Response to the Commonwealth Government's Horizontal Fiscal Equalisation Proposal

Tasmanian Department of Treasury and Finance

October 2018

Tasmanian Government

Key Points

The Basis of Horizontal Fiscal Equalisation (HFE)

HFE is a fundamental principle that binds the Federation, and ensures that all States and Territories (States) have a 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 that face higher service costs and/or weaker tax bases than the States with larger populations and economies. It is a critical feature of Commonwealth-State financial relations to ensure equity between the States as differences in the economic, social and demographic features of a State can impact expenditures and revenue.

It does not compensate for differences attributable to policy, practice or relative inefficiency.

If States were not provided with a similar capacity to provide services through HFE, inequality within the Australian community would increase over time, because disadvantaged States would not have the capacity to compensate for their disadvantages and stronger States would have a greater capacity than required to meet their needs.

Through the fortunate abundance of natural resources, Western Australia was able to take advantage of world demand for these minerals and reap the unprecedented economic benefits. As a result, Western Australia has had, and will continue to have, extremely high royalty revenues compared to other States.

However, this boom came at the expense of other State economies. Tasmania, for instance, experienced the down side effects of the very high exchange rates on its own exports. In addition, the mining boom drove significant wage increases in the public sector, impacting on service delivery costs in a number of States.

Key Points

Notwithstanding the reduction in Western Australia's GST share, its total revenue per capita remained above the national average largely due to its increasing mineral royalties.

The CGC also estimated that it benefited from an additional $7 billion in GST revenue from 2010-11 to 2013-14 due to the lagged effect of the GST distribution.

The decreasing State relativity of Western Australia has drawn considerable attention over recent times and raised ill-informed arguments that it is bearing an unfair equalisation burden. It was also the major driver of the decision to task the PC with a review of HFE.

Analysis of the Commonwealth Government's Response to the PC Report

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 Commonwealth's response to the PC Report. 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".*

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.

In fact, around 70 per cent of the GST pool boost and direct top ups of $6.7 billion will be distributed to Western Australia by 2026-27.

Key Points

Even if the Commonwealth's proposal leaves Tasmania better off in the short term, it will set in place a system that will entrench a gap between the fiscally strongest State (Western Australia) and the other States.

This does not meet the fundamental principal of HFE to ensure an equitable outcome for all Australians, no matter where they live.

However, there are also significant risks associated with the Commonwealth's proposal that would suggest that the former Treasurer's commitment that all States will be better off will not eventuate.

The Commonwealth has presented one modelled scenario, 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.

Alternative scenarios modelled by the States show that 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.

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.

Key Points

No Worse off Guarantee

A formal guarantee from the Commonwealth will 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".

It is proposed that the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018 be amended to allow for this guarantee.

Given the complexity of the HFE methodology, it is proposed that any guarantee should be drafted in consultation with all States and Territories and the CGC to ensure that it is workable.

This will ensure that the Commonwealth Government delivers on the former Treasurer's commitment

> *"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".*

Tasmanian Government

PART A - Background to HFE and the Outcome of the Productivity Commission's Inquiry into Horizontal Fiscal Equalisation

Tasmanian Government

What is HFE?

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.

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

HFE 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.

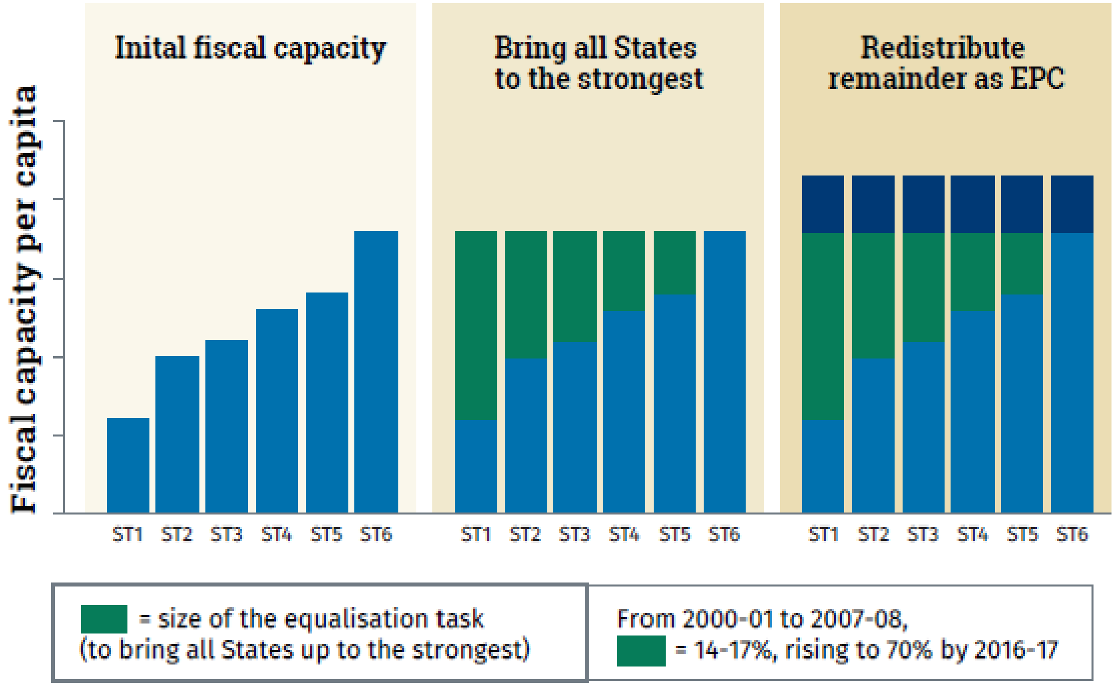
How does HFE work to distribute GST?

