

Queensland Government Submission

Productivity Commission Inquiry into Horizontal
Fiscal Equalisation – Draft Report

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Executive summary

The Queensland Government has significant concerns with the reform approaches canvassed by the Productivity Commission (PC) in its draft report which will compromise the ability of Queensland and other States and Territories (States) to deliver a similar standard of services to all Australians regardless of the State in which they live. Such approaches will result in some States becoming fiscally stronger than others, which in turn may enable them to deliver higher standards of services to their communities.

When addressing inequalities of service delivery, the differing circumstances of each State must be taken into account. For Queensland, its large geographical size, significant indigenous population and decentralised population with many regional and remote communities presents challenges in providing equitable access to services including education, health and transport.

As the PC estimates, if the two reform approaches canvassed – equalising to the second highest State or to the average – were adopted and applied to the 2017-18 GST payments, Queensland's GST revenue would be \$729 million and \$1,588 million lower respectively compared to the current system. Such a reduction in revenue would negatively impact the ability of Queensland to provide similar level of services to the community.

The proposed reform approaches also do not address the major concerns the PC has identified with the current system as they keep current processes largely intact and do not fundamentally change the incentives States face to undertake efficiency-enhancing reform. Further, the approaches do not acknowledge that the distribution of the goods and service tax (GST) forms only one part of a wider framework of federal financial relations, the various elements of which all have a part to play in achieving equity across States. Queensland encourages the Productivity Commission to consider approaches for achieving HFE where the redistribution of the GST is not the sole lever.

Queensland supports the PC's conclusion that an equal per capita approach, as advocated by New South Wales and Western Australia, is not a viable option at present because it would not meet the core equity objectives of horizontal fiscal equalisation (HFE) having regard to the current structure of the Australian economy. As the PC estimates, if such an approach was adopted and applied to the 2017-18 GST payments, Queensland's GST revenue would be \$2,399 million lower.

Queensland believes developing a definition of HFE agreed to all by Commonwealth and State Governments would provide a clear policy basis for what HFE is expected to achieve. It is envisaged any revised definition would be presented by the Commonwealth to States for approval through the Council of Federal Financial Relations (CFFR) and Council of Australian Governments. Once agreed, this definition should be included in the *Intergovernmental Agreement on Federal Financial Relations*. Queensland also agrees the CGC should be responsible for considering opportunities to simplify the existing assessment processes, together with playing a more public role in explaining HFE and enhancing formal interactions with the States to enhance clarity.

In tandem with the review of HFE, meaningful reform of federal financial relations to address vertical fiscal imbalance is critical. Queensland supports the Productivity Commission's recognition of this as a vital element of national fiscal reform.

Reform of federal financial relations provides an opportunity to improve Commonwealth-State relations to work towards improved economic outcomes nationally to allow each level of government to more autonomously deliver required services. This work should be led by CFFR and include clarification of the respective roles of each level of government, with an improved focus on accountability and certainty for better outcomes and service delivery, and consideration of ways to better match funding to service delivery and expenditure responsibilities, including greater State access to untied funding, for example through personal income tax sharing. Queensland encourages genuine engagement by the Commonwealth and States to undertake this important work.

Introduction

1. While Queensland supports horizontal fiscal equalisation (HFE), it welcomes this opportunity to review the way that HFE is currently being achieved and consider how it may best be effected in the future. The Productivity Commission's (PC) review of HFE provides an opportunity to review how HFE is conceptualised, how it is implemented, whether criticisms of the current system are justified and supported by evidence, and ultimately whether there are alternative options that will more effectively achieve the desired objective of equalisation for both the short-term and long-term benefit of all Australians.
2. Queensland provided an initial submission to the PC in June 2017 following the release of the PC's guidance note. The initial submission discussed the equalisation concept and challenges faced by the current system. It noted Queensland's position that equalisation is most helpfully viewed as a system designed to provide each State and Territory (States) with the fiscal capacity to deliver similar levels of services and infrastructure without preventing States from making policy choices about the revenue and expenditure mix and effort.
3. The initial submission also called for meaningful engagement by the Commonwealth and States on reform to federal financial relations.
4. This submission addresses the recommendations set out in the PC's draft report *Horizontal Fiscal Equalisation* (PC report) and builds on Queensland's position that any changes to the current system of HFE must be equitable, ensuring that all Australians, regardless of what State they live in, should have access to a similar level of services.

