

Productivity Commission Review into Horizontal Fiscal Equalisation

Initial submission by the Tasmanian Government
in response to the Productivity Commission's guidance note

June 2017



Tasmania
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KEY POINTS

- Horizontal Fiscal Equalisation (HFE) is based on the longstanding objective that all States and Territories (States) should have similar fiscal capacity thus ensuring that the States are able to provide equitable access to a similar standard of services. This principle has not changed.
- A change to the current system, such as partial equalisation, requiring HFE to deliver other policy objectives, such as meeting efficiency or productivity benchmarks, or simplifying its methodology that does not achieve full HFE would be inconsistent with that fundamental objective.
- While the total amount redistributed between the States is relatively small at about 12 per cent of the total GST pool, the amounts above a per capita share for the smaller States¹ are very significant as a proportion of State revenue compared to the larger States. In Tasmania's case, it is \$1.1 billion or 18 per cent of total General Government revenue.
- There is no evidence that HFE either encourages or discourages economic development or State economic or fiscal reform. No State Government would restrict such activity because of possible GST impacts. Donor States like Western Australia did not limit or impede their mining development because of HFE nor has a recipient State like Tasmania limited the development of its economy.
- Because of the Commonwealth Grants Commission's (CGC) lagged assessment methodology, there was a delay in equalising Western Australia's GST while it enjoyed high levels of royalty revenue during the mining boom period up to 2013-14. This period to some degree gives an indication what partial HFE would deliver. Rather than contribute to national welfare, the additional GST revenue to Western Australia because of the lagged assessment, estimated by the CGC to be about \$7 billion, was used for increased recurrent expenditure and infrastructure despite recognition by the Western Australian Government of the time that its GST revenue would decline substantially in later years.
- Alternatives to the current HFE system have been proposed from time to time, such as a relativity floor or an equal per capita distribution (EPC). However, as found by the GST Distribution Review in 2012, there is no evidence that these alternatives specifically improve or address the issue of efficiency or productivity. They just change the mechanism of distribution of the GST and would likely lead to serious inequity between the States.
- In contrast, there is some evidence that HFE improves national efficiency through discouraging inefficient migration of labour and capital between the States.
- An examination of Tasmania's track record demonstrates that despite being a recipient of HFE, it has a strong record in managing its budget and exercising fiscal discipline, and that HFE has not been an impediment to undertaking economic reforms. The outlook in the 2017-18 State Budget for Tasmania's economic and employment growth over 2017-18 is forecast to be significantly stronger than in recent years.

¹ Smaller States means smaller in terms of its population and size of its economy.

INTRODUCTION

Australia's fiscal equalisation system, its processes and outcomes have been debated on many occasions and at varying levels of intensity over time. More recently, mining and housing booms, along with demographic and other structural changes, have contributed to substantial changes in the distribution of GST revenue among the States. These changes have raised concerns from various commentators and the larger States² as to whether the current system of HFE remains the most appropriate system of fiscal equalisation for Australia into the future.

The factors that have driven the more recent changes in the GST distribution are primarily a result of temporary growth in own-source revenue capacity which is largely beyond the control of State Governments and is the product of market forces in the domestic and the international economy.

Rather than being of concern, Tasmania strongly believes that this strengthens, rather than diminishes, the importance of the current equalisation system which fully equalises diverging fiscal capacities, is equitable, and mitigates incentives for inefficient migration of labour and capital from the smaller to the larger States.

The decreasing State relativities of Western Australia and for a period, Queensland, have drawn considerable attention and raised arguments that these resource rich States are bearing an unfair equalisation burden. However, this overlooks the fact that they were recipient States and beneficiaries of the HFE system as recently as the mid-2000s and in Queensland's case, it has returned to being a beneficiary of HFE since 2013-14.

There is no evidence that the current equalisation system prevents, or necessarily discourages, States from improving their economic and fiscal capacities. The actual experience of the resource rich States has been to pursue growth regardless of HFE. Importantly, the equalisation system does respond, albeit with a lag, to the changing relative circumstances of the States. This demonstrates that the equalisation system does, in fact, operate as it was designed to.

Critics of HFE question whether smaller States should receive the level of support they do through HFE. It should be acknowledged that a State's economic performance is a result of a range of factors, of which government policy is only one. There are many factors outside of government control. When the mining boom was at its peak and the resource rich States were enjoying strong economic growth this also had a negative impact on other States such as Tasmania. Exposure to the high exchange rates from the mining boom negatively impacted other parts of the economy, such as exports and the tourism industry. Strong wages growth in the mining States also created wages cost pressure and net outmigration.

HFE has not been an impediment to smaller States like Tasmania in undertaking economic reform and it has a strong record in managing its budget and exercising fiscal discipline.

This submission outlines the Tasmanian Government's initial responses to the Productivity Commission's guidance note released on 19 May 2017.

² Larger States means larger in terms of its population and size of its economy.

TASMANIA'S RESPONSES TO SPECIFIC QUESTIONS RAISED IN THE PRODUCTIVITY COMMISSION'S GUIDANCE NOTE

I. How does the current HFE system impact the Australian community, economy and State and Territory governments?

In answering these questions it is useful to first put the quantum of fiscal transfers from HFE into perspective with the national economy.

In the OECD's report on fiscal equalisation in OECD countries,³ it surveyed member countries to compare fiscal equalisation systems. The report showed that in 2004, of those countries surveyed, fiscal equalisation as a percentage of Gross Domestic Product (GDP) was the lowest in Australia at 0.49 per cent. The highest was Japan at 4.04 per cent and the unweighted average was 2.26 per cent.

While more recent estimates for other countries are not available, for Australia the current amount of the total GST pool that is used for fiscal equalisation is \$7.9 billion⁴ for 2017-18 or 12.6 per cent of the total GST pool as shown in the table below. Australia's GDP was \$1.7 trillion for the four quarters ending March 2017. Thus, as a proportion of GDP, fiscal transfers remain at a similar proportion of GDP (0.47%).

Australia's fiscal equalisation transfers are therefore not large by OECD standards, possibly because the differences in fiscal capacity within regions are not as great as in some other countries due to Australia's long history of fiscal equalisation and community expectations. Further, because Australia has such a high degree of Vertical Fiscal Imbalance (VFI), the central government is able to fund a significant number of other programs in areas such as health and education, on a per capita basis, thus helping to overcome regional disparities which might otherwise exist. If we did not have these other mechanisms, HFE would have to play a greater role.

Nevertheless, for the smaller States, equalisation is significant as their GST share represents a higher proportion of Gross State Product (GSP) and General Government revenue compared to the larger States. The way the GST is distributed has the potential to significantly impact small State economies and communities, while for the larger States it has a relatively smaller impact.

The amount of GST used to fiscally equalise the States is shown in Table I.

³ Hansjörg Blöchliger, Olaf Merk, Claire Charbit, Lee Mizell, *Fiscal Equalisation in OECD Countries*, OECD, France, September 2007, page 11.

⁴ The amount of the GST pool that is effectively used for redistribution to the recipient States is the sum of the differences between an EPC and actual distribution for recipient States.

Table 1: Amount of GST used to fiscally equalise the States

	NSW \$m	VIC \$m	QLD \$m	WA \$m	SA \$m	Tas \$m	ACT \$m	NT \$m	TOTAL \$m
2017-18 distribution ⁵	17 680	14 829	14 963	2 354	6 360	2 403	1 230	2 921	62 740
EPC distribution	20 111	15 862	12 565	6 818	4 405	1 328	1 026	625	62 740
Difference	-2 432	-1 032	2 399	-4 464	1 955	1 075	203	2 296	0
Total General Government revenue ⁶	77 005	60 370	53 449	25 681	18 263	5 574	5 058	5 891	251 291
GSP/GDP ⁷	531 323	373 624	314 569	101 096	255 214	26 039	36 225	23 648	1 661 739
Share of GST as per cent of total revenue	23.0%	24.6%	28.0%	9.2%	34.8%	43.1%	24.3%	49.6%	25.0%
Share of GST as per cent of GSP/GDP	3.33%	3.97%	4.76%	2.33%	2.49%	9.23%	3.40%	12.35%	3.78%

Source: CGC 2017 Update Report and Treasury calculations

The concept of HFE and the way that it is implemented through the redistribution of the GST is not well understood by some politicians, elements of the media or the broader community. It can be difficult to explain and as a consequence this can lead to many myths and misconceptions. Some of these misconceptions are promoted for political purposes and could be easily clarified by an authoritative and independent voice. That role could be taken up by more proactive commentary from the CGC.

This issue was discussed by the GST Distribution Review Panel and it was noted that:

...the CGC does not actively seek to promote understanding of HFE within the States outside of the various Treasuries. A more widespread program of engagement (with States and the public) may help to ensure that equalisation principles are better understood by politicians and throughout the bureaucracy, with the result that the GST distribution process is more widely supported.⁸

Such an approach would improve the public's confidence in the system of HFE and in the way in which the GST is distributed. Tasmania would support such an active approach provided that the CGC was able to maintain its independent viewpoint and was not subject to political interference.

⁵ Commonwealth Grants Commission 2017 Update, *Report on GST Revenue Sharing Relativities*, March 2017, page 3.

⁶ Various State Budget Papers.

⁷ Australian Bureau of Statistics, *Australian National Accounts: State Accounts (5220.0)*, June 2016.

⁸ GST Distribution Review, *Final Report*, October 2012, page 82.

a) Is the current HFE system getting in the way of States pursuing higher economic growth and productivity, and at the expense of higher national prosperity? If so, how?

An issue in responding to this question is that we cannot know for certain what the counterfactual outcome would have been had the current system of HFE not been in place.

However, there is no evidence to suggest that the current form of HFE, which has been a feature of intergovernment transfers for many decades, has acted as a disincentive to the States to pursue economic growth and productivity.

By way of example, Western Australia and Queensland moved from being recipient to donor States from the mid-2000s (Queensland subsequently returned to being a recipient State since 2013-14) which in large part is explained by the pursuit of economic development associated with the mining boom. While the resource rich States were fully aware of the redistribution impacts of the revenue generated from the development of their mining industry, that development still occurred. Any disincentive for development is weakened by the lagged effect of GST relativity changes and the interaction with other States' activity on GST relativities, which can extend beyond the political cycle.

Economic development is more likely to be associated with private sector decisions based on a range of external factors such as access to natural endowments, exchange rates, interest rates, commodity prices, and national tax settings rather than fiscal equalisation transfers to the States.

It has also been argued by some commentators that the current HFE system is inefficient in that it can lead to recipient States becoming dependent on grant funding, having larger public sectors, and being less likely to pursue policies to improve their overall welfare.

Critics of HFE also argue that the increase in revenue from fiscal transfers from the GST tend to stick with State Governments (resulting in an inefficiently large public sector in so-called recipient States) and that little of this additional revenue is passed on to individuals in the form of tax cuts (the so called 'flypaper effect'⁹).

A contrary argument is that additional government spending as a result of HFE transfers could boost investment in areas such as health and education, thereby increasing the level of human capital. As Commonwealth Treasury suggested, this argument can be extended to suggest that a State with below average fiscal capacity could have below average education and health outcomes that would serve to further push down economic performance, revenues and services generally¹⁰.

While there has been much written about the 'flypaper effect', the GST Distribution Panel found that¹¹:

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

⁹ Hines, J.R. and Thaler, R. *The Flypaper Effect* Journal of Economic Perspectives – Volume 9, Number 4, Fall 1995, pages 217-226.

¹⁰ Australian Government, The Treasury, *Submission to the GST Distribution Review*, October 2011, page 33.

¹¹ GST Distribution Review, *Final Report*, October 2012, Page 32.

Garnaut and FitzGerald¹² argued that having a larger proportion of public sector workers in recipient States creates distortions in the local political economy. That is, States with a larger proportion of public sector workers will be more inclined to prefer social and environmental objectives to economic ones. Garnaut and FitzGerald noted that the scale of this effect is difficult to quantify, but suggested that it may be significant.

The Commonwealth Treasury submission¹³ to the GST Distribution Review observed that the reason for higher public expenditure in recipient States is that:

States that are net recipients on the expenditure side could be expected to need a larger public sector to overcome the difficulties (such as remoteness) that the HFE system seeks to compensate States for. This is what makes it so difficult to determine whether or not the HFE system is resulting in an inefficiently large public sector: some States will require more resources to deliver average services than others.

The GST Distribution Review Panel also considered this effect and found that there was:

...little firm evidence to support these concerns. State shares of Commonwealth support are much closer together when all Commonwealth payments are considered and State performance on economic and social indicators is often much closer than differences in fiscal capacity. Differences in fiscal capacity (or other indicators) can largely be traced to geographic, demographic and economic factors outside a State's control. While State governments sometimes make poor decisions, this is surely true of both donor and recipient States¹⁴.

