



DEPARTMENT OF TREASURY

Mr John Spasojevic
Secretary
Commonwealth Grants Commission
Cypress Court
5 Torrens Street
CANBERRA ACT 2612

Dear Mr Spasojevic

**ACT SUBMISSION ON THE ARCHITECTURE OF HORIZONTAL FISCAL
EQUALISATION AND CONTEMPORANEITY**

Thank you for the opportunity to provide a submission to the Commonwealth Grants Commission's Issues Paper CGC 2006/03 '*Architecture of Horizontal Fiscal Equalisation: Principles and Interpretation*' and CGC 2006/04 '*Contemporaneity*'.

The attached submission primarily outlines the ACT's views on the principles and interpretation of HFE, as well as other matters raised by the Commission associated with the architecture of HFE.

The ACT does not believe that the 2010 Review Terms of Reference provide grounds for reviewing the principles and interpretation of HFE. As governments have not agreed to change the existing HFE definition, the Commission does not have the mandate to reinterpret equalisation. In this context, it is considered that the Commission should continue to use the equalisation principle in place at the time the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* came into effect, that is, the 1999 Review principle.

It is also noted that the timetable within the Commission's HFE Issues Paper suggests that further comments may be requested from the States by mid October 2006. While the ACT is on record as not objecting to the proposal to progress both issues of principle and aggregation concurrently, it is our view that delaying decisions on the HFE principle beyond the 2007 *Ministerial Council for Commonwealth-State Financial Relations* will only produce uncertainty for the 2010 Review. We consider it to be of paramount importance that the HFE principles are 'bedded-down' as soon as practicable.

If you have any questions regarding the attached response, please contact Mr Roger Broughton Executive Director, Investment and Economics Division (phone 6207 6082).

Yours sincerely

for Paul Grimes
Under Treasurer
7 July 2006



AUSTRALIAN CAPITAL TERRITORY

SUBMISSION TO THE COMMONWEALTH GRANTS COMMISSION'S ISSUES PAPERS:

***2006/03: ARCHITECTURE OF HORIZONTAL
FISCAL EQUALISATION: PRINCIPLES AND
INTERPRETATION***

2006/04: CONTEMPORANEITY

June 2006



Key Points

Overarching views on HFE

- As governments have not agreed to change the existing HFE definition, the Commission does not have the mandate to reinterpret equalisation. This view is consistent with the:
 - Australian Treasurer's statement that GST revenue is to be distributed on the long-standing HFE principle and that changes to HFE would only be considered if States were in unanimous agreement;
 - Commission's 2004 Review position that decisions about the financial architecture of the Federation are matters for governments and that it did not have the mandate to consider and make recommendations on such matters; and
 - *Intergovernmental Agreement (IGA)* which expressly refers to the distribution of GST revenue in accordance with HFE principles – consistent with what the Commission has said in the past, the only HFE interpretation it can take is the one consistent with the 1999 Review (the current definition at the time the IGA was implemented).
- In terms of the objective of the GST pool, the intention is that all Australian citizens can access a similar standard of public services regardless of which jurisdiction they reside in and subject to their own choices about priorities.
- Efficiency equalisation is not supported:
 - as it is contrary to the existing HFE principles of citizens accessing average standards of service; and
 - the Commission '*has no mandate for considering efficiency arguments*', as stated by the Chairman in 2005.

Three Pillars

- The ACT strongly supports the three pillars of equalisation ('policy neutrality', 'what States do' and 'capacity equalisation') as a means of achieving HFE.
- Policy neutrality principles are integral to the equitable sharing of GST revenue and prevent participants adopting policies that can directly influence outcomes.
- The use of internal standards is supported as it obviates the need for the Commission to undertake extensive 'value' judgements if external standards were used.
- Capacity equalisation is about equalising the fiscal capacity of the States not the circumstances of individuals, households or communities. As such, the ACT supports the adoption of the 'narrow view' of the scope of fiscal equalisation.

Other Issues

- Notwithstanding the ACT's views on HFE, comments have been provided on the specific issues raised by the Commission.

