<td>The value of payrolls in each State, excluding small employers, the general government sector of the Commonwealth, the States and local government and payrolls below the tax-free threshold. Measured using ABS data on compensation of employees, private sector wages and salaries and public sector wages and salaries.</td>
</tr>
<tr>
<td>Land tax</td>
<td>The value of residential (non-principal place-of-residence only), commercial and industrial land, adjusted for the effects of tax free thresholds and progressive tax rates. Measured using State data on land values.</td>
</tr>
<tr>
<td>Insurance taxes</td>
<td>Total premiums paid for general and compulsory third party insurance. Measured using Australian Prudential Regulation Authority data on premiums.</td>
</tr>
<tr>
<td>Motor vehicle registrations</td>
<td>The number of light and heavy vehicles registered. Measured using the ABS motor vehicle census.</td>
</tr>
<tr>
<td>Mining royalty revenue</td>
<td>Gross value of minerals produced in each State plus an adjustment for revenue received under revenue sharing arrangements with the Commonwealth. Measured using ABS and State data on the value of mining production.</td>
</tr>
<tr>
<td>Other revenue</td>
<td>Population. All States were assessed to be able to raise the average per capita revenue for this category.</td>
</tr>
</tbody>
</table>

\textsuperscript{46} The content of this Appendix has been sourced from the CGC 2015 Review, Volume 2.
EXAMPLE OF A REVENUE ASSESSMENT - INSURANCE TAX

This category includes insurance tax levied on the premiums of a range of insurance products and emergency service levies collected from policy holders by some States.

Assessed revenue and revenue raising capacity ratio

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual revenue ($m)</td>
<td>1 821</td>
<td>1 067</td>
<td>731</td>
<td>611</td>
<td>435</td>
<td>98</td>
<td>34</td>
<td>44</td>
<td>4 841</td>
</tr>
<tr>
<td>Taxable premiums ($m)</td>
<td>11 985</td>
<td>8 139</td>
<td>7 076</td>
<td>3 688</td>
<td>2 849</td>
<td>611</td>
<td>505</td>
<td>325</td>
<td>35 178</td>
</tr>
<tr>
<td>Average tax rate (%)</td>
<td>13.8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assessed revenue ($m)</td>
<td>1 649</td>
<td>1 120</td>
<td>974</td>
<td>507</td>
<td>392</td>
<td>84</td>
<td>69</td>
<td>45</td>
<td>4 841</td>
</tr>
<tr>
<td>Population ('000)</td>
<td>7 465</td>
<td>5 787</td>
<td>4 687</td>
<td>2 549</td>
<td>1 677</td>
<td>514</td>
<td>384</td>
<td>244</td>
<td>23 308</td>
</tr>
<tr>
<td>Assessed revenue ($pc)</td>
<td>221</td>
<td>194</td>
<td>208</td>
<td>199</td>
<td>234</td>
<td>164</td>
<td>181</td>
<td>183</td>
<td>208</td>
</tr>
<tr>
<td>Revenue raising capacity</td>
<td>1.064</td>
<td>0.932</td>
<td>1.000</td>
<td>0.959</td>
<td>1.126</td>
<td>0.788</td>
<td>0.872</td>
<td>0.883</td>
<td>1.000</td>
</tr>
</tbody>
</table>

1. In this example, a State’s capacity to raise revenue from insurance tax is assessed using the value of premiums paid, which are collected from the Australian Prudential Regulatory Authority. This is the actual revenue raised.

2. Adjustments are made to account for forms of insurance that are taxed, or not taxed, by each State. A consistent revenue base (taxable premiums base) is therefore established.

3. An ‘average’ Australia-wide tax rate is calculated:
   \[
   \frac{\text{TOTAL line 1}}{\text{TOTAL line 2}} = 13.8\%
   \]

4. The assessed revenue for each State is calculated
   \[
   = \text{revenue base for each State} \times 13.8\%
   \]

5. Population as at 31 December.

6. The per capita assessed revenue for each State and for Australia is calculated:
   \[
   = \frac{\text{assessed revenue}}{\text{population}}
   \]

7. The per capita assessed revenue for each State is compared to the national per capita assessed revenue ($208) to obtain an Insurance Tax relativity:
   \[
   = \frac{\text{per capita assessed revenue for each State}}{\$208}
   \]

Where a State has a calculated relativity of greater than one, that State is assessed as having an above average revenue raising capacity for the particular tax line. A relativity of less than one indicates a below average revenue raising capacity.

In this example, NSW and South Australia are assessed as having an above average revenue raising capacity for Insurance Tax. Victoria, Western Australia, Tasmania, the Act and the NT are assessed as having a below average revenue raising capacity, and Queensland is assessed as having an average revenue raising capacity.
**EXPENSE ASSESSMENTS**

Expense assessments aim to measure how much each State would spend to provide the average level of service to its population, given its characteristics, if it followed average expense policies.

