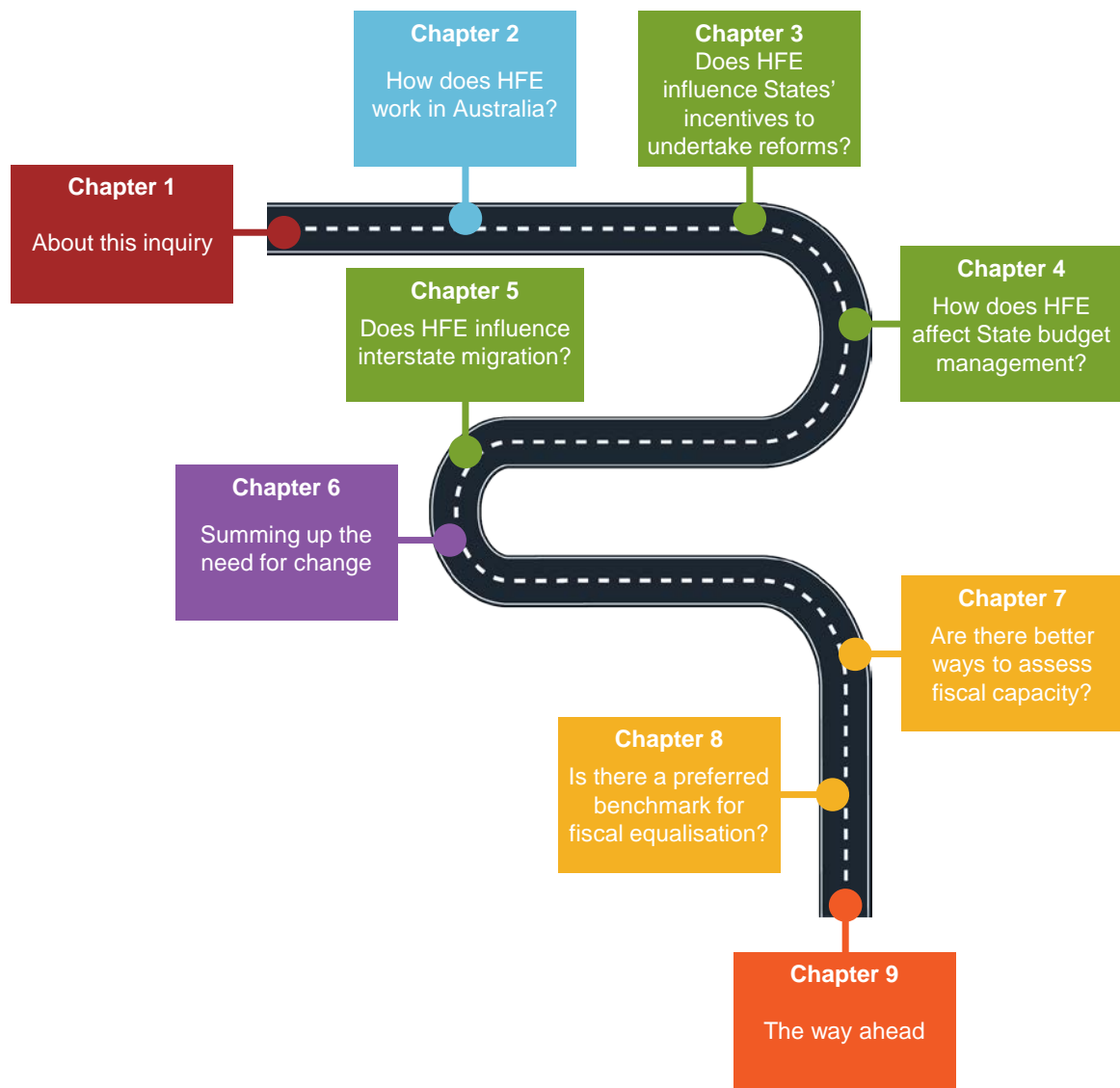




A roadmap to our HFE report

HFE inquiry: final report roadmap



The next 11 pages provide a roadmap to help you quickly navigate your way to the figures, tables and text that support our report's primary key points and findings. The roadmap is set out by chapter.



