

# Victorian Response to the Productivity Commission's Draft Report on HFE

November 2017

TRIM ref D17/355943

The Secretary  
Department of Treasury and Finance  
1 Treasury Place  
Melbourne Victoria 3002  
Australia  
Telephone: +61 3 9651 5111  
Facsimile: +61 3 9651 2062  
[dtf.vic.gov.au](http://dtf.vic.gov.au)

Authorised by the Victorian Government  
1 Treasury Place, Melbourne, 3002

© State of Victoria 2017



You are free to re-use this work under a Creative Commons Attribution 4.0 licence, provided you credit the State of Victoria (Department of Treasury and Finance) as author, indicate if changes were made and comply with the other licence terms. The licence does not apply to any branding, including Government logos.

Copyright queries may be directed to [IPpolicy@dtf.vic.gov.au](mailto:IPpolicy@dtf.vic.gov.au)

ISBN 000-0-000000-00-0  
Published month 2017

If you would like to receive this publication in an accessible format please email [information@dtf.vic.gov.au](mailto:information@dtf.vic.gov.au)

This document is also available in Word and PDF format at [dtf.vic.gov.au](http://dtf.vic.gov.au)

# Contents

1. Overview.....	1
2. Equalisation to a ‘reasonable standard’ .....	4
2.1 The HFE system .....	5
2.2 Equalisation to a ‘reasonable standard’ .....	10
2.3 Volatility and mining royalty revenue .....	14
2.4 Long term effects of a move to the proposed ‘reasonable standard’ .....	15
2.5 International comparisons .....	18
3. Efficiency and incentives in HFE .....	18
4. HFE and state budgeting.....	20
5. Alternative options for HFE .....	21
6. Complexity and comprehensibility .....	22
7. Governance and accountability .....	23



# 1. Overview

While Victoria shares the Productivity Commission's views on many of the draft findings of the Draft Report into Horizontal Fiscal Equalisation (the Draft Report), Victoria cannot accept the conclusions drawn regarding the Horizontal Fiscal Equalisation (HFE) system, which appears at odds with many of the Commission's own findings.

As highlighted in Victoria's initial submission to the Productivity Commission (the Commission), and as found by the Commission itself, there is scant evidence that HFE has impeded productivity and economic growth.

The Victorian submission and the Commission's Draft Report concur with Saul Eslake in his keynote address to a Workshop on Federal Relations and Tax in August when he noted:

“What seems clear in the context of the extent to which the pursuit of horizontal fiscal equalization in Australia involves trade-offs between efficiency and equity is that there is plenty of ‘hard’ evidence as to the benefits in terms of equity of current arrangements, and very little ‘hard’ evidence as to its costs in terms of efficiency”.<sup>1</sup>

Given this lack of evidence, it is surprising that the Commission has recommended a substantial departure from the current distribution mechanism, whereby GST funds would be distributed based on some arbitrarily determined ‘reasonable standard’. The financial impact of such a move was modelled by the Commission to be up to \$1 billion per year for some states and territories (states). Such a major change should be supported by robust empirical evidence, which has not been presented.

This is despite the Draft Report finding that the HFE system is functioning reasonably well with regard to equity, is stable, and features an independent and transparent process.

The proposed solutions for achieving a ‘reasonable standard’ lack coherence, and importantly, are inequitable and potentially inefficient.

The Commission displays a broad acceptance for both the current assessed expenditure and revenue methodologies - rejecting calls for global revenue measures, external standards, discounting for mining revenues or a relativity floor. Yet the Draft Report goes on to recommend alternative approaches that are analogous to many of the methods the Commission explicitly reject.

The current HFE methodology is already considered by Victoria to be a reasonable standard, with the standard being set by the average of what states currently do, adjusted for material disabilities. By referring to alternative proposals as ‘reasonable standards’ the Commission are implying the current standard is unreasonable, an assertion that Victoria rejects. What the Commission are proposing is a move away from full equalisation towards achieving partial equalisation, which in Victoria's view is movement away from equity.

The Commission has relied on an illustrative example used by the CGC to conclude that the current method brings states up to the fiscal capacity of the fiscally strongest state.

---

1 <http://www.saul-eslake.com/inequality-inefficiency-australias-system-horizontal-fiscal-equalization/#sthash.Pg1TU0Nz.dpbs>

However this is an illustrative representation of the outcome of HFE system, and does not accurately depict the process of HFE.

The Commission has taken this illustrative example out of context, and used it in their argument for equalisation to a 'reasonable standard', including consideration of equalisation to the second strongest state.

The proposed move to a 'reasonable standard' accepts the current system to determine the fiscal capacity of states, but then undoes a proportion of the equalisation to benefit the state(s) with the strongest fiscal capacity. This additional step currently lacks a clear conceptual basis, and treats one state differently to all others. If the Commission had issues with individual assessments, it would be more simple, equitable and efficient to deal with those issues directly rather than imposing an arbitrary global adjustment on top of the existing methodology.

The Commission provided a series of cameos to present theoretical inefficiencies in the current system, such as a stamp duty-land tax swap. However the Commission's proposed distribution methods do nothing to address these theoretical inefficiencies, with the incentives in a stamp duty-land tax swap remaining broadly unchanged.

The move to a 'reasonable standard' is an attempt to reduce volatility in a particularly fiscally strong state's GST revenue. However, this comes at the direct cost of equity, which is an unacceptable trade off.

The current volatility in Western Australia's GST share has come about as a direct result of additional royalty revenue from the mining boom. The Commission's Draft Report supports the full assessment of mining revenue, with Draft Finding 7.1 stating that "Removing mining from the HFE process, or the use of a discount factor within the mining assessment, is inequitable and not justified."

To remove the volatility of the mining boom is to remove a significant proportion of mining from the HFE process.

Volatility in a state's share of GST is not a problem to be removed, as it is offset by the volatility in that state's own revenue sources. The issue arises from the lagged nature of the HFE process, which the Commission agrees should be maintained.

Volatility is not the issue. It is sound budget management to deal with lagged equalisation. Fortunately for state governments, due to the lagged nature of HFE, GST shares are fairly predictable.

As the Draft Report rightly recognises,<sup>2</sup> Western Australia successfully forecast the steep drop off in GST well in advance, but chose to ignore the fiscal realities of the HFE system and make the unfounded assumption that the CGC would unexpectedly change the HFE system, abandon its current principle of HFE and provide Western Australia with pre-mining boom levels of GST. This did not eventuate, and consequently Western Australia has been under considerable fiscal strain from a lack of forward looking budget management.

The proposal to equalise to the second strongest state is essentially a floating floor for the strongest state, and always disadvantages all other states. This is despite the Commission recommending strongly against a floor for the GST distribution (Draft Finding 7.2).

The Commission find that the current HFE system is overly complex. There is a general consensus that simplicity is preferred where possible, including from the CGC itself.

---

2 Box 2, Productivity Commission Draft Report on HFE, pg 10

However there is a trade-off between simplicity and accurately reflecting what states do. The current Draft Recommendation to equalise to a 'reasonable standard' fails on both levels, deliberately undoing some of the accuracy that comes from the existing HFE system while adding further complexity, essentially adding another process on-top of the existing complex system.

The Draft Report also relies on international evidence to show that Australia's HFE system pursues equalisation beyond what other federations do, and, therefore, goes too far.

However this does not demonstrate a shortcoming of the current system, but rather an achievement in delivering HFE in a way that other countries have been unable to do, due in large part to political and historical barriers. Incomplete HFE systems in other countries are not evidence of their superiority.

Victoria agrees with the Commission that "There is a need to revisit the broader operating environment in which HFE takes place, and to renew efforts to reform federal financial relations in the broad."

As the Commission notes, the Commonwealth is increasingly attaching conditions to funding, constraining the manner in which states spend revenue. Such conditions have included matched funding requirements; onerous risk sharing where states bear all cost overrun risk; and maintenance of effort provisions that dictate to states how they will fund their services.