Horizontal Fiscal Equalisation

5. Queensland places great value on HFE.
6. The community expects that all Australians will receive similar standards of services regardless of the State in which they live and HFE is a key element in meeting this expectation by seeking to facilitate equal fiscal treatment of the States. The equity that underlies this principle is fundamental and must be preserved.
7. HFE has, and has had for many years, a significant nation-wide impact by helping States deliver similar levels of services and infrastructure to the community through equitable distribution of goods and services tax (GST) revenues. HFE reflects an understanding that, while there are factors beyond an individual State's control, the fiscal effect of these factors can be shared across the federation. These factors can be both structural and cyclical, and Queensland considers that HFE plays an important role in equalising both. Equalising structural factors ensures States have the capacity to provide similar levels of services despite underlying differences such as their geography or population distribution, whereas equalising for cyclical factors provides a valuable way for States to share risks and spread the impact of fiscal shocks across the nation.
8. Given the broad service delivery responsibilities of the States, limited access to revenue sources, and the pressures that some of those service delivery areas will face into the future, HFE is essential. However, review of the way HFE is achieved is timely, and Queensland supports a constructive reform agenda aimed at delivering real benefits nationally while continuing to ensure all States can provide the services expected by their communities.
9. Over time the approach taken by the Commonwealth Grants Commission (CGC) to determining how HFE should be achieved through the GST distribution has moved from seeking partial to full equalisation. The articulation of the objective of HFE, as noted in the CGC's 2015 Methodology Review, demonstrates this precise (or complete) equalisation goal:

State governments should receive funding from the pool of goods and services tax 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.

10. However, this aspirational goal has proved elusive and impediments such as data limitations, the difficulty of separating policy choice from underlying capacity, and the need to consider simplicity, contemporaneity and transparency, all impact the extent to which equalisation is possible. It is arguable that HFE has therefore never provided States with precisely the same fiscal capacity.
11. As noted in Queensland's initial submission, there are benefits in moving from this attempted precision to a more pragmatic approach that seeks to provide all States with the ability to provide a similar level of services and infrastructure while continuing to allow them to make their own policy choices about the revenue and expenditure mix and effort.
12. An objective that seeks to equalise to similar levels has the potential to create a simpler and more transparent system which does not attempt to adjust for every possible factor and is likely to be less subject to the criticisms of false precision that are sometimes directed at the current system. Consideration of how the revenue and expenditure assessments are undertaken, for instance, may deliver broader benefits to the equalisation process.
13. Any system of equalisation must have proper regard to each State's circumstances and the factors impacting service delivery throughout the State; to not do so will compromise the equalisation objective. In Queensland's case, the decentralised nature of the State presents challenges when it comes to providing services. Queensland has several regional population centres spread across the second largest State in the nation, in addition to having residents in remote or very remote areas. It is important that these factors, and the associated need for equitable access to services including education, health (such as regional hospitals of a standard to meet the regional population base) and transport, are properly recognised in the equalisation process.
14. Queensland acknowledges the PC's call for a revised objective for HFE to be articulated and notes the PC's position that, while equity should remain at the heart of HFE, it should aim to provide States the fiscal capacity to provide a *reasonable* level of services.
15. Queensland's view that equalisation should be undertaken to facilitate services being provided to a similar level nationally is conceptually consistent with the PC's proposal that equalisation should ensure all States can deliver a reasonable level of services. Expressed another way, moving States to a position where their ability to deliver services was markedly different would not be *reasonable* and would not meet the equity requirement.
16. The framing of a reasonableness test, or indeed any other test, therefore requires careful consideration. How this is effected is key; any change must continue to preserve the core tenets of HFE.
17. Queensland considers it vital that, in considering how HFE can be achieved, the redistribution of the GST should not be seen as the sole lever to achieve equalisation. A broader perspective should be taken. Payments from the Commonwealth to the States under Special Purpose and National Partnership Payments, including special one-off payments, should also be considered as part of HFE, as should other support the Commonwealth provides, such as industry assistance and defence contracts.
18. Ultimately, HFE must continue to ensure, now and in the future, that Australians living in different parts of the country can be provided with broadly similar levels of service. This is the principle against which any proposed change to HFE must be tested.