BACKGROUND

1. The Commission's 2004 Review Report summarised a series of arguments, made by some States, in favour of reinterpreting the principles of Horizontal Fiscal Equalisation (HFE). Other States and Territories¹ supported the existing principles and/or suggested minor revisions to augment them.
2. The 2006 Progress Report to the Ministerial Council for Commonwealth-State Relations (MinCo) identified differing State positions on the interpretation, implementation and level of equalisation that should be achieved.
3. Issues Paper 2006/03 builds on the 2006 Progress Report to MinCo and outlines the Commission's interpretation of the 2010 Review Terms of Reference (ToR) and thus the implications for HFE. The Issues Paper structures discussion on the principles and architecture of HFE around three themes involving the:
 - most appropriate definition of equalisation;
 - interpretation and implementation of equalisation principles – including the scope of equalisation; and
 - objectives of the GST pool distribution – should it be on the basis of equalisation or something else?
4. One observation made by the Commission is that the 2010 Review ToR is silent on the form that HFE should take, and thus a review of the principles and interpretation of equalisation is required. State's views are sought on what objectives should underpin HFE and how HFE should be implemented.
5. This submission provides the ACT's views on the principles of HFE, reasons for retaining HFE as currently practiced and other architecture issues. It also reviews arguments proposing changes to the underlying HFE principles and responds to the specific questions raised by the Commission.

OVERARCHING VIEWS ON THE PRINCIPLES OF HFE

No Mandate for reviewing the existing definition of equalisation

6. Some parties have suggested that the absence of specific comment in the ToR to the principles of HFE provide grounds for reviewing the principles and interpretation of HFE. The ACT considers that as governments have not agreed to change the existing HFE definition,² the Commission does not have the mandate to reinterpret equalisation.
7. The Australian Treasurer's 2004 MinCo press release³ highlighted that GST revenue is to be distributed amongst the States on the long-standing [HFE] principle that all State Governments should have the same capacity to provide quality services to their citizens.

¹ The word 'States' refers to the 'States and Territories' unless otherwise specified.

² "... if each [State] made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard." - CGC (2004), *Report on State Revenue Sharing Relativities 2004 Review*, Chapter 2, Page 4, Paragraph 3.

³ Typical of the wording adopted for all MinCo press releases for at least the last 3 years.

8. In regard to some States' dispute with the distribution of the GST, the Treasurer stated that:

*"If all States and Territories come united to the Australian Government and want the formula changed, I will consider their proposal."*⁴
9. This statement infers that for the principle of fiscal equalisation to be changed, there must be unanimous support and that the decision to do so rests with the Australian Treasurer. Accordingly, there would appear to be no mandate for the Commission to review the architecture of HFE. This is the view that the Commission took in the 2004 Review Report where it stated that:

*"...decisions about the financial architecture of the federation are decisions for governments. We did not accept that our terms of reference gave us the mandate to consider and make recommendations on these matters."*⁵
10. Furthermore, the basis for the distribution of GST revenues is established by the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (IGA)*. Clause 8 of that agreement requires the distribution of GST revenues among the States to be in accordance with HFE principles.
11. The 2010 Review ToR specify, in particular, that the Commission should seek to 'simplify its assessments and improve the quality and fitness for purpose of both data and methodology' for the calculation of the 2010 Review relativities, whilst ensuring that doing so is consistent with the principle of HFE. They do not request a reconsideration of the HFE principles.
12. The ToR has regard to the work progressed by Heads of Treasuries (HoTs) after the 2004 MinCo, which examined aspects of the HFE methodology. The work found the methodology, while generally robust, could be simplified without compromising the underlying HFE principles.
13. The intent of this outcome is reflected in the 2010 Review ToR. All States, with the support of the Australian Government, agreed at the 2005 Treasurers' Conference that the HoTs' recommendations be progressed, consistent with the equalisation principle:

*"HoTs recommended that as part of the 2010 Review, the Commission be asked to undertake work on simplification and continuous improvement that is consistent with the equalisation principle and builds on the work by HoTs."*⁶
14. The ACT considers that, without explicit terms to the contrary, the 2010 Review task precludes any examination of HFE because the IGA expressly refers to the distribution of GST revenue in accordance with HFE principles:

*"The Commonwealth will distribute GST revenue grants among the States and Territories in accordance with horizontal fiscal equalisation (HFE) principles"*⁷
15. The ACT's view appears to have been supported by the position the Commission took in its 2004 Review Report, that as HFE was not specifically defined in the IGA (and

⁴ <http://www.treasurer.gov.au/tsr/content/pressreleases/2004/016.asp>

⁵ Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities, 2004 Review*, page 83.