Imposition of these constraints limits states' policy and budget autonomy, and blurs accountability and transparency between levels of government. They also reduce the capacity for states to flexibly deliver services in accordance with local needs, and reduce the incentive to introduce innovation in the provision of services which may lead to long term efficiencies and improved outcomes.

In summary, while Victoria shares the Commission's views on many of the draft findings of the Draft Report, it cannot accept the conclusion the Commission has drawn regarding the HFE system, or proposals which appear at odds with many of its own findings. Victoria therefore cannot support the proposal of equalisation to the second-strongest state, or some alternative 'reasonable standard'.

This approach appears arbitrary, designed to address the point-in-time, fiscal concerns of one particular state and undermines the equity objective of HFE. It does little to improve the transparency, simplicity, economic efficiency, or equity of the current system, and may represent a worse alternative on all these counts.

## 2. Equalisation to a ‘reasonable standard’

The Draft Report finds that the HFE system is functioning reasonably well regarding the criteria of *equity*, an *independent and transparent process* and *stability*. Victoria welcomes this assessment and shares the Commission’s views in this matter.

The Draft Report also notes that Australia’s HFE system has typically been found to have little direct effect on national efficiency and growth. Chapter 6 of the Draft Report observes that the redistribution of revenue that arises from Australia’s HFE system is small in magnitude when compared to total government revenue for most jurisdictions, and that HFE would be expected to have little effect on an individual’s decisions to relocate to another state. No evidence is provided in the report that the current HFE system is having a negative impact on migration and productivity.

The Overview chapter also points out some areas in which the Commission felt the current HFE process was deficient, namely *policy neutrality*, the *simplicity and comprehensibility* of the current system and the claim that *equalisation is taken too far*. It is in response to these concerns that the current draft recommendation aims for *reasonable* rather than *full* equalisation (Draft Recommendation 2.1).

The potential issues raised under policy neutrality are areas of concern for all states. The theoretical issues surrounding the incentives for states exist and are well known. Importantly, however, the Commission found no direct evidence that the distribution of GST has influenced policy decisions. Further, it is inherent in any HFE system that equalises based on internal standards that there will be impacts of some kind on policy neutrality.

The Commission’s Draft Recommendation to equalise to a ‘reasonable standard’ rather than the current process does little or nothing to directly address these incentives. This is further discussed in section 3.

The finding that the current HFE system is overly complex is addressed in section 6. There is a general consensus that simplicity is preferred where possible, including from the CGC itself. However there is a trade-off between simplicity and accurately reflecting what states do. The current Draft Recommendation to equalise to a ‘reasonable standard’ fails on both levels, deliberately undoing some of the accuracy that comes from the existing HFE system while adding further complexity, essentially adding another process on-top of the complex system.

The claim that the current HFE system is deficient simply because it aims to equalise, or in the Commission’s words, “is taken too far”, is hard to justify. Equalisation implies that all states’ fiscal capacities are equal, and to deliberately aim for less than this is to move away from the principle of HFE. The Intergovernmental Agreement on Federal Financial Relations 2009, clearly states under Part 2, Objectives, that “federal financial relations is the improvement of the well-being of all Australians through... (f) the equalisation of fiscal capacities between States and Territories”.



## 2.1 The HFE system

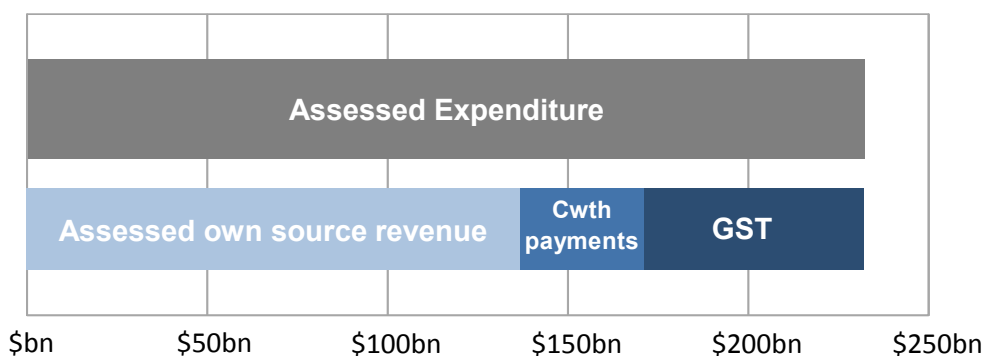
The Commission takes aim at the current HFE process because of the claim that it equalises to the fiscally strongest state. Throughout the Draft Report the Commission relies on the premise that states are equalised to the fiscally strongest state, using a conceptual three step process in which states are raised to the average fiscal capacity, then raised to the fiscal capacity of the fiscally strongest state with any remaining GST being distributed on an equal per capita (EPC) basis.

However this process has been adapted from an illustrative example used by the CGC as an alternative representation only.<sup>3</sup> It does not accurately represent the operation of the current HFE system and overlooks how the level of fiscal capacity is determined.

The actual process for achieving HFE is to ensure that each state has the fiscal capacity to provide services and the associated infrastructure at the same standard. For each state the process is to bring assessed revenue up to the assessed expenditure task (Figure 1).

Assessed own source revenue and expenditure are calculated by using the averages from what states actually do. In order to assess revenue equally across all states, the CGC seeks to calculate what states would raise if they put in the same revenue raising effort as other states. This is generally done by assessing each tax source and determining what the consistent tax base is in each state, and applying average state tax rates on these tax bases. Similarly the assessed expenses are calculated using the average expenditure on services, after adjusting for cost and use disabilities. Finally Commonwealth payments are added, leaving the gap as the GST requirement (Figure 1).

**Figure 1: HFE, Assessed expenditure and revenue**



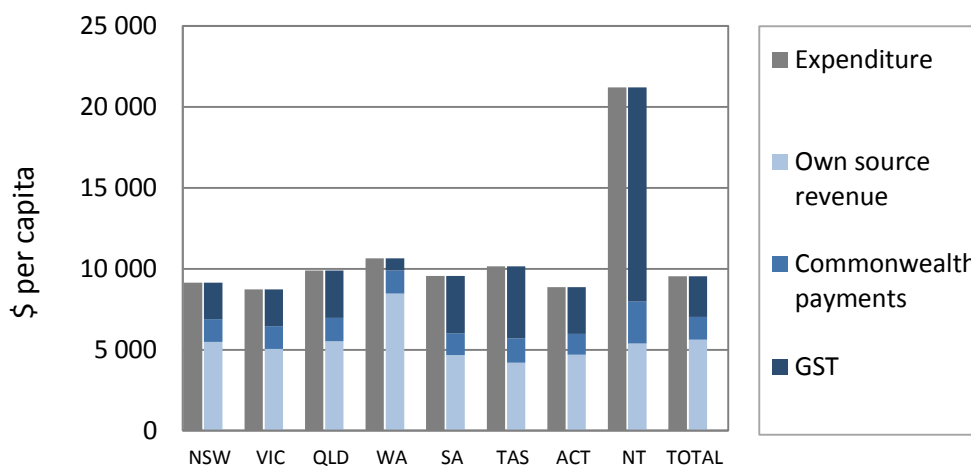
Source: Commonwealth Grants Commission 2017.<sup>4</sup>

3 Slide 14 from CGC presentation “Introduction to Fiscal Equalisation in Australia” [https://cgc.gov.au/index.php?option=com\\_content&view=article&id=258&Itemid=536](https://cgc.gov.au/index.php?option=com_content&view=article&id=258&Itemid=536) and 2017 Update, Table 1-10 pg 36.

4 CGC Slidepack, How the Commission does its Job. [https://www.cgc.gov.au/index.php?option=com\\_content&view=article&id=258&Itemid=536](https://www.cgc.gov.au/index.php?option=com_content&view=article&id=258&Itemid=536)

Looking at all the states concurrently on a per capita basis, each state has varying levels of need, and therefore varying levels of revenues with which to meet those needs (Figure 2).