Issues with the current approach to HFE

19. In its draft report the PC has found that the current system of HFE is functioning reasonably well in relation to the following.
 - a. Equity: Australia's HFE system achieves an almost complete degree of equalisation.
 - b. Independent and transparent process: As an independent agency, the CGC is well placed to conduct the HFE distribution process.
 - c. Stability: HFE results in reasonably stable GST payments for the States and a level of predictability for budgets.

20. However, the PC has also identified a number of deficiencies with the current approach to HFE, some of which it considers have become more pronounced recently.
 - a. Unique approach: Australia is unique among OECD countries with the central government eliminating disparities in the fiscal capacity of sub-central governments by equalising to the strongest State.
 - b. Complexity: The current system of HFE creates complexity and even a false sense of precision.
 - c. Policy neutrality: The current system struggles when State circumstances differ markedly. There is limited consideration of efficiency and the potential for State policy to be distorted, which may affect decisions about pursuing major reform (taxation or mining).
 - d. Vision: There is an absence of leadership on the objectives of HFE.
21. The PC canvases the view that fiscal equalisation in Australia goes too far, especially compared to other federations, in seeking to equalise fiscal capacity to ensure that all States can provide services and the associated infrastructure at the same standard.
22. This pursuit of trying to fully equalise the fiscal capacity of all States is found to be resulting in broader (albeit in most instances small) costs to the economy and potentially distorting State policy decision making. It also considers that equalising to the strongest State, particularly when that State is much stronger than the rest, results in volatility which is undermining an otherwise strong social consensus for HFE.
23. The PC suggests that revising the objective of HFE would be in the best interest of national productivity. It proposes that, while equity should remain at the heart of the system, the primary objective of the HFE system should be to provide the States with the fiscal capacity to allow them to supply services and the associated infrastructure of a reasonable standard.
24. It considers this objective should be pursued to the greatest extent possible provided that it does not unduly influence the States' own policies and choices beyond providing them with fiscal capacity, it does not unduly hinder efficient movement of capital and people between States, and the process for determining the distribution of funds is transparent and based on reliable evidence.

What should be considered a reasonable standard of services?

25. The PC draft report does not specify what would constitute a reasonable standard of services, only that equalisation should no longer be to the strongest State. The PC is seeking submissions on what level of fiscal capacity would be consistent with enabling States to provide a reasonable level of services.
26. Queensland welcomes the opportunity to set out what would constitute a reasonable standard of services to enable the PC to provide a clear recommendation in its final report as a basis on which the Commonwealth and States can engage.
27. Queensland considers that to meet community expectations, a reasonable standard of services must provide similar standards to all Australians no matter the State in which they live. This also has proper regard to the differing circumstances of each State and the impact these factors have on service delivery. For Queensland, its size and the large geographical spread of regional population centres present challenges in providing equitable access to services including education, health and transport.
28. This reflects that what is *reasonable* should be a concept based on need. Put another way, not to provide such equalisation could be considered unreasonable because different States would have the capacity to deliver services at different standards, undermining the intention of HFE because Australians would no longer be indifferent to where they live based on the services and infrastructure available across the country. This would have implications for the economic growth potential of weaker States.

Will a revised objective for HFE deliver economic benefits?

