Productivity Commission Inquiry into Horizontal Fiscal Equalisation

Commonwealth Government Response

Department of Treasury and Finance Analysis

October 2018

Tasmania
Explore the possibilities

CONTENTS

Background

On 30 April 2017, the Commonwealth Government Treasurer requested that the Productivity Commission (PC) 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).

Throughout the inquiry, the Tasmanian Government made a number of submissions supporting the current HFE system, arguing that the PC's alternatives would redirect GST funding to the strongest States and reduce the GST funding to the other States. This would, over time, reduce equity between the States.

The Tasmanian Government considered that the PC had not been able to demonstrate that HFE had been detrimental to national productivity, efficiency and growth, and that its conclusions on these issues were predicated on assertions, not evidence. Copies of the Tasmanian Government submissions are available at https://www.treasury.tas.gov.au/gst-distribution-to-tasmania/publications. The Treasurer of Tasmania, the Hon Peter Gutwein MP's presentation to the Productivity Commission's public hearings held in Hobart on 1 December 2017, is also available from the Tasmanian Treasury website.

On 5 July 2018, the *Final Report* of the PC's inquiry into HFE was tabled in the Commonwealth Parliament.

The PC assessed the influence of the current system of HFE on productivity, efficiency and economic growth, the incentives for the States to undertake reforms that improve the operation of their jurisdictions, and on the States' abilities to prepare and deliver annual budgets. The PC identified a package of changes that it asserted would improve the equity, efficiency, and transparency and accountability of the HFE system.

The Report included 18 Recommendations and Findings, the majority of which had not changed substantially since the release of the PC's *Draft Report* on 9 October 2017.

The Final Report retains the key recommendation to redefine HFE to be at a *reasonable*, rather than the *same*, standard of services and infrastructure, with the Terms of Reference for all future Commonwealth Grants Commission (CGC) Relativity Updates and five-yearly Methodology Reviews to reflect this revised objective. In addition, it recommended that the CGC should equalise to the average fiscal capacity of all States.

The Report further proposed:

- that the basic premise of HFE - fiscal equality in the Australian Federation - has broad support from all levels of Government;
- promoting the use of more policy neutral indicators and higher materiality thresholds to improve efficiency and simplicity in CGC assessments, in line with achieving a reasonable standard of equalisation; and
- strengthening the decision-making framework of the CGC through Commonwealth Treasury and Treasurer input.

The Department of Treasury and Finance (Treasury) remains of the view that the current system of HFE is not "broken" and that the PC did not made a convincing case that it needs changing. Treasury considers that any potential change to the current system of HFE to benefit one State at the expense of all other States is unwarranted and would undermine the equitable basis on which the HFE system is built and would lead to growing inequality between the States.

Background information about HFE and the distribution of the GST is available in the document titled "Horizontal Fiscal Equalisation: an equitable approach to GST distribution" dated June 2017 at https://www.treasury.tas.gov.au/gst-distribution-to-tasmania.

Commonwealth Government's Proposal

On 5 July 2018, the Commonwealth Government released its interim response to the PC's Final Report. The interim response implements a range of measures to reform the current system of HFE. In its interim response, the Commonwealth accepted all the PC's recommendations except the recommendation to equalise to the average fiscal capacity of all States.

The Commonwealth has instead proposed an alternative to equalise to the fiscal capacity of New South Wales or Victoria (whichever is higher) together with a range of measures to transition to the new arrangements.

The Commonwealth Government's response is detailed in the document "Productivity Commission Inquiry into Horizontal Fiscal Equalisation: Government Interim Response" dated July 2018 which is available at https://treasury.gov.au/publication/p2018-308096/.

In this document, the then Treasurer, the Hon Scott Morrison MP indicated a willingness

> *"to work in cooperation with States to reach a long-term solution - one that leaves Australia with a more stable and predictable source of revenue for all States, while preserving the best features of our HFE system in terms of equity and leaving all states better off".*

A summary of the Commonwealth's proposal is provided at Attachment 1.

According to the single scenario presented by the Commonwealth, every State will be better off financially, (with Western Australia substantially better off). The outcome from the Commonwealth's scenario is detailed in Table 1.