**Figure 2: CGC example of assessed GST requirements per capita**



Source: Commonwealth Grants Commission 2017.<sup>5</sup>

It is clear from this example that the HFE process does not directly bring states up to the strongest states' fiscal capacity, but rather that each state receives the GST contribution required to bring its total revenue up to its assessed expenditure needs.

The illustrative example presented by the CGC in the 2017 Update is an alternative way of presenting the outcome from the HFE process.<sup>6</sup> It illustrates that the current outcome can be visualised as bringing states to the fiscal capacity of the strongest state before it receives its GST requirement, and then providing this per capita GST share to all states in order to bring all the states up to the GST required to meet assessed expenses.<sup>7</sup>

5 CGC Slidepack, How the Commission does its Job. [https://www.cgc.gov.au/index.php?option=com\\_content&view=article&id=258&Itemid=536](https://www.cgc.gov.au/index.php?option=com_content&view=article&id=258&Itemid=536)  
 6 CGC 2017 Update Report, Table 1-10 page 36  
 7 CGC 2017 Update Report, Table 1-10 page 36

In this alternative presentation, the fiscally strongest state is defined as the state with the lowest GST requirement after achieving full equalisation (Table 1). The illustrative example for 2017-18 (Table 2) presents this as taking Western Australia's per capita GST share off all states' GST requirement, leaving a notional "equalisation requirement" - which is the amount required to bring all states up to the same fiscal capacity as Western Australia (resulting in a shortfall in fiscal capacity of \$878 per capita compared to assessed expenses – the shortfall between assessed revenue and assessed expenses experienced by WA). \$878 per capita is then provided EPC to all states, bringing states up to the point at which each state's revenue equal assessed expenses.

It is important to note that this is not the process used to distribute GST, and the illustration is only one way of presenting the outcome achieved by bringing each state up to the point at which total revenue is equal to assessed expenses.

**Table 1: CGC GST distribution, 2017-18**

GST distribution (\$ per capita)									
	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
<b>GST</b>	2,235	2,377	3,028	878	3,671	4,601	3,046	11,881	2,543
Ranking of fiscal strength	2	3	4	1	6	7	5	8	

Source: 2017 Update and DTF calculations

**Table 2: Equalisation to the strongest state illustration, 2017-18**

GST distribution (\$ per capita)									
	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Equal per capita	878	878	878	878	878	878	878	878	878
Equalisation requirement	1,357	1,499	2,150	0	2,793	3,723	2,169	11,003	1665
Per capita allocation	2,235	2,377	3,028	878	3,671	4,601	3,046	11,881	2,543

Source: 2017 Update, Table 1-10

Using the same illustrative process and equalising to the second strongest state yields the following result (Table 3). Importantly, the GST requirements remain the same and this holds true regardless of what state you chose to equalise to.

**Table 3: Equalisation to the second strongest state representation, 2017-18**

GST distribution (\$ per capita)									
	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Equal per capita	2,235	2,235	2,235	2,235	2,235	2,235	2,235	2,235	2235
Equalisation requirement	0	142	793	-1,357	1,436	2,366	811	9,646	307
Per capita allocation	2,235	2,377	3,028	878	3,671	4,601	3,047	11,881	2543

Source: 2017 Update and DTF calculations

The Commission has distorted the CGC's illustrative example to come up with a new process that brings all states other than the fiscally strongest state to the fiscal capacity of the second strongest state. Here the strongest state (Western Australia) retains a GST share that enables it to have a fiscal capacity above that of the second strongest state, and therefore all other states (Table 4). The process is no longer an alternative way of presenting the results of the existing HFE process, but a proposed method to adjust the results and redistribute GST away from most states and towards the strongest state.

In order to achieve this, the equal per capita amount provided to all states at the end of the process has been reduced (from \$2,235 to \$2,088). This is to make up for Western Australia's fiscal capacity not being brought down to the same level as the rest of the states (the fiscal capacity of the second strongest state, NSW, which would require a deduction of \$1,357 in GST per capita from Western Australia and into the pool for redistribution). This results in states' fiscal capacities no longer being equalised, the effects of which are discussed further in Section 2.2.

**Table 4: Commission's equalisation to the second strongest state**

GST distribution (\$ per capita)									
	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Equal per capita	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2088
Equalisation requirement	0	142	793	0	1,436	2,366	811	9,646	455
Per capita allocation	2,088	2,230	2,880	2,088	3,524	4,454	2,899	11,734	2543

Source: 2017 Update, Productivity Commission and DTF calculations

The Commission uses a less intuitive three stage process in which the weaker states are first brought to the average before being equalised to the second strongest state. However, this is conceptually the same process as has already been described, and the results above have been recreated in Table 5 using the three step process.

**Table 5: HFE using a three stage process, 2017-18**

GST distribution (\$ per capita)									
	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
<b>Current methodology</b>	2,235	2,377	3,028	878	3,671	4,601	3,047	11,881	2,543
Ranking of fiscal strength	2	3	4	1	6	7	5	8	
<b>Equalisation to second strongest state representation, DTF calculations</b>									
Amount above an EPC									
share	0	0	485	0	1,129	2,059	504	9,338	321
Bring to second strongest	0	142	307	-1,357	307	307	307	307	-14
EPC balance	2,235	2,235	2,235	2,235	2,235	2,235	2,235	2,235	2,235
Total	2,235	2,377	3,028	878	3,671	4,601	3,047	11,881	2,543
<b>Commission's equalisation to second strongest state</b>									
Amount above an EPC									
share	0	0	485	0	1,129	2,059	504	9,338	321
Bring to second strongest	0	142	307	0	307	307	307	307	134
EPC balance	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2,088
Total	2,088	2,230	2,880	2,088	3,524	4,454	2,899	11,734	2,543

Source: Productivity Commission, CGC 2017 Update and DTF calculations.

In conclusion, it is only accurate to say that at the end of the current HFE process all states have the same level of fiscal capacity, that is to say, given similar revenue raising efforts across states each has funding to provide a similar level of services to its population.

The illustrative example used by the CGC has been taken out of context by the Commission, and does not accurately reflect the reality of how the GST requirement is calculated to bring states' revenues up to their assessed expenses.

Instead of addressing individual assessments that make up the GST requirement calculation, the Commission has opted to apply a macro level readjustment after equalisation that essentially undoes equalisation in a manner that benefits those states that have the greatest ability to meet their own expense needs. This goes against the stated objective of the IGA FFR to improve the well-being of all Australians through the equalisation of fiscal capacities between states.

## 2.2 Equalisation to a ‘reasonable standard’

Achieving HFE is a theoretical exercise, as the true costs and revenue raising capacity of states can never be fully known, and no perfect external standard of state policies and taxation rates exist.

The current process can be considered *equalisation to a ‘reasonable standard’*, with the standard being set by the average of what states currently do, adjusted for material disabilities. There are many other alternatives that can be argued to equalise to a ‘reasonable standard’, such as using global revenue measures or using external standards to determine to what standard states should be equalised. However, the Commission agrees with the Victorian view that these solutions are inferior to the current system.

By referring to alternative proposals as reasonable standards the Commission is implying the current standard is unreasonable, an assertion that Victoria rejects. What the Commission are proposing is a move away from full equalisation towards achieving partial equalisation.

The solutions proposed by the Commission for achieving a ‘reasonable standard’ lack coherence and are inequitable. On the one hand the Commission displays a broad acceptance for both assessed expenditure and revenue methodologies, and rejects calls for global revenue measures, external standards, discounting for mining revenues or a relativity floor. Yet on the other hand the Draft Report concludes that the HFE process “goes too far” and seeks the imposition of a system that is analogous to many of the methods the Commission explicitly rejected.