The average level of service is represented by the average expenses per capita, which encapsulates the average policies, service delivery efficiency and circumstances of the States.

The average expenses per capita are adjusted up or down to allow for the financial impact of differences in State circumstances — but only to the extent that those circumstances are beyond the direct control of individual State governments.

National differences in spending on particular population groups are recognised together with differences in the shares States have of the particular population group. Differences in national spending levels arise because of differences in the service use patterns of particular groups and differences in unit costs of service delivery.

<table>
<thead>
<tr>
<th>Category</th>
<th>Indicator of State shares</th>
<th>Disaggregated use attributes</th>
<th>Other disabilities assessed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Schools education</td>
<td>Student numbers</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Post-secondary education</td>
<td>Population</td>
<td>X X X X</td>
<td>X</td>
</tr>
<tr>
<td>Health</td>
<td>Population</td>
<td>X X X X</td>
<td>X</td>
</tr>
<tr>
<td>Welfare</td>
<td>Population</td>
<td>X X X X</td>
<td>X</td>
</tr>
<tr>
<td>Housing</td>
<td>Households</td>
<td>X X X</td>
<td></td>
</tr>
<tr>
<td>Services to communities</td>
<td>Population</td>
<td>X X</td>
<td></td>
</tr>
<tr>
<td>Justice</td>
<td>Population</td>
<td>X X X</td>
<td></td>
</tr>
<tr>
<td>Services to industry</td>
<td>Sector size, number of establishments and private sector investment</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Roads                       | Length and use of roads   | X                            | X                           | X                           |
| Transport                   | Population                | X                            |                             | X X                         |
| Other expenses              | Population                | X X X                        |                             | X X X X                     |
| Depreciation)               | Assessed stock            | X                            |                             |                             |
| Investment                  | Assessed stock            | X                            |                             |                             |
| Net borrowing               | Population                | X                            |                             |                             |
EXAMPLE OF AN EXPENDITURE ASSESSMENT - ROADS

The Roads category covers State spending on the maintenance of roads, bridges (including tunnels) and other related services.

The assessment of State roads costs is the sum of separate assessments for rural roads, urban roads, local roads, bridges and other services. Separate assessments are required since the factors affecting each of these components vary.

Higher costs are assessed for States with:

- longer road networks – those with larger rural areas need to spend more on maintenance and repairs than other States
- greater traffic volumes as they require greater spending on traffic control and safety measures (such as signage and traffic lights) and
- greater heavy vehicle use, which causes greater pavement wear and tear that drives up minor and major maintenance to restore the pavement to acceptable service standards.

The assessment also recognises the differences between States in wage costs and, for some rural road expenses, the higher costs of providing services in remote and very remote locations.

The cost data collected by the Grants Commission comes from the National Transport Commission, and has the following components and disabilities:

<table>
<thead>
<tr>
<th>COMPONENT</th>
<th>$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rural roads</td>
<td></td>
</tr>
<tr>
<td>Road length</td>
<td>797</td>
</tr>
<tr>
<td>Traffic volume</td>
<td>896</td>
</tr>
<tr>
<td>Heavy vehicle use</td>
<td>975</td>
</tr>
<tr>
<td>Rural total</td>
<td>2 668</td>
</tr>
<tr>
<td>Urban roads</td>
<td></td>
</tr>
<tr>
<td>Road length</td>
<td>357</td>
</tr>
<tr>
<td>Traffic volume</td>
<td>1 257</td>
</tr>
<tr>
<td>Heavy vehicle use</td>
<td>443</td>
</tr>
<tr>
<td>Urban total</td>
<td>2 057</td>
</tr>
<tr>
<td>Local roads</td>
<td></td>
</tr>
<tr>
<td>Road length</td>
<td>417</td>
</tr>
<tr>
<td>Bridges</td>
<td></td>
</tr>
<tr>
<td>Population</td>
<td>264</td>
</tr>
<tr>
<td>Other services</td>
<td></td>
</tr>
<tr>
<td>Population</td>
<td>1 575</td>
</tr>
<tr>
<td>Total</td>
<td>6 981</td>
</tr>
</tbody>
</table>

Using the rural roads category as an example, the Commission works through the following processes to arrive at an assessed expense, taking account of the disability factors applicable to rural roads - road length, traffic volume and heavy vehicle use.
**Road length**

1. The actual length of sealed and unsealed rural roads are established, and a weighted length is calculated, with sealed roads having a weighting of 1.0 and unsealed roads having a weighting of 0.5.

2. A location factor is calculated for each State, being a combination of wage costs and regional cost factors. This factor recognises the differences in wage costs between States and also takes account of the fact that the costs of providing rural roads increases with increasing remoteness. A factor greater than one indicates that the State is disadvantaged by wage costs and remoteness, and a factor less than one indicates that the State is advantaged by wage costs and remoteness relative to other States.

3. The $797 million allocation to rural roads on the basis of road length is then shared between the States on the basis of each State's share of the weighted road length adjusted by the location factor disability (and then re-scaled so the total allocation does not exceed $797 million).