The GST Distribution Review Panel's observation in the last sentence is particularly salient. During the period when Western Australia was enjoying high royalty revenue and its GST revenue had yet to be fully equalised, but still a donor State, the then Government significantly increased its recurrent public sector expenditure and infrastructure expenditure. This was despite what was clearly temporary and exceptional growth in its mining royalty revenue and a forecast declining GST share. It now faces a difficult budget position as a result of those unsustainable spending decisions.

An examination of Tasmania's track record demonstrates that HFE has not impeded the State's efforts to implement economic reform.

Examples of this include:

- Tasmania's commitment to implementing the National Competition Policy (NCP) reforms in the period from 1997 to 2005, including wide ranging reforms to the electricity sector, and water pricing;
- governance arrangements related to the commercial activities of Government businesses and implementing competitive neutrality policies. This considered a range of regulatory reforms including the more difficult areas such as shop trading hours in 2002 (an area still to be reformed in Western Australia) and the taxi industry in 2003;
- Tasmania being one of only two jurisdictions that received all NCP-related payments, and being one of the first jurisdictions to implement the 1999 Intergovernmental Agreement on Federal State Financial Relations (IGAFFR) to abolish a range of inefficient State taxes on the introduction of the GST. There are still a number of States, including NSW, which are yet to abolish all taxes agreed under the IGA. Tasmania was also one of the first States to commit to the development of harmonised payroll tax arrangements, and its *Service Tasmania* concept as a single point of contact for all

¹² Garnaut, R and FitzGerald, V, *Review of Commonwealth-State Funding, Final Report*, Melbourne, 2002, pages 145-6.

¹³ Australian Government, The Treasury, *Submission to the GST Distribution Review*, October 2011, page 35.

¹⁴ GST Distribution Review - Final Report, October 2012, page 139.

government services was the subject of considerable, positive feedback from mainland and New Zealand officials;

- the Tasmanian Government's education reforms aim to improve educational outcomes by extending the compulsory years of education and training. From 2020, students must participate in education and training until they complete year 12, attain a Certificate III or they turn 18 years of age (whichever occurs first). Further, from 2021, the reforms include an earlier Prep starting age allowing voluntary access to Prep from four and a half years of age (subject to an order and report being tabled in, and approved, by both Houses of Parliament);
- the State's planning system has been reformed by introducing a single planning scheme - the Tasmanian Planning Scheme. The Scheme aims to make the planning system faster, simpler and cheaper by ensuring an 80 per cent consistency in respect of planning schemes across the State, compared to a 15 per cent consistency that existed previously. Individual council planning schemes will be replaced with one State-wide scheme with consistent rules; and
- the State Government's support for the sharing economy in Tasmania. The operation of ride sourcing, such as Uber, is legal in Tasmania. Further, from 1 July 2017, homeowners will be able to rent up to four bedrooms in their homes on platforms such as Airbnb without the need for government approval, and shack or investment property owners will be able to rent their properties for short stays using a one-step process.

Experience with implementing reforms such as the NCP reforms and IGAFRR tax reforms suggest that there is no relationship between willingness to undertake economic reform and HFE. As noted above, Tasmania was one of two jurisdictions to receive all of its NCP payments, the other being Victoria.

The Henry Tax Review¹⁵ stated that (because of HFE) States had no incentive to resist or favour tax reform:

A change in tax mix adopted by all States will change their relative revenue-raising capacities, therefore affecting the distribution of GST revenue. A change in tax mix might be revenue-neutral to the States in an aggregate sense, but an individual State might have one of their relatively stronger bases replaced with a relatively weaker base, such that revenue from their own taxes is lower. However, this loss in revenue could be made up through the HFE process, as the loss of their relatively stronger tax base means that their revenue needs are higher. In theory, if all States apply the same revenue-raising effort, no State would have a financial incentive to resist or favour a revenue-neutral reform of State tax base composition on the basis of the local strength or weakness of particular tax bases.

In practice, however, the States will be affected differently because they apply different policies to their existing tax bases and are likely to continue to do so in regard to tax bases they have access to in the future. The redistribution of GST revenue will not take into account the impact of changes to tax bases on a State where it does not apply the average policy. That is, if a State is raising more than the average revenue off a base that is abolished, HFE will not compensate for revenue lost above the average, just as if a State was making a below-average effort that State would not be penalised. This may cause difficulties for some States, particularly if the States do not have the same ability to raise marginal revenue from the new tax base as they did with the old one.

¹⁵ Report to the Treasurer, *Australia's future tax system*, Part Two Volume 2, December 2009, page 685.

The GST Distribution Review¹⁶ found:

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

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

Claims that HFE has discouraged economic growth and productivity are unfounded. This issue is further addressed in Tasmania's responses to guidance note question 1(c).

¹⁶ GST Distribution Review, *Final Report*, October 2012, page 137.

b) What evidence is available on whether and how the current HFE system affects the movement of labour and capital across State borders, particularly if a region is experiencing high labour demand?

It has been asserted¹⁷ that HFE leads to resource misallocation across Australia because it discourages employment-related interstate migration. It is argued that the fiscal transfers from the application of HFE enable people to remain in less productive regions and that this counteracts market incentives for individuals to move to where there are employment opportunities in higher productivity jobs. This, it is argued, would have the effect of lower overall productivity, which is the equivalent of a loss of potential output for the nation as a whole.

This assertion ignores the fact that individuals and households face a range of factors that influence living standards and, in turn, where they choose to live. Living standards are influenced by individual and household income, primarily determined by employment. They are also influenced by the net fiscal benefit arising from living in their jurisdiction, determined by factors such as the level of State taxes and the level of public services and infrastructure.

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

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

Buchanan¹⁸, in his seminal study for the United States of America, found that HFE was beneficial not only from an equity perspective but also because it was consistent with economic efficiency principles. His work showed that HFE prevents the migration decisions of households from being influenced by the fact that State boundaries exist, where different States have different levels of net fiscal benefit.

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

Independent Economics¹⁹ examined this theory from the perspective of one State experiencing a mining boom. Under that environment, an increased demand for mining industry labour leads to higher wages, and it would be efficient for households to move to that State to take advantage of that outcome. However, there comes a point in the migration process where average labour productivity begins to decline as more households migrate to the mining boom State. In addition, adverse externalities begin to increase in the State traffic, commute times and pollution as its population increases and congestion problems increase. Under normal

¹⁷ Review of Commonwealth-State funding, *Final Report*, R Garnaut V Fitzgerald, August 2002, page 153.

¹⁸ The American Economic Review, Buchanan, James M, *Federalism and Fiscal Equity*, Volume 40, No 4. September 1950.

¹⁹ Independent Economics, *Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects*, February 2012, pages 3-48.

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

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

In practice, States compete to provide attractive net fiscal benefits, both for employers and for households. HFE gives the States the ability to provide the average per capita level of services where they levy the average national tax rate. The HFE system, therefore, is an important component in constraining the differences in net fiscal benefits, thereby restricting the extent to which migration moves from an efficient level to an inefficient level due to any inherent or acquired differences in net fiscal benefits. The HFE system therefore encourages efficient migration, and not inefficient migration.

In its report on geographic labour mobility, the Productivity Commission²⁰ was asked to identify the key determinants of labour mobility, to assess the current strategies used by employers and governments, and to estimate the prospective economy-wide impacts of reducing impediments to geographic mobility.

The Commission found that, at an aggregate level, a region's gravity (population or economic size), physical size and economic opportunities are the key determinants of geographic labour mobility. At an individual level, personal and locational factors interact to influence movements – predominantly life events and family circumstances, but also including housing availability, living costs, employment, local economic and social infrastructure and the level of education.

The Commission found that people in the labour force are more likely to move to areas with greater economic opportunities, and that young people generally move from regional areas to the capital cities. In contrast, older people are more likely to move from the capital cities to regional areas.

With particular regard to Tasmania, the Commission noted that labour mobility can interact with population ageing to exacerbate population decline, as younger people move away for work or education. The Commission observed that this poses substantial risks to the ongoing viability of communities, and can affect the provision of essential services.

The Commission also noted that the resources boom has contributed to the process of structural change in Australia, and that the decline of manufacturing has particularly affected New South Wales, Victoria, South Australia and Tasmania.

The Commission's report advised that there are no simple means of influencing labour mobility, and that many policies aiming to influence where people live and work in regional or remote areas have had limited impact. Poorly designed policies can have a negative effect on labour mobility, and the Commission identified some taxes, such as stamp duty, and other issues like housing supply and affordability, and the harmonisation of occupational licensing as policy areas where reform would lessen the impediments to geographic labour mobility.

²⁰ Productivity Commission, *Geographic Labour Mobility Research Report*, April 2014.

The Commission noted that education is an enabler of geographic labour mobility, and can be a pull factor for some regions. The Commission concluded that geographic labour mobility has been an important mechanism for adjusting to demographic and structural changes in Australia. It also found that labour does appear to be moving to areas with better opportunities, and that there do not appear to be significant impediments that are distorting decisions.

The Commission's conclusion that there are no significant impediments to labour mobility and that for some regions, inherent demographic factors can exacerbate population decline which poses substantial risks for communities and affects the provision of services is a strong argument for maintaining HFE.

At the time of Federation, Tasmania's resident population²¹ was approximately 5 per cent of the national total, whereas it now represents less than 3 per cent. South Australia's resident population was larger comparatively to Western Australia's up until 1981 and Queensland's population has also increased significantly since Federation. Despite HFE having been in place in some form or another over the past 80 years, had HFE been such an impediment, you would not have expected these demographic shifts to have occurred. This demonstrates that the Australian population is dynamic and responds to changing economic conditions with other factors affecting labour mobility more so than HFE.

Tasmania as well as other States experienced labour mobility out of their States during the mining boom period while at the same time, Western Australia experienced strong interstate migration into the State in response to its strong labour market at that time. These migration flows have since returned to pre-mining boom levels and is evidence that labour will flow to where the jobs are irrespective of HFE.

In the Commonwealth Treasury²² submission to the GST Distribution Review it observed that:

In the case of individuals, it would seem that the amount of funding redistributed by the current system, and therefore the differences in government services, infrastructure and taxes resulting from the redistributed funds, are likely to have a small impact on their decision to migrate...

In the context of all of the other factors at play, the influence of HFE on a potential worker's decision whether or not to move to Western Australia to take advantage of the mining boom is likely to be small.

There is more recent evidence that HFE actually promotes allocative efficiency. Research conducted by Independent Economics²³ modelled the impact of changing from the current HFE distribution to an EPC distribution. It found that:

Inefficient, fiscally-induced migration leads to a loss in living standards, as the distribution of the population across States moves away from being determined by State economic environments. Abolishing the current HFE system and moving to a modified EPC system is estimated to lead to a permanent loss in annual living standards of \$521 million in 2015-16 terms.

Under the current HFE system, each State is provided with the same fiscal capacity to provide government services, which negates fiscally induced migration. Without HFE, it could otherwise lead to the inefficient relocation of businesses. For example, the head offices of many financial institutions could relocate purely for State taxation reasons or from other State funded incentives rather than where they are most productively located. Such distortions would reduce the welfare of all Australians.

²¹ Australian Bureau of Statistics, *Australian Historical Population Statistics (3105.0.65.001)*, September 2014.

²² Australian Government, The Treasury, *Submission to the GST Distribution Review*, October 2011, page 32.

²³ Independent Economics, *Horizontal Fiscal Equalisation: modelling update and scenarios*, May 2015, page 23.

In its submission to the 2012 GST Distribution Review, Commonwealth Treasury suggested that, because the amount of funding redistributed by the HFE system is only small from a national perspective, it would only have a small impact on the decision by individuals to migrate. In any event, it argued, there are other drivers of location decisions that are taken into account (including cultural factors, friends and family and climate to name a few) that would balance a migration decision. Factors such as a common safety net of welfare payments and uniform minimum wage agreements are probably greater factors inhibiting population movements as well.

The Commonwealth Treasury therefore concluded that²⁴:

...there does not appear to be a need for reform of the system on the basis of location decisions.

²⁴ Australian Government, The Treasury, *Submission to the GST Distribution Review*, October 2011, page 33.

c) Does the current HFE system create perverse incentives or unintended consequences for reform at the State level? What evidence is there on how these incentives affect State policies and ultimately outcomes for the Australian community?

One of the principles used by the CGC in its methodology is that its assessments should, as far as practicable, reflect what States collectively do. That is, they should reflect the average range of services actually provided by the States and the average range of taxes they impose. This approach removes the need for the CGC to make judgements on what States could or should do.