⁶ Commonwealth Grants Commission, *Progress Report to Ministerial Council for Commonwealth-State Financial Relations, 2006*, Chapter 2, Page 3, Paragraph 9.

⁷ Australian Government (1999), *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999*, Schedule 2, *IGA on the Reform of Commonwealth-State Financial Relations*, Part 2, Page 35, Paragraph 8.

without explicit ToR to review HFE principles) the only interpretation it could take was one consistent with the 1999 Review (the current definition at the time the IGA was implemented):

*“We noted that Schedule 2 to the IGA provides that GST revenue is to be distributed among the States on the basis of horizontal fiscal equalisation principles. These principles are not defined in the IGA, but we interpreted this to mean that our approach should be based on the equalisation principle in place at the time the IGA came into effect – that is, the 1999 Review principle.”*⁸

16. Furthermore, the Commission expressed its desire to review the interpretation of HFE, however, conceded that without specific direction from MinCo it was unable to do so. No such direction has been provided.
17. The ACT believes that had governments intended for the principles of HFE to be reviewed, it would have been explicitly called for in the 2010 Review ToR. This has not been done. Rather, the 2010 Review ToR provides for some aspects of the methodology to be reviewed, but only to the extent it is consistent with the principles of HFE.

Objectives of the GST pool distribution / current HFE distribution

18. The GST pool objective is to provide State governments with the capacity to provide services at the same level to their citizens. Clearly, the intention is that all Australian citizens can have access to a similar standard of public services regardless of which jurisdiction they reside in and subject to their own choices about priorities. The fact that GST funding is untied lends further support to the interpretation that States are not obligated to provide average levels of service and that equalisation merely provides the capacity to do so if States desire. Issues relating to the interpretation and measurement of standards are dealt with later in this submission.
19. The ACT considers that the terms ‘equality’, ‘not appreciably different from’, ‘reasonably comparable’, and ‘average standard’ all have similar meaning to ‘same level’, and the differences are largely semantic. Such a view is reinforced by the fact that the 1993 Review ToR and the 1999 (and 2004 Review) ToR used different words - ‘not appreciably different from’ and ‘average standard’ respectively - and yet adopted fundamentally the same methodology to deliver capacity based equalisation outcomes.
20. The ‘same level’ or ‘average standard’ definitions are considered to be more appropriate as they are more specific and thus better reflect the comprehensive equalisation system currently practiced. However, proposals to adopt greater simplification and aggregation, including the use of relatively high materiality thresholds has the effect of moving towards a ‘looser’ definition which might be described as ‘reasonably comparable’.
21. Providing financial assistance to only the ‘weakest States’ is not supported for a range of reasons. Foremost, it is not clear how ‘weakest States’ would be defined, and would require the Commission to make judgement decisions.
22. Further, the approach equates to partial equalisation only and would not do anything to address the range of differing circumstances facing the States, such as physical, geographic, business/government mix, locational, and legislative constraint differences.

⁸ Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2004 Review*, Page 82, Chapter 7, Paragraph 18.

23. The current approach, whereby HFE automatically captures the latest circumstances of the States (albeit with a lag), also allows States that are financially ‘weaker’⁹ at the time to receive a greater level of GST compensation, adequately captures ‘weakness’ in their economy. Basing HFE on selected ‘weaker’ States would be too rigid as it would override the existing responsive system, and may need revising from year to year.

Interpretation of equalisation principles

‘Broad’ versus ‘narrow’ interpretation

24. In the 2004 Review the Commission noted that:

*"The definition makes it clear that it is the fiscal capacity of the States that is being equalised. Fiscal equalisation is not directed towards equalisation of the circumstances of individuals, households or communities."*¹⁰

25. The ACT considers that the focus on States' budgets means that the 'narrow' approach to equalisation, that is focussing on actual revenues and expenditures of governments and excluding actual expenditures and revenues incurred by or raised by non-government sectors. This issue is discussed further under the section which refers to the three pillars of equalisation.