Overview

- The basic premise of Horizontal Fiscal Equalisation — fiscal equality in the Australian federation — has broad support from all levels of government.
- The current practice of HFE seeks to give all States the same fiscal capacity to deliver public services. To do this, all States are brought up to the fiscal capacity of the fiscally strongest State (currently, as assessed by the Commonwealth Grants Commission, Western Australia).
- This approach to HFE is under intense scrutiny at present as Western Australia’s share of the GST has fallen to a record low. Even so, the current system of HFE has strengths.
 - It compensates States for their structural disadvantages and achieves an almost complete degree of fiscal equalisation — unique among OECD countries.
 - The independent and expert CGC is well placed to recommend GST relativities. It has well-established processes that involve consultation and regular methodology reviews.
- But the current approach also has significant weaknesses. Reform and development opportunities are likely being missed at the expense of community wellbeing over time.
 - There is much scope for the system to discourage State policy for major tax reform and desirable mineral and energy policies (royalties and development).
 - Full fiscal equalisation does not systematically allow States to retain the dividends of their policy efforts. This raises concerns about the fairness of equalisation outcomes and corrodes public confidence in the system.
 - The system is very poorly understood by the public and indeed by most within government — lending itself to a myriad of myths and confused accountability.
- While equity should remain at the heart of HFE, there is a need for a better balance between equity and efficiency.
 - The Commonwealth Government should set a revised objective for HFE to provide States with the fiscal capacity to deliver a **reasonable standard** of services. Changing the objective is an essential precursor to further improvements to the HFE system.
- Governance reforms are also needed. This includes the CGC playing a more prominent communication role to inform the public discourse on HFE.
- The CGC should be directed (without delay) to pursue more simple and policy-neutral assessments, and increase its materiality thresholds, in line with achieving a reasonable level of equalisation. Other ‘in-system’ changes proposed by others, such as mining discounts, do not resolve HFE’s deficiencies and pose too much of a risk to fiscal equality.

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|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------|
| <ul style="list-style-type: none">• In-system and governance changes will improve HFE but can only go so far. Additional efficiency gains are only in prospect from an alternative equalisation benchmark, which many would regard as a fairer outcome. | p. 219 |
| <ul style="list-style-type: none"><ul style="list-style-type: none">– Amongst a number of options designed to equalise to a reasonable standard, equalisation to the average of all States (rather than to the strongest State) is judged to provide a better balance between fiscal equality, fairness and efficiency. | pp. 25-29;
232-236;
248;254 |
| <ul style="list-style-type: none">• Changing the benchmark in the current fiscal environment will lead to a material redistribution of the GST. This change is likely to prove manageable for all States if phased. Transition should be funded by the beneficiary States and by hastening slowly, such that no State sees a reduction in its GST from one year to the next of more than 2 per cent of its overall revenue. | pp. 32-33;
258-263 |
| <ul style="list-style-type: none">• The transition paths outlined in this report would soften any year-on-year impact, to less than 1 per cent of State revenue. | pp. 34-35;
266;
Appendix F |
| <ul style="list-style-type: none">• Improving HFE will deliver benefits to the Australian community. But ultimately, greater benefits will only come from more fundamental reforms to Australia's federal financial relations: namely, to spending and revenue raising responsibilities and ensuing accountabilities. | pp. 20; 278-
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Chapter 1: About this inquiry