If a State was to introduce a reform that increased its revenue raising capacity or reduced its cost of delivering services then there may be redistribution effects because of HFE. However, this would require the reform by that State to materially affect national average spending on that service or the average taxation rate; an impact largely confined to the most populous States which predominantly determine the population weighted national average standard.

However, these effects are a secondary issue as the primary reason for undertaking reform is to increase efficiency and to improve the general welfare of the community.

In its submission to the GST Distribution Review, the Commonwealth Treasury examined whether the incentives for States to pursue growth enhancing policies are blunted by the effects of the HFE system. For example, if a State adopts business friendly policies that result in large firms moving to that State, its payroll tax base will grow. In turn, the CGC will assess that State as having a higher capacity to raise payroll tax revenue, and it will see some, but not all of the benefits of the larger tax base equalised away in the form of less GST.

It found that²⁵:

It seems unlikely that there are a large number of unambiguously efficiency enhancing reforms available for which HFE is the marginal factor that is dissuading governments from pursuing reform.

This review provides an opportunity for governments and other participants to identify any efficiency enhancing reforms which have not proceeded due to HFE. As will be demonstrated by a few indicative examples, the HFE redistribution effects tend to be small compared to the total cost or benefit of the policy. In fact, the total benefits of pursuing growth enhancing policies are likely to be very diverse and outweigh any HFE effects, such as higher State GSP, and more and/or higher paying jobs being made available in that State. Furthermore, a large driver of the current redistribution is the difference in resource endowments, which is largely independent of State government policies.

²⁵ Australian Government, The Treasury, *Submission to the GST Distribution Review*, October 2011, pages 35-44.

Further, it concluded that²⁶:

Key point 3: The averaging approach currently adopted by the CGC results in relatively small impacts on States that realise efficiency gains in government expenditure, and in some cases, there is an added incentive to improve efficiency.

Key point 4: HFE is one of many issues influencing State tax reform, and should be viewed within this environment. The averaging approach currently adopted by the CGC results in relatively small impacts on States that engage in tax reform. Additionally, efficiency gains associated with the reforms flow to the reforming States.

Key point 5: Overall, there are some HFE effects that discourage efficiency to a greater or lesser extent, and therefore there may be a case for modest reforms in order to mitigate those effects. However, there does not seem to be an efficiency case for radical reform of the HFE system. Further, impacts for individual States are generally situation-dependent.

It is therefore very unlikely that HFE is at the forefront of a State government's mind when it proposes implementing State reforms. As noted earlier, a number of major reforms have taken place in Tasmania over the years and HFE has not been a barrier to such action. The benefits of the reforms are of greater importance than possible GST implications.

Further, HFE would never be the determinant consideration in any such decision. It would be weighed up against a number of other policy implications and outcomes. Commonwealth Treasury suggests that it is unlikely that HFE would be a marginal factor that would dissuade governments from pursuing reform agendas²⁷.

i. Does the HFE system impede State tax reform over time, including States' decisions on developing their revenue bases and rates? If so, how and to what extent?

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

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

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

As mentioned, Tasmania was one of the first jurisdictions to implement the 1999 Intergovernmental Agreement on Federal State Financial Relations (IGA) to abolish a range of inefficient State taxes on the introduction of the GST. There are still a number of States, including NSW, which are yet to abolish all taxes agreed under the IGA. Tasmania was also one of the first States to commit to the development of harmonised payroll tax arrangements.

As part of the GST Distribution Review, the Panel investigated whether HFE acted as a disincentive to tax reform.

²⁶ *ibid*, page 6.

²⁷ *ibid*, page 6.

The GST Distribution Review Panel found that²⁸:

Nevertheless, a number of factors other than changes in GST shares drive State tax policy decisions, in particular, the political constraints associated with large changes in the gross incidence of taxation. The significance of changes in GST shares to State tax policy decisions is probably diminished further by the delay in changes to GST being felt because of the lag, any change in GST will not occur until several years after a tax policy change has been implemented. Examining the empirical evidence, States do not necessarily appear to act in accordance with the apparent GST share incentives. Ultimately, there is no hard evidence on whether GST share effects influence State tax reform decisions. The Panel doubts that GST share effects are a very powerful factor when States are considering tax reform.

For small States like Tasmania, changes in its State tax rates are unlikely to affect the average tax rate as assessed by the CGC and consequently affect its GST share. Tasmania will still be assessed on the average tax rate not on the actual tax rate it imposed. The more likely impediment to tax reform is that any reform will result in 'winners and losers', the difficulty of implementing tax reform in challenging economic conditions, and the need for a national approach.

In 2010-11, the Tasmanian Government established a Review of its State taxes. This involved producing a discussion paper, inviting submissions, and an extensive consultation process. However, following the National Tax Forum in October 2011 it became clear that significant State tax reform required the cooperation of the Australian Government to be effective. On 22 November 2011, the State Tax Review Panel announced its decision to discontinue the Review. This decision was due to a number of factors including budgetary pressures faced by governments, the challenging economic conditions confronting businesses and individuals in the aftermath of the Global Financial Crisis, the related cost of living pressures, and a perception that the best prospect for meaningful State tax reform would be provided by pursuing reform at a national level in cooperation with other States and Territories and the Australian Government. There was no consideration of the issue of HFE in the tax discussion paper regarding the GST distributional impacts of tax reform.

As noted earlier, the Commonwealth Treasury also concluded that HFE was unlikely to materially impact State decisions to undertake tax reform.

ii. Does the HFE system impede the efficiency of State service delivery, infrastructure investment and policies affecting where people live? If so, how and to what extent?

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

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

One of the CGC key principles is to ensure that its assessments are policy neutral. States therefore have the incentive to make their operations more efficient and to not suffer any penalty if they do so. Likewise, if they are less than efficient or choose to provide a higher standard of service they gain no compensation or reward.

As a result of this principle, fiscal equalisation is also efficiency neutral. Under the current methodology, all States are assumed to incur the national standard (weighted average) level of expenditure to deliver a service.

²⁸ GST Distribution Review, *Final Report*, October 2012, pages 136-137.

This internal standard is then adjusted for the disabilities faced by each State to deliver that service. No adjustment is made in relation to how efficiently a State delivers a service.

If a State is able to deliver the average level of service at a cost below the national average, its funding from the GST would only be affected by the marginal impact it would have on the average national standard.

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

States therefore continue to have the incentive to reduce costs as they will retain the benefit of greater budget flexibility and will not be discouraged from improving efficiency by the equalisation process.

While the CGC's methodology is neutral in terms of the impact that it has on the efficiency with which governments provide services, it could be argued that fiscal equalisation has other efficiency impacts. For example, it could be argued that, by compensating States for disabilities such as scale and dispersion, equalisation provides States with the capacity to provide services to small, dispersed populations which would otherwise be uneconomic. It also provides a barrier to the rationalisation of these services. This is where there is a fundamental trade-off between the notions of equity and efficiency.

Research²⁹ commissioned for the Garnaut and FitzGerald Review demonstrates that any theoretical efficiency losses arising from the application of HFE are minimal. The research found that the welfare gains from moving from HFE to a per capita distribution were between \$150 million and \$250 million a year. This is insignificant compared to Australian GDP of around \$708 billion a year at that time.

Modelling, commissioned by the Queensland Government in response to a CGC staff paper in 2006³⁰ and undertaken by Monash University's Centre for Policy Studies (which also undertook the Garnaut and FitzGerald modelling) yielded strikingly different results. Based on slightly modified, though more realistic, assumptions, the Queensland modelling suggested that moving to an EPC distribution would result in losses of up to \$620 million in national economic welfare, compared to HFE.

More recently, the 2015 study undertaken by Independent Economics on behalf of the South Australian Government³¹ found that moving to a modified EPC distribution of GST revenues (indigenous expenditure remains equalised), would lead to a permanent loss in national living standards of about \$521 million (in 2015-16 terms).

Once again the magnitude of the impact of HFE is small compared to national GDP.

Therefore, it can be argued that there is no clear evidence that HFE discourages efficiency, with the implications of a State government's spending decisions largely borne directly by them, without being influenced by HFE.

²⁹ Dixon et al, *Effects of changes in Commonwealth Grants to the States: an applied equilibrium analysis*, April 2002, page 15.

³⁰ Queensland Treasury, *Architecture of Horizontal Fiscal Equalisation: Principles and Interpretation*, June 2006, page 6.

³¹ Independent Economics, *Horizontal Fiscal Equalisation: modelling update and scenarios*, May 2015, page 23.

iii. Is policy neutrality adequately addressed under the average State policy approach? Why or why not?

One of the key principles used by the CGC in its revenue and expenditure assessments is that a State's own policies or choices do not directly influence the level of grants it receives. That is, its assessments are policy neutral.

In its 2015 Methodology Review the CGC sought feedback on its policy neutrality principle and noted that³²:

Some States have argued that the current approach is not policy neutral. This is because collectively, the policies of States set the standards. To be policy neutral the standards should be based on what States could do. It is true that some States have a greater influence on setting the average policy. That is, because the average policy is a weighted policy and, the more people they have, the more influence they have on the average.

In practice, State decisions are based on more immediate considerations than the potential effect of equalisation and there is no evidence that State decisions are affected by equalisation considerations. While the Commission accepts the potential for assessments to provide incentives for States to make certain decisions, it is not clear that the effects are material or potential solutions are reliable or simple.

In the CGC's 2015 Report of Revenue Sharing Relativities it simplified its approach to determining average policy³³. In the case of revenues it assumes that every tax imposed by one or more States is part of average policy and affects State fiscal capacities. Any revenue raised will be subject to differential assessment and will impact GST shares where it meets the revised disability materiality test.

This approach means that to affect GST shares, a State tax will need to have large revenues and/or a diverse tax base. The CGC considers that this approach is simpler, more inclusive and less likely to suffer from policy neutrality problems than the test used in its previous methodology.

In the case of the assessment of a service expenditure, even if only provided by some States, if it would have a material effect on the GST distribution, then the service would be treated as average policy and assessed.

Tasmania has been a long term supporter of both the average policy (what States do) and policy neutrality principles and considers these to be mutually reinforcing pillars of the current horizontal equalisation approach.

While some States made assertions to the GST Distribution Review about the capacity of States to selectively distort their (revenue) policies in order to gain a GST advantage, as noted in the response to question c(i), the GST Distribution Review Panel found no evidence that HFE acts as a material disincentive to State tax reform³⁴.

For example³⁵, the New South Wales Financial Audit (the Lambert Report) recommended a switch from insurance taxes to payroll tax. Despite the recommendation, and though at the time New South Wales would have gained GST share by switching from insurance tax to any other tax, it chose not to do so.

³² Commonwealth Grants Commission 2015 Review, *Implementation and Methodological Issues (CGC 2013-06-S)*, October 2013, page 10.

³³ Commonwealth Grants Commission 2015 Review, *Implementation and Methodological Issues (CGC 2013-06-S)*, October 2013, page 7.

³⁴ GST Distribution Review, *Final Report*, October 2012, page 140.

³⁵ GST Distribution Review, *Second Interim Report*, March 2012, pages 35-36.

Consideration of the GST impacts of tax changes is also not evidenced by the fact that the Western Australian Government decided to increase its royalties on iron ore fines in 2010-11 despite the fact that it would have had the effect of reducing its GST share by more than the royalty revenue it received³⁶. Western Australia chose to proceed with the royalty change because it considered the fiscal equalisation system so broken the case for reform would not be ignored. The Australian Government subsequently intervened and directed the CGC to keep iron ore fines in its low royalty group for GST assessment purposes.

It is acknowledged that the CGC's approach to achieving policy neutrality by assessing the average of what States do is not a pure policy-free measure. However, an alternative approach that, for example, uses an external standard of what States could do or should do, would mean achieving other goals (such as efficiency) rather than the fundamental objective of equalising fiscal capacity to the average standard. It is not the role of the CGC to determine such measures and other policy objectives can, and are, being achieved through targeted Commonwealth funding arrangements with the States.

It is also acknowledged that some States, notably the larger States, can affect the average policy. However, as has been noted by the CGC and the GST Distribution Review, this issue has not been shown to be material.

Tasmania therefore supports the CGC's current approach to policy neutrality, and notes that where there are circumstances where this cannot be adequately achieved, the CGC has in the past used its judgement and placed less weight on this principle to reach a better HFE outcome.

³⁶ From 1 July 2010, Western Australia increased its royalty rate for iron ore fines from 3.75 per cent to 5.625 per cent through the removal of a royalty concession. In the CGC's mining revenue assessment at that time, it classified mineral royalties as either being in a low royalty group or high royalty group. The removal of the concession moved iron ore fines from the low royalty group into high royalty rate group. Based in the CGC's mining revenue assessment it would have reduced Western Australia's GST by more than the increase in royalties it received from iron fines because the actual royalty rate applied to iron ore fines was lower than the average rate for the high royalty rate group. Thus, its assessed revenue (for GST distribution purposes) using the average royalty rate for the high royalty group would be greater than its actual royalty revenue.

d) Does the current HFE system influence State policies to facilitate, restrict or tax the development of economic activity, and in particular energy and mineral resources?