Comprehensiveness and a growing GST pool

26. While acknowledging that at the margin HFE could be simplified to reduce complexity, a comprehensive form of equalisation, as currently practiced, is fully justified. Comprehensive equalisation is defensible as this ensures that States are provided with an amount of GST funding that reasonably reflects the resources required to provide an average level of government service.
27. The size and rate of growth in the GST pool and the degree of Vertical Fiscal Imbalance in Australia, with State Governments heavily dependent on fiscal transfers from the Australian Government, further reinforces the need for a comprehensive system.

Costs of HFE

28. Some States have attacked the efficiency of HFE on the basis that the States and Australian Government incur large expenses in operating HFE. However, given that HFE will distribute approximately \$45 billion¹¹ in 2005-06, operating costs of around \$10 million per year are very efficient.
29. It has also been cited that receiving an above average share of Australian Government grants under the HFE system, due to the higher cost of providing government services, reduces the incentive a State has to provide services more efficiently. In reality, a State gains far more from improving the efficiency of its government services than it would hypothetically lose in GST funding due to the efficiency gain. Likewise, a State bears almost all the costs of its own inefficiency.
30. The argument that HFE provides a disincentive to improve efficiency is fallacious.

⁹ That is, have a relatively high Cost of Service Provision and low Revenue Raising Capacity.

¹⁰ Ibid, page 4.

¹¹ Approximate combined GST and Health Care Grant pools (2005-06).

Tying the distribution of GST revenue to specific State outcomes

31. Attaching additional provisions to the HFE principles is cause for concern as they could lead to a quasi-tying of GST revenues to specific performance outcomes. This approach would effectively override HFE principles, with some States being required, for example, to reduce their expenditure to achieve efficiency benchmarks, thereby impacting on their ability to provide an average level of service. This also directly conflicts with the IGA:

*“GST revenue grants will be freely available for use by the States and Territories for any purpose.”*¹²

32. Notwithstanding that the ToR do not allow HFE to be reinterpreted on an efficiency basis, any move to distribute GST funding on these grounds would require robust evidence unambiguously showing that distributional and technical efficiency would not themselves create distortionary effects within State government fiscal priorities.
33. Current attempts to discredit the comprehensive implementation of HFE have involved claims of distortionary effects (such as Garnaut and Fitzgerald¹³, and to a lesser extent Warren¹⁴), although such effects have only been suggested at the margin. These claims are based on tenuous assumptions and are not supported by robust data. Indeed, there is evidence indicating that HFE may actually decrease distortionary effects.¹⁵
34. The ACT understands that it is the role of the Commission to consider the views of States in respect of these matters. However, the ACT agrees with the views expressed by the Chairman of the Commission, at the HoTs Conference of 24 November 2005, that there was no mandate for considering efficiency arguments, and by implication, there was no need to consider such arguments as no definitive evidence had been provided highlighting that equalisation causes distortionary effects:

*“I have not seen anything definitive and authoritative to indicate that equalisation was a dead hand on economic efficiency, on growth... Efficiency of course is not part of the mandate of the Commission. So we would need to be told that it was part of the mandate...”*¹⁶

THE THREE PILLARS

Capacity Equalisation

Broadening or narrowing the equalisation principle – need for consistency

35. The ACT strongly supports the three pillars of equalisation (‘policy neutrality’, ‘what States do’ and ‘capacity equalisation’) as a means of achieving HFE.
36. One issue of interpretation that does arise, however, regards the ‘capacity equalisation’ pillar and how it is interpreted - ‘narrow view’ or ‘broad view’ of equalisation.

¹² Australian Government (1999), *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999*, Schedule 2, *IGA on the Reform of Commonwealth-State Financial Relations*, Part 2, Page 35, Paragraph 7.

¹³ Garnaut, Ross and Fitzgerald, Vince (2002), *Review of Commonwealth State Funding (Final Report)*, NSW Treasury, Victoria Treasury, Western Australia Treasury.

¹⁴ Warren, Neil (2006) *Benchmarking Australia’s Intergovernmental Fiscal Arrangements (Interim Report)*, NSW Treasury.

¹⁵ Hancock, Jim & Smith, Julie (2001), *Financing the Federation*, The South Australian Centre for Economic Studies, Chapter 4, Part 4.3.2.4, page 87-88.