4. Population as at 31 December.

5. The per capita share for each State is then calculated.

**Traffic volume**

6. The level of traffic volume on rural roads is established by reference to data on vehicle kilometres travelled (VKT) supplied by the Bureau of Infrastructure, Transport and Regional Economics.

7. A location factor is calculated for each State. In this case, it relates to a wages costs factor only.

8. The $896 million allocation to rural roads on the basis of traffic volume is then shared between the States on the basis of each State's share of the traffic volume adjusted by the location factor disability (and then re-scaled so the total allocation does not exceed $896 million).

9. The per capita share for each State is then calculated.

**Heavy vehicle use**

10. The extent of heavy vehicle use on rural roads is established by reference to data on average gross mass-kilometres (AGM-km) supplied by the Bureau of Infrastructure, Transport and Regional Economics.

11. A location factor is calculated for each State. In this case, it relates to a wages costs factor only.

12. The $975 million allocation to rural roads on the basis of heavy vehicle use is then shared between the States on the basis of each State’s share of the average gross mass-kilometres adjusted by the location factor disability (and then re-scaled so the total allocation does not exceed $975 million).

13. The per capita share for each State is then calculated.
### Mapped length

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>km</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sealed</td>
<td>24 804</td>
<td>14 325</td>
<td>23 976</td>
<td>17 289</td>
<td>9 792</td>
<td>2 634</td>
<td>6 7 557</td>
<td>100 383</td>
<td></td>
</tr>
<tr>
<td>Unsealed</td>
<td>1 762</td>
<td>1 389</td>
<td>4 829</td>
<td>3 591</td>
<td>1 762</td>
<td>49</td>
<td>0</td>
<td>3 167</td>
<td>16 549</td>
</tr>
</tbody>
</table>

### A. Road length

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>km</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Weighted length</td>
<td>25 685</td>
<td>15 020</td>
<td>26 391</td>
<td>19 085</td>
<td>10 673</td>
<td>2 659</td>
<td>6 1 41</td>
<td>108 658</td>
<td></td>
</tr>
<tr>
<td>2. Location factor</td>
<td>0.970</td>
<td>0.896</td>
<td>1.076</td>
<td>1.169</td>
<td>1.033</td>
<td>0.954</td>
<td>0.878</td>
<td>1.271</td>
<td>1.000</td>
</tr>
<tr>
<td>Expense ($m)</td>
<td>797</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Total ($m)</td>
<td>174</td>
<td>94 198</td>
<td>156</td>
<td>77</td>
<td>18</td>
<td>0</td>
<td>81</td>
<td>797</td>
<td></td>
</tr>
<tr>
<td>4. Population</td>
<td>7 465</td>
<td>5 787</td>
<td>4 687</td>
<td>2 549</td>
<td>1 627</td>
<td>514</td>
<td>0</td>
<td>3 167</td>
<td>23 308</td>
</tr>
<tr>
<td>5. Per capita</td>
<td>23</td>
<td>16</td>
<td>42</td>
<td>61</td>
<td>46</td>
<td>34</td>
<td>0</td>
<td>332</td>
<td>34</td>
</tr>
</tbody>
</table>

### B. Traffic volume

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>km</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Rural VKT ('000 km)</td>
<td>11 933</td>
<td>930</td>
<td>818</td>
<td>758</td>
<td>949</td>
<td>083</td>
<td>0</td>
<td>618</td>
<td>41 090</td>
</tr>
<tr>
<td>7. Location factor</td>
<td>1.005</td>
<td>0.988</td>
<td>0.989</td>
<td>1.038</td>
<td>0.991</td>
<td>0.974</td>
<td>1.023</td>
<td>1.044</td>
<td>1.000</td>
</tr>
<tr>
<td>Expense ($m)</td>
<td>896</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Total ($m)</td>
<td>262</td>
<td>214</td>
<td>190</td>
<td>108</td>
<td>85</td>
<td>23</td>
<td>0</td>
<td>14</td>
<td>896</td>
</tr>
<tr>
<td>9. Per capita</td>
<td>35</td>
<td>37</td>
<td>41</td>
<td>42</td>
<td>51</td>
<td>45</td>
<td>0</td>
<td>58</td>
<td>38</td>
</tr>
</tbody>
</table>

### C. Heavy vehicle use

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>km</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Rural AGM ('000 km)</td>
<td>48 017</td>
<td>36 095</td>
<td>37 584</td>
<td>23 974</td>
<td>18 690</td>
<td>3 957</td>
<td>0</td>
<td>2 826</td>
<td>171 143</td>
</tr>
<tr>
<td>11. Location factor</td>
<td>1.005</td>
<td>0.988</td>
<td>0.989</td>
<td>1.038</td>
<td>0.991</td>
<td>0.974</td>
<td>1.023</td>
<td>1.044</td>
<td>1.000</td>
</tr>
<tr>
<td>Expense ($m)</td>
<td>975</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Total ($m)</td>
<td>275</td>
<td>203</td>
<td>212</td>
<td>142</td>
<td>106</td>
<td>22</td>
<td>0</td>
<td>17</td>
<td>975</td>
</tr>
<tr>
<td>13. Per capita</td>
<td>37</td>
<td>35</td>
<td>45</td>
<td>56</td>
<td>63</td>
<td>43</td>
<td>0</td>
<td>69</td>
<td>42</td>
</tr>
</tbody>
</table>