States require differing levels of GST revenue because 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 Tasmania - it will have high assessed expenses and will require more GST revenue.

Simply put, a State's GST requirement is 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 1 - Stages of the HFE Process



Tasmanian Government

How does HFE work to distribute GST?

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.

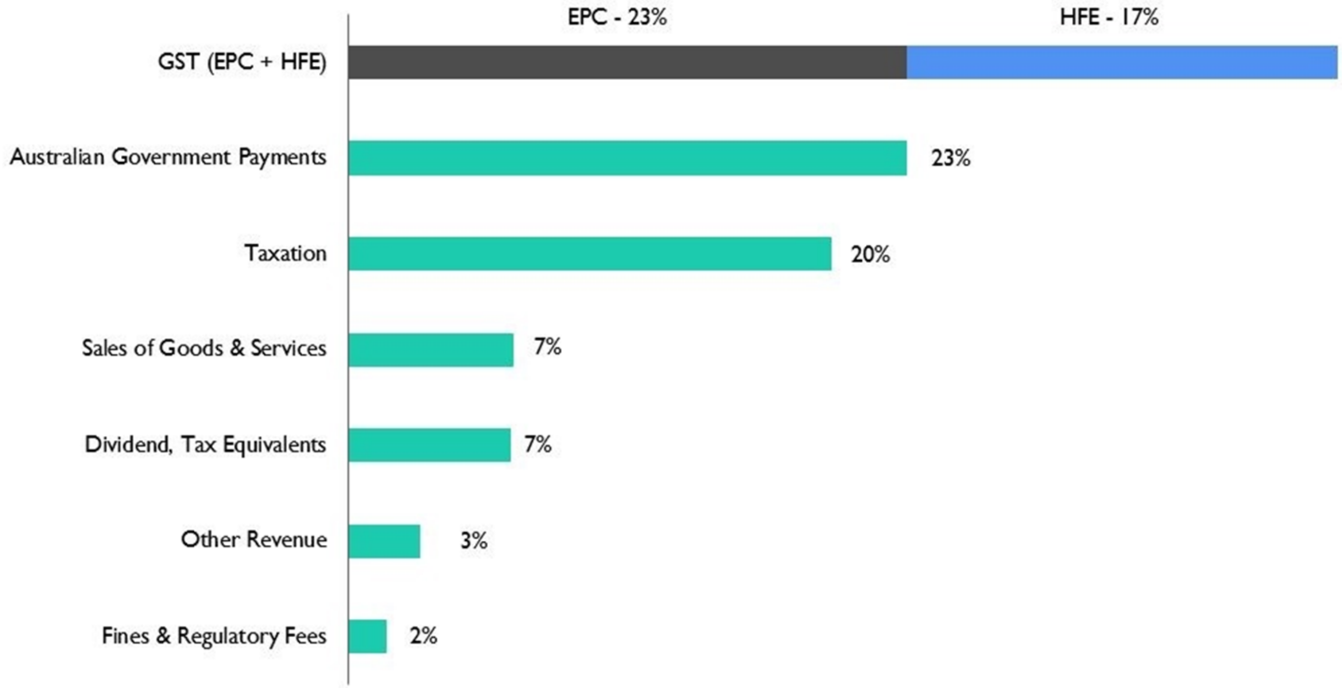
What does HFE mean for Tasmania?

GST is the single largest source of revenue for Tasmania representing 40 per cent of general sector government in 2018-19.

Tasmania will receive $1.1 billion more in GST revenue than its population share of $1.4 billion in 2018-19 because of HFE. This is 17 per cent of total revenue and almost the same as the amount received from the Australian Government payments for specific purposes. This represents 60 per cent of Tasmania's health expenditure, or 68 per of education expenditure.

The relative importance of each source of revenue for Tasmania is shown in the following chart.

Chart 1 - Tasmanian Revenue Sources 2018-19



Tasmanian Government

Recent criticism of HFE

The ongoing debate about the integrity of the current HFE system has primarily been generated by the decline in Western Australia's GST share.

Given the abundance of natural resources within it State boundaries, Western Australia has been able to take advantage of world demand for these minerals and reap the unprecedented economic benefits of the mining boom.

As a result Western Australia has had, and will continue to have extremely high mining royalty revenue compared to other States. HFE balances this out by allocating it a smaller share of GST grants.

It is incorrect to suggest that other States 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.

A number of States experienced the down side of the very high exchange rates on their own exports. In addition the mining boom drove significant wages increases in the public sector, impacting on service delivery costs in some, if not all, jurisdictions.