Tasmania's response to this question has been largely covered in question c(i) and elsewhere.

i. What evidence is there for the HFE system affecting State policy choices relating to resource extraction (including regulatory restrictions on development)?

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

As noted in responses to earlier questions, there is no evidence that States which are slow growing or have lower economic development potential are not pursuing economic development because it may reduce their GST share.

It has been suggested that Tasmania's above average share of GST revenue has made it easy for it to accede to pressure from environmental groups rather than to confront difficult economic development decisions. However, this presents a simplistic view of events. Tasmania is also fortunate to have a unique natural environment, which is highly valued as an Australian, not just a Tasmanian, asset. As a result, in a number of instances, Tasmania has had its economic development capacity restricted through land use decisions that have reflected national, rather than simply Tasmanian, preferences.

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

It is noted that Western Australia has publicly argued that the CGC's asymmetrical approach to economic development expenditure (in particular its lack of recognition of the provision of State infrastructure which underpins the generation of mining royalties) is a disincentive to the pursuit of economic growth. However, it is arguable whether the provision of infrastructure to support economic development is a private or public responsibility. The validity of the CGC recognising economic development expenses within its methodology has been debated in previous reviews.

In the CGC's 2015 Report of Revenue Sharing Relativities one of its terms of reference was to consider the appropriate treatment of mining related expenditure (arising from recommendation 7.3 of the GST Distribution Review). It found that mining expenditure was largely already captured within its existing assessments.

The CGC also concluded that economic development expenditure reflects a policy choice of governments and has decided not to include it as an assessment. On a practical level, it is difficult to see how such an assessment could be undertaken given the different reasons put forward for undertaking economic development. For example, while Western Australia argues that its abundance of mineral resources requires it to incur costs to support their exploitation, Tasmania would argue that it is the absence of mineral resources

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

In relation to the question of whether HFE discourages policies to promote economic development, the GST Distribution Review Panel found³⁷:

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

Where a State prohibits the extraction of a mineral resource, usually for environmental or political reasons, the CGC assesses that State to have no capacity in relation to the banned activity.

Coal seam gas (CSG) is banned in all States except Western Australia and Queensland. For those States that produce CSG, it is assessed as part of the onshore oil and gas component of the CGC's mining revenue assessment. However, as the current value of production of CSG is relatively low it is not material enough to be separately assessed by the CGC nor does it have a material impact on the relevant State's assessed mining capacity. However, the CGC notes that this could change in the future with projected increases in CSG production in Queensland.

The CGC therefore suggests that it may have to review its treatment of banned mineral exploitation should it become material. Because a number of States prohibit this activity, this could involve the CGC having to estimate the unexploited revenue base for those States, so as to not 'penalise' the States that do not impose the ban.

Tasmania would be concerned if the CGC were to depart from its current principle of assessing 'what States do' and attempted to estimate 'what States could do' where a policy decision has been made not to develop a resource for sound environmental reasons, and where HFE was not a consideration in that decision. This approach would open up other sources of revenue that are either partially, or not fully, exploited and would create added complexity and argument over how such an assessment could reasonably be made.

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

Therefore, the argument that HFE acts as a disincentive affecting State policy choices relating to resource extraction does not hold.

³⁷ GST Distribution Review, *Final Report*, October 2012, page 138.

e) How does the current CGC relativity process affect States' fiscal management from year to year and over time? How does this affect policy outcomes and economic activity in each State?

A State's GST relativity (and hence its share of total GST revenue) is highly variable from year to year. Factors that can influence changes in relativity include changes to:

- the pool of GST revenue available for distribution, and the State's population share;
- the CGC's methodology - the next CGC methodology review is already underway and it will first have an impact on relativities from 2020-21;
- the CGC's data sources - for example, the use of a new dataset to estimate comparative interstate public sector wages cost Tasmania approximately \$30 million in the 2017 Update;
- other States' own source revenue raising capacity. Western Australia's mining royalties are the most visible example of this. However, New South Wales is currently experiencing rapid growth in conveyance duty revenue as a result of its strong property market. If NSW's property market were to wind down significantly this would, in time, result in less GST being distributed away from NSW and therefore less GST being distributed to Tasmania;
- a State's own-source revenue raising capacity. Most recently, a strong property market, is expected to have a negative impact on Tasmania's forecast GST revenue over the forward estimates period; and
- Commonwealth-State financial arrangements.

i. *Does the current process impact the ability and propensity for States to manage budgets through cycles, especially for those States relatively more reliant on large and volatile revenue streams?*

Budget and forward estimates of GST revenue to Tasmania can change significantly from one major update of estimates to the next (from budget to mid-year report, or budget to budget). GST revenue makes up approximately 40 per cent of Tasmania's total revenue, and small percentage changes in GST revenue can result in significant dollar changes in the context of total revenue.

As discussed below, Tasmanian Treasury maintains a comprehensive GST relativity forecasting model, which has proved to be as accurate as, and in some cases more accurate than, the forecasting of other revenue sources.

It is argued that, because of HFE, recipient States can become dependent on grant funding and are less likely to pursue policies to improve their financial circumstances. However, practical experience does not show this to be the case. For example, Tasmania as a recipient State has a strong record in managing its Budget. During the 1990s and early 2000s, successive governments exercised high degrees of fiscal discipline to achieve a sustainable Budget and reduce high levels of net debt. In 2004-05, Tasmania became one of the first States to be General Government Sector Net Debt free, and remains so.

However, the CGC's relativities are not the only source of variability in States' GST revenue. Changes to State population shares and the size of the GST pool also make a significant contribution to the variability in GST to each State. The accuracy of State's forecasting (and therefore their ability to plan for and manage periods of high or low revenue) would be well served by any improvements that can be made to the forecasting of these components.

States, like Western Australia, with large and volatile revenue streams will, of course, experience significant changes in the share, and amount, of GST revenue they receive, depending on where they are in their own-source revenue cycle. However, it is not difficult to anticipate the impact of rising own-source revenue bases on a State's GST revenue and plan for it within the budgetary process.

At the height of the mining boom, Western Australia was well aware of the future impact of significantly increased mining revenue on its GST share, forecasting a rapidly declining share as early as the 2010-11 State Budget. Indeed, in the 2011-12 State Budget, Western Australia projected its relativity to fall towards 0.3.

Despite this, the Western Australian Government announced, in its budget, unprecedented levels of expenditure on infrastructure funded through borrowings. As stated by the Hon Christian Porter in his 2011-12 Budget Speech to Parliament³⁸:

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

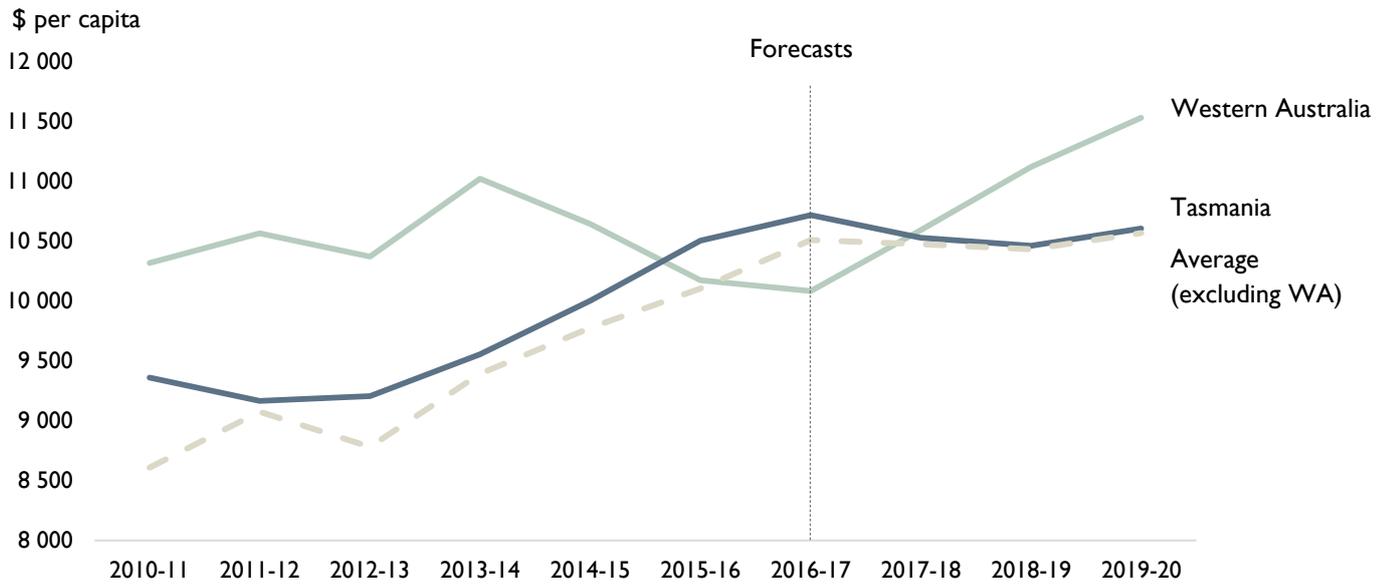
If that change does not occur in that year, the State Government will then have no choice but to wind back infrastructure investment to decrease debt'.

During the following years, Western Australia continued to experience a benefit because of the lag in the GST distribution methodology, retaining very high own-source revenues and higher GST revenue than would have been the case if the GST distribution were based on its actual circumstances in the distribution year.

The CGC quantified the benefit Western Australia received from the lag in the GST methodology in its *Report on GST Revenue Sharing Relativities – 2015 Review*, estimating that since 2010-11, Western Australia had received around \$7 billion in additional GST as a result of the time lagged assessment methodology. During this period, until 2014-15, Western Australia's average total revenue per capita (including GST and other Commonwealth payments) exceeded Tasmania's by 12 per cent. Western Australia's above average total and own-source revenue during this period is shown in Figure 1A and 1B below. Despite the decline in GST its total revenue per capita remained higher than Tasmania until 2015-16. Western Australia's total per capita revenue is forecast to once again exceed Tasmania's in 2018-19 and 2019-20.

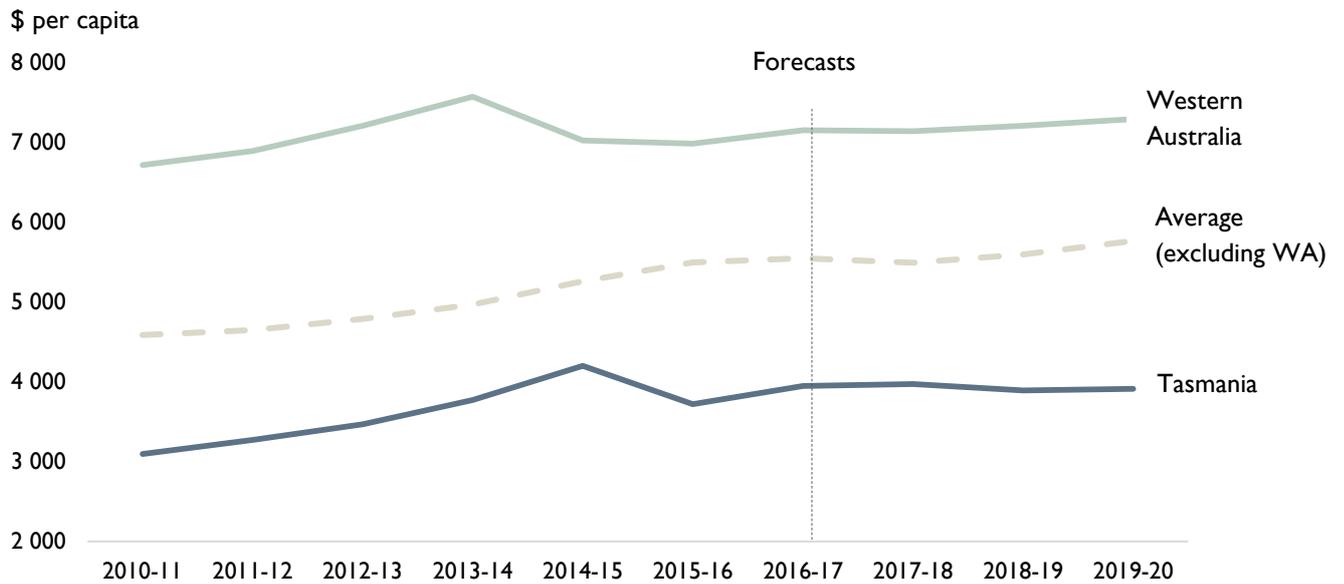
³⁸ Western Australian Government, *Budget Speech 2011-12*, May 2011, page 3.