29. The draft report outlines a clear need for a revised objective for HFE to address concerns the current system creates incentives for States to not pursue efficiency-enhancing reforms which would deliver improved economic outcomes.
30. Though no direct evidence is presented in the draft report that such incentives have changed specific policy decisions, the PC concludes “an absence of evidence is not evidence of absence” and the current HFE system can discourage efficiency-enhancing reform where a State experiences a large reduction in GST payments.”
31. As outlined in Queensland’s initial submission, a distinction must be made between incentives or problems that exist in theory, and those where there is evidence of the problem in practice. While it may be technically possible for States to influence their GST shares at the margin by changing their expenditure or tax mix as demonstrated in the cameos presented in the draft report, Queensland continues to remain unaware of any evidence that this is a factor for governments in the setting of expenditure and revenue policies.
32. The policy focus for States is on economic development, service provision and sound fiscal management. Governments focus on the benefits and risks that come from any particular policy change, rather than on possible outcomes of the current HFE system.
33. A range of practical challenges exist to implementing large scale tax reforms, besides any potential GST implications. Large-scale tax reforms are difficult to implement because they can have significant long-lasting impacts on the economy, some of which are difficult to predetermine. They may also have negative financial outcomes for certain sectors of the economy, with political implications that need to be weighed by governments and which may limit the adoption of such reforms.
34. Furthermore, if the claim that the current system creates a disincentive to reform is true, the impact of the distribution would need to be large enough to have a material impact on the decisions of State Governments. Queensland suggests that this is often not the case. Any reduction in GST would be outweighed by the benefits of reform.
35. Where potential HFE impacts are considered in the policy decision making process, they are at best fourth or fifth order considerations. This means that many of the incentives or disincentives that are identified in the literature, and mentioned above, exist in theory but not to any material degree in practice. A similar conclusion was reached by the 2012 GST Distribution Review, which suggested that, while the current system creates perverse theoretical incentives in some instances, there is little practical evidence of efficiency losses.
36. Recent experience also suggests that despite potential negative GST consequences, States in recent years have implemented tax policies when there are clear overall benefits and when there is political support. These include:
 - a. ACT transitioning to abolish transfer duty and broaden its land tax base.
 - b. Several States have adopted a stamp duty surcharge for foreign land purchasers.
 - c. In the 2017 Budget, Western Australia imposed a payroll tax levy on big businesses and increased gold royalties by 1.25 per cent.
 - d. Western Australia increased its rate on iron ore fines which has initially resulted in lower relativity. The CGC has subsequently changed its mining assessment which resolved this issue.
37. Additionally, as Queensland set out in its initial submission, the most immediate benefit brought about by the current system of HFE is arguably in the services it allows States to provide. Any change proposed to HFE on the grounds that it will reduce disincentives to pursue economic growth must be balanced against the social costs of any potential reduction in services in some parts of the country – and the important role those services play in the long-term health of the economy.