The Western Australian *Special Inquiry into Government Programs and Projects* noted large remuneration increases across the public service in Western Australia and strong growth in key service delivery agencies[1].

1 Government of Western Australia, *Special Inquiry into Government Programs and Projects – Final Report (Volume 1)*, February 2018, pg.44.

Tasmanian Government

Recent criticism of HFE

Chart 2 - Total revenue per capita – WA, TAS and an average of all States (excl. WA)

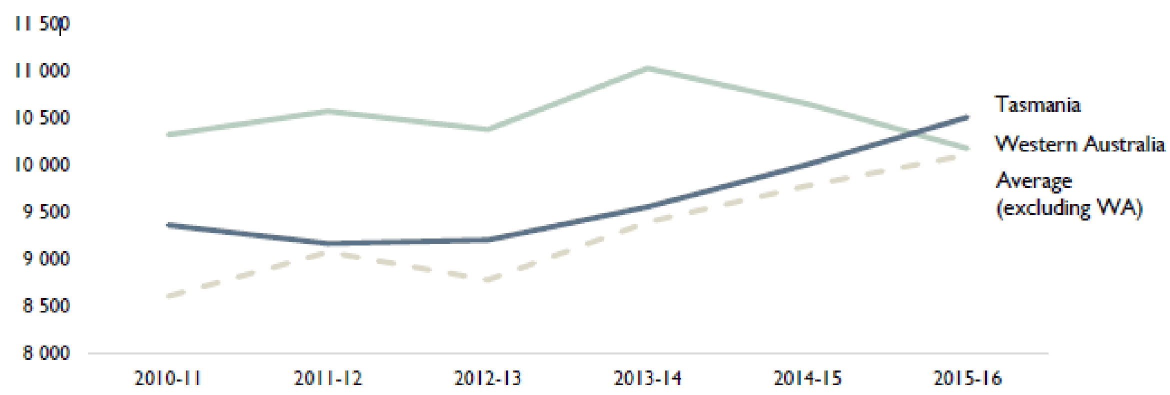
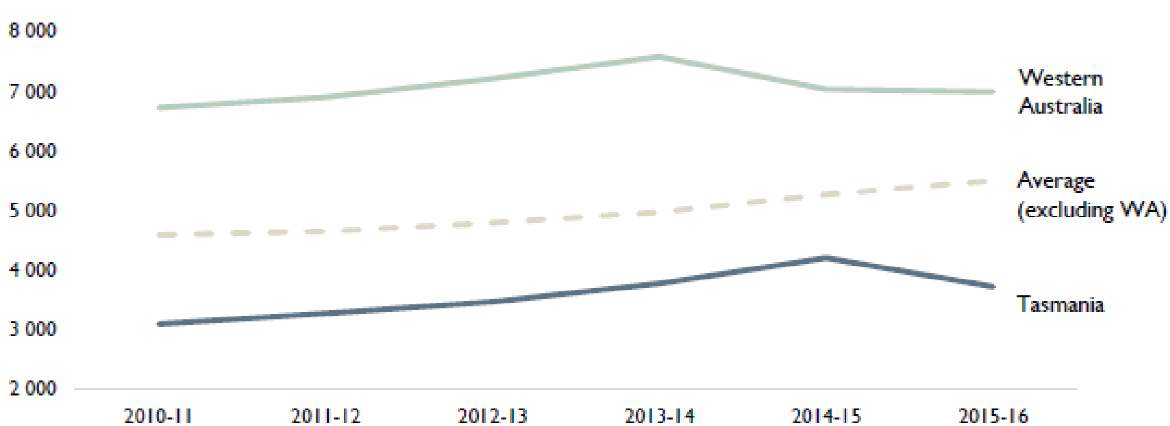


Chart 3 - Total own-source revenue per capita – WA, TAS and an average of all States (excl. WA)



As highlighted in the charts opposite, Western Australia had above average total and own source revenue per capita from 2010-11 to 2013-14.

Despite the decline in Western Australia's share of the GST, its total revenue per capita remained higher than Tasmania until 2015-16. However, Western Australia's total revenue per capita is forecast to once again exceed Tasmania's in 2018-19 and 2019-20, largely due to the lagged effect of GST distribution.

Even when Western Australia's GST share fell to around 0.3 of an equal per capita share as a result of its large increase in mining royalties, its total own-source revenue per capita remained above the national average.

Notwithstanding this, the Commonwealth Government has provided over $1.2 billion in top up payments to Western Australia since 2014-15, to effectively maintain Western Australia's relativity at 2014-15 levels.

Tasmanian Government

Recent criticism of HFE

Western Australia failed to take account of the CGC's lagged assessments and did not budget for the sharp decline in WA's relativity which coincided with the subsequent decline in its iron ore royalties post the mining boom.

However, Western Australia benefited from these 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 $7 billion in additional GST from 2010-11 to 2013-14 as a result of the lagged effect of mining revenue assessment.

The fact that Western Australia found itself in difficult financial circumstances is not the fault of HFE or the GST distribution methodology.