Table 1: State by state impact compared to current HFE system - Commonwealth scenario using PC relativities

	NSW $m	Vic $m	Qld $m	WA $m	SA $m	Tas $m	ACT $m	NT $m	Total $m
2018-19	0	0	0	0	0	0	0	0	0
2019-20	0	0	0	814	0	0	0	69	883
2020-21	0	0	0	585	0	0	0	0	585
2021-22	78	84	87	568	41	17	7	24	906
2022-23	30	45	61	421	31	14	5	24	631
2023-24	14	31	51	495	28	13	5	25	664
2024-25	70	84	102	575	50	22	9	37	948
2025-26	85	96	112	580	54	23	10	39	999
2026-27	74	85	105	663	53	23	10	40	1 053
Total	**351**	**425**	**518**	**4 702**	**257**	**112**	**46**	**258**	**6 669**

Under the proposed changes, Western Australia will have a greater permanent and increasing fiscal capacity than any other jurisdiction and will be able to deliver a higher standard of services and/or lower taxes to its constituents relative to all other jurisdictions. Alternatively, Western Australia could increase its mining royalties, further increasing its fiscal capacity. Even if the Commonwealth's proposal leaves Tasmania better off in the longer-term, it will set in place a system that will entrench a gap between the fiscally strongest State and the other States.

Treasury Analysis of Proposal

Since the Commonwealth Government released its interim response, Treasury has been undertaking detailed analysis of the proposal and has been actively engaging with the Commonwealth and other State Treasuries.

The Commonwealth's proposal presented one modelled scenario that suggested that Tasmania would be better off under the new arrangements, compared to the current system of full HFE. However, this modelling does not take into account the impact of the other recommendations and is therefore incomplete.

There are a number of feasible scenarios, based on different assumptions, which would appear to indicate that the proposed changes to the GST distribution may be detrimental to Tasmania's fiscal position.

Treasury's analysis is separated into two key areas:

- the recommendation to equalise to the fiscal capacity of New South Wales or Victoria (whichever is higher); and
- all other recommendations accepted by the Commonwealth Government.

Recommendation to Equalise to the Second Highest State

The CGC distributes the GST to the States using a complex formula that aims to equalise the fiscal capacity of the States to the strongest State (currently Western Australia) so that each State has the capacity to provide the 'same' standard of services. Each year, the CGC makes recommendations to the Australian Treasurer, in the form of relativities, on how GST Revenue should be distributed between the States to best achieve HFE.

In the Commonwealth's response, the Commonwealth accepted the PC's recommendation to amend the objective of HFE to a 'reasonable' equalisation standard. To do this, the Commonwealth has proposed moving to a benchmark that would equalise the fiscal capacity of all States to New South Wales or Victoria (whichever is higher) rather than the current approach of equalising to the strongest State.

The PC's "Consensus" Relativity Forecasts

The Commonwealth's proposal and its assessed financial impacts are largely predicated on the PC's forecasts of State GST relativities included in its Final Report[1]. These are detailed in Table 2.

As part of the review process, the PC sought current relativity forecasts from each of the States out to 2026-27 to enable it to calculate an average of State relativities. In November 2017, Treasury provided the PC with its 2017-18 Tasmanian Budget relativity forecasts for 2018-19 to 2020-21. It is not certain whether all States provided forecasts to the PC. However, States do not forecast relativities past the Budget and Forward Estimate period and if they do, they are heavily caveated. Also some States do not forecast relativities.

The PC's Report presents relativity projections for a period of five years beyond the Forward Estimates, to cover the eight-year period 2018-19 to 2026-27.

[1] Productivity Commission Inquiry Report, Horizontal Fiscal Equalisation, 15 May 2018.