¹⁶ Commonwealth Grants Commission (2005), *Commonwealth Grants Commission / Heads of Treasuries Conference 2010 Review*, Transcript of Proceedings, page 69.

37. In the 1993 Review the Commission decided that the ToR required it to focus on the revenue and expenditure transactions of governments (including private services partly funded by government), not those of the wider 'community'. The Commission concluded this meant the adoption of a 'narrow view' of the scope of fiscal equalisation.
38. This view implies that a State would be entitled to a larger per capita share of general revenue grants if its community demanded relatively more publicly funded services. This 'narrow view' led to the majority interpretation that actual enrolments in the government and non-government sectors should be the basis for assessing needs.
39. The rejection of the minority view, that States should not receive smaller grants as a result of greater citizen effort, is confirmation that fiscal equalisation was, in the 1993 Review, about government and not 'community' equalisation.
40. There is currently an inconsistency in the approach to non-government service provision that should be rectified.
41. In the case of schools education, those States that have a higher proportion of their students in non-government schools receive lower needs in the government schools assessments. That is, implicitly, the actual level of non-State service provision is incorporated into the assessment as needs – the 'narrow' view.
42. However, for inpatient services, those States with a higher proportion of private hospital provision do not receive lower needs for public hospital services, implying an assumption that all States have an average provision of private hospital services. This is more consistent with the 'broad' view of equalisation.
43. The use of actual road length (which excludes toll road lengths) in the roads assessment implies that States with a greater provision of private roads (ie. toll roads) have lower needs for road expenditure. This reflects the 'narrow' view in the same way as the government schools categories do.
44. Along the same lines, revenue base measures which take account of the actual level of transactions, such as for conveyance, direct greater funding to those jurisdictions where the citizens seek to avoid taxes or alternatively less funding to those jurisdictions where citizens choose to engage in taxable transactions. This is consistent with the 'narrow' view or government fiscal capacity equalisation. On the other hand, adoption of broader underlying measures of revenue capacity, for example, household disposable income for the gambling revenue assessment, where the measure of need makes no reference to the actual level of engagement in the taxable activity, is akin to the 'broader' approach to equalisation - that is, it equalises communities rather than government capacities.
45. Whichever view is adopted by the Commission, 'narrow' or 'broad', the assessments should be reviewed to ensure that the principle are applied consistently.
46. The ACT considers that equalisation should be based on the 'narrow', government capacity interpretation. This is mainly for pragmatic reasons. The budget capacity approach allows for more clearly defined boundaries. A broader approach opens up a much wider range of services and fees for consideration, such as non-government welfare services, toll roads and possibly private security services.

What States Do / Internal Standards

47. **Whether the current interpretation of standards as an average of the policies of all States should be changed to standards based on what some States do or to external standards based on a desired level of service or tax policy or a desired level of efficiency in service delivery. What might be the implications of such changes and how might decision on the appropriate standard be made?**
48. The use of external standards based on an efficiency concept or an 'ideal' level of service while potentially feasible will require extensive 'value' judgements by the Commission and may not equalise States' capacities. A consequence of such an approach may be greater criticism of the process as it requires greater use of judgment, which would not be supportable by data.
49. The use of internal standards is supported. While it would be possible to develop less inclusive internal standards, such as limiting the standard to the average of only some State, it is unclear as to what criteria would be used to decide which States are part of the standard and which are not. Moreover, would the mix of States in the standard differ for various assessment, for example, mining revenues?
50. It is worth noting that the three most populous States provide approximately 78 per cent of the standard in many categories. The adoption of internal standards, that is a national average using all States, is a simple construct that is easily understood and requires no judgements on the part of the Commission.
51. **Should 'what States do' be broadly interpreted, in terms of State policy objectives or in terms of the many services States provide to achieve those policy objectives? How might the Commission establish the policy objectives? How might cost differences States face in achieving a policy objective be measured?**
52. While States probably share very similar objectives in a broader sense, the circumstances of States differ sufficiently for the pursuit of such objectives to be achieved by way of a different mix of services and/or priorities. Accordingly, the ACT considers that assessments should be based on the actual services provided rather than the broader objectives.
53. The use of a comprehensive set of assessments to capture States' policy objectives is consistent with the usual approach of assessing disabilities related to the full range of State services and revenues as it reflects 'what States do'. An increase or reduction in the scope and aggregation of assessments may be reasonable, however, if is consistent with HFE.
54. Policy objectives should be established by considering the actual activities of States; the funding mechanisms in place (eg. SPPs); and the goals and objectives of jurisdictions.
55. As an example, it would be fair to say that all States pursue a broad policy agenda of economic development. In some instances this is primarily achieved through investment friendly tax regimes, while in other cases the focus is on direct expenditure for industry assistance programs. It is unclear just how an assessment based on the broader policy objective would be undertaken in a way that equitably recognised the different approaches adopted by States. On the other hand, assessments based around individual categories of expenditure and revenue are far more objective and intuitive.