The lagged GST assessment and the decline in Western Australia's share were predictable and well known by Western Australia. In its 2011-12 Budget, the Western Australia 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 Western Australia's anticipation that the CGC would change its methodology and prevent a drop in Western Australia's relativity, this did not eventuate. As a result, Western Australia's financial position deteriorated significantly.

A key finding from the *Special Inquiry into Government Programs and Projects,* found that Western Australia's Treasury warned of the potential negative impact on the State's finances of the Royalty for Regions program prior to the formation of Government in 2008. Treasury also consistently predicted a fall in the State's share of the GST revenue throughout the term of the Barnett Government. Its concerns with these matter, and the pace of the capital works program, were not given sufficient weight[2].

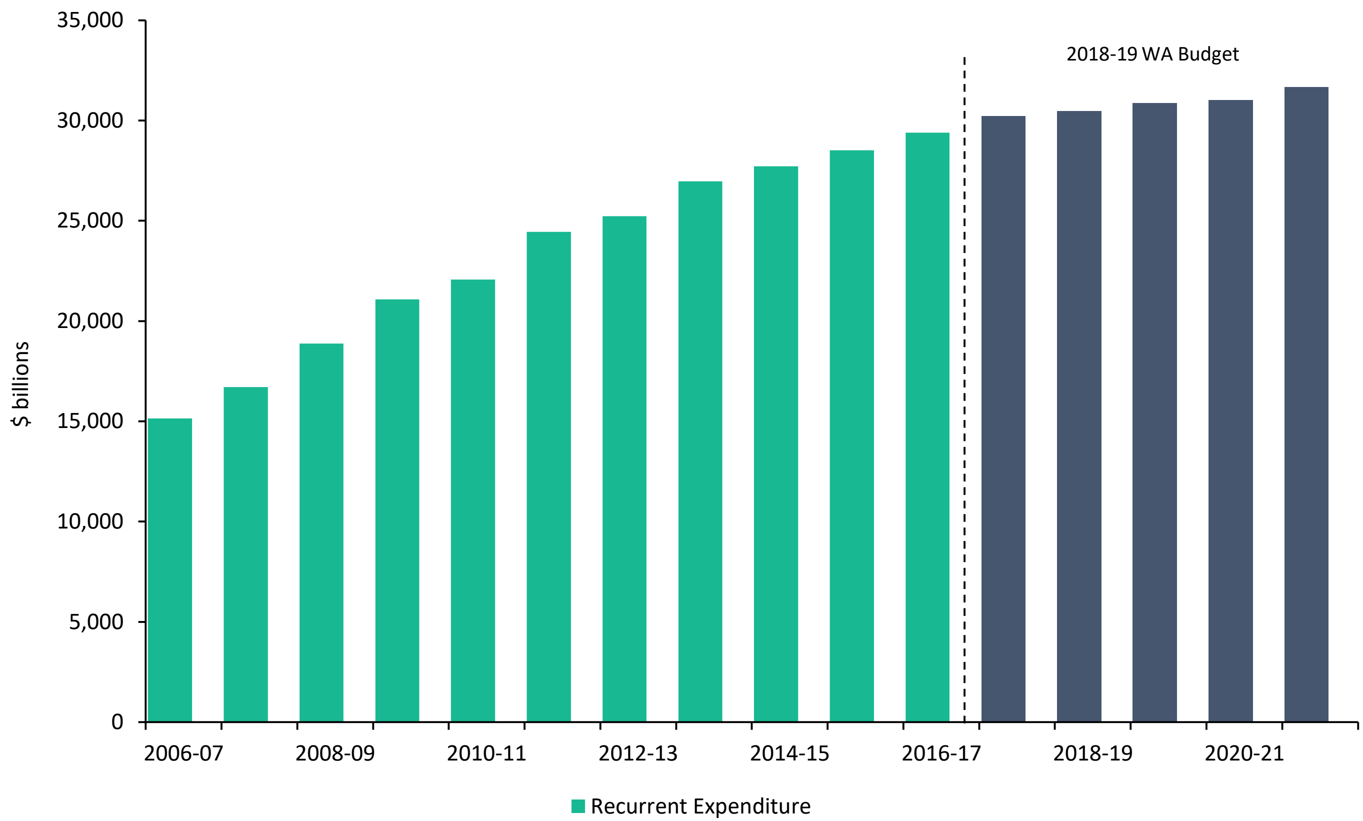
2 Government of Western Australia, *Special Inquiry into Government Programs and Projects – Final Report (Volume 1),* February 2018, pg.163.

Recent criticism of HFE

Rather than being financially prudent in the face of a declining relativity, Western Australia chose to increase its recurrent expenditure by historically very large rates on public sector wages and salaries, services and infrastructure. Much of this increased expenditure has become structurally embedded, such that it is very difficult to unwind.

Consequently, Western Australia faces major financial difficulties.