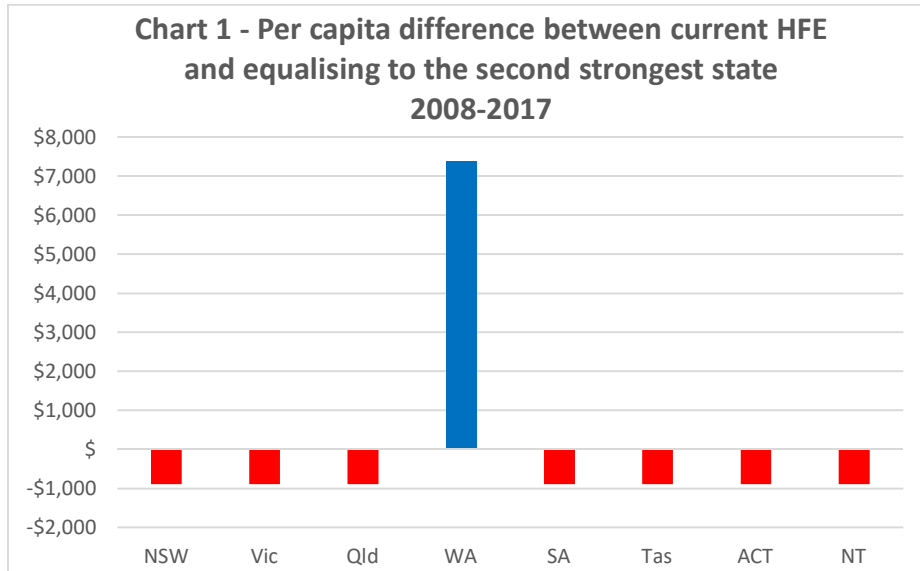
38. As previously noted, HFE seeks to ensure States have the capacity to provide similar levels of services in their areas of responsibility, including the key service areas of health and education. Provision of health, education and social services are critical foundations to an efficient, competitive and resilient economy. An educated, skilled and healthy population is likely to be more productive and obtain higher wages, to remain engaged in the labour market for longer, and to transition better into new forms of employment when structural changes in the economy alter the mix of skills and knowledge require by industry.
39. As well as contributing to stronger economic and employment outcomes, a healthier and more educated labour force also helps reduce the fiscal burden on Governments associated with structural and demographic change over time, as well as the better utilisation of government-funded services, such as housing, child protection and justice. This enables funding to be directed to more productive endeavours that further support jobs opportunities, growth in real incomes and improved living standards.

Alternate methods canvassed by the PC

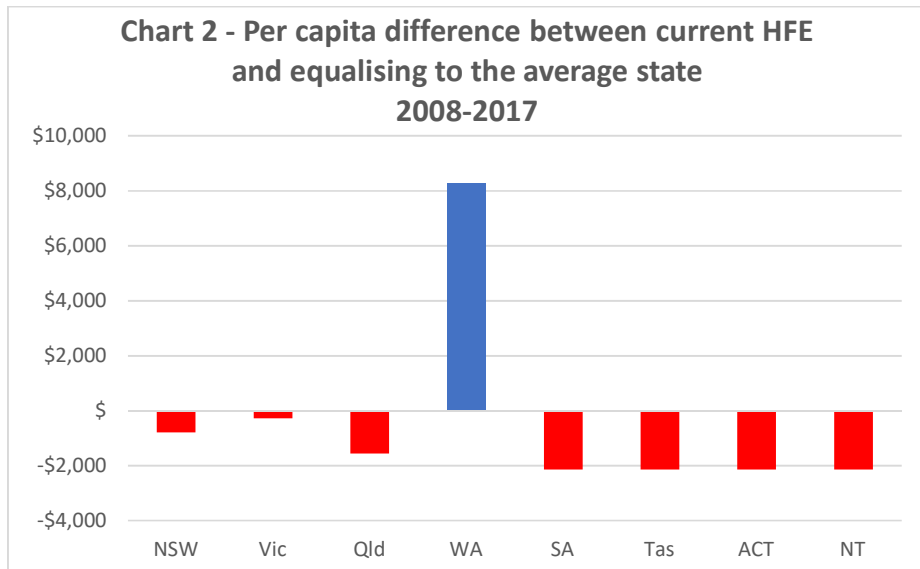
40. In the context of developing a reasonable standard test, the PC has considered several alternative approaches to the current HFE system. These range from adjustments to the current methodology to more fundamental changes. The PC notes that the trade-off between equity, efficiency and simplicity for these models is inescapable and each has its advantages and disadvantages.
41. The draft report identifies two possible approaches for moving away from equalisation to the fiscally strongest State – equalisation to the second strongest State or to an average level of fiscal capacity. Queensland notes that neither of these approaches has been explicitly recommended by the PC and that submissions are sought on what level of fiscal capacity would be consistent with enabling States to provide a reasonable level of services. Nevertheless, the two approaches raise a number of issues which require careful consideration.
42. Other approaches, such as equal per capita (EPC) and a relativity floor, are also canvassed by the PC.