Table 2: Commonwealth (PC) relativity projections

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
2018-19	0.86	0.99	1.10	0.47	1.48	1.77	1.18	4.26
2019-20	0.82	0.96	1.12	0.59	1.43	1.81	1.19	4.55
2020-21	0.82	0.95	1.12	0.62	1.43	1.80	1.18	4.75
2021-22	0.82	0.94	1.14	0.63	1.42	1.78	1.16	4.67
2022-23	0.81	0.93	1.15	0.66	1.40	1.75	1.15	4.84
2023-24	0.81	0.93	1.14	0.70	1.39	1.75	1.16	4.86
2024-25	0.82	0.92	1.12	0.73	1.39	1.75	1.16	4.88
2025-26	0.82	0.91	1.12	0.75	1.39	1.75	1.17	4.90
2026-27	0.83	0.91	1.11	0.76	1.38	1.75	1.18	4.91

While the PC initially provided the States, in February 2018, a staff discussion paper for feedback that included initial forecasts of relativities, pool and population, it did not give any details on how the relativities were estimated, or which States provided relativity projections to the PC. The PC did not consult with the States on the set of relativities it used in its final report.

At the time, Treasury made a submission to the PC expressing significant concerns with its approach to forecasting relativities and in particular, the attempt to project relativities beyond the forward estimates period. Relativity forecasts are generally volatile and, for this reason, most States do not forecast them beyond the Forward Estimates period. Estimates of relativities over the longer term are also highly unreliable given the interactions between States and unforeseen changes in State circumstances.

It was also noted that the PC had not provided any detailed working data to enable a more comprehensive examination of the projections. It is understood that a number of other States expressed similar concerns.

The PC has assumed that States' relativities trend to their long term average at the end of the Forward Estimates period. This assumption produces an outcome in which Western Australia's relativities to 2026-27 continue to increase. This increase could only occur if Western Australia's mining royalties decline over this period, rather than remaining at near record levels, as they are currently projected to do in the 2018-19 Western Australian State Budget.

In addition, while projecting an increase in Western Australia's relativity, the PC has not projected a corresponding decline in other States' relativities. This outcome is not possible under the GST distribution methodology and the assumption would appear to distort the 'zero sum' outcome of the GST methodology whereby any financial distribution to one State must be offset by a redistribution away from other States.

Variability in Relativities

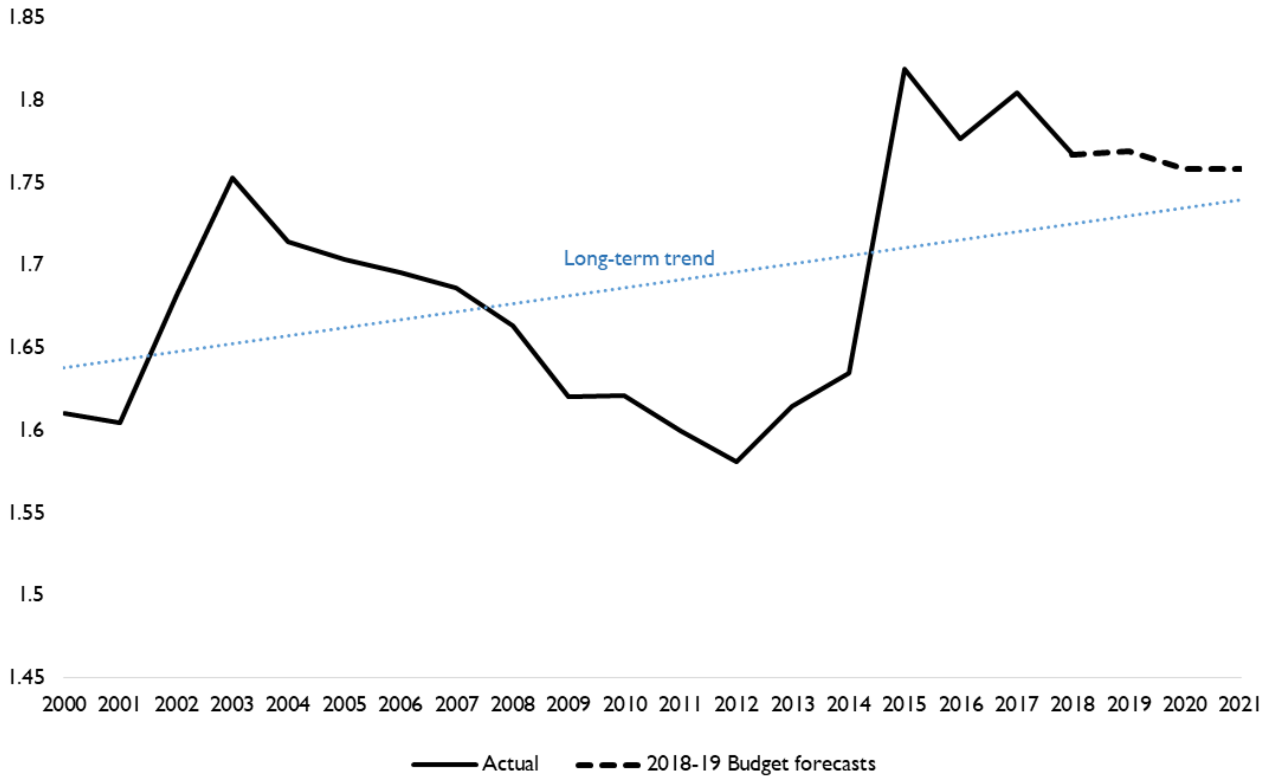
As mentioned above, relativities are generally volatile. Chart 1 illustrates the high level of historical variability in Tasmania's annual GST relativity. This variability can be driven by Tasmanian-specific factors such as growing own-source revenue, or by external factors such as high iron royalties in other States during the mining boom.