Chart 4 - Western Australia's Recurrent Expenditure



Tasmanian Government

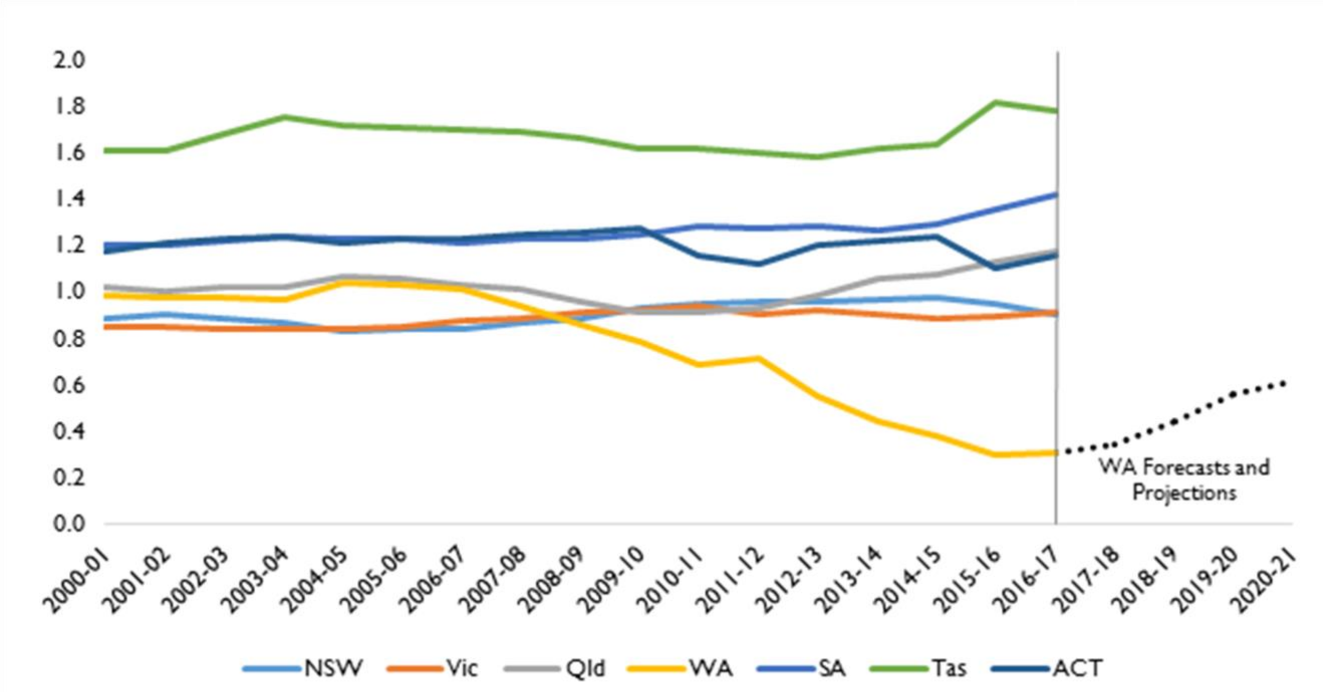
HFE – working as it should

The following chart which illustrates the decline in Western Australia's relativity as its own source revenues grew rapidly from the mid 2000s until 2013-14. As Western Australia's need for the GST fell, the comparative needs of other States grew. However, with the 2014-15 correction in Western Australia's iron ore revenues and strong growth in revenues projected in other States, Western Australia's relativity is forecast to grow over the next three years to 0.617 by 2020-21. This would result in other States relativities experiencing a corresponding decline and a subsequent narrowing of the current divergence.

This demonstrates that HFE is working as it should without the need to drastically change the system.

In effect, HFE works as an automatic stabiliser to ensure an equitable level of fiscal capacity between the States.

Chart 5 - Historic actual State relativities and Western Australia's forecast relativities



Tasmanian Government

PART B - Treasury's Analysis of the Commonwealth Government's Proposal

Tasmanian Government

Commonwealth Government's Response

The Commonwealth Government released its interim response to the PC's Final Report in July 2018.

The Commonwealth has accepted all of 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 NSW or Victoria (whichever is higher) together with a range of measures to transition to the new arrangements. The Commonwealth's singled modelled scenario forecasts the outcome set out in the table below.

In the document released by the Commonwealth, 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".*