Figure 1A: Total revenue per capita, Tasmania, Western Australia and an average of all States (excluding WA)



Source: State and Territory Budgets and Mid-Year Updates

Figure 1B: Total own-source revenue³⁹ per capita, Tasmania, Western Australia and an average of all States (excluding WA)



Source: State and Territory Budgets and Mid-Year Updates

Despite being well aware of the impact that high own-source revenues would have on their future GST revenue, the Western Australian Government failed to implement a fiscal policy that took account of the benefits of coinciding high own-source revenues and high GST in preparation for the inevitable decline in GST that the Western Australian Treasury forecast.

³⁹ Own-source revenue for Western Australia and Northern Territory (included in average) includes the Grants in Lieu of Royalties provided by the Australian Government.

When downgrading Western Australia's Aa1 credit rating outlook from stable to negative in June 2015, Moody's noted that as iron ore and other commodity prices spiked to record highs in 2013, along with adjustments to the royalty rate, Western Australia's reliance on this volatile source of revenue grew from 8.4 per cent of income in 2006-07 to 21.6 per cent in 2013-14. Moody's noted that, at the same time, these windfalls fuelled a rapid rise in current expenditures, with significant enhancements to healthcare, education and justice services resulting in deficit operations during a period of strong economic growth.

The Western Australian economy remains very strong and its own-source and total revenues are substantially higher than they were a decade ago and remain higher than the national average as shown in Figure 1A. Despite the decline in mining revenue and the short term reduction in GST revenue, Western Australia's 2016-17 Pre-Election Financial Projections Statement forecasts total revenue per capita that exceeds the average of all the other States by 3 per cent in 2017-18 and 8 per cent in 2019-20.

Western Australia's problem is not revenue, it is expenditure management, which is apparent in Figure 1B where its total own-source revenue per capita (albeit reducing from the mining boom peak) remains above the national average. Had recent Western Australian Governments better managed expenditure, Western Australia could have remained in a very sound financial position at this time. Instead they have spent the benefits of the mining boom and have a legacy of debt and high recurrent expenditure.

ii. *How does data reliability and the three-year averaging process affect fiscal management? Is there a better trade-off between GST relativity precision and timeliness?*

The issue of contemporaneity was extensively investigated in the both the CGG's 2010 and 2015 Methodology Reviews.

The CGC's current three-year averaging methodology represents an appropriate balance between stability, reliability, and contemporaneity (it is assumed the Commission's reference to timeliness is equivalent to the term contemporaneity used in previous discussions of this issue).

Any change to the methodology to improve one of these three factors will generally come at the expense of the other factors.

The CGC bases its assessments on an average of the three most recent complete data years available at the time it completes an annual update report or five-yearly methodology review. In the case of the 2017 Update Report, these years are 2013-14, 2014-15 and 2015-16.

The CGC's current three-year averaging methodology is suitably contemporaneous when considered in the context of the CGC's primary objective of achieving HFE.

The CGC's methodology is specifically designed to recognise the innate differences in States' revenues and expenditures which would cause their fiscal capacities to diverge and to recommend a distribution of GST revenue which would remove the impact of that divergence on State finances. On a first principles basis, Tasmania considers that any methodological changes to adjust the balance between relativity precision and timeliness should seek to maintain or improve the CGC's ability to deliver on its primary objective.

Tasmania is strongly of the view that the magnitude of specific changes in State circumstances should not be viewed as justification in itself for considering adjusting the CGC's methodology. Tasmania believes the adequacy of the methodology, including the issue of whether the assessment methodology is sufficiently contemporaneous, should always be considered on the basis of principle. That is, changes should be considered on the basis of how the methodology can best be structured so as to produce a recommended GST distribution that is most aligned with the principle of HFE.

Tasmania recognises that a move towards a more contemporaneous assessment may improve the relative applicability of the assessment to the States' actual fiscal circumstances in the application year. However, Tasmania does not believe this can be achieved in a reliable way that maintains or improves the methodology's capability of achieving HFE, given the compromises it would necessitate.

Specifically, Tasmania notes that greater contemporaneity can only be achieved at the expense of at least one of the following principles:

- the reliability of the data that the assessments are based on (reliability and practicality);
- the pursuit of less complexity within the methodology (simplicity); and
- the value of States' having a level of predictability in GST revenue (stability).

The current approach of basing assessments on the observed data for the latest three years achieves an appropriate balance between contemporaneity and these competing principles.

Tasmania notes that this issue was considered extensively in the 2010 Methodology Review, including within *Issues Paper 2006/04 - Contemporaneity*. That Issues Paper outlined a number of options for giving greater weight to contemporaneity and explicitly recognised the direct trade-off between contemporaneity, reliability and practicality and States' preference for stability in GST revenue.

Having considered the views of all States regarding a series of possible options, the CGC made the decision to shorten the lagged assessment period from a five-year average to a three-year average. It concluded that this balance was preferred over an even more contemporaneous assessment because it provides some stability in State shares of the GST, a major source of revenue, despite volatility in State own-source revenue⁴⁰.

Tasmania agreed with the CGC's analysis at that time, and continues to do so. Tasmania does not believe that recent perceptions of a lack of responsiveness or applicability of relativities warrants a change in this deliberate and informed balance, particularly in the absence of a comprehensive analysis of a full range of options. The benefits and disadvantages of trade-offs between these competing principles were examined carefully during the 2010 Methodology Review, with significant input from States.

The issue of contemporaneity was again examined during the CGC's 2015 Methodology Review and, after consulting with the States, the CGC concluded that, inter alia:

- a three-year lagged assessment is, at least in most circumstances, the most reliable practical approach to providing a reasonable estimate of State circumstances in the application year;
- in adopting as the basis for all assessments the data for three historical years, the CGC accepted that fiscal equalisation is achieved over a run of years with a lag. While imperfect, this approach recognises that State fiscal capacity in any one year must take account of the operation of the system over a run of years;
- there is a trade-off between contemporaneity and data reliability. It did not consider that State, or independent, forecasts of revenues in the application year are sufficiently reliable for us to use as the basis of the GST distribution; and
- the use of unreliable data would almost certainly require consequent GST adjustments in future to compensate for errors, which could then undermine the contemporaneity of future years GST distributions.

⁴⁰ Commonwealth Grants Commission 2010 Review, *Revenue Sharing Relativities - Main Report*, Volume I, February 2010, page 38.

Tasmania considers that any improvement in the contemporaneity of the CGC's methodology should only be pursued if it can be clearly demonstrated that it would not reduce the achievement of HFE. Tasmania considers that a reliable assessment, based on robust data, is vital to achieving HFE. As such, options for how contemporaneity could be improved need to be considered primarily in the context of the need for reliable data.

In the CGC's 2015 Methodology Review, Western Australia proposed that contemporaneity could be improved if the CGC was to use projections or forecasts of State circumstances as the basis for its assessment. Tasmania is strongly opposed to the use of projections or forecasts of State circumstances in the application year as the basis for the CGC's assessments.

Tasmania notes that the CGC's methodology is specifically designed to recognise innate differences (notwithstanding materiality thresholds) in States' revenues and expenditures to facilitate the recommendation of an appropriate distribution of GST revenue. Tasmania considers that an accurate assessment of these differences can only be achieved through observed historical data, rather than projections or forecasts that are likely to be subject to error and which may require later adjustments to distribution shares if the projections are found to be inaccurate. This would add complexity and create potential issues on how *ex-post* adjustments are made.

In the 2010 Methodology Review, the CGC considered the option of undertaking a full contemporary equalisation based on projections of States fiscal capacities. At that time, the CGC noted a number of disadvantages, including that:

- the assessment would be complex and data intensive, which would conflict with the simplification objective;
- it would have implications for the stability of States' GST revenue;
- it is unlikely that the CGC could accurately predict State's application year fiscal capacities; and
- it could expand the role of judgement in the assessment process⁴¹.

The CGC also considered the use of forward estimates rather than historical financial data, but noted it would have concerns about reduced reliability and accuracy, as well as grant design issues associated with using unaudited State data⁴².

Tasmania considers that these recognised disadvantages remain valid and are sufficient barriers to warrant ruling out of the use of projections or forecasts of circumstances as the basis for the CGC's assessments.

⁴¹ CGC 2010 Review, *Issues Paper 2006/04 – Contemporaneity*, page 10.

⁴² *ibid*, page 8.

Given that Western Australia proposed the use of projections in the 2015 Methodology Review, it is worth noting comments on the issue in 2006:

We are strongly opposed to any use of forward estimates or projections of future economic and demographic circumstances to forecast application year relativities. None of this information is sufficiently reliable, there would be opportunities for 'gaming' behaviour by States, and such approaches would add substantial complexity.

Such an approach would also require a complex system of 'completion' grants or relativity adjustments to correct the previous estimates when actual data became available, and ensure that equalisation was actually achieved over time⁴³.

Tasmania also notes that the CGC again rejected the idea of using projections in their *Significant Changes* paper in the 2015 Methodology Review, stating that it did not consider State or independent forecasts of revenues in the application year sufficiently reliable for use as the basis of the GST distribution⁴⁴.

The CGC also stated that it considers 'that a 3 year lagged assessment is, at least in most circumstances, the most reliable practical approach to providing a reasonable estimate of State circumstances in the application year'⁴⁵. Tasmania agrees with this, and considers it unlikely that a reliable, practical, unbiased assessment that is based on projections or forecasts can be developed for any assessment category.

If the use of historical data is accepted as necessary, its availability creates an unavoidable 'lag' in the assessment of State circumstances, effectively reducing contemporaneity. Tasmania considers this reasonable and necessary when balanced against the need to ensure reliability in the CGC's methodology.

From a baseline of accepting the use of historical data, the question becomes one of how contemporaneity can be improved in the context of a lagged assessment methodology. The options to do so include:

- reducing the number of data years taken into account to produce the relativities (currently three);
- giving greater weight to the more recent assessment years; and
- linking States' GST requirements in the historical assessment year to the application year.

Tasmania is opposed to all of these options, for the reasons discussed below.

Reducing the number of assessment years

Reducing the number of assessment years averaged to produce the relativities will increase the level of volatility in States' shares of GST revenue. The use of three-year averaging is designed to deliver a level of stability through effectively 'smoothing' the impact of large movements in circumstances and data irregularities, and preventing 'one-off' anomalies from having a large effect on the GST distribution. Tasmania would argue that averaging is necessary for these reasons, and considers that the use of three-year averaging achieves an appropriate balance between contemporaneity and stability in States' shares of GST revenue.

As noted above, the assessment years were reduced from a five-year average to a three-year average during the 2010 Methodology Review. At the time, the CGC concluded that this balance was preferred over an even more contemporaneous assessment because it provides some stability in State shares of the GST, a major source of revenue, despite volatility in State own-source revenue⁴⁶. Indeed, Western Australia noted in its

⁴³ Western Australia Treasury, *Western Australia's comments on the Architecture of Horizontal Fiscal Equalisation*, July 2006, page 7.

⁴⁴ CGC 2015 Review, *Significant Changes since the Draft Report, Commission Position Paper CGC 2014-04*, page 3.

⁴⁵ *ibid*, page 3.

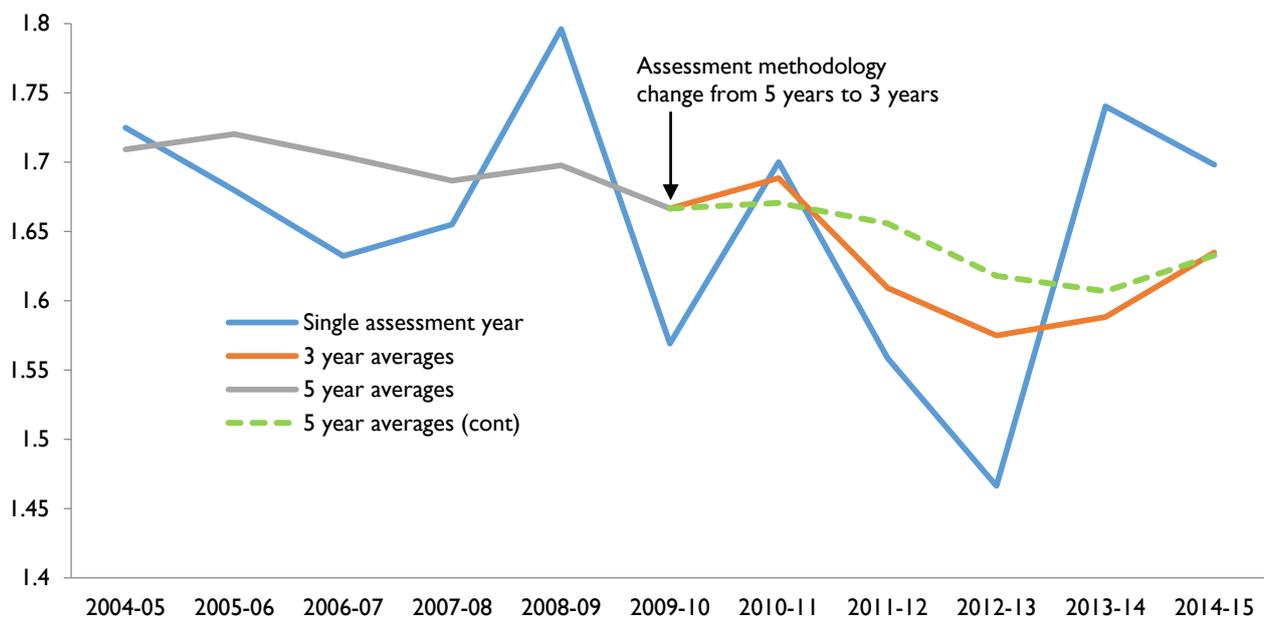
⁴⁶ Commonwealth Grants Commission 2010 Review, *Revenue Sharing Relativities - Main Report*, Volume 1, February 2010, page 38.

submission that ‘predictability in GST revenues is very important’⁴⁷, and ACT stated that it considered ‘stability of GST revenue... more important than the stability of total State revenue’⁴⁸. Tasmania concurs with these views.