### D. Total for rural roads

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$m</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Road length</td>
<td>174</td>
<td>94</td>
<td>198</td>
<td>156</td>
<td>77</td>
<td>18</td>
<td>0</td>
<td>81</td>
<td>797</td>
</tr>
<tr>
<td>Traffic volume</td>
<td>262</td>
<td>214</td>
<td>190</td>
<td>108</td>
<td>85</td>
<td>23</td>
<td>0</td>
<td>14</td>
<td>896</td>
</tr>
<tr>
<td>Heavy vehicle use</td>
<td>275</td>
<td>203</td>
<td>212</td>
<td>142</td>
<td>106</td>
<td>22</td>
<td>0</td>
<td>17</td>
<td>975</td>
</tr>
<tr>
<td>Total ($m)</td>
<td>710</td>
<td>511</td>
<td>600</td>
<td>405</td>
<td>268</td>
<td>63</td>
<td>0</td>
<td>112</td>
<td>2 668</td>
</tr>
<tr>
<td>Total ($pc)</td>
<td>95</td>
<td>88</td>
<td>128</td>
<td>159</td>
<td>160</td>
<td>122</td>
<td>0</td>
<td>459</td>
<td>114</td>
</tr>
</tbody>
</table>

Similar calculations are undertaken for the remaining components of the Roads category - urban roads, local roads, bridges and other road services.
The Table below provides the context for where the revenue and expenditure assessments are placed once all the assessments are completed.