However, the PC's relativity projections for Tasmania used in the Commonwealth's modelling are extremely stable, with an average annual variability of only 0.5 per cent.

By comparison, historical actual average annual variability for Tasmania's relativity is 2.2 per cent, with variations of up to 11.3 per cent. Annual variability has exceeded one per cent in 13 out of 18 years and two per cent in 8 out of 18 years. The average annual change in Tasmania's actual relativity over three years is 5.0 per cent.

Given this, the stable long term relativity projections relied on by the Commonwealth are highly unlikely to reflect actual future outcomes.

Chart 1: Variability in Tasmanian GST relativities



As part of its budget process, Tasmanian Treasury has modelled GST relativities since the 2012-13 Tasmanian Budget, and has observed that these forecasts become progressively less accurate over the out years, as the modelling process becomes less reliant on actual data and more reliant on forecast and projected data. Basing GST distributions on relativities forecast over an 8-year period, therefore, has the potential for a high degree of error.

A one per cent change in Tasmania's relativity in 2018-19 is equivalent to approximately $25 million in GST revenue, and a one per cent change in Tasmania's relativity in 2026-27 (based on the PC's projections) is equivalent to $33 million in GST revenue.

Similarly, a five per cent variation in Tasmania's 2026-27 relativity from that used in the Commonwealth's modelling could result in an unforeseen movement of approximately +/- $150 million in GST revenue to Tasmania in that year, indicating that small variations in the projected relativities can result in significantly different financial outcomes for Tasmania.

Alternative Scenario Analysis

Treasury has modelled a number of alternative relativity scenarios to illustrate the range of outcomes that could result from the Commonwealth's proposal.

One scenario is where Western Australia achieves rapid short term growth in mining royalties. This would only require a 20 per cent increase in mining royalties, which is modest compared to the variability during the mining boom (its mining royalties increased by 36 per cent from 2012-13 to 2013-14 and then declined by 24 per cent in the following year).

Under this scenario Western Australia would be significantly better off under the Commonwealth's proposal, and all other States significantly worse off than under full HFE, as evident from Table 3.

Table 3: Scenario Analysis - Rapid Growth in Mining Royalties - State by state impact compared to current HFE system

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	$m	$m	$m	$m	$m	$m	$m	$m
Total	**-5 462**	**-4 580**	**-3 199**	**25 132**	**-965**	**-248**	**-267**	**232**

Source: Treasury modelling based on PC forecasting.

A more conservative scenario is for a gradual return to 10-year average relativities by 2026-27. Under this scenario, Western Australia's relativity hovers at around 0.50, which is consistent with its current forecasts of stable mining revenues. Western Australia would be significantly better off under the Commonwealth's proposal and all other States significantly worse off than under full HFE, as evident from Table 4.