The proposal to equalise to the second strongest state is essentially a floating floor for the strongest state, and always disadvantages all other states. This is despite the Commission recommending strongly against a floor for the GST distribution. Draft Finding 7.2 states that:

“The introduction of a minimum relativity floor would blunt extreme equalisation outcomes and might theoretically introduce greater incentives for States to pursue development opportunities. But a floor will likely prove a band-aid solution as it does not address the identified deficiencies of HFE, and may even introduce greater complexity and unpredictability into the HFE system.”

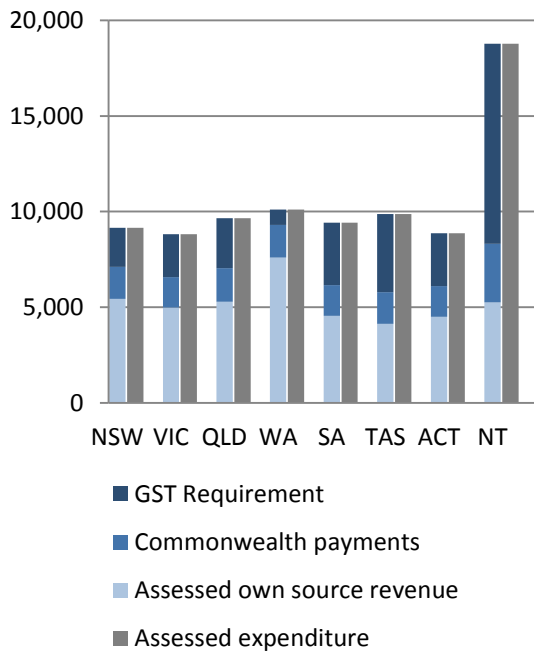
The proposal to equalise to the second strongest state or the average of the states is inconsistent with Draft Finding 7.2 on the suggestion of implementing a floor, and is even more complex and inequitable than a straightforward floor. While a floor would only come into effect in “extreme circumstances” the proposals outlined by the Commission would corrupt the existing HFE process in each and every year.

Equalising to the average state option is difficult to grasp conceptually, and is a two stage process that provides the weaker states (those who currently receive more than EPC) their original distribution above an EPC distribution, and then redistributes whatever is left to all states EPC. This effectively undoes a proportion of the equalisation and benefits the state(s) with the strongest fiscal capacity. If the Commission has issues with the current revenue assessment, it would be more simple, equitable and efficient to deal with those issues directly rather than imposing a global adjustment to the existing methodology for which there is no conceptual case.

Modelling to compare what HFE would look like under equalisation to the second strongest state shows the inequality of the current suggestion. Using data from the CGC 2017 Update, the HFE outcomes for the single year 2014-15 are illustrated in Figures 3 and 4. This example has evaluated a single year only, and has removed the averaging from the process. 2014-15 has been selected as it is the middle year in the current assessment for the 2017-18 GST distribution.

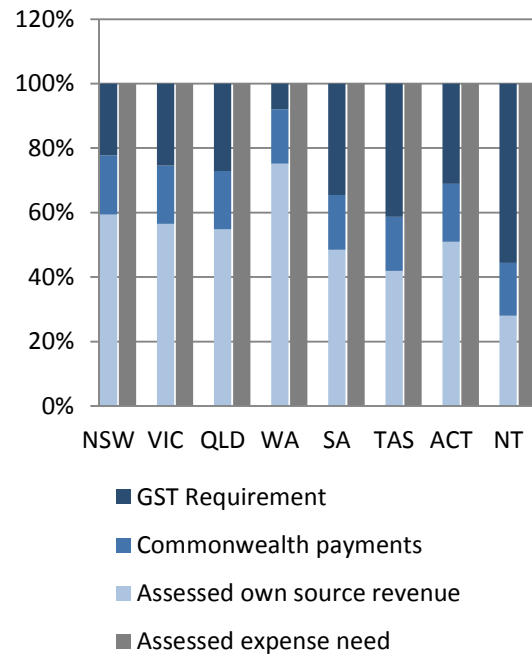
Each state has differing levels of need, and revenue has been provided in a manner consistent with enabling states to have equal capacity to meet their different needs. Figure 4 shows that each state has the same revenue as their assessed expenses.

**Figure 3: HFE requirements, 2014-15  
\$ per capita**



Source: DTF calculations based on Commonwealth Grant's Commission 2017 Update.

**Figure 4: Ratio of revenue to expenditure, 2014-15**

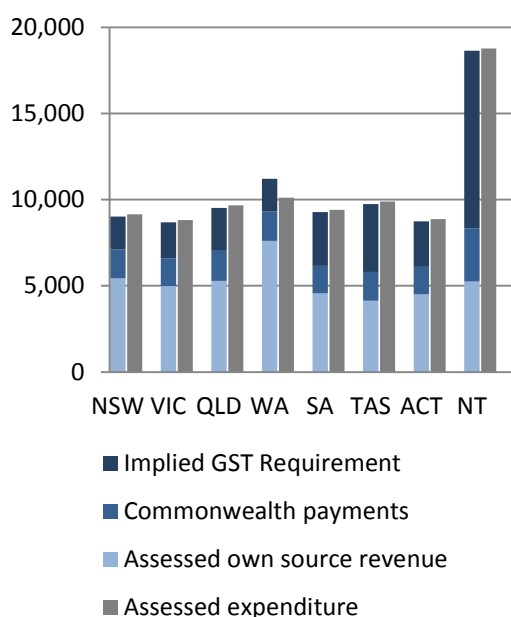


Source: DTF calculations based on Commonwealth Grant's Commission 2017 Update.

Using the same methodology and applying the proposed approach to equalise to the second strongest state produces the outcomes depicted in Figures 5 and 6. These clearly show that Western Australia now has excess fiscal capacity while other states and territories' fiscal capacity is below their assessed expenses.

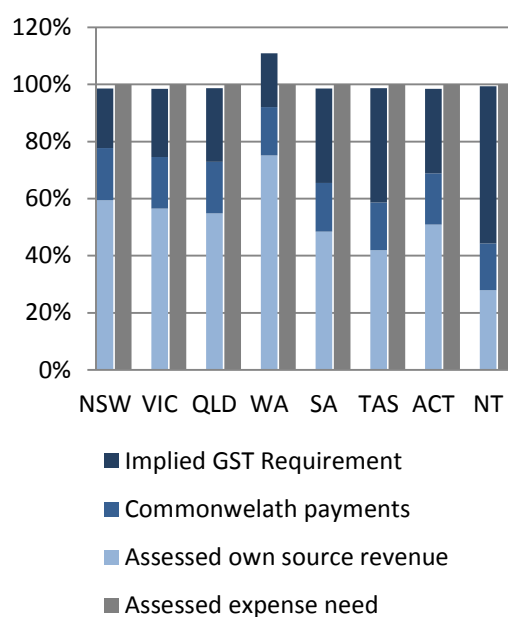
For the 2014-15 year the GST requirement for Western Australia is now \$1098 higher than their assessed expenses per capita, while all other states are short of their assessed expenses by \$135 per capita.

**Figure 5: HFE requirements adjusted to equalise to the second strongest state, 2014-15 - \$ per capita**



Source: DTF calculations based on Commonwealth Grant's Commission 2017 Update.

**Figure 6: Ratio of assessed revenue to expenditure, adjusted to equalise to the second strongest state, 2014-15**



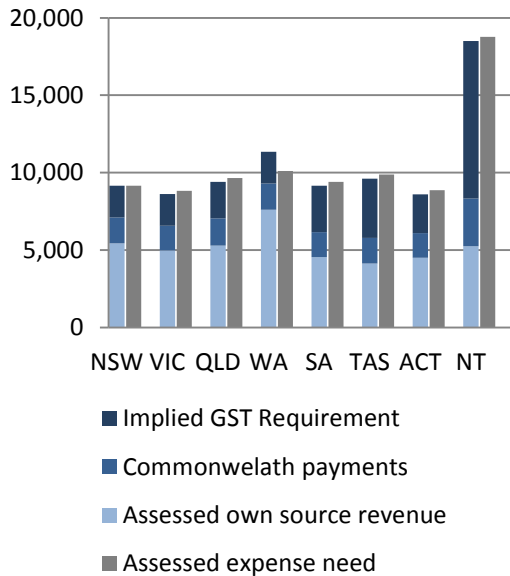
Source: DTF calculations based on Commonwealth Grant's Commission 2017 Update.