### Assessed revenue, expenses and Commonwealth payments

<table>
<thead>
<tr>
<th></th>
<th>NSW $pc</th>
<th>Vic $pc</th>
<th>Qld $pc</th>
<th>WA $pc</th>
<th>SA $pc</th>
<th>Tas $pc</th>
<th>ACT $pc</th>
<th>NT $pc</th>
<th>Ave $pc</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assessed revenue</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll tax</td>
<td>941</td>
<td>823</td>
<td>866</td>
<td>1,310</td>
<td>718</td>
<td>869</td>
<td>976</td>
<td>911</td>
<td>976</td>
</tr>
<tr>
<td>Land tax</td>
<td>339</td>
<td>366</td>
<td>346</td>
<td>419</td>
<td>242</td>
<td>200</td>
<td>213</td>
<td>258</td>
<td>213</td>
</tr>
<tr>
<td>Stamp duty</td>
<td>952</td>
<td>809</td>
<td>746</td>
<td>877</td>
<td>477</td>
<td>404</td>
<td>710</td>
<td>625</td>
<td>710</td>
</tr>
<tr>
<td>Insurance tax</td>
<td>221</td>
<td>194</td>
<td>208</td>
<td>199</td>
<td>234</td>
<td>164</td>
<td>181</td>
<td>183</td>
<td>208</td>
</tr>
<tr>
<td>Motor taxes</td>
<td>254</td>
<td>294</td>
<td>300</td>
<td>331</td>
<td>301</td>
<td>323</td>
<td>243</td>
<td>255</td>
<td>286</td>
</tr>
<tr>
<td>Mining revenue</td>
<td>191</td>
<td>14</td>
<td>473</td>
<td>2,787</td>
<td>223</td>
<td>105</td>
<td>0</td>
<td>691</td>
<td>490</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,029</td>
<td>2,029</td>
<td>2,029</td>
<td>2,029</td>
<td>2,029</td>
<td>2,029</td>
<td>2,029</td>
<td>2,029</td>
<td>2,029</td>
</tr>
<tr>
<td><strong>Assessed expenses</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Schools education</td>
<td>1,925</td>
<td>1,816</td>
<td>2,066</td>
<td>2,031</td>
<td>1,992</td>
<td>2,092</td>
<td>1,821</td>
<td>3,304</td>
<td>1,959</td>
</tr>
<tr>
<td>Post-secondary education</td>
<td>245</td>
<td>238</td>
<td>246</td>
<td>254</td>
<td>247</td>
<td>250</td>
<td>263</td>
<td>321</td>
<td>246</td>
</tr>
<tr>
<td>Health</td>
<td>2,111</td>
<td>2,021</td>
<td>2,175</td>
<td>2,341</td>
<td>2,275</td>
<td>2,645</td>
<td>2,017</td>
<td>3,828</td>
<td>2,167</td>
</tr>
<tr>
<td>Housing</td>
<td>130</td>
<td>117</td>
<td>140</td>
<td>149</td>
<td>150</td>
<td>154</td>
<td>93</td>
<td>467</td>
<td>136</td>
</tr>
<tr>
<td>Welfare</td>
<td>658</td>
<td>583</td>
<td>696</td>
<td>628</td>
<td>676</td>
<td>801</td>
<td>451</td>
<td>1,605</td>
<td>655</td>
</tr>
<tr>
<td>Services to communities</td>
<td>220</td>
<td>211</td>
<td>290</td>
<td>347</td>
<td>298</td>
<td>298</td>
<td>210</td>
<td>1,704</td>
<td>268</td>
</tr>
<tr>
<td>Justice</td>
<td>711</td>
<td>638</td>
<td>770</td>
<td>815</td>
<td>727</td>
<td>777</td>
<td>620</td>
<td>2,323</td>
<td>734</td>
</tr>
<tr>
<td><strong>Roads</strong></td>
<td>2,662</td>
<td>2,571</td>
<td>3,327</td>
<td>3,392</td>
<td>3,343</td>
<td>3,273</td>
<td>1,830</td>
<td>1,780</td>
<td>300</td>
</tr>
<tr>
<td>Transport</td>
<td>512</td>
<td>539</td>
<td>422</td>
<td>494</td>
<td>416</td>
<td>198</td>
<td>341</td>
<td>186</td>
<td>479</td>
</tr>
<tr>
<td>Services to industry</td>
<td>236</td>
<td>237</td>
<td>259</td>
<td>323</td>
<td>263</td>
<td>266</td>
<td>213</td>
<td>394</td>
<td>254</td>
</tr>
<tr>
<td>Depreciation</td>
<td>512</td>
<td>470</td>
<td>560</td>
<td>644</td>
<td>582</td>
<td>580</td>
<td>466</td>
<td>1,616</td>
<td>543</td>
</tr>
<tr>
<td><strong>Other expenses</strong></td>
<td>1,016</td>
<td>984</td>
<td>1,432</td>
<td>1,226</td>
<td>1,166</td>
<td>1,403</td>
<td>1,798</td>
<td>2,144</td>
<td>1,159</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>8,541</td>
<td>8,113</td>
<td>9,383</td>
<td>9,644</td>
<td>9,136</td>
<td>9,736</td>
<td>8,475</td>
<td>18,671</td>
<td>8,899</td>
</tr>
<tr>
<td><strong>Investment</strong></td>
<td>487</td>
<td>554</td>
<td>484</td>
<td>745</td>
<td>335</td>
<td>160</td>
<td>364</td>
<td>735</td>
<td>514</td>
</tr>
<tr>
<td><strong>Net borrowing</strong></td>
<td>481</td>
<td>493</td>
<td>488</td>
<td>520</td>
<td>464</td>
<td>445</td>
<td>484</td>
<td>493</td>
<td>488</td>
</tr>
<tr>
<td><strong>Commonwealth payments</strong></td>
<td>1,591</td>
<td>1,753</td>
<td>1,627</td>
<td>1,579</td>
<td>1,577</td>
<td>1,680</td>
<td>1,664</td>
<td>2,837</td>
<td>1,652</td>
</tr>
</tbody>
</table>
ASSESSMENT CALCULATION

A State’s GST allocation (its equalising requirement) is the difference between its assessed spending on service provision and asset acquisition and its assessed revenues. More specifically, it is calculated as:

- the expenses it would incur to provide the average services (its assessed expenses) plus
- the investment it would make to have the infrastructure required to provide the average services (its assessed investment) less
- the net borrowing it would make to finish the year with the average per capita net financial worth (its assessed net borrowing) less
- the revenue it would raise if it made the average revenue raising effort (its assessed revenue) less
- the revenue from Commonwealth payments which are available to fund its spending requirements.

A per capita relativity is derived for each State by expressing its per capita GST allocation as a ratio of the national average per capita GST distributed in the year.