Table 4: Scenario Analysis - Return to 10-year average relativities - State by state impact compared to current HFE system

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	$m	$m	$m	$m	$m	$m	$m	$m
Total	**-3 316**	**-2 744**	**-1 914**	**18 086**	**- 528**	**- 125**	**- 150**	**404**

Finally, Treasury has modelled a scenario that reflects relative stability from the end of the current forward estimates period. The outcome over eight years is not significantly different from the Commonwealth's modelling. However, it does show that very small changes in assumptions about relativities can result in some states being worse off, rather than better off. New South Wales and Victoria become progressively worse off than current HFE over time, and the annual benefit to Western Australia grows progressively larger.

Table 5: Scenario Analysis - Stable relativities from 2020-21 - State by state impact compared to current HFE system

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	$m	$m	$m	$m	$m	$m	$m	$m
Total	**- 32**	**146**	**231**	**4 689**	**219**	**90**	**28**	**787**

These scenarios reinforce the significant risks inherent in the Commonwealth's proposal for most States.

Scenario analysis undertaken by other State Treasuries suggests that the outcomes under the scenarios above are consistent with Treasury's modelling. There is significant variation in outcomes depending on the scenario modelled, reinforcing that there are a range of potential future outcomes that could eventuate.

Western Australia is by far the main beneficiary of the Commonwealth's proposal. Also under all scenarios Treasury has modelled, Western Australia is significantly better off under the Commonwealth's proposal than under the existing methodology, through its increased share of the GST pool and direct top-ups.

Treasury's view is that the alternative GST distribution scenario modelled by the Commonwealth Government is only one of many possible scenarios, but one that which is likely to portray a "best case" for the States and significantly understates the probable benefits to Western Australia and the costs to other States on a permanent basis.

Other Recommendations

As noted above, the CGC distributes the GST to the States using a complex formula that aims to equalise the fiscal capacity of the States to the strongest State so that each State has the capacity to provide the 'same' standard of services.

As part of its Terms of Reference, the PC was required, among other things, to consider options for simplifying the current system. Treasury considers that, given the significant amounts of revenue distributed among the States, a level of complexity is warranted. Complex systems and legislation are common in many fields such as taxation, superannuation and energy policy. Also, in many respects it is no more complicated than the methodology used to distribute health and education grants where recognition is also given to factors such as location, socio-economic disadvantage and indigeneity.

The PC suggested in its final report that the system "is very poorly understood by the public and by most within Government - lending itself to a myriad of myths and confused accountability".

In reality, the model proposed by the Commonwealth Government is more complex than the current arrangements.

The other recommendations proposed by the PC and accepted by the Commonwealth Government are generally professed to support a more informed public debate about HFE as well as an improved understanding of the workings of the HFE methodology.

As noted previously, the financial impact of these recommendations is not included in the Commonwealth Government forecasts detailed on page 2.

A number of these recommendations are largely administrative in nature and are generally supported in principle by Treasury on condition that the Commonwealth Government consults with the States and the CGC in relation to the practical implementation of these measures.

However, a small number of the recommendations are of particular concern and will result in Tasmania being worse off than under the current system of full HFE.

The PC has recommended that the objective of HFE should be refocused to provide the States with the fiscal capacity to provide services and associated infrastructure of a reasonable (rather than the same) standard.

This is a broad change to the objective of HFE that would leave the smaller States exposed to a future Commonwealth Government implementing a potentially wide range of measures such as reducing the degree of equalisation, or simplifying the CGC's assessment methodology. This would have the effect of reducing HFE and therefore the GST distributed to the smaller States.

There is no clarity on what a 'reasonable standard' should be. For example, at what point does a change to the CGC's methodology exceed reasonable equalisation? The CGC would need clear guidance from the Commonwealth Government as to what reasonable equalisation means in order for it to ensure that its methodology meets the revised objective.

It is not clear that the Commonwealth's proposal to equalise to the stronger of New South Wales or Victoria could be considered reasonable equalisation (without a definition of what reasonable equalisation is). However, in addition to this measure the PC has recommended that the CGC be directed to examine simpler and more aggregated revenue and expenditure assessments, which would be consistent with achieving a reasonable standard of services and to adopt significant increases in materiality thresholds. This should be included in revised terms of reference for the CGC's 2020 Methodology Review.