56. Broader interpretation of policy objectives is not consistent with a ‘narrow’ interpretation of capacity. The ACT considers the ‘narrow’ interpretation is most appropriate and that this implies that internal standards should be developed around the actual activities of States and not broader policy objectives.
57. **Currently, the ‘same effort to raise revenue’ is interpreted as applying the same definition of the revenue base and rates of tax, but should it be interpreted broadly to encompass the same policies for creating / growing the tax base as well as those for taxing it? Could that be done in a simple & robust way?**
58. The ACT does not support a broad interpretation of revenue raising capacity because:
- it is not consistent with the ‘narrow’ definition of capacity equalisation;
 - it does not reflect the constraints on revenue raising faced by States, including their inability to tax income and consumption; and
 - would not result in equalising States’ capacities to provide the same or comparable services.
59. While all States aim to grow their tax base, various constraints such as natural endowment, constitutional and other limitations applying to the ACT’s relatively narrower tax base limits its ability to expand its tax base. For example, the ACT is unable to grow its mining revenue base due to a dearth of mineral wealth. Similarly, it does not have the high levels of demand for car parking nor the large proportion of private firms operating in large capital cities, thereby preventing central business parking levies being introduced like other States.
60. Legislatively, under the Australian Constitution, the ACT is constrained in terms of taxing its largest employer, the Australian Government. As such, this has implications for a range of taxes such as payroll tax and land tax.
61. The ACT also faces limitations to growing its tax base due to high levels of tax mobility. That is, businesses and residents can shift their taxable location (to NSW) so as to avoid ACT taxes while still accessing ACT government services and infrastructure. The result is that the ACT is constrained in its ability to implement global revenue policies (such as payroll and land tax rates) significantly higher than those in NSW.
62. **The average standard approach implies all States notionally provide services in the same way. Is this appropriate given different circumstances? Are there practical alternatives?**
63. In order to assess non-policy influences on costs, an average policy must be implied. In many cases the differences from the average will be marginal, however, in some circumstances the differences in policy could be material. In the latter cases, the assessment of non-policy influences may be made more difficult, however, the ACT considers that the approach of adopting a notional average policy remains superior to alternative approaches.
64. **Is equalisation being asked to do too much? Should relativities be based on what is required to allow the underlying causes of certain disabilities to be overcome? If so, how might it be achieved and how could the Commission decide which disabilities should be addressed?**

65. Equalisation based on funding to enable underlying disabilities to be overcome is in effect performance equalisation. The ACT does not support performance equalisation as there is considerable risk that States would be rewarded for under-performing. The ACT is unclear as to how such an arrangement would work in practice. For example, if a State with below average school participation were to be funded to enable it to achieve average participation, some mechanism would be required to ensure that the additional funding was spent for that purpose in an effective manner. Otherwise, the incentive would be for the State to continue to perform below average to obtain additional funding. In other words, the measure of disability would not be policy neutral.
66. In many cases, the causes of underlying disabilities cannot be overcome even if funding was directed towards them. Disabilities under the current methodology are intended to be at least policy neutral and in many cases policy free. It could be assumed that those disabilities that are policy free could not be addressed by extra funding; for example, no amount of additional funding could address the ACT's lack of mineral endowment.
67. Given limited resources, some prioritisation of the most important disabilities to be overcome would be needed, requiring significant judgement. It is not clear how the Commission would determine the most pertinent disabilities to be addressed. Would targeting congestion be to the interests of all Australians if billions of dollars were poured into Sydney and Melbourne at the expense of providing welfare payments for food, clothing and housing to low income groups? How would this be justified?
68. Nor would it be straightforward to establish what in fact are the underlying causes. For example, if funding was provided to overcome vandalism, there is no concrete evidence as to whether this occurs because of youth boredom, settlement patterns, urbanisation, big city effects, drug/alcohol dependency, depression, low income, etc. Without a clear indication of the drivers of vandalism, and their relationship, it would be difficult to target the main causes of vandalism.