- Australia’s system of horizontal fiscal equalisation (HFE) acts to distribute revenue among the States — seeking to equalise States’ fiscal capacities to deliver public services. HFE is achieved primarily through the Commonwealth’s distribution of GST revenue to the States.
 - HFE broadly pursues ‘horizontal equity’, whereby people in similar circumstances, but in different States, should have access to similar levels of public services.
 - The HFE system coexists with a vertical fiscal imbalance (VFI) and a complex web of other payments from the Commonwealth to the States.
- Each year, the Commonwealth Grants Commission (CGC) calculates a relativity for each State, based on its assessed fiscal capacity. This assessment takes into account both the revenue and expenditure sides of State budgets.
- The specific practice of HFE has often been debated amongst the States. But in recent years, the divergence between some States’ relativities has reached an unprecedented level, and contention around HFE has escalated.
 - A major factor is Western Australia’s share of the GST, which has fallen to an unprecedented low as the impact of the mining investment and construction boom flows through the CGC’s formula, even as the Western Australian economy is no longer at its peak.
- Critics have suggested that the HFE system impedes economic growth by acting as a disincentive for State Governments to pursue economic development, or to undertake efficiency-enhancing reforms. Others have argued that HFE is crucial to providing a level of equity in the public services used by all Australians.
- The Productivity Commission has been asked to examine how the current HFE system impacts the Australian community, economy and State and Territory Governments, and to identify desirable improvements or alternatives to the current system.
- The Commission has assessed the current HFE system, and a range of potential alternative approaches, against a framework built on the criteria of **equity, efficiency, and transparency and accountability**. In carrying out this assessment, the Commission has constructed a set of ‘cameos’ to illustrate the effects of possible State policy changes on GST shares (and to estimate the distributional impacts, and possible incentive effects, of the current HFE system).

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Box 1.2
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Chapter 2: How does HFE work in Australia?

- Since Federation, the fiscal power of the Commonwealth relative to the States has increased. Key developments marking this shift were the Commonwealth's introduction of income tax, and the High Court's disallowance of State indirect taxes on goods.
- Some form of horizontal fiscal equalisation (HFE) has been in place in Australia since Federation, to address both the imbalance between revenue raising capabilities and expenditure responsibilities between the States and the Commonwealth, and differences in fiscal capacities across the States.
- The Commonwealth Grants Commission (CGC) plays a prominent role in HFE. It was established in 1933 following numerous ad hoc measures to provide assistance to financially weaker States and the threat of Western Australia's secession.
- The definition of equalisation adopted by the CGC and its methods have evolved over time. Many of the changes have been driven primarily by the CGC, in consultation with the States.
 - Up until 1981, the CGC's role in HFE was to recommend special grants to those States making claims for financial assistance — 'recipient' States.
 - In 1981, the CGC commenced full equalisation, in which a given pool of funds were to be distributed amongst the six States (later joined by the Northern Territory and the ACT), marking the beginning of the 'zero sum' distribution.
 - At this time, the definition of equalisation referred to payments to enable States to provide services 'not appreciably different', but by 1999, this had evolved to 'the same standard' at the behest of the CGC. Unsurprisingly, the current definition of equalisation is not reflected in the *Commonwealth Grants Commission Act 1973* (Cwlth).
 - Since 2000, the Commonwealth has not played a substantive role in determining the amount of revenue to be distributed amongst the States for the purposes of HFE, with it being solely funded by the GST pool (with the exception of Health Care Grants until 2009).
- Most of the GST pool is distributed on an equal per capita (EPC) basis, with only about 10 per cent redistributed away from EPC.
 - The pool has increased (in real terms) from about \$25 billion in 1981-82 to \$36 billion in 2000-01 (GST only), and is estimated to be over \$62 billion in 2017-18. However, the annual growth rate of the GST pool roughly halved between 2000-08 and 2009-17.
- Australia's system of HFE is aspirational — seeking to comprehensively and fully equalise fiscal capacities across the States. In reality it achieves proximate equalisation.
 - It does not equalise aspects such as living standards across States, regions, communities, or individuals — that is, it does not focus on interpersonal outcomes.
 - Data and conceptual considerations mean that in practice, much is either unassessed or discounted — over 35 per cent of revenues were assessed on an EPC basis in 2016-17.
- The key factors that currently lead to redistribution among the States are mining production, population growth, Indigeneity, remoteness and property sales.
- Australia achieves a higher degree of fiscal equalisation compared with other federations.