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**

Commonwealth Government's Response – Short Term Top Ups and Pool Boost

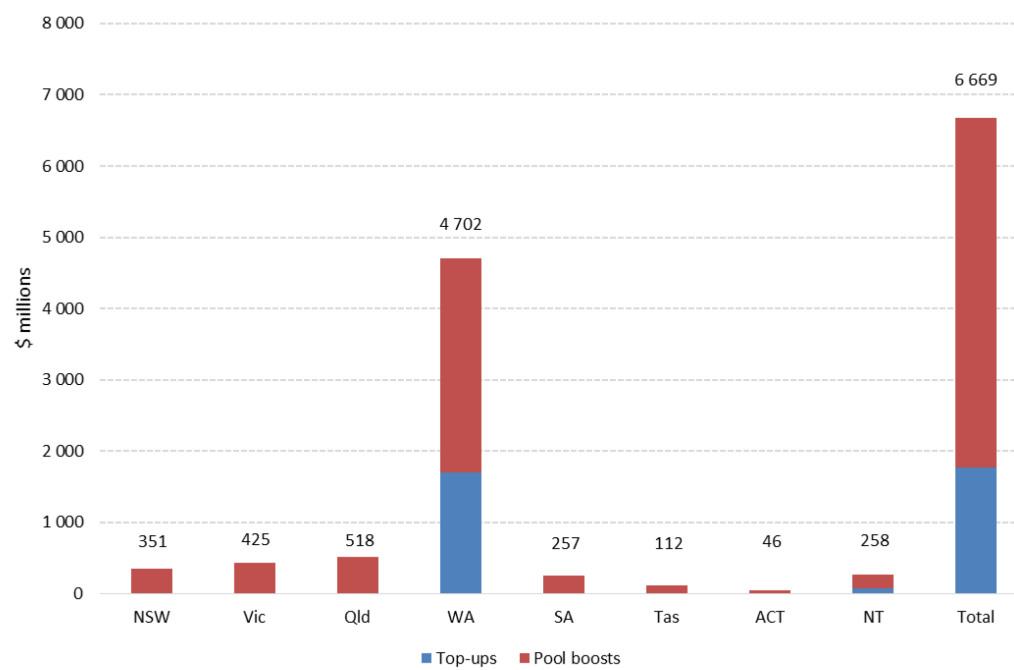
In its Interim Response to the PC's Inquiry, the Commonwealth Government has committed to provide short term funding over the three years from 2019-20 to 2021-22 to ensure that no State receives less than 70 cents per person per dollar of GST. In the same period, the Northern Territory will also be guaranteed at least its current share of GST.

The Commonwealth Government has also committed to inject an additional $600 million into the GST distribution in 2021-22, the first year of transition to the new equalisation standard. The expanded GST pool would continue to grow at the same rate as growth in GST collections each year.

This would be followed by a second injection of $250 million in 2024-25, half way through the transition to the new equalisation standard.

This will result in an additional $6.7 billion in top ups and boost to the pool based on forecast pool growth[3]. However, around 70 per cent of this funding will be provided directly to Western Australia.

Chart 6 – Benefit from top-ups and pool boosts (2026-27)



3 Australian Government, *Productivity Commission inquiry into horizontal fiscal equalisation: Government interim response*, July 2018, pg.21 (Tables 5 and 6).

Commonwealth Government's Response – Benefits to Western Australia

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.

Western Australia could also 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 (Western Australia) and the other States.

As noted by the CGC in its response to the PC enquiry:

> *"the fiscally strongest State would receive more than it requires to provide the average level of service. If it remained the fiscally strongest State over the intermediate term, it would be able to:*
>
> - *provide service in excess of the average; and/or*
> - *provide services of a higher quality than the average; and/or*
> - *levy lower than average own-source taxes and charges; and/or*
> - *retire debt at a faster rate than other States.*

Treasury Analysis of the Proposal

As indicated earlier, the Commonwealth's proposal presented one modelled scenario that suggested that Tasmania would be better off under the new arrangement, 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 alternative scenarios based on different assumptions which would indicate that the proposed changes may be detrimental to Tasmania's situation.

Treasury's analysis focuses on two key aspects of the Commonwealth Government's proposal:

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

Treasury Analysis of the Proposal – Recommendation to Equalise to the Second Highest State

The PC's "Consensus" Relativity Forecasts

The Commonwealth's modelling is based on the PC's forecasts of State GST relativities.

The PC sought relativity forecasts from each State to enable it to calculate an average of State relativities. Treasury provided the PC with its 2017-18 Tasmanian Budget relativity forecasts. These were restricted to the Budget and Forward Estimates period given the variability in relativities. A similar approach appears to have been taken by most other States.

In February 2018, Treasury commented on a PC paper that included initial forecasts of relativities for 8 years, among other things. It did not provide any detail of how the relativities were estimated and therefore Treasury was unable to undertaken a comprehensive analysis of the data.

In a submission, Treasury expressed significant concerns with the approach to forecasting relativities and in particular, the approach to forecasting beyond the forward estimates period.

The forecast relativities, which trend to their long term average, would only occur if Western Australia's mining royalties decline over the period - which is inconsistent with Western Australia's current State Budget forecasts.