Policy Neutrality

69. Policy neutrality is an essential requirement for an equitable sharing arrangement. It is vital that participants are not able to adopt policies that can directly influence the outcome.
70. Some parties have argued that the current equalisation methodology enables States to influence the outcome. It is the fact that States may be able to re-arrange expenditure priorities or tax structures to influence the assessment category standards to their favour. However, these are second order effects and, as well as providing only marginal improvements, are not fully realised for seven years due to the five year averaging process for establishing relativities. The fact that any benefit is likely to be marginal and to take a long period to be fully realised means that State governments are entirely unlikely to give such a strategy priority over the current needs of their electorates.
71. Large policy differences which may inappropriately impact on the assessment of disabilities, and which override policy neutrality, should be adjusted for in the normal manner. Cost differences in providing policy objectives should be determined by considering each States' non-policy influenced costs relative to the average policy.

Other Pillars

72. **Whether efficiency, simplicity, robustness, transparency, stability or predictability should be included as a pillar of equalisation?**
73. The ACT supports the current three pillars: capacity equalisation, internal standards and policy neutrality. Capacity equalisation defines the scope of equalisation. Internal standards provides an objective benchmark against which needs are assessed. Policy neutrality ensures the integrity of the model. These three pillars are essential to the current equalisation principle. That is they support the principle.
74. On the other hand, issues such as robustness, simplicity and transparency, while possibly sound objectives, should be subordinate to the primary aim of equalisation. Accordingly, the ACT would not describe these lesser objectives as essential to, and therefore pillars of, equalisation.
75. **Whether including efficiency as a pillar (based on either the broad interpretation of allocative efficiency or the narrower interpretation of the technical efficiency of service provision), would be consistent with fiscal equalisation? If so how might it be done in a simple and reliable way?**
76. The ACT does not consider there is any legitimate requirement to take efficiency into account in assessing equalisation. In our view, equalisation is neutral in relation to its impact on technical efficiency – neither encouraging nor discouraging States from improving their efficiency. In relation to allocative efficiency, the debate is less than conclusive with views ranging from marginal negative impacts to possible positive impacts.
77. In terms of technical efficiency, the ACT rejects claims that the current HFE methodology gives States an incentive to be inefficient in terms of service provision. All State Governments have economic and political incentives to promote growth through increased efficiency. The benefits of increased efficiency far outweigh the partial cost recovery for inefficient States through HFE.
78. There is no evidence that shows HFE causes major distortionary effects in economic or allocative efficiency. In reality, various papers have argued for and against efficiency gains on the margin. Mr Jim Hancock and Dr Julie Smith¹⁷ concluded that HFE increases allocative efficiency as equalising State net fiscal benefits means people locate where their labour is most productive, rather than where they can obtain the greatest net fiscal benefit.
79. We do not see how HFE based on efficiency could be undertaken in any simple and reliable way given that it would require significant judgment as to what constitutes efficiency and how it might be achieved.
80. The Commission has not been given a mandate to distribute GST revenue based on efficiency grounds. The IGA places an overarching requirement for the methodology to be based on HFE principles, and as such, an efficiency pillar is inconsistent with HFE.

¹⁷ Hancock, Jim & Smith, Julie (2001), *Financing the Federation*, The South Australian Centre for Economic Studies, Chapter 4, Part 4.3.2.4, page 87-88.