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Figure 2.1
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Figure 2.1
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Chapter 3: Does HFE influence States' incentives to undertake reforms?

- Despite the CGC's aspiration and endeavour, Australia's HFE system is not policy neutral. State policy decisions can and do influence the share of GST revenue flowing to each State.
- On the revenue side, changes in one State's tax rates generally have a small impact on GST shares. However, the effect can be substantial in some circumstances — such as large tax reforms where one State departs from what other States do on average, or where State policy has a significant influence on the size of a tax base (such as mining activity in some States).
 - HFE can discourage efficiency-enhancing reform or resource development where, as a consequence, a State experiences a large reduction in GST payments, or where the GST impacts of reform are uncertain. Though there is no direct evidence to link such incentives to individual policy changes, there is likely to be an effect on policy decisions at the margin.
 - The impacts can be pronounced where a State significantly reforms an existing tax. Policy cameos suggest that revenue-neutral reform can have significant effects on GST payments for some States — especially if done unilaterally — which would pose a first-mover disadvantage to reform.
- Definitive evidence that HFE influences State policy decisions is unsurprisingly scant, although there is some limited international evidence.
- On the expenditure side, changes in State policy can affect GST shares, though the potential to do so is much lower than on the revenue side. There is no compelling case that Australia's HFE system systematically biases State expenditure policy.
 - HFE is unlikely to directly discourage (nor encourage) States from improving the efficiency of service delivery or addressing their structural disadvantages given the broader benefits of doing so to the community. A greater driver of expenditure effort is accountability, which is lacking due to vertical fiscal imbalance and blurred funding responsibilities.
- The potential for HFE to distort State policy is pronounced for mineral and energy resources. States that increase mineral production or royalty rates will lose much of the additional revenue to equalisation — such that they retain as little as their population share of any increase in revenue or bear as little as their population share of any decrease.
 - These perverse incentives are largely driven by the high concentration of mineral production in several States, and were exacerbated by the mining boom. The incentives have the potential to distort trade-offs States make between fiscal and other policy objectives, including controversial decisions to facilitate or restrict resource extraction.
 - To some extent, these incentives are an inevitable consequence of pursuing full and comprehensive equalisation with disparate treatment of revenues, which has embedded policy non-neutrality in the HFE system.
 - Previous reviews have dealt extensively with the equalisation of resource development costs. The Commission has not received any new or compelling evidence that the treatment of mining-related expenditures requires change.

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table 3.1
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box 3.6
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(p. 121);
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Chapter 4: How does HFE affect State budget management?

- Australia’s HFE system provides most State Governments with a substantial share of their overall revenue, and its implementation can impact State budget management.
- The lack of contemporaneity of Australia’s HFE system has mixed impacts on State budget management, but changes do not offer unequivocal improvements.
 - The three-year assessment period and two-year data lag limit the responsiveness of GST payments to changes in States’ budget positions. This can exacerbate the fiscal impact of economic cycles when States experience large, localised economic shocks. This appears to have been the case with Western Australia through the mining investment and construction boom, which is still influencing its GST payments.
 - These impacts can generally be accommodated by sound budget management processes, and do not represent a case for significant change.
 - Introducing a shorter assessment period would not offer unequivocal improvements, as there is a trade-off between contemporaneity and smoother, more predictable GST payments. Further, the stability of overall revenues is more important for State budget management than GST payments alone.
 - Reducing the data availability lag would require the use of forecasts, which would introduce additional complexity, volatility and the potential for unintended consequences.
- The three-year assessment period reduces the volatility of GST payments. Compared with other sources of State Government revenue, GST payments are relatively stable. Despite this, States have experienced mixed results in budget forecasting.
- GST payments have not been the steady, growing source of revenue for States that was first envisaged. However, this is largely a product of a rising share of consumption on education and health services — which are exempt from the GST tax base — rather than a lack of contemporaneity in how HFE is enacted.
- Although Western Australia currently receives less GST than it would under fully contemporaneous equalisation, it benefited from the lack of contemporaneity (by about \$7 billion) before the construction phase of the mining boom came to an end and while iron ore royalties were increasing (between 2010-11 and 2015-16). Moreover, it is possible that this sum may never be completely ‘unwound’.
- Western Australia’s revenue-raising capacity remains structurally higher than it was before the mining construction boom and the highest of all the States. Its current (low) GST payments are chiefly reflective of this relative fiscal strength.
- The current implementation of HFE blurs accountability for State budget outcomes, as it seeks to address both vertical and horizontal equalisation. This is exacerbated by overlaps in funding and service delivery responsibilities between the Commonwealth and States. The need for sustainable and accountable fiscal management by States is not negated by Australia’s current HFE arrangement.