Per capita GST requirement and relativities

<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
<th>Ave</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessed expenses</td>
<td>8 541</td>
<td>8 113</td>
<td>9 383</td>
<td>9 644</td>
<td>9 136</td>
<td>9 736</td>
<td>8 475</td>
<td>18 671</td>
<td>8 899</td>
</tr>
<tr>
<td>plus: Assessed investment</td>
<td>487</td>
<td>554</td>
<td>484</td>
<td>745</td>
<td>335</td>
<td>160</td>
<td>364</td>
<td>735</td>
<td>514</td>
</tr>
<tr>
<td>Assessed expenditure</td>
<td>9 028</td>
<td>8 667</td>
<td>9 866</td>
<td>10 390</td>
<td>9 471</td>
<td>9 896</td>
<td>8 839</td>
<td>19 406</td>
<td>9 412</td>
</tr>
<tr>
<td>less: Assessed net borrowing</td>
<td>481</td>
<td>493</td>
<td>488</td>
<td>520</td>
<td>464</td>
<td>445</td>
<td>484</td>
<td>493</td>
<td>488</td>
</tr>
<tr>
<td>less: Assessed revenue</td>
<td>4 928</td>
<td>4 528</td>
<td>4 967</td>
<td>7 953</td>
<td>4 224</td>
<td>3 746</td>
<td>4 245</td>
<td>5 018</td>
<td>5 080</td>
</tr>
<tr>
<td>Total requirement for assistance</td>
<td>3 619</td>
<td>3 646</td>
<td>4 411</td>
<td>1 916</td>
<td>4 784</td>
<td>5 706</td>
<td>4 110</td>
<td>13 894</td>
<td>3 844</td>
</tr>
<tr>
<td>less: Commonwealth payments</td>
<td>1 591</td>
<td>1 753</td>
<td>1 627</td>
<td>1 579</td>
<td>1 577</td>
<td>1 680</td>
<td>1 664</td>
<td>2 837</td>
<td>1 652</td>
</tr>
<tr>
<td>GST requirement</td>
<td>2 028</td>
<td>1 893</td>
<td>2 785</td>
<td>337</td>
<td>3 207</td>
<td>4 026</td>
<td>2 446</td>
<td>11 058</td>
<td>2 192</td>
</tr>
<tr>
<td>Per capita relativity</td>
<td>0.925</td>
<td>0.864</td>
<td>1.270</td>
<td>0.154</td>
<td>1.463</td>
<td>1.837</td>
<td>1.116</td>
<td>5.045</td>
<td>1.000</td>
</tr>
</tbody>
</table>
Appendix C: Alternative HFE models raised in the 2012 GST Distribution Review.

From the less equalisation perspective, the Inquiry considered the following options:

Equalising to a capacity other than the ‘all States’ average’, to promote efficiency.

On this option, the Inquiry concluded:

‘……. that the HFE system as currently manifested cannot achieve this through efficiency discounts, as there are factors beyond a State’s control that lead to higher than average expenditure. While it might theoretically be possible to overcome this deficiency if the CGC were to fully separate cost and use elements of its assessments, that result is not guaranteed, and the additional process would risk complicating the CGC’s assessments further’.

Allowing one State to remain above the average, either by:

Equalising to a set proportion of the strongest State’s capacity

Under this approach, States would be equalised to a set proportion (the Inquiry used 95 per cent as an example) of that of the strongest State. This would result in less of the GST pool required to deliver ‘equalisation’, with more being allocated on an EPC basis. The strongest State would end up with a higher fiscal capacity than all other States, while the other States would have the same fiscal capacity as each other.

OR

Equalising recipients to the average capacity of some or all donor States

On this option, the Inquiry concluded that:

‘as the average fiscal capacity of donor States would be higher than the average that includes all States, the proportion of the donor State average would need to be quite low, and much lower than the proportion considered when compared with the strongest State’. 47

OR

Establishing a relativity floor

This would be equivalent to all States receiving a set amount of the GST pool on an EPC basis. Therefore, if the relativity floor was set at 0.3, 30 per cent of the GST pool would be distributed on an EPC basis.

Because these approaches redirect GST funding to the strongest State and reduce the GST funding received by the other States, the Inquiry concluded that they would ‘…potentially undermine their confidence in the federation’.

Allowing States to retain some greater proportion of a ‘fiscal benefit’

The basis of this option is that, although revenues should be generally subject to equalisation, a State should have some proportion of its revenue kept out of the equalisation process. The Inquiry suggested that possible ways to implement this would be to apply a discount to own-source revenue, all revenue, to both revenue and expenses separately, or to relativities overall.

However, the Inquiry expressed concern that large discounts would produce ‘severe impacts on recipient States’ and subject the smaller States to ‘very high risks and costs’ as their economies adjusted. The option was effectively dismissed by the Inquiry.

Equalising to a capacity other than the ‘all States’ average’, to recognise that differences in expenditure ‘effort’ are States’ policy choices.

This option suggests that, rather than seeking to equalise to the average of all States, the standard should be set at the minimum service level that any State’s residents, in practice, are willing to accept. The minimum or acceptable level of service identified was that of the State with the lowest assessed effort. Although the original option proposed using the minimum State effort for all expenditure and revenue categories, the Inquiry suggested that a more practical approach would be to use the minimum effort concept at the overall spending and revenue levels rather than category-by-category.

The Inquiry found that the adoption of the minimum effort concept would result in small discounts - 5 per cent for expenditures and 3 per cent for revenues, but concluded that these would have a significant impact on the small States.*

The Inquiry concluded that:

‘….the discounts indicated could only be considered to be minimal — perhaps even symbolic — from the large States’ point of view, while having a significant impact on small States. After deep deliberation, (the Inquiry determined on balance), not to recommend adopting discounts to reflect the minimum effort’.