The Commonwealth Government has accepted this recommendation with no further analysis.

Materiality thresholds are currently used by the CGC to remove both revenue and expenditure factors from the equalisation process that do not exert a material impact on the redistribution process. The current threshold is $30 per capita (which increased from $10 per capita in the 2015 Methodology Review). The CGC is currently considering increasing the threshold to $35 per capita as part of the 2020 Methodology Review.

The Commonwealth Government has not provided details as to what constitutes a 'significant' increase in materiality thresholds. However, in its Final Report, the PC referred to an earlier proposal to quadruple materiality thresholds to $120 per capita.

Depending on the level of threshold chosen, any change could have a significant negative impact on Tasmania's fiscal position.

If implemented, these changes are likely to result in a further reduction in HFE as greater simplification of the methodology results in less recognition of States' disabilities and fewer assessments. This will lead to a greater proportion of the GST pool being allocated on an equal per capita basis. Increasing materiality thresholds will also significantly advantage the larger States at the expense of the smaller States.

Considering that the larger States will be the greatest beneficiaries of the proposed changes to the GST distribution, increasing materiality thresholds will reduce the equalisation task and will further widen the gap between the fiscally stronger States and the weaker States, significantly advantaging the larger States at the expense of the smaller States. Table 6 highlights the redistributive impacts of raising materiality thresholds from the current $30 level.

Table 6: Impact on GST distribution per annum compared to Budget from increasing materiality thresholds

Materiality threshold (pc)	NSW $m	Vic $m	Qld $m	WA $m	SA $m	Tas $m	ACT $m	NT $m
$30	$0	$0	$0	$0	$0	$0	$0	$0
$35	-$44	-$13	$25	$79	-$31	-$8	-$7	-$1
$50	$87	-$132	-$7	$120	-$25	-$54	$7	$3
$100	-$216	$246	-$329	$297	$86	-$63	-$24	$2
$120	-$21	$582	-$542	$75	$51	-$119	$25	-$50

Source: Treasury analysis of CGC modelling provided to the States.

Note: The 'lumpiness' of the impacts is due to the fact that, in some cases, negative GST impacts for a State can reduce following a materiality threshold increase when a disability that distributes significant GST away from that State is removed from the assessments.

The PC's recommendation to have simpler and more aggregated revenue assessments could also include a range of measures that reduce the recognition of state revenue raising or service delivery cost disabilities and will in effect lead to lesser fiscal equalisation. The more measures that are included as part of 'reasonable' equalisation, the further away the system moves from the current full HFE.

Once again, the impact of this proposal is not included in the Commonwealth Government's modelling.

Summary of Proposal

The former Commonwealth Treasurer, the Hon Scott Morrison, has expressed the view that all States will be better off, both now and into the future, from the proposed arrangements. In a press conference on 5 July 2018, he stated

> "*as the Commonwealth Treasurer, it's my responsibility to ensure there's a better arrangement. At the end of the day, that means ensuring no State is worse off, and, indeed, making sure they're better off*".

However, as noted in this document there are significant risks associated with the Commonwealth's proposal that would suggest this may not occur.

The Commonwealth's proposal presented one modelled scenario that suggested that Tasmania would be better off under the new arrangements, compared to the current system of full HFE. However, this modelling does not take into account the impact of the other recommendations and is therefore incomplete.

There are a number of feasible scenarios, based on different assumptions and more realistic relativities, which would appear to indicate that the proposed changes to the GST distribution may be detrimental to Tasmania's fiscal position. Treasury's view is that this scenario also significantly understates the benefits to Western Australia and the costs to the other States on a permanent basis.

In addition, the Commonwealth's proposal includes a number of other recommendations adopted from the PC's report which have not been included in its modelling and will result in Tasmania being worse off than under the current system of full HFE. A number of these recommendations will significantly advantage the larger States at the expense of the smaller States.

Under the proposed changes, Western Australia will have a greater permanent and increasing fiscal capacity than any other jurisdiction and will be able to deliver a higher standard of services and/or lower taxes to its constituents relative to all other jurisdictions. Alternatively, Western Australia could increase its mining royalties, further increasing its fiscal capacity. Even if the Commonwealth's proposal leaves Tasmania better off in the longer-term relative to the status quo, it will set in place a system that will entrench a gap between the fiscally strongest State and the other States.