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Chapter 5: Does HFE influence interstate migration?

- HFE in Australia has mainly been focused on providing fiscal equity. HFE's influence on economic efficiency and productivity remains a secondary and subsidiary concern for the Commonwealth Grants Commission.
- The traditional focus of how HFE bears on efficiency has been its impact on the interstate movement of labour and capital. There are two schools of thought.
 - The most common is that fiscal equalisation can counteract distortions caused by movements of labour and capital that are fiscally induced (the 'efficiency in migration' theory).
 - An alternative is that HFE dulls economic signals for labour and capital to move to where they are most productive. That is, HFE can make it more attractive for labour and capital to remain in fiscally weaker States even though they are less productive and it is more costly to deliver government services.
- Modelling results provide no clear evidence on whether HFE's influence on migration enhances or reduces efficiency. Model outcomes are largely driven by assumptions of whether HFE is good or bad for efficiency, rather than having this determined by the model itself.
- Bearing these caveats in mind, the modelling results available suggest that the size of HFE's impact on interstate migration of labour is small. Other factors, such as differences in work opportunities between States, and family reasons, are a bigger driver of interstate migration.
- However, the current HFE redistribution task in Australia is historically high. To the extent there are (migration) efficiency effects at the margin, these would be more pronounced in the current environment. Similarly, fiscally induced movement may become apparent if State fiscal capacities were to diverge over a sustained period, although the gap in fiscal capacities would need to be substantial for it to have a material influence on migration decisions.

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box 5.2
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Chapter 6: Summing up the need for change

- Australia’s system of HFE mostly delivers equitable fiscal outcomes with a degree of transparency and few distortions to economic activity. However, it has some major shortcomings.
 - On equity, HFE achieves almost complete fiscal equalisation; as such, it enables all States to provide the average national level of services and mostly adjusts for fiscal disadvantages that are out of States’ control. But it does not systematically provide for State Governments to retain a reasonable share of the fiscal dividends of their policy efforts or economic development (without them being equalised away), raising concerns about fairness.
 - On efficiency, there is no clear evidence that the HFE system distorts patterns of interstate migration. And GST payments are mostly unaffected by changes in State policy settings. But in some cases, there can be material disincentives for a State embarking on significant tax reforms and resource development policies, especially where it is a first mover.
 - The independent CGC is highly regarded. It carries out the GST distribution at arm’s length from government and with generally transparent processes for consultation with the States. But concerns have been raised with the CGC’s decision-making framework and insufficient leadership from the Commonwealth Government.
- Many of these problems are due to the pursuit, above all else, of comprehensive equalisation of fiscal capacities. In doing so, it is likely that opportunities are being missed to achieve broader equity outcomes (which incorporate fairness by rewarding States for their policy efforts) and to improve efficiency in the Australian economy.
- The objective of HFE should be reframed to allow for trade-offs to be made between equity and efficiency. The system should enable State Governments to provide a ‘reasonable’ standard of services, rather than the ‘same’ as under the current system.
- Governance changes are also needed to enhance transparency and accountability.
 - Greater leadership from the Commonwealth Government is required. Further, the CGC should play a more prominent public communication role to inform the public discourse on HFE. It should also provide the States with ‘draft rulings’ on the HFE implications of a proposed policy change.
 - The Commonwealth Treasury should provide input into the CGC’s consultation processes. This will ensure the CGC’s judgements can be informed by perspectives that take into account the costs and benefits for the community as a whole.
 - Outlining clear guidelines detailing the basis on which Commonwealth payments are to be quarantined from HFE by the Commonwealth Treasurer would ensure the CGC’s relativities are not undermined or the objective of HFE compromised.
 - Public release of data provided by the States (as well as the CGC’s calculations) would improve government accountability in the HFE system.