The inequality from moving to a second strongest state approach is exacerbated by moving to the average of the states. Figures 7 and 8 show the even greater inequality in the fiscal capacities of states from equalising to the average of the states, with revenues ranging from 112 per cent (WA) to 97% (QLD) of assessed expenses.

For the 2014-15 year the GST requirement for Western Australia is now \$1,234 higher than their assessed expenses per capita, while the fiscally weaker states are \$263 short of their assessed expenses per capita, with Victoria \$203 short and NSW left practically equal with their assessed expenses.

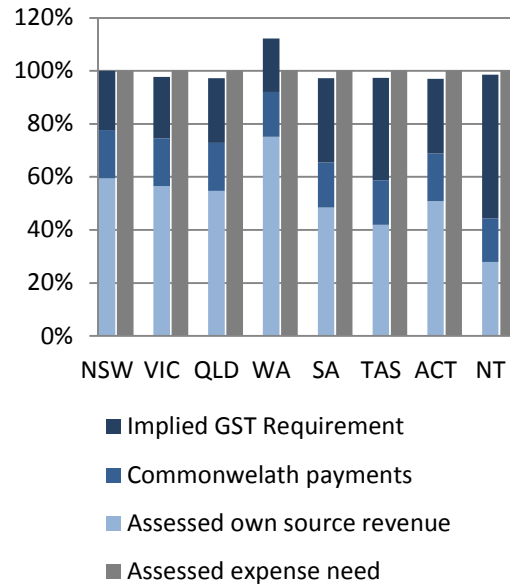


**Figure 7: HFE requirements adjusted to equalise to the average of states, 2014-15 \$ per capita**



Source: DTF calculations based on Commonwealth Grant's Commission 2017 Update.

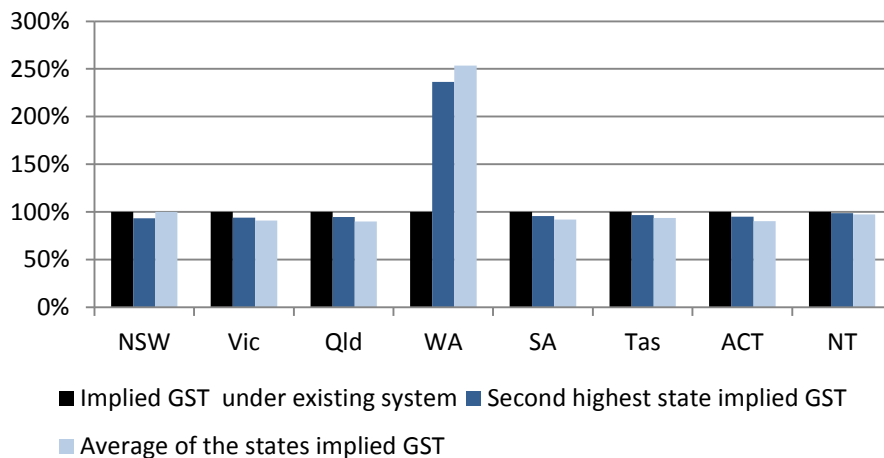
**Figure 8: Ratio of assessed revenue to expenditure, adjusted to equalise the average of states, 2014-15**



Source: DTF calculations based on Commonwealth Grant's Commission 2017 Update.

Figure 9 isolates the variation in GST requirements under the previous scenarios for each of the states. It is clear that there is now a significant shortfall in the GST required in order to meet assessed expenses for most states under the alternative options, with the main beneficiary being Western Australia who receives significantly more GST than required in order to meet their assessed expenses.

**Figure 9: Ratio of GST required to meet assessed fiscal requirements, and implied GST requirements under the three alternate systems, 2014-15.**



Source: DTF calculations based on Commonwealth Grant's Commission 2017 Update.

The Draft Report models the change in the GST distribution from a move to the second strongest or the average of the states standard for 2017-18 (Tables C.2 and C.3). A summary of these tables are presented in Table 6.

**Table 6: Difference in GST between the current and proposed HFE methodologies to equalise to the second strongest and average of states, 2017-18**

\$ million	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
<b>Second Strongest</b>	-1,167	-920	-792	3,244	-256	-77	-60	-36
<b>Average</b>	-110	-972	-1,588	3,602	-557	-168	-130	-79

Source: Productivity Commission Draft Report on HFE.

## 2.3 Volatility and mining royalty revenue

What the draft recommendation to move to a 'reasonable standard' attempts to achieve is a reduction in volatility in the strongest fiscal state's (or states') GST revenue, particularly the options of equalising to the second strongest state. However, this comes at the direct cost of equity. The current large decrease in Western Australia's GST share has come about as a direct result of the mining boom. The Commission notes that the current method means that in such a boom the redistribution task is considerable, and the standard being equalised to is potentially volatile.

However, the Commission also makes strong statements in support of assessing mining revenue, and the importance of including it in the HFE process. Draft Finding 7.1 states that:

“Removing mining from the HFE process, or the use of a discount factor within the mining assessment, is inequitable and not justified. However, there is a need to consider potential improvements in the assessment method in light of problems with policy neutrality.”

As already outlined in Victoria's original submission, the conceptual economic argument for fully equalising on immobile revenue bases (such as natural endowments in minerals and land) is particularly strong.

Absent the equalisation process, states that have larger immobile revenue bases such as minerals and land are able to raise more revenue from sources such as mineral royalties and land tax. This allows these states to reduce taxes on more mobile factors and/or increase the level of services, thereby offering a more appealing tax-government services bargain to labour and capital located in other jurisdictions. This has the potential to induce an economically inefficient flow of capital and labour across states as migration may not be towards where those factors of production are the most productive.

Comprehensive equalisation of revenue sources is key to achieving the objective of HFE, which seeks to compensate states for factors beyond their control. Given that the location of mineral resources cannot be influenced by any individual or government, and that state boundaries are relatively arbitrary, it is entirely consistent with HFE that mineral royalties revenue is equalised.

Western Australia argue in their submission that “from 1942-43 to 2012-13, no state had ever had a relativity below 63%. However, Western Australia’s relativity has now remained below 38% for four years.”<sup>8</sup> This is indisputable, but as Saul Eslake points out, what is also unprecedented is Western Australia’s revenue-raising capacity relative to other states.<sup>9</sup>

To remove the volatility of the mining boom is to remove a significant proportion of mining royalty revenue from the HFE process. This seems inconsistent with the Commission’s own advice that mining revenue must be part of the HFE process.

Volatility in a state’s share of GST is not a problem to be removed, as it is offset by the volatility in that state’s revenues. The problem arises from the lagged nature of the HFE process, which the Commission agrees should be maintained.

Volatility in a state’s share of GST is not the issue then, but rather sound budget management to deal with lagged equalisation. Fortunately for state governments a state’s share of the GST is fairly predictable due to the lagged nature of HFE, making volatility in a state’s share of the GST an invalid reason to change the HFE system. This is covered in more detail in Section 4 on HFE and state budgeting.

#### *Commonwealth intervention in state mining policy*

As outlined in Victoria’s first submission to the inquiry, Victoria rejects intervention by the Commonwealth Government in resources policy via the currently independent assessment of resource revenues by the CGC.

This would represent unprecedented Commonwealth government intervention in state policy – which would undermine state accountabilities to their constituents, and may reduce the capacity for sovereign state governments to balance potential economic gains of extracting non-renewable natural resources against other economic and policy considerations. Doing so undermines economic efficiency as it encourages states to consider and implement policies based on short-term financial incentives rather than broader, long-term, economic, social and environmental benefits.