Outcome of Council of Federal Financial Relations meeting

A special Council of Federal Financial Relations (CFFR) meeting was held on 3 October 2018 to discuss the Commonwealth Government's proposal.

In advance of this meeting, the States were actively working together to understand the impacts and the assumptions of the Commonwealth's proposal and modelling. This included the States cooperatively undertaking scenario modelling to understand the range of possible outcomes for each State.

Given the significant concerns associated with the Commonwealth's proposal, a letter from the Board of Treasurers signed by all Treasurers was sent to the former Commonwealth Treasurer on 10 August 2018 requesting details of the Commonwealth's proposal and seeking a binding guarantee that no state will be worse off under the proposed system compared to the current system in perpetuity. Additionally, it sought to ensure that the source of top-up funding to meet the GST guarantee would not diminish other sources of grant revenue.[2]

A guarantee will require the CGC to continue to model the current system and produce two sets of relativities. However, this should not be an onerous process as the CGC will need to do this under the Commonwealth's proposal in order to then equalise to the stronger of New South Wales or Victoria. This later equalisation is simply a subsequent step in the calculation of final relativities. This does not require the CGC to run two systems.

The draft Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018 was provided to the States by the Commonwealth on 1 October 2018 in advance of the CFFR meeting which amends the *Commonwealth Grants Commission Act 1973* and the *Federal Financial Relations Act 2009* to give effect to key elements of the Government's interim response to the Productivity Commission's Inquiry Report, Horizontal Fiscal Equalisation. At the meeting, all Treasurers reiterated their request that a formal guarantee be included as part of the legislation.

A formal guarantee from the Commonwealth would provide a greater level of confidence that States will not be negatively impacted by the proposal and will embed in legislation the former Treasurer's commitment that all States will be "better off".

At the CFFR meeting, the Commonwealth Government indicated it will introduce the legislation unamended in the next parliamentary session, which begins on October 15. The Tasmanian Government has publically stated it will not support the legislation in its current form without the guarantee.

Additionally, at the CFFR meeting the Treasurers decided to refer the other recommendations to the Heads of Treasuries (HoTs) forum for further discussion.

[2] Board of Treasurers, Media Release, 'Vow to ensure all states GST winners', 3 August 2018, https://www.treasury.nsw.gov.au/board-treasurers.

Attachments

Attachment 1 - Summary of Commonwealth's Proposal

The Commonwealth's proposal is summarised as follows:

Providing initial top-up funding to Western Australia and the Northern Territory

Over the period 2019-20 to 2021-22 the Commonwealth Government will top-up Western Australia's GST share with a separate payment so that the combined GST and top-up payment are equivalent to the GST payment it would receive with a relativity of 0.70. The Commonwealth Government will, likewise, top-up the Northern Territory's GST payment so that it gets at least its 2017-18 GST share. Based on the Commonwealth Government's projections, this is expected to cost a total of $1.77 billion from 2019-20 to 2020-21.

Equalising the fiscal capacity of all the States to at least the equal of NSW or Victoria (whichever is higher).

The Commonwealth Government proposes that the GST distribution will transition from the current method to equalise to the stronger of NSW or Victoria over six years from 2021-22 to 2026-27. Treasury modelling indicates that this transition will be implemented by applying an adjustment to each State's GST revenue equivalent to 1/6th of the difference between the existing full HFE distribution in 2021-22, 2/6ths of the difference in 2022-23, and progressively transitioning until the new distribution is fully implemented in 2026-27.

Introducing a GST relativity floor to provide an additional safety net

The Commonwealth Government is proposing to implement a relativity floor over the course of the transition to a new equalisation standard to provide a safety net to prevent a repeat of the situation where Western Australia's relativity dropped sharply during the mining boom. The floor would initially be set at a relativity of 0.70 in 2022-23, before moving up to 0.75 in 2024-25. The Commonwealth Government has assumed that all States will be above the floor by the time it is implemented. In fact, no State is likely to require a floor to be activated once the distribution is fully transitioned to the revised methodology. Both the strongest and second strongest States would need to have a relativity under 0.75 for the floor to be activated and this is highly unlikely.