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Chapter 7: Are there better ways to assess fiscal capacity?

- The HFE methodology could be improved to help address some of the problems with Australia’s HFE system, in conjunction with the changes to the HFE objective and governance proposed in chapter 6.
- Introducing more policy-neutral indicators (of fiscal capacity) and higher materiality thresholds for what is incorporated into the equalisation process would partially mitigate some of the HFE system’s problems, and complement any reform to the equalisation benchmark.
 - The CGC should be directed to develop simpler and more policy-neutral indicators for its 2020 methodology review (such as by aggregating taxes with similar bases) as a way to better balance equity and efficiency. This would be supported by a significant (and overdue) increase in materiality thresholds.
- Some other in-system changes offer prospective benefits, but on balance are not practicable.
 - Benchmark costs — set to reflect efficient costs of service delivery (what States ‘should do’) — would encourage greater efficiency, but face daunting practical difficulties and much scope for dispute.
 - Using a single broad indicator (such as gross state product) to assess fiscal capacity offers the prospect of a radically simpler and genuinely policy neutral approach. But most indicators do not adequately reflect States’ revenue-raising capacities or expenditure needs and therefore pose a significant risk to fiscal equity.
 - Elasticity adjustments may help to mitigate the impact of policy-induced changes to tax bases on the GST distribution (albeit only those arising from tax rate changes), but would be difficult to implement, subject to dispute, and only possible to apply on an ad hoc basis.
- Blunter approaches to assess fiscal capacity, such as discounting entire revenue categories (for instance, mining), would come at too high a cost to fiscal equity.
- Another way to help address policy non-neutrality problems, especially in regard to the mining assessment, would be to apply discounts relating to future tax rate changes. This has recently been proposed by the CGC.
 - However, this departure from full equalisation represents a limited and poorly targeted way to reduce disincentives to reform. It would only address policy influence on average mineral tax rates, and only for Western Australia for the foreseeable future. Moreover, it is not well suited to addressing policy influence over tax bases or other non-mining tax rates.
 - There are no obvious approaches (including use of policy-neutral indicators) that would mitigate the policy non-neutrality problems that beset the mining assessment — the biggest driver of redistribution within HFE for the foreseeable future.
- Some of the disincentive effects within HFE — namely, those arising from the equalisation of tax bases — are inherent to equalisation itself and cannot be removed completely by way of methodological adjustments. The only way to address such disincentives would be to reduce the extent of equalisation (such that changes in States’ tax bases do not impact their GST payments).

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- pp. 197-199; table 7.1 (p. 198)
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- pp. 214, 216; figure 7.1 (p. 214); box 7.7 (p. 215)
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Chapter 8: Is there a preferred benchmark for fiscal equalisation?