Victoria welcomes the Commission’s finding that making adjustments to the HFE system specifically to add incentives for resource exploration policies that are deemed to be desirable would be an intentional breach of policy neutrality and State autonomy; be a source of additional complexity; and come at the expense of equity.

## **2.4 Long term effects of a move to the proposed ‘reasonable standard’.**

Attempting to solve a volatility problem by moving to the proposed ‘reasonable standard’ approach will also have significant and material effects on states under what is traditionally considered “normal” conditions (that is those years in which the relativities are more compressed), preventing proper HFE from being achieved. This is an inevitable consequence of reacting to the larger redistribution task due to Western Australia’s increase in own source revenue as a result of the mining boom.

Figures 10-13 illustrate the proposed changes for the single year 2004-05 year using the same method as in Section 2.2. Tables 7 and 8 show the changes in GST requirements for

---

8 Government of Western Australia, 2017b page 9

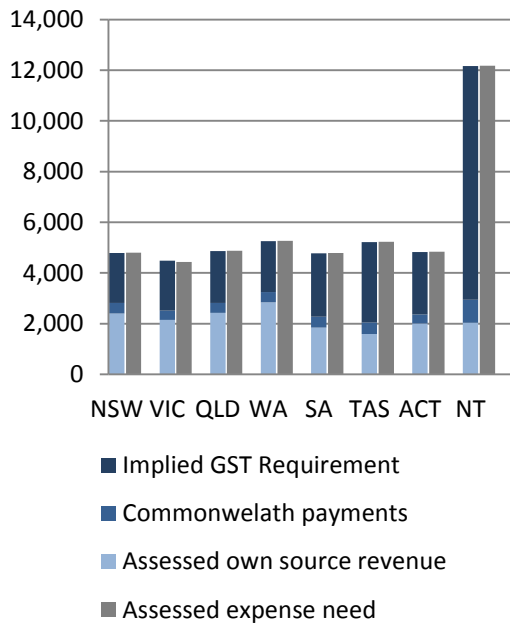
9 <http://www.saul-eslake.com/inequality-inefficiency-australias-system-horizontal-fiscal-equalization/#sthash.Pg1TU0Nz.dpbs>

that year. Charts are not included for the existing HFE system, but would show that each state's fiscal capacity would be equal to its assessed expenditure as per charts 3 and 4.

While the effects are minor in the equalisation to the second strongest state scenario, it still sees a windfall gain of over \$200 million to Victoria, the strongest state at the time. Under the equalisation to the average proposal, the outcome is much more inequitable, with an additional ~\$400 million flowing to Victoria in GST, and ~\$150 million to NSW. The bulk of this would come from the fiscally weaker states South Australia and Queensland.

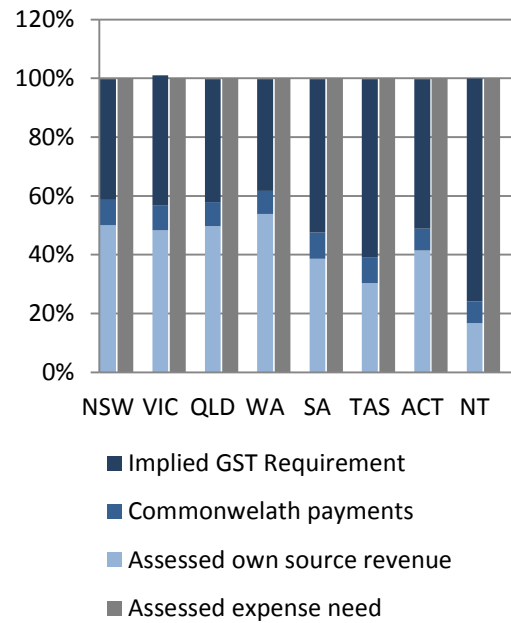
There seems no merit in creating a more inequitable system for the long term in order to deal with the fallout from the divergent relativities and associated budget challenges from of a once-off event that is now almost behind us.

**Figure 10: HFE requirements adjusted to equalise to second strongest state, 2004-05, \$ per capita**



Source: DTF calculations based on Commonwealth Grant's Commission 2006 Update.

**Figure 11: Ratio of assessed revenue to expenditure, adjusted to equalise to the second strongest state, 2004-05**



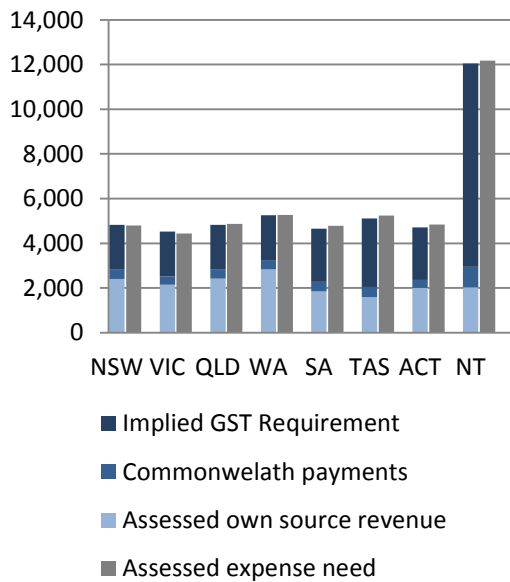
Source: DTF calculations based on Commonwealth Grant's Commission 2017 Update.

**Table 7: Outcome for GST distribution based on 2004-05 assessment year, adjusted to equalise to second strongest state**

\$ million	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
<b>GST before treatment</b>	13,282	9,500	7,892	3,968	3,839	1,529	800	1,837
<b>GST after treatment</b>	13,186	9,716	7,837	3,940	3,817	1,522	795	1,834
<b>Difference</b>	-96	215	-55	-28	-22	-7	-5	-3

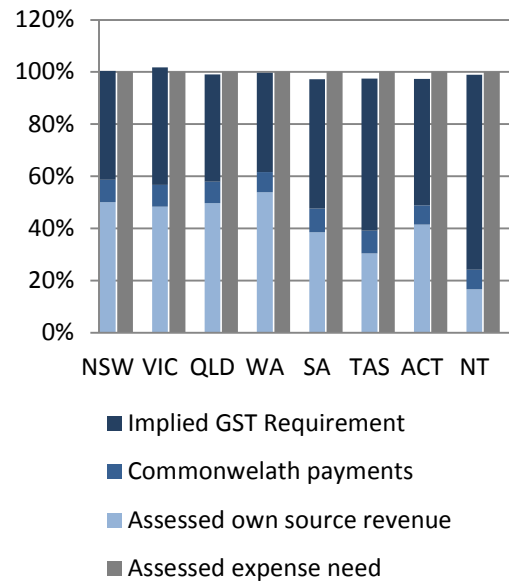
Source: DTF calculations based on Commonwealth Grant's Commission 2006 Update.

**Figure 12: HFE requirements adjusted to equalise to the average of states, 2004-05 \$ per capita**



Source: DTF calculations based on Commonwealth Grant's Commission 2006 Update.

**Figure 13: Ratio of assessed revenue to expenditure, adjusted to equalise to the average of states, 2004-05**



Source: DTF calculations based on Commonwealth Grant's Commission 2006 Update.

**Table 8: Outcome for GST distribution based on 2004-05 assessment year, adjusted to equalise to the average of states**

\$ million	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
<b>GST before treatment</b>	13,282	9,500	7,892	3,968	3,839	1,529	800	1,837
<b>GST after treatment</b>	13,431	9,897	7,707	3,937	3,640	1,466	758	1,811
<b>Difference</b>	150	396	-185	-32	-199	-62	-42	-26

Source: DTF calculations based on Commonwealth Grant's Commission 2006 Update.