Equalising to less than the fiscally strongest State

43. Queensland has concerns the approaches canvassed by the PC – equalising to the second highest State or to the average – will not ensure the desired HFE outcome will be achieved in the short and long term given the current structure of the Australian economy.
44. Equalising to less than the fiscally strongest State will mean that at least one State has a superior ability to deliver services compared to the other States. The number of States in this situation and the degree of the superiority will depend on the economic conditions at the time. For this reason, Queensland does not consider that such an approach satisfies the core equity objective of HFE or that it meets the *reasonable standard* test proposed by the PC.
45. The calculations and cameos presented in the draft report illustrate this point. For a number of States the estimated fiscal impacts would be significant and may prevent them from delivering the services required by their communities while other States would have excess capacity to deliver services.
46. Specifically, the PC's modelling shows that equalising to the average of the States would result in an additional \$3.6 billion in GST revenue to the strongest State in 2017-18 while reducing other State's GST revenue by as much as \$1.588 billion. Similarly, equalising to the second strongest State in the same year increases the GST distribution to the strongest State by \$3.244 billion while other States can have their GST revenue reduced by as much as \$1.167 billion.
47. Over time, such approaches may result in significant differences in GST revenue outcomes between the States, and therefore significantly different fiscal capacities. Using the PC's methodology, Queensland estimates that, compared to the current system, equalising to the second strongest State over the 10 years between 2008 and 2017 would have resulted in an increase of \$7,384 per capita to Western Australia while reducing all other States including Queensland by \$898 per capita (Chart 1).



48. Over the same period, equalising to the average of the States would have resulted in a redistribution of \$8,287 per capita to Western Australia while reducing the GST funding of Queensland by \$1,561 per capita (Chart 2).



49. Queensland also notes that under both of these approaches a substantial proportion of the GST pool would have been distributed on an EPC basis in 2017-18.

50. Further, equalising to the average or the second strongest State does not address the complexity and transparency issues that the current HFE model is often criticised for. Both models still require the current complex process to be carried out. Specifically, to implement the proposed approaches, the CGC will first need to determine the strongest State, second strongest State or the average using the current approach before States are re-equalised and relativities recalculated. This further adds to the complexity of the current approach, making it less transparent and less comprehensible.

Equal per capita distribution / equal per capita with 'top-up' funding

51. Queensland supports the PC's conclusion that an EPC approach, as advocated by New South Wales and Western Australia, is not a viable option at present because it would not meet the core equity objectives of HFE having regard to the current structure of the Australian economy.
52. Such an approach has no regard to individual State's needs and their relative strengths and weaknesses. On an EPC basis, larger States receive more funding even though their service delivery requirements may not be as significant as a smaller State's which has a decentralised population or high levels of indigeneity.
53. The significant service delivery disabilities that some States face, coupled with large differences in revenue raising capacities between the States, therefore mean that an EPC distribution would not be able to provide the necessary funding some States need to deliver the similar standards of services to their communities. It would result in stronger States benefitting at a cost to the fiscally weaker States.
54. In relation to an EPC distribution with 'top-up' funding, it relies on additional funding from the Commonwealth. As the PC notes, top-funding of the magnitude needed to ensure no State is worse off under this approach is unlikely to be forthcoming. If such an approach can only be implemented by reducing other tied grants provided to the States, then this opportunity cost unwinds any equalisation outcomes from the top-up funding. Even if unconditional top-up funding is provided, it will always be subject to budget pressures faced by the Commonwealth and this can create significant funding uncertainty to smaller States.
55. The EPC with 'top-up' funding approach canvassed by the PC only distributes an EPC funding to the largest four States including Queensland. Such an approach is not robust because it ignores the service delivery challenges of the four largest States. While larger States generally have greater fiscal capacity compared to smaller States over time, they also face significant service delivery challenges and at times require funding in addition to an EPC amount to meet service delivery obligations. Therefore, this approach is unlikely to consistently meet the core equity objective of HFE.

Relativity floors

56. Queensland has previously expressed concerns about a relativity floor and stressed that such an approach would result in a more complex system that did not achieve equalisation to allow all States to deliver services to a similar, or reasonable, standard. These concerns are supported by the PC's findings that introduction of a relativity floor is unlikely to holistically address the various complexity and efficiency concerns of the current system, and may even increase uncertainty and unpredictability.