- Alternative approaches to distributing the GST involve trade-offs between equity, efficiency, and transparency and accountability. The current approach to managing these trade-offs is manifest in the equalisation benchmark, which to date has been set by the CGC as equalising to the same standard and thus to the strongest State plus an equal per capita (EPC) amount.
- Several alternative equalisation benchmarks (proposed by inquiry participants) would not deliver a reasonable level of equalisation and do not provide a clear improvement over the current system.
 - An EPC benchmark appealed to some participants, and it performs well in terms of efficiency, fairness (reward for policy effort) and transparency, but does not equalise the fiscal capacities of States (to any benchmark) and, thus, is inimical to HFE.
 - An EPC benchmark with top-up funding could limit these downsides and offer benefits for transparency. However, funding the top up could create other losers, and should only be contemplated as part of broader reform to federal financial relations. Moreover, such funding is not certain and subject to the vagaries of the Commonwealth budget.
 - A relativity floor is not well targeted at the efficiency and fairness problems of the HFE system, such as disincentives to undertake major tax reform (efficiency) and receiving reward for policy effort (fairness).
- Other options for equalising fiscal capacities to less than that of the strongest State (which the Productivity Commission considers a desirable change) hold more promise. These options can deliver (to varying degrees) a reasonable level of equalisation and at the same time enhance the efficiency and fairness of the HFE system.
- Options include equalising to the fiscal capacity of the second strongest State, to the average of the fiscally strong States, or to the average of all States. Other options involve full equalisation for the smallest States only and 90 per cent full equalisation (with 10 per cent EPC).
- No option is unambiguously superior. On balance, equalising to the average (ETA) fiscal capacity of all States is judged to be the preferred alternative. ETA is expected to provide the greatest scope for efficiency gains and to improve fairness compared with the alternatives. It would enable fiscally stronger States to keep a greater portion of the fiscal dividends of their policy effort, and the fiscal impacts are likely to be modest and manageable using a careful transition approach.
 - For those States that would receive less GST (compared to the current system), the largest revenue reduction (without transition) is 2.5 per cent or less of State revenue.
 - All States would be able to meet a high level (at least 97 per cent) of their assessed expenditure needs.
 - States can choose (as they do already) to prioritise the way they spend their GST payments to ensure that key services continue to be funded to meet community expectations.

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- pp. 254-255;
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- Figure 8.6
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Chapter 9: The way ahead

- The Commission has identified a package of reforms that will improve the equity, efficiency and transparency and accountability of the HFE system. Most of these improvements can be pursued without delay, including:
 - revising the HFE objective to give States the capacity to deliver reasonable service levels
 - governance changes to improve the transparency and accountability of the HFE system
 - in-system changes to achieve simpler and more policy neutral assessments.
- These reforms can only go so far. Equalising to the average fiscal capacity of the States (ETA) would meet the revised objective and provide additional fairness and efficiency gains. This change will require a transition period to ensure that States are able to adjust and manage their budgets, while also generating the reform benefits within an acceptable timeframe.
- The most effective transition approach is one that: enables States to manage their budgets during the current forward estimates period, is fiscally sustainable for all governments and delivers the benefits of reform in a timely manner.
- Either a four year or eight year transition path is judged to be manageable for the States. A four year transition would deliver the benefits of reform more quickly, but an eight year transition gives States more time to adjust and provides greater latitude to deal with changes in the future fiscal circumstances of the States. Both approaches would be 'funded' from within the GST pool. By delaying the full implementation of ETA, both transition paths are effectively funded by the States that stand to benefit the most from the new benchmark.
- Both transition paths would soften any (negative) year-on-year impact to less than 1 per cent of State revenue.
- There is only so much an improved HFE system can deliver in isolation. The greatest benefits will come from broader reform to federal financial relations, addressing the twin accountability issues of vertical fiscal imbalance (VFI) and spending responsibilities. This proved the single unifying view shared by States during the course of this inquiry.
- Governments should renew their concerted endeavours towards broader reform to federal financial relations, led by the Council on Federal Financial Relations and with the newly formed Board of Treasurers providing input and assuming a proactive role.
 - As a first step, the reform process should assess how Commonwealth payments to the States — both general revenue assistance and payments for specific purposes — interact.
 - The process should also include consideration of a practical division of responsibilities between the States and the Commonwealth, and accompanying accountability and performance arrangements. Clearly defining responsibilities and establishing accountabilities for Indigenous policy should be given priority.
 - Following this, options for addressing VFI, and particularly the extent to which these options are able to improve accountability, should be considered and advanced.
 - If there is sufficient progress towards broader reform (including in relation to VFI), the transitional impact on some States could be further reduced.

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