## 2.5 International comparisons

The Draft Report also relies on international evidence to show that Australia's HFE system pursues equalisation beyond what other federations do, and therefore goes too far. However, the Draft Report clearly notes that:

“horizontal equalisation arrangements in other countries are inextricably linked to their particular distribution of authority to collect taxes, legal and constitutional allocation of responsibilities for the provision of public services, and to federal–state government agreements to provide shortfall funding as appropriate.”<sup>10</sup>

In Victoria's view Australia has overcome many of the political and institutional barriers that hinder other OECD countries from achieving full equalisation. Many countries that do not equalise do so for political and historical reasons. Setting up a system which redistributes money between states is difficult to gain consensus for and to implement. Simply because Australia is the only OECD country to achieve full equalisation is not an argument for the current system to be pared back to a partial equalisation system like other OECD countries.

Rather, the current full equalisation system should be seen as an achievement from using GST tax reform as a means to achieve true horizontal fiscal equalisation in a way that other countries have been unable to do, due in large part to political and historical barriers.

## 3. Efficiency and incentives in HFE

### *No evidence that the current system impedes productivity*

As highlighted in Victoria's initial submission, and as found by the Commission itself in its Draft Report, there is little evidence that HFE has impeded productivity and economic growth.

Given this lack of evidence, it is surprising that the Commission has recommended a substantial departure from the current distribution mechanism, whereby GST funds would be distributed based on some arbitrarily determined 'reasonable standard'.

The Commission's Draft Report estimated the financial impact of its proposal could be up to \$1 billion per year for some states. Such a major change should be supported by robust empirical evidence, which has not been presented.

### *Conceptual case is flawed*

The Commission recommendation of 'reasonable' rather than full equalisation appears to be based entirely on the conceptual argument that the current system penalises states that undertake certain reforms – the Commission uses a switch from stamp duties to land tax as an example (Box 3, Draft Report).

Victoria notes that the figures presented by the Commission are heavily inflated by the application of tax elasticities to stamp duty cuts – this has the effect of inflating the stamp duty base for a jurisdiction that cuts stamp duty. Such a jurisdiction is then taken to have a

---

10 Productivity Commission Draft Report on HFE, pg 10

higher capacity to raise stamp duties, and is therefore, 'penalised' under the current distribution system.

The use of elasticities in the cameos is misleading – tax policy costings estimates generally do not incorporate behavioural impacts. This is because an accurate point estimate of elasticities usually cannot be obtained. Additionally, the use of elasticities can be highly contentious and subject to misuse, whereby 'Laffer Curve' effects are presented where tax cuts are estimated to increase tax revenue. Given this, the cameos presented in Box 3 of the Draft Report are not representative of how tax policy costings information is generally presented to decision makers.

Victoria has re-estimated the potential GST impact on Victoria of a partial, 50 per cent, unilateral switch from stamp duty to land tax, as used in the Commission's cameos. Victoria estimates a GST requirement impact of around +\$10 million for 2017-18, assuming no elasticity effects, which shows that even at a conceptual level, there are no GST impediments to such a reform. This is substantially lower than the Commission estimated GST impact of up to -\$1.1 billion for 2017-18, at the upper bound.

Importantly, Victoria has also estimated the potential GST impact of the switch from stamp duty to land tax if the Commission's proposed method of GST redistribution was adopted (redistribute GST funds to give all but the strongest state the same fiscal capacity as the second-strongest state, and distribute the remaining funds on an equal per capita basis). It shows that had the proposal been in place, the GST impact of such a reform would be around +\$3 million (see Table 9). This clearly illustrates that:

1. The negative GST impact of a stamp duty-land tax swap under the current method of GST redistribution is negligible, particularly in the context of the significant economic benefits of such a reform (cutting stamp duty by 50 per cent reduces stamp duty revenue by around \$3 billion per year); and
2. The negative GST impact of a stamp duty-land tax swap under the Commission's proposal is around the same as under the current distribution method. Therefore, the Commission's proposed distribution method does not address theoretical inefficiencies that it has identified in the current methodology.

**Table 9:** Estimated 2017-18 GST requirement impact of cutting stamp duty by half, and replacing with broad based land tax for Victoria (policy change assumed to occur in 2015-16).

Methodology	Estimated 2017-18 GST impact
Productivity Commission (incl. upper bound elasticity effects) – current GST distribution methodology	Up to -\$1,120m
Victorian calculation (no elasticity effects) – current GST distribution methodology	+\$10m
Victorian calculation (no elasticity effects) – equalisation to the second-strongest state	+\$3m

Source: Productivity Commission Draft Report on HFE and DTF calculations.

### *Reduced equalisation could harm economic efficiency*

The Draft Report acknowledged that fiscal equalisation promotes economic efficiency by reducing fiscally-motivated, economically inefficient interstate migration.

Reducing the scale of equalisation, as the Commission has proposed, blunts the positive economic effects of equalisation. This is particularly the case in the current and foreseeable environment, where fiscal differences between some states are largely driven by minerals royalties.

Victoria highlights that states that have larger immobile revenue bases such as minerals and land are able to raise more revenue from sources such as mineral royalties and land tax. Without full equalisation, this allows these states to reduce taxes on more mobile factors and/or increase the level of services, thereby offering a more appealing tax-government services bargain to labour and capital located in other jurisdictions. This has the potential to induce an economically inefficient flow of capital and labour across states as migration may not be towards where those factors of production are the most productive.

Full equalisation, therefore, is the most appropriate method of redistribution to promote economic efficiency and growth. Any move away from this, such as those proposed by the Commission, can distort economic efficiency.

## **4. HFE and state budgeting**

Victoria broadly agrees with the Commission's findings with respect to how HFE affects state budget management.

Victoria's initial submission highlighted that the stability and predictability of revenue that is imbedded in the current three-year assessment period and two-year lag system outweighs contemporaneity concerns, particularly as short-term gaps in revenue can be addressed through borrowings. Given state governments' responsibility for delivering essential services such as hospitals, schools and public safety, it is more important that revenue over the medium and long term is predictable, such that any structural revenue issues that could affect service delivery can be addressed through the budget planning process.

It is also welcome that the Commission has acknowledged Western Australia's current GST relativities were foreseen during the height of the mining boom. As Victoria and other states have pointed out, Western Australia's current fiscal position is not the result of how GST is distributed, but of budget management. The Western Australia State Government was fully aware of the future GST impacts of strong growth in its royalties revenue.<sup>11</sup> Yet, it continued to increase government expenditure at unsustainable rates, based on the assumption that a GST relativity floor of 0.75 would be introduced.<sup>12</sup>

Any substantial change to the current distribution mechanism that increases GST funds to Western Australia would only serve to reward and encourage poor budget management.

---

11 Victorian Government submission to the PC on HFE, charts 4-7, pg 13; Western Australian Budget Papers Box 2, Productivity Commission Draft Report on HFE, pg 10



In summary, due to the lagged nature of the current HFE system, volatility in GST payments does occur but is predictable, can be budgeted for and is not a reason to change the HFE system. Rather it is up to states to manage their budgets accordingly.

The weakness in the lagged system is where there is a structural trend that would result in a permanent benefit (if an upward trend) or loss (if a negative trend) to the state experiencing the structural trend. Since the introduction of the current lagged averaging process, the only observed structural trend has been a broad upward trend in mining revenues. As at 2015, the CGC estimated this change has provided around \$7 billion more in GST revenue to WA than if fully contemporaneous assessments had been in place.<sup>13</sup> Unless iron ore prices revert to levels observed prior to the boom, this will represent a permanent benefit to WA as the lagged approach will not compensate this underestimation of revenues and reclaim previous overprovision of GST revenue.

Victoria also notes that since 2014-15, the Commonwealth Government has provided over \$1.2 billion in payments for infrastructure projects to Western Australia which have been quarantined from the HFE process in order to help make up for their low GST share.

## 5. Alternative options for HFE

It is Victoria's position that the current HFE framework has, broadly, served Australia well, and will continue to do so for the years to come. This is because much of the framework has been designed using a principles-based approach.

As demonstrated in Victoria's initial submission, Victoria has also attempted to undertake a principles-based approach in considering approaches to HFE, moving away from the self-serving advocacy that has plagued much of the debate in this area.