Other approaches worth investigating

57. Queensland considers that the benefits of HFE reform can be achieved by refining the current system to improve the assessment processes to achieve greater simplicity, comprehensibility and transparency. Aggregating revenue and expenditure assessments, for example, may deliver real benefits to the equalisation process without fundamental shifts in fiscal capacity that would impact HFE. Similarly, the introduction and expansion of the materiality threshold by the CGC, which has over the years eliminated processes that do not have a material impact on the equalisation outcome, is a good example of a relatively straightforward option to reduce complexity.
58. Simplification of the assessment processes requires pragmatism; acceptance that any change to the current processes will result in some States being better off and some worse off. This needs to be accepted as a natural consequence of reform of the GST distribution process and moving from attempted precision to equalisation to a *similar level of services* standard. However, the impacts should not be so substantial that they result in significantly different service delivery capacities across the States.

Working together to define the objective of HFE

59. Queensland supports the PC's recommendation that a clear definition of HFE should be specified by governments for implementation by the CGC, and envisages the Commonwealth would present any reform proposal to the Council of Federal Financial Relations (CFFR) and the Council of Australian Governments (COAG) for approval and inclusion in the Intergovernmental Agreement on Federal Financial Relations (IGA FFR).
60. Using a settled HFE objective, the CGC and the States should work together to develop the assessment processes and methodologies that will deliver the *similar level of services* objective.

Reform of federal financial relations

61. Queensland agrees with the PC's position that the distribution of GST forms only one part of a wider framework of federal financial relations, the various elements of which all have a role to play in achieving equity across States and ensuring they can meet their service delivery expectations. Review of HFE alone will not deliver meaningful fiscal reform.
62. Federal financial relations in Australia are characterised by vertical fiscal imbalance (VFI), which arises because the States' ability to raise own-source revenue is less than required to meet service delivery responsibilities, whereas the Commonwealth raises more revenue than is required to meet its service delivery responsibilities. The zero-sum nature of the current equalisation model, combined with the capped revenue pool available through the GST, limit the ability of the current arrangements to address this revenue/expenditure mismatch between the Commonwealth and States. This mismatch is exacerbated by the Commonwealth's use of tied grants to achieve policy objectives and the way these payments are taken into account for equalisation purposes.
63. Reform of federal financial relations is therefore necessary to address the institutional deficiencies that continue to be a feature of Australia's fiscal landscape; VFI being at the forefront.
64. This would provide an opportunity to properly consider the way that the Commonwealth and States can work together to ensure better fiscal outcomes nationally to allow each level of government to more autonomously deliver the services that the community expects and requires. It would be an important step in reducing the current barriers to the States undertaking meaningful taxation reform.
65. Queensland considers that reform should be led by CFFR and address the following:
 - a. Commonwealth and States confirm support for the IGA FFR's principles and objectives.
 - b. Clarify the respective roles of each level of government, with an improved focus on accountability and certainty for better outcomes and service delivery.
 - c. Develop guidelines for improving implementation and oversight of intergovernmental funding arrangements. This should include development of a robust performance reporting framework which provides the Commonwealth with transparency on outcomes being delivered, a reduction in the number of National Partnership Payments and conversion of all major service delivery programs, such as early childhood education and remote housing, to ongoing funding streams.
 - d. Consider ways to match funding to service delivery and expenditure responsibilities. This would include review of the use of tied funding by the Commonwealth and the opportunity to provide greater access to untied funding that would give the States increased autonomy in deciding how to provide services. This could for instance include consideration of options such as the Commonwealth providing the States with access to a share of personal income tax revenues as untied funding to replace specific tied funding.
 - e. Clarify how Commonwealth tied funding is taken into account for equalisation purposes. Under the current system of equalisation, the inclusion of Commonwealth payments may be seen as overriding national objectives and agreements established between Commonwealth and State governments to achieve a specific outcome. For instance, National Health Reform Funding provided on an efficient price basis is largely unwound in subsequent years and equalised as part of the CGC's assessment.