Tasmania considers it important to note that, in attempting to address volatility in certain States own-source revenues through adjustments to the contemporaneity of the assessment methodology, greater volatility will be introduced for all of the other States.

Figure 2 illustrates the significantly greater volatility in Tasmanian relativities that would have resulted if the assessment methodology had been based on the most recent single assessment year being applied to the application year, compared to the ‘smoothed’ relativities of five-or three-year averaging. It illustrates that the change from five-to three-year averaging has increased contemporaneity without resulting in significantly increased volatility. However, further increasing contemporaneity by removing the three-year averaging would have resulted in a high level of volatility in Tasmania’s relativity. The consequent fluctuations in Tasmania’s GST revenue share would have caused significant budgetary challenges.

Figure 2: Tasmania’s relativities⁴⁹ under different assessment periods



Source: Commonwealth Grants Commission

Tasmania does not believe that the potential contemporaneity gains from a reduction in the number of years used in the assessment would outweigh the loss of stability and ‘smoothing’ effects that would result.

⁴⁷ Western Australia Treasury, *Western Australia’s comments on the Architecture of Horizontal Fiscal Equalisation*, July 2006, page 5.

⁴⁸ ACT Treasury, *ACT’s submission on the Architecture of Horizontal Fiscal Equalisation and Contemporaneity*, July 2006, page 14.

⁴⁹ Single year relativity data for the years prior to 2007-08 were provided to Tasmania by Commission Staff and were modified by Staff so that health care grants were treated as a specific purpose payment, to be consistent with the current methodology. For comparative purposes, averages are constructed based on the same adjusted single year relativities.

Giving greater weight to the more recent assessment years

In principle, Tasmania can appreciate that giving greater weight to the more recent assessment years could result in a more contemporaneous methodology. However, Tasmania notes that any skewed weighting would also add another layer of complexity to the methodology and questions how the weighting of years could be achieved reliably and objectively.

Tasmania considers that a weighted approach would increase the level of judgement required of the CGC. Tasmania notes that the CGC shared this view during the 2010 Methodology Review, concluding that it was not viable as 'there is no objective way of deciding how to give more weight to more recent years'⁵⁰.

Tasmania also notes that, whilst a weighting skewed towards the most recent assessment year may be more contemporaneous, it would also be less reliable because data in the latest year is more likely to be revised. Further, weighting toward the most recent assessment year will lessen the 'smoothing' effect achieved by the current three-year averaging approach, thereby increasing volatility in GST distribution outcomes.

Tasmania considers that the CGC's 2010 Methodology Review conclusion that weighting is not a viable option is still relevant. Tasmania does not consider the potential gain in contemporaneity sufficient to warrant the increased level of judgement this option would require, nor the reduction in simplicity, stability and reliability.

Linking of States' GST requirements in historical years to the application year

In the CGC's 2010 Methodology Review, consideration was given to the option of using an indexing approach where the GST each State required in the historical years was indexed to the application year by estimated movements in price levels, with any additional GST available in the application year distributed on an EPC basis.

Tasmania considers that any approach which attempts to link the historical assessment to the application year unviable as it would reduce reliability by requiring increased levels of judgement in how this 'linking' should occur. For example, in the case of the 2010 Methodology Review proposal, judgement would have been required to determine the indexation factor, as well as the method of distributing any residual GST. Such approaches would also add significant complexity to the CGC's methodology.

Whilst not specifically addressed in the 2010 Methodology Review option, the issue of whether and how to subsequently 're-adjust' distribution outcomes once actual data became available would be key points of judgement and debate. If such re-adjustments were deemed necessary, their application could inadvertently undermine the contemporaneity of future years GST distributions.

Tasmania is of the view that the additional complexity and judgement required under such an option would not justify any possible gains in contemporaneity.

⁵⁰ Commonwealth Grants Commission 2010 Review, *Revenue Sharing Relativities - Main Report*, Volume I, February 2010, page 55.

iii. What is the ability (and track record to date) of States to project and anticipate their own GST relativities, including any impacts of major State initiatives?

Most States maintain relativity forecasting models. The focus of these models can vary from State to State depending on the particular drivers of a State's relativity, and the sophistication can vary depending on whether a Treasury's Executive prioritises timeliness (rapid provision of updated forecasts after major data update) or comprehensiveness (taking into account as much data as possible, with a corresponding data entry overhead).

Tasmanian Treasury contracted Deloitte Touche Tohmatsu to perform a quality assurance audit on its GST relativity model in 2016, and Treasury conducted an informal survey of GST forecasting sophistication in other jurisdictions. The audit identified that the Tasmanian GST model is robust, and the informal survey of other States' models identified that it is at least as sophisticated as those maintained by other States.

The forecasting model closely duplicates the CGC's assessment methods for Commonwealth payments and States' own-source revenues. The model incorporates each States' Budget and forward estimates of each major tax line. The model uses these forecasts to project the CGC's assessed tax bases for each State and average tax rates to estimate the CGC's future assessment of each States' revenue raising capacity. The model excludes the impact on tax bases of announced revenue policy changes that are not within the CGC's scope of 'average' policy.

The model incorporates Australian Budget forward estimates of each individual Commonwealth payment and the CGC's actual or likely treatment of that payment (impact or not impact on the relativities). However, it does not model the impact of Commonwealth own purpose expenses (COPES) that may impact on the relativities, because information on COPES can be difficult to identify and collect data on for Tasmania, let alone for those that relate to other States.

The model is able to be used to investigate scenarios, such as a rapid movement in revenue from a major tax line in a particular State or the impact of a significant Commonwealth payment during its negotiation.

Tasmania's model, however, is less data intensive, less sophisticated, and less capable of scenario modelling in the CGC's three other assessment categories - infrastructure, expenses and net lending. Modelling involves projections of the CGC's most recent assessment of each States' assessed expenditure needs in these categories by a proxy for growth in funds available for expenditure, controlling for forecast changes in States' population shares. States' forecasts of expenditure are not used, because it is impossible to control for States' policy decisions that increase expenditure outside of the CGC's scope of 'average' policy.

Tasmania has been forecasting relativities and GST revenue to Tasmania since the 2012-13 Tasmanian Budget. Prior to 2012-13, Australian Budget forecasts of GST revenue to Tasmania were used, with occasional modification to account for specific risks. In the 2014-15 Tasmanian Budget the Australian Budget forecasts were again used temporarily ahead of the delayed release of the CGC's *Report on GST Revenue Sharing Relativities 2015 Review*.

As shown in Table 3, Tasmania's relativity model has had an average (absolute) error in forecasting relativities over the current forward estimates of 2.7 per cent. This compares favourably to the variation between the highest and lowest relativity during that period of 14.7 per cent.

Table 3: Tasmanian relativity modelling error

	Budget year %	1st Fwd Estimate %	2nd Fwd Estimate %	3rd Fwd Estimate %	Total %
Forecasting error	0.0	2.8	2.1	3.4	2.7

Source: Tasmanian Treasury modelling

Tasmanian relativity forecasting error compares Tasmania's forecasting model's relativity forecasts for the first to third out year at each State Budget and excludes the Budget year when generating the average error, as the Budget year relativity had been recommended by the CGC at the time of finalising the relativity forecasts. The data shown in Table 3 is calculated using modelled relativities and excludes non-modelled decisions to modify relativities that may have been taken subsequent to the completion of modelling.

Despite developing its own relativity forecasting model, Tasmania has continued to use the Australian Government's GST pool and State population forecasts because Tasmanian Treasury does not have an advantage in forecasting these variables. They are also subject to inaccuracy and substantial revision at times.

Table 4 shows the average error in Tasmania's published GST estimates since 2012-13 compared to all other States and the variability in Australian Government forecasts of the GST pool. Actual GST excludes the prior year residual adjustments and is based on collections reported in the Australian Government Final Budget Outcomes, and not on distributions, which are based on the GST revenue estimated outcome at the following Australian Budget.

Table 4: GST forecasting error since 2012-13

	Budget year %	1st Fwd Estimate %	2nd Fwd Estimate %	3rd Fwd Estimate %	Total %
Australian Government (GST pool)	0.9	1.3	2.1	2.2	1.4
Average of all States	1.2	5.0	8.3	5.3	4.1
Tasmania	1.0	3.3	4.6	5.0	2.9

Source: Tasmanian Treasury modelling

It should be noted that Australian Government GST pool forecast error makes up a significant proportion of States' forecasting error. Although not displayed, Australian Government population forecast error will also contribute to States' forecasting error.

Tasmania therefore considers that while the GST distribution methodology is complex, it can nevertheless be modelled with reasonable accuracy for budgeting purposes. The complexity and potential volatility is no argument to simplify the GST distribution using the justification that it will increase States' forecasting accuracy. The GST distribution is but one factor and it should not be ignored that GST pool and population share forecasts are equally as important and therefore have equal potential to impact on the accuracy of States' GST forecast accuracy.

iv. *What resources do individual States expend dealing with HFE matters?*

The Tasmanian Department of Treasury and Finance currently has a team of four specifically allocated to the CGC's 2018 Update, 2020 Methodology Review, and the Productivity Commission's HFE investigation. That team will draw on the skills of other Treasury and line agency staff as necessary.

During annual CGC update cycles Tasmanian Treasury staff deal with CGC and HFE matters as necessary alongside their other intergovernmental relations duties with the assistance of other Treasury and line agency staff as necessary.

Primary responsibility for GST forecasting in Tasmania currently attaches to one policy analyst, with support from other staff as necessary. GST forecasting takes around one quarter of an FTE.

Given the importance of GST revenue to Tasmania (the component of GST attributable to equalisation is roughly equivalent to total taxation revenue in Tasmania) the allocation of these resources is not considered onerous or inefficient.

2. What preferable alternatives are there to the current HFE system (as adopted by the CGC in its calculation of GST relativities) of equalising States' fiscal capacities?

a) What should be the objective of HFE?

Tasmania is strongly of the view that the current objective of HFE best meets community expectations that, as a nation, Australians believe that promoting equality between jurisdictions in terms of the level of services State and Territory governments are able to provide is the primary consideration and is what HFE should achieve. It ensures that all jurisdictions can provide similar quality public services, such as health and education, which all citizens can enjoy regardless of where they live. Any other objective would very likely result in less equalisation and a greater level of inequality between jurisdictions.

HFE is not strictly defined in the IGA or in legislation. Instead, HFE has been defined and refined by the CGC through its periodic methodology reviews. The CGC has examined this issue on numerous occasions as it is required to distribute the GST on the basis of HFE.

The CGC's current definition of HFE is⁵¹:

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

Tasmania believes it is inappropriate that HFE be used to achieve other broader objectives and that it is possible to overburden the equalisation system. Equalising States' fiscal capacities is a large and sufficiently complex task without obscuring the process further with additional requirements. Hence it is more appropriate to pursue other objectives, such as service delivery efficiency, through other mechanisms rather than through the equalisation system (which is focused on equity).

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

A 2007 OECD paper⁵² sets out the rationale for fiscal equalisation as follows:

⁵¹ Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities*, 2017 Update, page 72.

⁵² Hansjörg Blöchliger, Olaf Merk, Claire Charbit, Lee Mizell, *Fiscal Equalisation in OECD Countries*, OECD, France, September 2007, page 7.