Ensuring all the States are better off with an additional, direct and permanent boost to the GST pool.

The size of the boost to the GST pool would be set at a level that ensures that no State is worse off as a result of the move to a new equalisation benchmark. The Commonwealth Government proposes to top-up the GST pool on a permanent basis with an additional $600 million in 2021-22 indexed by the growth in GST collections in the pool. A further $250 million will be added to the pool in 2024-25, again indexed by the underlying growth in the pool. Based on the Commonwealth Government's projections, the total additional boost to the GST pool (excluding initial top-ups to Western Australia and the Norther Territory) will be $7.2 billion by 2028-29.

Changing the way HFE is calculated

The Commonwealth Government has accepted the PC's recommendation in its interim response that the Commonwealth Treasurer direct the CGC to examine simpler and more efficient assessments of States financial positions. In particular, it has been recommended that the CGC should adopt significant increases in materiality thresholds and consider using more aggregated revenue and expenditure assessments. The Commonwealth Government has also accepted Recommendation 3.2 from the October 2012 GST Distribution Review Final Report to round the CGC's relativities to two decimal places.

Attachment 2 - Other Recommendations

Other Recommendations
Recommendation 6.1 The objective of the HFE system should be refocused to provide the States with the fiscal capacity to provide services and associated infrastructure of a reasonable (rather than the same) standard.
Recommendation 6.2 The CGC — through its Chairperson and Commission members — should provide a strong neutral voice, to facilitate a better informed public discourse on the HFE system.
Recommendation 6.3 The CGC should strengthen its formal interactions with the State and Commonwealth Governments. In particular, when requested by a State Government, it should provide provisional 'draft rulings' on the HFE implications of a policy change.
Recommendation 6.4 The Commonwealth Government, in consultation with the States, should develop clear guidelines detailing the basis on which Commonwealth payments are to be quarantined from HFE by the Commonwealth Treasurer (so that they do not unnecessarily erode the efficacy of the CGC's relativities and compromise the objective of HFE). The guidelines should strike a balance between enhancing accountability and transparency, while not unduly affecting the Treasurer's ability to quarantine payments in exceptional circumstances that in the national interest.
Recommendation 6.5 The Commonwealth Government should strengthen the CGC's decision-making framework. In particular: • The Commonwealth Treasury should provide input, including public submissions, to the CGC's five-yearly methodology review process, drawing upon its community-wide perspective; and • The Commonwealth Treasurer should nominate specific areas of focus for the CGC in the terms of reference for the five-yearly methodology reviews, following (as is currently the case) consultation with the States.
Recommendation 6.6 The CGC should immediately and systematically make the data provided by the States publically available on its website, along with the CGC's calculations on these data.

Recommendation 7.1 The Commonwealth Treasurer should direct the CGC (in accordance with the refocused HFE objective) to: • examine simpler and more aggregated revenue and expenditure assessments that use more policy-neutral indicators, consistent with achieving a reasonable standard of services; and • adopt significant increases in materiality thresholds, which would assist in determining and applying more policy-neutral category level indicators. This initial direction should be embedded in revised terms of reference for the CGC's 2020 methodology review.
Recommendation 9.1 The Commonwealth and State Governments, through the Council on Federal Financial Relations and recently formed Board of Treasurers, should work towards meaningful reform to federal financial relations. In the first instance, the process should: • assess how Commonwealth payments to the States — both general revenue assistance and payments for specific purposes — interact with each other, given the significant reforms to payments for specific purposes that have occurred in recent years; and • develop a better-delineated division of responsibilities between the States and the Commonwealth and establish clear lines and forms of accountability. Policies to address Indigenous disadvantage should be a priority. Following this, options to address the vertical fiscal imbalance should be considered and advanced.
Recommendation 3.2 (from GST Distribution Review Final Report - October 2012) In addition to the PC's Recommendations, the Government agrees that relativities produced from the CGC's process be rounded to two decimal places in the annual Updates and Reviews. Implementing this additional recommendation from the 2012 GST Distribution Review would further address false precision in the system.