On balance, the Inquiry came to the conclusion that

‘. it can neither recommend very small changes that would deliver only symbolic benefits to the large States (at the cost of even less simplicity), nor …….recommend larger changes that would have major negative impacts on small States’.

* In an effort to overcome this adverse outcome and to protect the small States in transition, the Inquiry suggested a fiscal guarantee funded out of GST growth. However, it did not prove to be a mechanism that the Inquiry could recommend.
References


Commonwealth Grants Commission, Submission to GST Distribution Review on its Interim Reports, July 2012


Commonwealth Grants Commission, Response to Treasurer - Advice on the treatment of large and volatile State revenues, February 2015


Commonwealth Grants Commission, 2020 Review - Achieving HFE - Other approaches to Distributing the GST, Staff Discussion Paper CGC 2017-03 S, May 2017,


Murphy, C, Independent Economics. Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects, Report prepared for the South Australian Department of Treasury and Finance, February 2012.

DEPARTMENT OF TREASURY AND FINANCE


Glossary of terms

**Actual per capita (APC) assessment method**
The assessed expense or revenue for each State is set equal to its actual expense or revenue. It is used when, in the Commission’s judgment, the policies of all States are the same and any differences in expenses or revenue per capita are due to differences in State circumstances.

**Application year**
The year in which the average of the assessed GST distributions for each assessment year (expressed as relativities) is to be used to distribute the GST revenue. For example, in the 2017 Update the year of application is 2017-18.

**Assessed differences (also known as needs)**
The financial impact on a State’s budget of its disabilities. They are measured, for example, as the difference between assessed expenses and average expenses, assessed revenue and average revenue. Assessed differences can be either positive or negative.

**Assessed expenses**
The expenses a State would incur if it were to follow average expense policies, allowing for the disabilities it faces in providing services, and assuming it provides services at the average level of efficiency. Assessed expenses exclude differences from the average due to policy choices under the control of a State.

**Assessed GST requirement**
A State’s requirement for funds from GST revenue in an assessment year. It is measured as its assessed expenses, plus its assessed investment, less its assessed revenue, less assessed Commonwealth payments and less assessed net borrowing.

**Assessed net lending**
The net lending assessment aims to provide each State with the same per capita stock of financial assets at the end of the year, assuming it started the year with the average at that time. A State with above average population growth is expected to need above average net lending.

**Assessed revenue**
The revenue a State would raise if it were to apply the average policies to its revenue base, and raise revenue at the average level of efficiency. Assessed revenue excludes differences from the average due to policy choices under the control of that State, for example a higher or lower tax rate applied by a State compared to the average.

**Assessment years**
The financial years used in a review or an update to calculate the assessed GST requirement, from which an annual relativity is calculated. The Commission uses data for three assessment years (where each assessment year corresponds to a financial year). For example, the GST distribution recommended in the 2017 Update (for the application year 2017-18) is based on the average of three assessment year annual relativities calculated for the most recent completed financial years at the time the relativities are released (2013-14 to 2015-16 assessment years).

**Average (or Australian average)**
The benchmark against which the performance or characteristics of a State are assessed. It is an average derived from the policies or financial data of all States, and hence may be a financial average or a policy average.

**Average expenses**
The average per capita expense, in a category, a group of categories or in total. It is calculated as the sum of expenses of all States, divided by the Australian population.
Average revenue
The average per capita revenue, in a category, a group of categories or in total. It is calculated as the sum of State revenues, divided by the Australian population.

Category
A classification of in-scope transactions relating to distinct services or revenue sources, used for analytical purposes. In the 2017 Update, the adjusted budget is divided into Commonwealth payments, seven revenue categories, thirteen expenditure categories and net borrowing.

Commonwealth payments
Payments to States made by the Australian Government, including general revenue grants, payments for specific purpose (PSPs) and Commonwealth own purpose expenses. The Commission examines the purpose of each payment using established guidelines to decide whether the payment has an impact on State fiscal capacities.

Disability
An influence beyond a State’s control that requires it:
- to spend more (or less) per capita than the average to provide the average level of service, or
- to make a greater (or lesser) effort than the average to raise the average amount of revenue per capita.

Disability factor
A measure of a State’s use, cost or revenue raising disability, expressed as a ratio of the State’s assessed expense or assessed revenue over the corresponding average figure. Policy differences between States are specifically excluded when calculating disability factors. The population weighted average of a disability factor is 1.0.

Distribution
State shares of GST revenue based on the principle of horizontal fiscal equalisation.

Distribution model
A formulation, mathematical or otherwise, of the way in which State GST shares (and relativities) are calculated. A mathematical presentation of the model is provided on the Commission’s website (www.cgc.gov.au).

Equal per capita (EPC) assessment method
Each State’s assessed expense or assessed revenue in a category is set equal to the Australian average per capita amount. It is typically used when there are judged to be no material disabilities between the States, or no reliable assessments could be developed due to data or other limitations. Such an assessment means that no needs are assessed for any State and that there is no impact on the GST distribution.