1. EQUITY

- To equalise per capita tax revenue raising capacity and the per-beneficiary cost of providing public goods and services across regions. Tax raising capacity per capita and cost of providing public services can differ across regions for geographic or socio-economic reasons. The objective of equalisation is to provide every citizen with an average level of public services at comparable tax rates.
- To equalise the marginal benefit of public spending across regions. OECD countries that have central government programs for important public services (such as health and education) administered by sub central governments, may use equalising transfers to equalise the marginal social benefit of public spending across regions.

2. EXTERNALITIES

- To avoid fiscal externalities resulting in a misallocation of labour and/or capital across regions. A decentralised fiscal system could distort the location decision of mobile factors. Unequal tax bases result in pecuniary incentives to locate in high tax base regions, thereby distorting location decisions of mobile factors of production. Grants that equalise tax bases across regions will eliminate this source of inefficiency.

3. INSURANCE

- To provide insurance against asymmetric income or employment shocks. If the regions of a country are subject to asymmetric shocks, redistributive grants may provide regions with insurance against the adverse effects of such shocks on income or employment.

In many OECD countries, fiscal equalisation plays an important role by enabling sub-central governments to have similar tax raising capacity and equal access to public services across jurisdictions. Tasmania considers that this rationale is appropriate and is consistent with the current objectives of HFE in Australia.

i. Should HFE address fiscal divergences across States due to both structural factors (beyond State influence) and cyclical factors (beyond State influence)? If so, over what time period should this be achieved?

As noted earlier, the objective of HFE is to provide each State with the fiscal capacity to deliver services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

Divergences in fiscal capacity also occur because of structural factors such as socio-demographic factors, regional dispersion, and scale. These factors can cause fiscal divergence through increasing cost to provide services because of a State's inherent disadvantages. These disadvantages may take a long time to resolve or may never be overcome. The purpose of HFE is to ensure that there is funding through HFE for these States to meet the additional costs. There should be no time limit imposed on HFE to address these inherent disadvantages. There are other mechanisms for addressing structural disadvantage such as the Australian Government's 'Closing the Gap' measures to address structural indigenous disadvantage.

Divergences in fiscal capacity occur because of cyclical factors. These tend to be revenue related as the economies in each State respond to cyclical movements most notably an increase in international demand for resources hence increasing State royalties, or property price escalation flowing through to higher property related taxes. These factors can create a temporary above-average per capita revenue for a State. While this situation is occurring, the State has less need for GST to provide the national average standard of services as

it can fund them through the increase in its own-source revenue. However, when the situation is reversed and the above-average own-source revenue ceases, the decline in own-source revenue is, over a period of time, replaced by additional GST through the HFE process.

It is appropriate that HFE also address this type of fiscal divergence.

ii. *Should HFE compensate States for fiscal divergences where a State has by choice diverged from efficient tax arrangements and service delivery?*

This is a common myth that States are rewarded for being less efficient through the GST distribution.

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

As mentioned earlier, the GST Distribution Review found no evidence that HFE discourages tax reform.

However, a concern put to the GST Distribution Review Panel was that HFE does not take into account the effect of a State's tax rates on the size of its tax base. If a tax base is relatively elastic (meaning that activity is relatively sensitive to tax rate changes), then a change in the tax rate could have a significant impact on a State's GST share by a resultant change in its tax base (unless tax policy changes are undertaken multilaterally).

The Panel found that:

Elasticity effects could have a relatively significant impact on a State's GST share if it moved to abolish an inefficient tax unilaterally. However, in circumstances where a State's tax base did observably change significantly following a major tax policy change, the CGC may be more amenable to introducing elasticity adjustments.

As with other theoretical incentives, it found no evidence that HFE has affected State decisions. Indeed it seems unlikely that States would increase their taxes so that they could receive more GST, given the amount would be uncertain, small relative to the overall effect on revenue, and at the expense of a large tax increase. However, at the margin, HFE may be a disincentive to lower tax rates⁵³.

It is noted that as part of the 2020 Methodology Review the CGC is currently reviewing its tax assessments for elasticity effects. The CGC is engaging a consultant to inform it on whether it is possible to determine the extent to which measures of State revenue bases are likely to be affected by differences in State tax rates.

iii. *Should past State policy decisions (such as on economic development, revenue bases and rates, or budget provisioning) influence the form or degree of fiscal equalisation? If so, how?*

Tasmania recognises that the major resource States have assisted the private sector to develop their industry and this has grown their State government revenue bases. However, this does not mean that this type of expenditure should influence the form or degree of fiscal equalisation.

The CGC has not accepted arguments to recognise economic development related costs in its expenditure assessments for a range of reasons, including the policy driven nature of these costs.

⁵³ GST Distribution Review, *Final Report*, October 2012, page 137.

To consider past policy decisions in determining the level of HFE would be extremely difficult and subjective. For example, how far back do you go and how would you assess what impact it should have? All States spend significant amounts on economic development and providing economic infrastructure, and there is no compelling reason why costs associated with, for example, developing the mining industry should be assessed differently to costs associated with developing other sectors of the economy (for example, significant investment in infrastructure to support the tourism and agriculture industries in Tasmania).

Tasmania shares the concern of CGC staff that equalising fiscal capacities because of past policy decisions by States is problematic. The CGC noted that:

In principle, we would prefer to measure the tax base each State would have if it had the average industry policy, the average level of infrastructure for industry, the average tax rate etc. We consider there are probably differences between States in these policies. However, we have no evidence on which States have more pro-development policies, and which have less pro-development policies. Nor have we identified any method for removing the policy differences in the revenue bases we measure.

We do not consider a discount is an appropriate response to this issue. The scale of mining in each State does not necessarily reflect the relative policy of each State. For example, the ACT's lack of mining is not due to its below average effort and it should not lose from an adjustment. Any adjustment for policy impacts would need to redistribute GST between mining States. A discount will not do this. Nor do we know whether to increase or reduce the tax bases of mining States. There is no evidence the actions of any State have increased or reduced their tax bases from the level they would be if average policy had been applied.

To operationalise an approach to recognising past policy effects on current revenue bases, the Commission would have to develop ways to identify the effect of each State's policies over time on its respective revenue bases. For example, future State policies on coal seam gas mining may have an impact on the revenue base observed in each State. To make an adjustment, the CGC would need to be convinced mines approved, or not approved, in one State would not have been treated in that way by the average State when circumstances were similar. Doing so will not be easy.

It is not clear the Commission can adjust for such policy differences in an equitable, reliable and comparable way across States. States were unable to propose ways of doing so. However, we will continue to monitor differences in State revenue raising policies to ensure the revenue bases we use are as policy neutral as possible⁵⁴.

iv. *What are the advantages and disadvantages of targeting full versus partial fiscal equalisation across States?*

Advantages of full versus partial equalisation

Full equalisation ensures that all States have the fiscal capacity to provide similar standards of service.

Full equalisation is a cornerstone of the Federation and reflects the Australian public's support that everyone should have similar levels of public services available to them with 77.5 per cent agreeing with the statement that 'money should be transferred from richer parts of Australia to the poorer parts to ensure that everyone can have similar levels of public services'⁵⁵. Partial equalisation would introduce other objectives and therefore reduce equity. It is unclear who would make a determination on the levels of partial equalisation and whether

⁵⁴ Commonwealth Grants Commission 2015 Review, *Report on GST Relativities, Volume 2 - Assessment of State Fiscal Capacities*, pages 15-16.

⁵⁵ Griffith University, *Australian Constitutional Values Survey 2014*, October 2014, page 10.

the levels would affect both revenue and expenditure. Further, there is no empirical evidence that any particular judgement would be an improvement on the current approach of full equalisation.

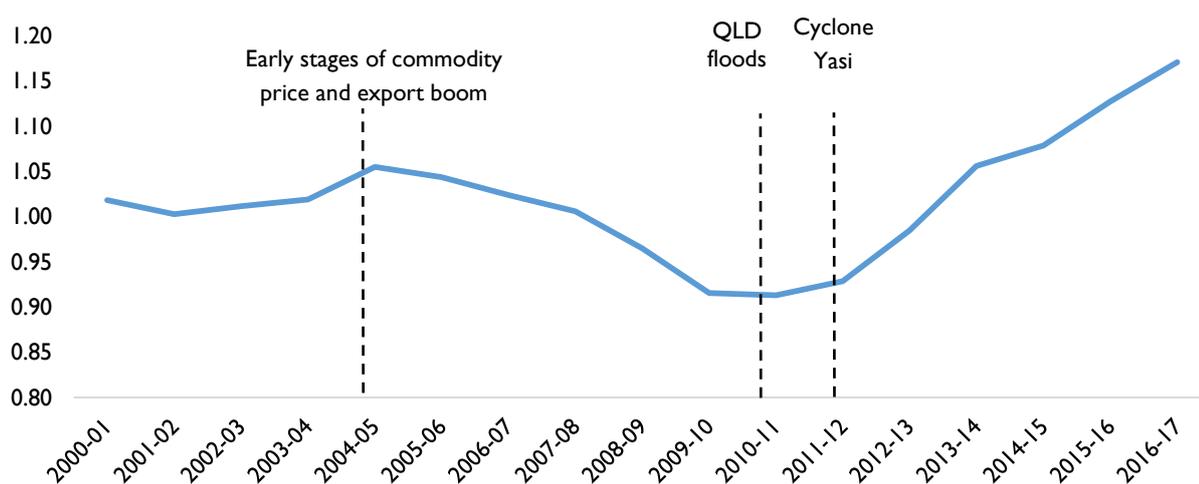
Full HFE discourages inefficient migration

As noted on the response to question I(b) HFE discourages inefficient migration with a recent study by Independent Economics⁵⁶ finding that there would have been a welfare loss of about \$500 million in 2015-16 if there had been no equalisation, primarily due to inefficient interstate migration. Partial equalisation would reduce the welfare loss but it is still likely to be negative. Independent Economics also modelled a relativity floor of 0.75 and found the welfare loss to be \$120 million.

Full HFE adjusts for changing circumstances and smooths out economic cycles in different parts of the nation.

Full HFE helps to stabilise the national economy (albeit with a lag) from rapid changes in economic circumstances faced by States at differing times. For example, when there were natural disasters in Queensland its GST share increased, and when there has been rapid revenue growth from the resources sector other States received higher GST which helped alleviate the negative impacts of a rising exchange rate, inflation, and wages. This is shown below.

Figure 3: Queensland relativity since 2000



Source: Commonwealth Grants Commission

Disadvantages of full versus partial equalisation

It is argued that full HFE adds complexity and administrative burden for the States and the Commonwealth.⁵⁷

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

Given the magnitude and the importance of equalisation, Tasmania does not believe the CGC methodologies to be unnecessarily complex, particularly given the importance of HFE to State budgets. One of the CGC's

⁵⁶ Independent Economics, *Horizontal Fiscal Equalisation: modelling update and scenarios*, May 2015, page 23.

⁵⁷ Review of Commonwealth-State Funding Final Report, Garnaut, R and FitzGerald, V, *A review of the allocation of Commonwealth grants to the States and Territories* August 2002.

supporting principles is that its assessments are practical. That is, based on sound and reliable data and its methods are as simple as possible while at the same time reflecting the major influences on State expenses and revenues as demonstrated in response to question I, while HFE only redistributes a small proportion of the GST pool, it has very significant financial impacts for some State budgets.

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

The GST Distribution Review Panel concluded that⁵⁸:

In relation to proposals to do 'less equalisation' the Panel finds that none of the approaches canvassed would be simpler, more transparent or improve efficiency. They would all require additional steps in the CGC's process, and additional steps would require additional explanation about how the distribution was determined, making the process less transparent.

It is also argued that HFE is not transparent for the lay person⁵⁹. However, just because something may have associated complexity does not necessarily mean that it is not transparent. The CGC is highly transparent, all methodological review and annual update materials are in the public domain.

v. *To what extent should States be held accountable for how they use funds received via equalisation?*

The GST is the primary source of untied funding to the States and replaced previous untied general revenue grants. In addition, as part of the financial arrangements agreed with the introduction of the GST, the States were required under the 1999 IGA to give up a range of their own-source taxes. There has been no requirement that the revenue be used for any specific purpose and it is available to the States to use as they see fit. Ultimately, State governments are accountable to their electorate on how they spend government revenue.

The specific amounts provided to the States through equalisation should not be used as a measure of what States should spend on particular service areas.

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

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

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

⁵⁸ GST Distribution Review, *Final Report*, October 2012, page 5.

⁵⁹ Review of Commonwealth-State Funding Final Report, Garnaut, R and FitzGerald, V, *A review of the allocation of Commonwealth grants to the States and Territories* August 2002.

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

There is no requirement or expectation that GST funds must be allocated in accordance with the CGC's distribution formula. This is the very essence of GST as a general (untied) revenue source.