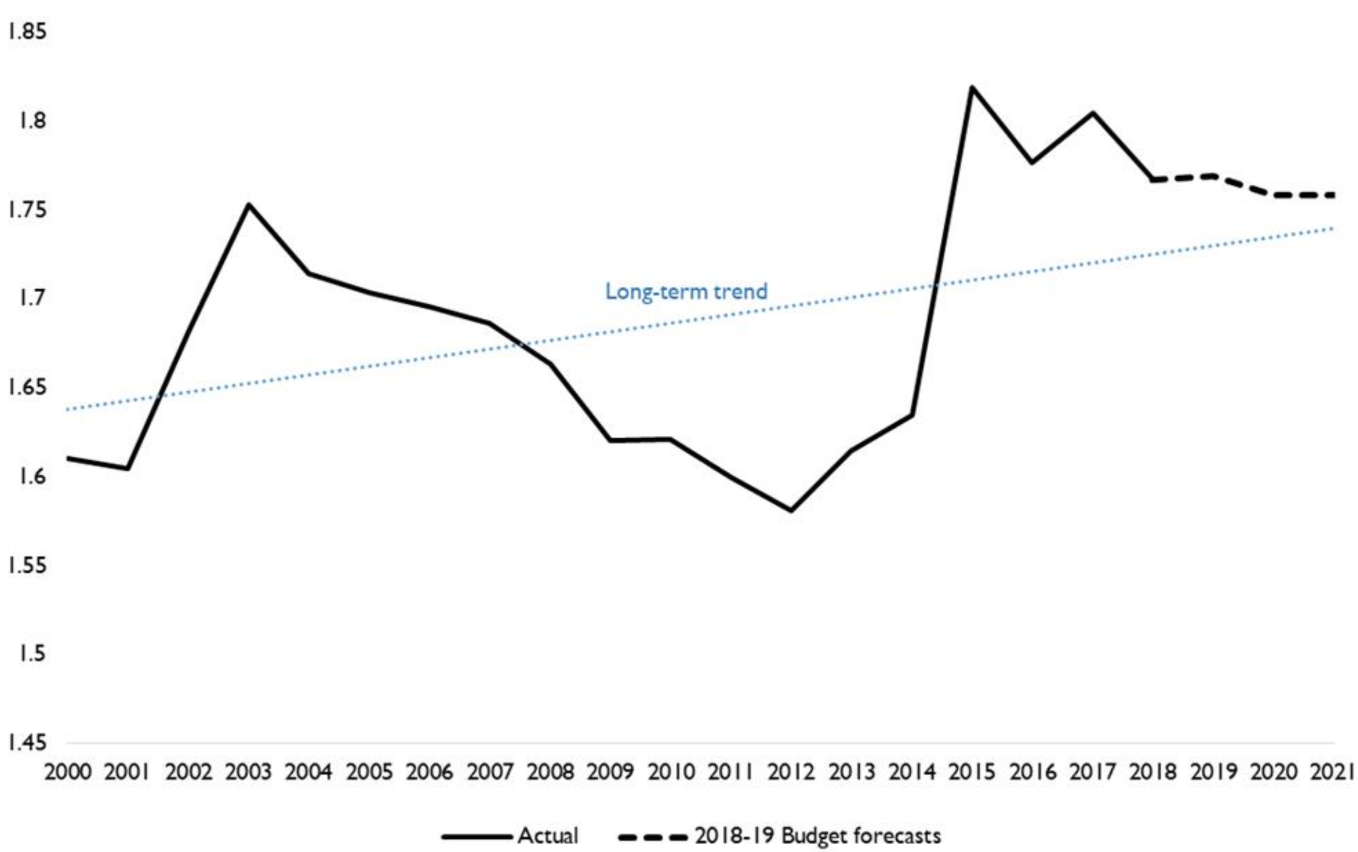
Also, while projecting an increase in Western Australia's relativity, the PC fails to forecast a reduction in other States' relativities - such an outcome is not possible under the "zero sum" principle of the distribution methodology.

Treasury Analysis of the Proposal – Recommendation to Equalise to the Second Highest State

Variability in Relativities

There is significant volatility in Tasmania's annual GST relativity. This can be driven by a range of factors, such as Tasmanian specific factors such as large Commonwealth payments which aren't excluded from the equalisation process or external factors such as high iron ore royalties in other States during the mining boom.

Chart 7 – Variability in Tasmanian GST relativities



Tasmanian Government

Treasury Analysis of the Proposal – Recommendation to Equalise to the Second Highest State

Variability in Relativities

Historic actual 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 18 years; and
- two per cent in 8 out of 18 years.

The average annual change in relativity over three years is 5 per cent.

The PC's relativity forecasts for Tasmania are extremely stable, with an average annual variability of only 0.5 per cent. This is highly unlikely to eventuate.

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

A five per cent change in 2026-27 could result in an unforeseen movement of approximately +/- $150 million.

Forecasting relativities beyond the Forward Estimates period also has the potential for a higher degree of error, as modelling becomes more reliant on forecast and projected data.

Treasury Analysis of the Proposal –
Recommendation to Equalise to the Second Highest State

Alternative Scenarios

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

Western Australia is by far the main beneficiary of the Commonwealth's proposal.

Also under all the alternative 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 single GST scenario modelled by the Commonwealth is only one of many possible scenarios, and it understates the benefits to Western Australia and the financial costs to all other States.

Scenario 1

In this scenario, 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).

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**

Under this scenario, Western Australia would be significantly better off under the Commonwealth's proposal, and all other States significantly worse off than under the current system.

Treasury Analysis of the Proposal –
Recommendation to Equalise to the Second Highest State

Alternative Scenarios

Scenario 2

This is a more conservative scenario that assumes 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 own current budget forecasts of stable mining revenues.

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**

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.

Scenario 3

This scenario reflects a period of 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.

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**

This scenario demonstrates 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 under the current HFE system over time, and the annual benefit to Western Australia grows progressively larger.