Equalisation
See horizontal fiscal equalisation (HFE).

Fiscal capacity
The fiscal capacity of a State is a measure of its ability to provide average services, including infrastructure, to its population if it raised revenue from its own revenue bases at average rates and received its actual Commonwealth payments, excluding the GST. Once the GST has been distributed using the Commission’s recommendations, State fiscal capacities should be equal. The relative capacity of each State is a comparison of its fiscal capacity with the average capacity.
Goods and Services Tax (GST) revenue or GST pool
The funds made available by the Australian Government for transfer to the States as untied financial assistance, consistent with the principle of horizontal fiscal equalisation.

Horizontal fiscal equalisation (equalisation)
A distribution of GST revenue to State governments such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and their associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources, operated at the same level of efficiency and maintained the average per capita net financial worth.

National partnership payments (NPPs)
Commonwealth payments to States that support the delivery of specified projects, facilitate reforms, or reward those jurisdictions that deliver on nationally-significant reforms.

National specific purpose payments (SPPs)
Commonwealth payments to States for specific purposes that enable national policy objectives to be achieved in areas that may be administered by States.

Needs
See assessed differences.

Payments for specific purposes (PSPs)
Australian government payments to the States for specific purposes in policy areas for which the States have primary responsibility. These payments cover most functional areas of State (and local government) activity, including health, education, skills and workforce development, community services, housing, Indigenous affairs, infrastructure and the environment. PSPs include SPPs, National Health Reform funding, Students First funding and NPPs.

Per capita
Population share of a total.

Policy average
The average policies as reflected in the practices of the States in the collection of revenue and the provision of services. These averages are usually weighted according to the size of the user or revenue bases in each State.

Policy neutral assessment
An assessment in which the policy average is applied to every State. The resultant assessment is therefore unaffected by the policies of individual States, other than through the influence of those policies on the averages.

Redistribution
The difference between an equal per capita distribution of GST revenue and one based on the principle of horizontal fiscal equalisation.

Relativity
A per capita weight assessed by the Commission for use by the Commonwealth Treasury in calculating the share of the GST revenue a State requires to achieve horizontal fiscal equalisation.

Revenue base
A measure of the transactions, activities, or assets that are taxed by the States. Differences between the revenue bases of each State are used by the Commission to determine the relative capacities of each to raise a particular type of revenue.

Revenue effort
The intensity of use of a revenue base (the implied tax rate) measured as actual revenue divided by the assessed revenue. It is influenced by the rate of tax or charge, the exemptions, and concessions provided, actual scope of the revenue base in a State, and the effort put into ensuring compliance.
Review
The process in which the Commission reconsiders the methods used to calculate the GST distribution, according to terms of reference given to it. From 1988 onwards, reviews have usually been done every five years. By contrast, an update is conducted every year other than a review year and updates the GST distribution using the methods determined in the last review and the latest financial data.

Socio-demographic composition disability
A disability that measures differences in both the average use and cost of providing services due to differences between States in the relative size of various socio-demographic groups. It can reflect differences between States in some or all population characteristics such as age-sex structure, socio-economic status, Indigenous status and location.

State(s)
Unless the context indicates otherwise, the term ‘State(s)’ includes the Australian Capital Territory and the Northern Territory.

Tax base
See revenue base.

Update
The annual assessment of the GST distribution undertaken by the Commission between reviews. Update assessments incorporate new budgetary developments and the most recent available data. In general, the methods used to calculate the GST distribution are those adopted in the most recent review.

Vertical Fiscal Imbalance
Vertical Fiscal Imbalance refers to the imbalance between the revenue raising powers and functional responsibilities at each level of government.
## Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABS</td>
<td>Australian Bureau of Statistics</td>
</tr>
<tr>
<td>APC</td>
<td>Average per capita</td>
</tr>
<tr>
<td>CGC</td>
<td>Commonwealth Grants Commission</td>
</tr>
<tr>
<td>HFE</td>
<td>Horizontal Fiscal Equalisation</td>
</tr>
<tr>
<td>EPC</td>
<td>Equal per capita</td>
</tr>
<tr>
<td>GST</td>
<td>Goods and Services Tax</td>
</tr>
<tr>
<td>IGA</td>
<td>Intergovernment Agreement on the Reform of Commonwealth-State Financial Relations 1999</td>
</tr>
<tr>
<td>IGAFFR</td>
<td>Intergovernmental Agreement on Federal Financial Relations 2008</td>
</tr>
<tr>
<td>MRRT</td>
<td>Minerals Resource Rent Tax</td>
</tr>
<tr>
<td>NCP</td>
<td>National Competition Policy</td>
</tr>
<tr>
<td>NRA</td>
<td>National Reform Agenda</td>
</tr>
<tr>
<td>ToR</td>
<td>Terms of reference</td>
</tr>
<tr>
<td>VFI</td>
<td>Vertical Fiscal Imbalance</td>
</tr>
</tbody>
</table>