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

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

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

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

b) What are some alternatives to the current system and how would they affect States' incentives to pursue higher prosperity? How would the alternatives perform, relative to the current system, in terms of efficiency, equity and simplicity, and ultimately which approach is best for national productivity and wellbeing?

Alternative options for distributing the GST have been put forward from time to time from both commentators and critics alike. These include alternatives proposed in the following investigations:

Review of Commonwealth-State Funding 2002⁶⁰

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

The report was released in August 2002. However, the Australian Government did not act upon it. This is most likely due to the fact that it was based on the objectives of the three States that commissioned the report, and that it would require the agreement of all States to change the current arrangements.

The 2012 GST Distribution Review⁶¹

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

That Review examined a number of alternative proposals by the large States to modify the system either by doing less equalisation than under the present model or by performing equalisation in a less precise or more general way. Table 5 shows a range of headline approaches (each with a myriad of variations) that were considered by the Review. Some of these apply to revenue assessments only, some affect expense assessments, while some apply overall.

⁶⁰ Garnaut R and FitzGerald V, *Review of Commonwealth-State Funding Final Report: A review of the allocation of Commonwealth grants to the States and Territories*, August 2002.

⁶¹ GST Distribution Review, *Final Report*, October 2012.

Table 5: Approaches that give rise to ‘less equalisation’

Revenue side	Apply a revenue discount to recognise States rights to having a share of revenue unequalised Equalise to the standard of the State with the minimum revenue ‘effort’
Expenditure side	Apply an efficiency dividend to expenditure needs Equalise to an externally determined efficient standard Equalise to the standard of the State with the minimum expenditure ‘effort’ Equalise to a 7-State average
Overall	Equalise to a proportion of the strongest State Raise recipients to a proportion of donor States Distribute a set (minimum) amount of GST on an EPC basis Establish a relativity floor

The Review also examined a number of options for making the equalisation process operate in a less precise or more general way than it currently does. It looked at a number of alternatives, including the use of GSP or Household Disposable Income as broad indicators of State fiscal capacity.

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

‘..... (was) not possible to use simple broad indicators and deliver States with the same, or very nearly the same, GST shares’.⁶²

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

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

The Review also gave some discussion to a proposal put forward by New South Wales, Victoria, Queensland and Western Australia that represented a fundamental move away from full equalisation. The four States proposed that HFE should be replaced with a per capita sharing of the GST revenues between States, supplemented by additional payments from the Commonwealth to maintain a form of HFE for the fiscally weaker States⁶³.

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

⁶² *ibid*, page 57.

⁶³ This is similar to a variation on the EPC option discussed by the CGC above.

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

...the Commonwealth has made it clear there is no additional money available to compensate States that would otherwise be worse off under an EPC model⁶⁴.

Essentially, the Review found that⁶⁵:

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

Reform of the Federation White Paper Process 2014-15⁶⁶

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

The relativity floor (proposed to be 75 per cent) is an alternative being considered by the current Australian Government. As stated in the Commonwealth Budget 2017-18⁶⁷:

The Government has also said it will consider a GST relativity floor to provide more certainty on the minimum share of GST that a State can receive in any year. The Government will explore a floor once relativities return to more normal levels - this is not expected for several years.

A relativity floor, by definition, would be triggered when the fiscal circumstances of one State meant that it had become excessively advantaged relative to all other States. The zero sum nature of the GST distribution means that all other States would need to receive GST allocations lower than required to deliver an average level of services in order to allow the advantaged State to maintain a high level of GST, alongside much higher than average own-source revenues.

Such an outcome would undermine Australia's system of comprehensive fiscal equalisation. It would allow one State to maintain a fiscal capacity in excess of the other States and because of the comparative advantage and consequent greater ability to provide higher quality services, better infrastructure and a more competitive tax regime, it would risk permanently entrenching that fiscal advantage.

CGC 2020 Methodology Review

As part of its 2020 Methodology Review, the CGC has released a Staff Paper⁶⁸ on other approaches to distributing the GST revenue to States. The CGC has compared three alternatives to the current distribution method to examine the likely effect on States using the 2017-18 application year as an example. The alternative methods include:

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

⁶⁴ GST Distribution Review, *Final Report*, October 2012, page 47.

⁶⁵ *ibid*, page 5.

⁶⁶ Department of the Prime Minister and Cabinet, *Reform of the Federation: Discussion Paper 2015*.

⁶⁷ Commonwealth Budget 2017-18, Budget Paper No.3: Federal Financial Relation, May 2017, page 4.

⁶⁸ Commonwealth Grants Commission Staff Research Paper, *Achieving HFE - Other Approaches to Distributing the GST*, May 2017, page 3-12.

An EPC distribution

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

The proportional loss in GST is far greater for the smaller States than the proportional gain to the largest States such as NSW and Victoria. Western Australia stands to gain the most in proportional terms given its significant decline in relativity over recent years due to the mining revenue boom. For example, in 2017-18, Tasmania would only receive an estimated \$1.3 billion in GST revenue, a reduction of \$1.1 billion or 45 per cent of its total GST revenue and 18 per cent of its total revenue.

If the GST was distributed on an EPC basis there would be a significant funding shortfall of around \$7.9 billion in 2017-18 for the recipient States that would require the Australian Government to provide if it were to maintain the current principle of equalising the capacity of States to provide services to their communities.

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

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

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

A partial EPC distribution

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

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

Under this option, the fiscally weaker States receive more than a population share of GST, but not as much as under the current equalisation distribution⁶⁹. Fiscally stronger States receive less than a population share of GST, but (in most cases) more than under the equalisation distribution.

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

⁶⁹ Fiscally weaker States receive less than the Commission's recommended distribution because all States (including fiscally weaker States) share the cost of the amount removed from the pool on a population basis.

An APC distribution⁷⁰

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

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

⁷⁰ Actual per capita assessments have a history in Australian equalisation. In early reviews, before the Commission was able to collect data to support all its assessments, equal per capita and actual per capita assessments were prevalent.

Quarantine of Western Australia's iron ore royalties

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

Mining revenue is one of the six categories of States' own source revenue that the CGC considers when determining GST shares amongst the States. The value and type of mining production in each State and the associated royalty revenue is used to produce an estimate of the amount of mining revenue that each State would raise, if it applied the average policy.

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

When considering the issue of mining revenue, the 2012 GST Distribution Review made it clear that it did not consider it appropriate to remove or quarantine mining revenues, and that it should continue to be equalised through the HFE process in the same way as other own-source revenues⁷¹.

However, the main conclusion of the Review on this issue is significant⁷²:

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

Tasmanian Treasury modelling of a 25 per cent quarantining of Western Australia's iron ore revenues suggests that there would be a significant impact on all other States as an estimated \$1 043 million is transferred to Western Australia. The modelling suggests that Tasmania would lose about \$24 million each year from this change to the HFE distribution process.

Table 6: Average annual impact of quarantined royalties

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Average annual impact	-375	-299	-234	1 043	-81	-24	-19	-11

Source: Tasmanian Treasury modelling

⁷¹ GST Distribution Review, *Final Report*, October 2012, page 109.

⁷² *ibid*, page 107.

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

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
GST distribution									
Equalisation	17 700	14 800	15 000	2 400	6 400	2 400	1 200	2 900	62 700
EPC	20 100	15 900	12 600	6 800	4 400	1 300	1 000	600	62 700
Partial EPC	17 600	13 900	13 400	6 000	5 800	2 200	1 100	2 800	62 700
APC	18 700	13 800	12 900	4 200	5 500	2 200	1 900	3 500	62 700
Difference									
EPC	2 400	1 000	- 2 400	4 500	- 2 000	- 1 100	- 200	- 2 300	7 900
Partial EPC	- 100	- 1 000	- 1 600	3 600	- 600	- 200	- 100	- 100	3 600
APC	1 000	- 1 100	- 2 000	1 800	- 800	- 200	700	600	4 100
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
GST distribution (per capita)									
Equalisation	2 238	2 372	3 035	895	3 694	4 596	2 972	11 796	2 541
EPC	2 541	2 549	2 550	2 536	2 540	2 490	2 477	2 441	2 541
Partial EPC	2 225	2 228	2 712	2 238	3 348	4 213	2 725	11 389	2 541
APC	2 364	2 212	2 610	1 566	3 175	4 213	4 706	14 237	2 541
Difference (per capita)									
EPC	303	176	- 486	1 641	- 1 154	- 2 107	- 495	- 9 355	0
Partial EPC	- 13	- 144	- 324	1 343	- 346	- 383	- 248	- 407	0
APC	126	- 160	- 425	671	- 519	- 383	1 734	2 441	0

Source: CGC calculation and Tasmanian Treasury calculation

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

Any reduction in revenue would have a significant impact on the State. Without any other funding from the Commonwealth this would mean either an 18 per cent reduction in expenditure on government services, or 18 per cent increase in State revenue from taxes, fees and dividends, or a combination of both. Clearly this would create an unsustainable budgetary position for the State.

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

While there have been a number of alternatives to the current HFE put forward from time to time, Tasmania considers that these depart from the longstanding principles of HFE that have served Australia well and continues to remain the best option.

Full HFE gives States the fiscal capacity to provide comparable services to their residents. Anything less than full HFE is highly likely to result in Tasmania being unable to provide comparable services and infrastructure to the fiscally stronger States.

The case has not been made that the current HFE and the GST distribution system needs reform. The current GST distribution methodology is working as it was designed to, and should not be modified in reaction to short term circumstances being experienced by one or two States.

c) How do these alternative approaches fit within the wider scheme of federal financial relations? Are some inequalities across States better dealt with outside the HFE system?

There are many examples of where inequality is already dealt with outside the HFE process. This is not because HFE is in anyway deficient, it is because it is not designed to address all forms of inequity.

The current system of HFE addresses inequality between the capacities of State governments to provide services to their communities. There is also inequality at the individual level and this is addressed through direct payments through a range of State and Commonwealth programs and social welfare benefits such as the Commonwealth age pension, Newstart Allowance and the Disability Support Pension. The provision of this assistance is largely driven by roles and responsibility between the Commonwealth and the States and the greater revenue raising capacity of the Commonwealth to fund such expenditures (VFI).

Some Commonwealth payments are paid to the States outside the HFE system. This can be because of structural disadvantage that the current HFE system does not address. HFE equalises capacity to provide services of a similar standard. However, HFE does not provide funding to make structural changes to address inherent disadvantages. For example, declining economic conditions may require targeted stimulus from the Commonwealth in the form of assistance with funding productive infrastructure or funding to assist industries undergoing transition. This is achieved by quarantining the Commonwealth payment from assessment by the CGC (at the direction of the Australian Government) so that it does not impact on relativities and so is not equalised away which would negate the intent of providing the additional funding.

Commonwealth payments that were quarantined in the CGC in its 2017 relativity update include:

- Assistance for Tasmania with Budget flexibility to implement national policy reforms
- Assisting preparation towards the launch of the National disability insurance scheme
- Caring for our country — animal and plant pest disease eradication
- Centenary of Canberra 2013 — A gift to the national capital
- Health care grants for the Torres Strait
- Improving health services in Tasmania
- National Health Reform funding — reward payments components
- Northern Territory remote Aboriginal investment
- Pilot of drought reform measures in Western Australia
- Roads to recovery
- Royal Darwin Hospital — equipped, prepared and ready
- Royal Victorian Eye and Ear Hospital redevelopment
- Sinking fund on State debt
- South Australian River Murray Sustainability Programme
- Stronger Futures in the Northern Territory
- Tasmanian Forests Intergovernmental Agreement
- Victorian cytology service
- Western Australia infrastructure projects.

d) What practices in other federations offer pertinent evidence for the Commission's considerations?

The system of HFE as practised in Australia is one of the few examples of full horizontal equalisation systems between sub-national governments. That is, it aims to eliminate fiscal disparities between the States to the greatest extent possible.

Fiscal equalisation between the national and sub-national governments in many other countries are either horizontal equalisation, vertical equalisation or both. The scope of equalisation also varies from revenue capacity only, such as Canada, cost equalisation only such as Spain, or equalising both revenue and expenditure. Some include transfers directly between sub-national governments such as Germany.

While there are a diverse range of approaches to fiscal equalisation, care needs to be taken when making comparison with other countries. As observed by the GST Distribution Review panel in its interim report⁷³:

While comparing the range of HFE approaches around the world can be useful, care is required before concluding that one country's approach is suitable for another, as a wide range of factors influences the chosen form of HFE. The political structures, the degree of VFI, and the historical and social circumstances of a nation all have a significant bearing on the form of HFE that is most appropriate for a particular country.

Tasmania agrees with this observation.

⁷³ GST Distribution Review, *Interim Report*, March 2012, page 5.