For example, despite being financially lucrative, Victoria argued in its initial submission that an EPC approach will not meet the equity objective of HFE and will not be feasible, unless the Commonwealth Government intervenes to provide additional funds to fiscally weaker states. The Draft Report echoes this.

However, even when viewed through an objective lens, Victoria cannot accept the Commission's proposal of equalisation to the second-strongest state or some alternative 'reasonable standard'.

This approach appears arbitrary, designed to address the point-in-time, fiscal concerns of one particular state, undermining the equity objective of HFE. It does little to improve the transparency, simplicity, economic efficiency, or equity of the current system, and may represent a worse alternative on all these counts.

Victoria's views on the issue have largely been addressed in Section 2 of this submission. Nevertheless, it is worth highlighting that the proposal appears to contradict the Commission's own views on other proposed interventions which the Commission have rejected.

---

13 CGC 2015, *GST Shares in the Presence of Large and Volatile State Revenues*, p.8

For example, the Commission correctly identifies the arbitrariness and equity issues associated with mining revenue discounts and relativity floors. Yet, its proposal effectively puts in place a moving relativity floor for the fiscally strongest state(s), in apparent response to WA's fiscal strength, driven by minerals royalties.

Victoria supports the current, principles-based HFE framework.

## 6. Complexity and comprehensibility

There has been substantial public commentary and discussion on the complexity of the HFE framework. The Commission argues that the complexity of the current system has led to the system being “poorly understood by the public, and even by many within government”.

It is Victoria's view that the basic concept of the current HFE framework is not complex – it seeks to equalise the fiscal capacities of all jurisdictions through GST funds, given the revenue bases and expense obligations and disabilities of each state.

While the actual assessment of individual expense and revenue categories involve more complexity, this is not a level of detail that the public would ordinarily be expected to access without some background knowledge. Certainly, few members of the public would understand the complexities behind bilateral Commonwealth-state funding agreements and all the conditions that are often attached to such arrangements.

While Victoria supports the principle of simplifying assessments, this needs to be balanced with potential compromises of fiscal equity. For example, service costs by sub-state regions may represent a significant point of difference between states. Therefore, while collecting data and assessing expenses based on multiple sub-state regions is complex, it brings us closer to objective of HFE.

Importantly, the worthy equity objective of HFE and the basic concept of its operation has often been tainted by the highly political nature of debate around the issue. For example, the current distribution mechanism is working as designed and redistributing GST to fiscally weak states given the strong fiscal position of WA during the mining boom. Yet, because of this, the HFE has been variously labelled as “unfair”<sup>14</sup> and “broken”<sup>15</sup>, with non-mining states being accused of “free riding”<sup>16</sup>. Such rhetoric only serve to distort the true purpose and operation of Australia's HFE framework. Given this, Victoria supports the Commission's views that the CGC take a more prominent role in public communication and education on HFE.

---

14 NSW Treasury Media Release - GST: Real Reform Needed to Give NSW a Fair Share 03 August 2017

15 NSW Treasury Media Release - GST Review Must Give NSW Taxpayers their Fair Share 30 April 2017

16 WA Treasurer from ABC article: GST reform: WA would keep half of mining royalty increases under Commonwealth plan <http://www.abc.net.au/news/2017-09-29/wa-hopes-for-more-gst/8998816>

## 7. Governance and accountability

As part of Draft Recommendation 2.1, the Commission recommends that the objective of HFE should be reflected in the terms of reference to the CGC, and also be included in the Intergovernmental Agreement of Federal Financial Relations.

The IGA FFR 2009 follows on from a series of agreements going back to the original agreement signed by the Premiers, Chief Ministers and Prime Minister at the 1998 conference. All agreed that the GST should be distributed on the basis of horizontal fiscal equalisation principles, or as the IGA FFR puts it, in “accordance with the principle of horizontal fiscal equalisation”.

As already touched on, the IGA FFR also states that one of the Objectives is the equalisation of fiscal capacities between states.

There is therefore no reason to go back and further refine the way in which the GST should be distributed. As already outlined, the current proposals to equalise to the second strongest state, or the average of the states, are not themselves consistent with the principle of equalisation, as it results in outcomes that are by their very nature, unequal. It is unlikely that all states would agree to a new objective for HFE that is sure to materially diminish the fiscal capacity of at least half the states and territories.

Further, it would be inappropriate for the Commonwealth Government to write into the CGC Terms of Reference to change the way that HFE is interpreted without the consent of all states.

While Victoria does not agree with the changes proposed by the Draft Report, any future changes to the current system should go to the Council of Australian Governments and be agreed by all states, as well as the Commonwealth. Implementation should be done through the next available 5 yearly methodology review performed by the CGC, with the CGC to inform the best transition path, following consultation with the states.

Due to the lagged and averaged nature of the current system, a sudden change in methodology may stop the current averaging process mid-cycle, representing inequitable benefits and losses to states as the lagged revenue and expenses will no longer be corrected in future assessments. It is important to ensure that states are not unduly benefited or harmed by changes in methodology.

Victoria agrees with the Draft Recommendation 7.2, that the Commonwealth needs to develop clear guidelines detailing the basis on which Commonwealth payments are to be quarantined from HFE by the Commonwealth Treasurer, and that these guidelines should be based on the principle that quarantining of payments ought to occur only in exceptional circumstances.

As outlined in our original submission, Commonwealth exclusions from the CGC HFE process can be arbitrary, and the treatment of revenues and expenditures should be independent and have a consistent policy rationale. While some exclusions may be legitimate in some circumstance, exclusions should be independently and consistently administered by the CGC, given its expertise in this area to prevent political decisions from interfering with the independent process.

Victoria also welcomes Draft Recommendation 9.1 and 9.2 in which the Commission calls for the CGC to provide a strong neutral voice in the public discussion on the HFE system, and to make the data provided by the states publicly available on its website, along with

the CGC's calculations on these data. Victoria supported this position in its first submission, and believes that transparency and an increased understanding of the HFE system would go a long way to reducing the blame shifting from a perception that the distribution process is unfair, regardless of what system is used. Victoria considers that the current problem is best addressed not by shifting between systems, but rather to properly explain the existing system.

The second half of Draft Recommendation 9.1, that the GCC could provide draft rulings to State Governments on the potential HFE implications of a policy change, has both pros and cons. On the one hand it helps state governments remove uncertainty around how a particular policy decision will be treated by the CGC once the best policy decision has been selected, and on the other hand it encourages states to actively include GST effects in evaluating a policy decision, which is generally undesirable.

Victoria also strongly agrees with the Commission that "There is a need to revisit the broader operating environment in which HFE takes place, and to renew efforts to reform federal financial relations in the broad." The Commission notes there is currently an impasse in achieving reform in Australia's federal financial relations, and that the termination of the Federation White Paper is an example of that.

While constitutionally states have a great deal of autonomy, the Commonwealth continues to use vertical fiscal imbalance to try and influence state policy decisions. As the Commission notes the Commonwealth is increasingly attaching conditions to funding, constraining the manner in which states spend revenue. Such conditions have included matched funding requirements, onerous risk sharing where states bear all cost overrun risk and maintenance of effort provisions that dictate to states how they will fund their services.

The recent Gonski 2.0 legislation goes beyond even this, threatening to cut billions of dollars in Commonwealth funds for schools unless states provide what the Commonwealth deems an appropriate amount of funding for both public and private schools.

Such Commonwealth requirements are in direct breach of the IGA FFR, which states that National Agreements and National Partnerships (to the fullest extent possible), will not include financial or other input controls. Imposition of these constraints limits states' policy and budget autonomy, and blurs accountability and transparency between levels of government. They also reduce the capacity for states to flexibly deliver services in accordance with local needs, and reduce the incentive to introduce innovation in the provision of services which may lead to long term efficiencies and improved outcomes.

Victoria joins the Commission in calling on the Commonwealth to drive reform in federal financial relations so that the federation can operate as intended.





Treasury  
and Finance