The relevance of these tied Commonwealth payments to the allocation of untied GST revenues needs proper examination, as does the Commonwealth's ability to direct at its discretion the CGC to exclude certain payments. This has the potential to undermine the equalisation process, particularly where it could be considered to be exercised in an arbitrary manner.

- f. Clarify the scope of payments to be taken into account. In addition to tied funding, the Commonwealth supports States in a range of other ways, including through industry assistance (where provided to industries focussed in one State) or regulation amendments to support particular projects or areas. To the extent the fiscal capacity of a State is enhanced as a result, consideration should be given to whether or how this assistance could be incorporated into the assessment of HFE.

Role of the Commonwealth Grants Commission

66. Queensland recognises the CGC's independence, expertise and well-established practices, such as consultation with the States and major methodology reviews every five years. Queensland considers the CGC is well-placed to support the achievement of HFE through its recommendations on GST relativities.
67. Separating the policy development process from the implementation of HFE as recommended by the PC will provide clear direction to the CGC to deliver HFE based on policy settled by government and further enhance its independent role.
68. Queensland supports the CGC taking a more active and public role in explaining HFE, including clearly explaining its processes and the reasons for its decisions in seeking to achieve the objective of HFE, and enhancing formal interactions with States to provide greater clarity.

Conclusion

69. Queensland has been a longstanding supporter of HFE and of an equalisation system which provides all States with the fiscal capacity to deliver a similar standard of services.
70. Friction in the current HFE system has increased in recent times as Western Australia's share of GST has fallen to an unprecedented low. While this has undoubtedly strained the current system, its effect is likely to be temporary. Western Australia's fiscal capacity has eased in recent years and this will translate to higher relativities in the future under the current system. Equalising the States to a significantly different standard represents a structural change with lasting impacts that will remain long after the effects of the current situation have abated.
71. Queensland contends that there are other factors that influence a State to undertake reforms and that the impacts on GST distribution are a minor or lower order consideration. A distinction must be made between incentives or problems that exist in theory, and those where there is evidence of the problem in practice. While it may be technically possible for States to influence their GST shares at the margin by changing their expenditure or tax mix, Queensland is not aware of any evidence that this is a factor for governments in the setting of revenue and expenditure policies.
72. Nevertheless, there is merit in reviewing the efficacy of the current arrangements and Queensland supports the PC's proposal that a new objective for HFE be stated. Queensland considers it is the role of governments to collectively determine what the most appropriate objective for HFE is, and how it is to be achieved. The process should involve the Commonwealth developing a proposed objective, having regard to the PC's recommendations, for consideration by CFFR and approval by COAG. To provide ongoing clarity and certainty, the objective should be included in the IGA FFR.

73. Any proposed new objective must continue to be assessed against the core principles of HFE – ensuring that all Australians can receive similar standards of services regardless of the State in which they live. A change that resulted in significant fiscal detriment to the majority of States and impacted the ability of weaker States in particular to deliver services at a similar level to the stronger States would be inequitable and fundamentally unfair.
74. The PC contemplates equalisation being undertaken to provide States with the fiscal capacity to provide a reasonable level of services. A shift away from the CGC's current approach of seeking precise equalisation towards one where equalisation is undertaken to ensure States receive the funds they need to provide a similar level of services and infrastructure would provide the opportunity to simplify the assessment process and provide greater process clarity. In the context of the PC's proposed new objective, it would be reasonable and should be further developed.
75. Review of HFE alone however will not deliver meaningful fiscal reform – the type of reform needed to address the significant mismatch between the Commonwealth and States' revenue raising capabilities and expenditure responsibilities. Queensland therefore supports the PC's call for renewed efforts to reform federal financial relations and encourages genuine engagement by the Commonwealth and States to meaningfully address VFI and ensure all Australians can receive the services they require regardless of where in Australia they live.