Treasury Analysis of the Proposal – Other recommendations

As part of its Terms of Reference, the PC was required, among other things, to consider options for simplifying the current system.

The other recommendations proposed by the PC are largely aimed at addressing a lack of understanding of the system and are generally administrative in nature and aimed at a ensuring a more informed public debate of HFE.

They are generally supported 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 number of recommendations are of particular concern and will result in Tasmania being worse off than under the current system of HFE.

The financial impact of these recommendations is not included in the Commonwealth Government's modelling.

Proposed Changes to Materiality Thresholds

One of the more significant recommendations is that the CGC should adopt a "significant" increase in materiality thresholds.

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 and 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. However, in its final report, the PC referred to an earlier proposal to quadruple materiality thresholds to $120 per capita.

Treasury Analysis of the Proposal – Other recommendations

Proposed Changes to Materiality Thresholds cont.

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

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

If implemented, these changes are likely to result in a further significant 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 GST being allocated on an equal per capita basis and significantly advantage the larger States at the expense of smaller States.

Tasmanian Government

Treasury Analysis of the Proposal – Other recommendations

A special Council of Federal Financial Relations meeting was held on 3 October 2018 to discuss the proposal.

In advance of the meeting, States and Territories were actively working together to understand the proposal and associated modelling.

A letter from the Board of Treasurers, signed by all Treasurers, was sent to the former Commonwealth Treasurer on 10 August 2018 seeking a binding guarantee that no State will be worse off under the proposed system compared to the current system in perpetuity.

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.

The draft Bill itself also relies on two sets of relativities being calculated through the transition period.

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".

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	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	$m	$m	$m	$m	$m	$m	$m	$m	$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

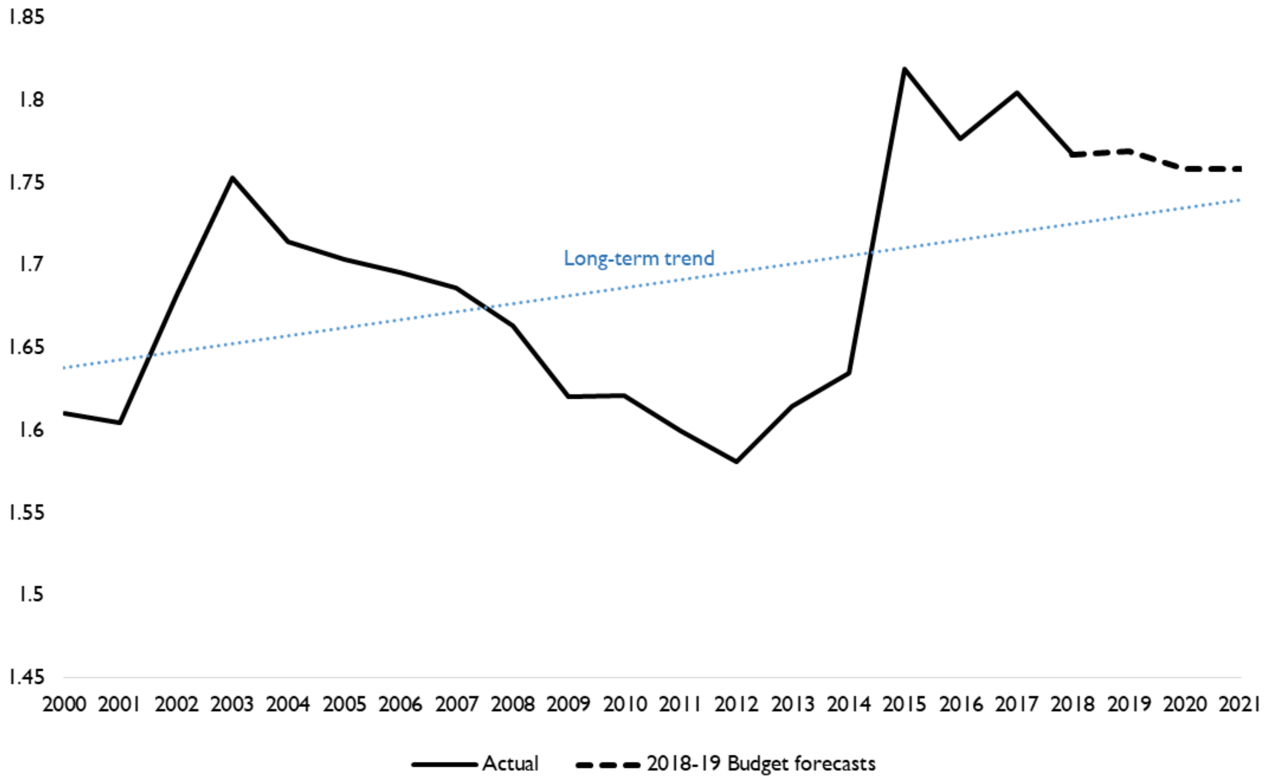
As mentioned above, relativities are generally volatile. Chart 1 illustrates the high level of historical variability in Tasmania's annual GST relativity. This variability can be driven by Tasmanian-specific factors such as growing own-source revenue, or by external factors such as high iron royalties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