THE SCOPE OF EQUALISATION

- 81. Whether equalisation should be confined to ‘merit goods’ or a concept of core State functions / taxes, such as education, health, and law and order. If so, how might ‘merit goods’ / another concept of core functions be defined and applied?**
82. The ACT considers that for reasons of comprehensiveness and transparency, the scope of equalisation should include all revenues and expenditures normally included in State Budgets. This is more for presentational purposes. The outcome of equalisation is, of course, dependant on which of these revenues and expenditures are subject to needs assessments. The ACT considers that differential needs assessments should be adopted where a valid case is made that to do so is consistent with HFE.
83. The use of a comprehensive set of assessments capturing the full range of State services and revenues is supported as it reflects ‘what States do’.
84. There is merit, however, in not extending the assessment of disabilities to services that may lead to outcomes that are contrary to sound economic policy, such as assessing economic development disabilities. Such disabilities may lead to inefficient competition for business and inefficient industry. As such, support for the current approach also extends to economic development arguments. The ACT considers that an adequate case for the assessment of disabilities in respect of economic development services has not been made.
- 85. Whether equalisation should cover all activities of State governments in providing services and raising taxes and charges – that is, State trading enterprises as well.**
86. Consistent with the ‘narrow’ interpretation of capacity, only those transactions affecting State Government budgets should be included in assessments. The gross revenues and expenditures of PTEs should, like toll roads and non-government schools, be excluded.
- 87. Should disabilities be confined to reflect interstate differences in the use of services – that is omit differences in the unit cost of providing services?**
88. The ACT considers that all relevant disabilities, including usage and unit cost should be assessed. However, all measures of need should meet appropriate tests of policy neutrality and data reliability.
89. Consistent with the 2010 Review assessment guidelines criteria, if data are not fit for purpose or not of suitable quality, the Commission should ‘*discount the impact that has been determined*’ or ‘*make no assessment*’.
- 90. Should location effect disabilities be omitted?**
91. It is our view that location disabilities¹⁸ are legitimate. Again, however, location based disabilities must meet relevant criteria.

¹⁸ Dispersion, urban influences, service delivery scale, isolation and socio-demographic composition.

USE OF BROAD INDICATORS

92. As previously indicated, it is our view that broad / global measures are inconsistent with the ‘narrow’ view of equalisation. The Commission’s inclination not to adopt global type assessments in the 2010 Review is therefore supported.
93. Broader revenue indicators fail to accurately reflect the impact on States’ budget capacities or what States do. In the case of the ACT, broader indicators:
- do not reflect actual ACT activity as a relatively large component of Commonwealth activity is allocated to the ACT;
 - fail to recognise data problems inherent in measures such as Gross State Product;
 - do not recognise that States have limited revenue raising powers;
 - do not reflect actual policies of the States and differences in the propensity of individuals to engage in taxable activities, and hence are incompatible with equalisation principles; and
 - do not take account of the problems associated with highly mobile taxes.

CONTEMPORANEITY - AVERAGING RELATIVITIES AND THEIR APPLICATION

- 94. Whether the current approach of applying historically derived relativities to the future remains the most appropriate way of implementing equalisation.**
95. While most of the options for averaging relativities would over the period of time produce much the same results (other things being equal), changing the method produces transitional impacts which would not necessarily apply equally to all States. The ACT sees no compelling reason to change from the current method of applying historically derived relativities to the future.
96. The proposal to use forward-looking fiscal capacities of the States in future years is not practicable, as unacceptable levels of uncertainty and complexity are involved with forecasting such scenarios. Furthermore, this would expose the Commission and HFE to criticism if predictions were significantly different from actual State outcomes.
97. In addition, it would be difficult for States to assist the Commission with its projections given that, for example, revenue capacity is measured using a revenue base such as *Compensation of Employees* data which States do not use to project own-source taxes.
- 98. Views on the trade-off between contemporaneity and stability of relativities – if historical assessments are retained should they be averaged over 5, 3, or 1 years?**
99. The ACT acknowledges the trade-off between contemporaneity and the stability of relativities and that a balance between the two objectives needs to be achieved.
100. As data errors, data volatility, data revisions and economic circumstances may have a significant impact on a State’s share of the GST in a particular year, the move to a one or two year average is not supported. Additionally, the longer averaging period acts as a useful disincentive for parties to attempt to influence the outcome – notwithstanding that such attempts are marginal in effect at best.

101. The ACT would be amenable to moving to a three or four year average as it would produce more up to date relativities whilst still being long enough to smooth out any data errors or revisions. Additionally, not only would this strike a balance between the two opposing issues, but it would also simplify the Commission's assessments (less data required), and may reduce errors (less data being used).
102. However, the Commission's reluctance to change the assessment period is supported given that frequent changes will not deliver HFE in the long term. As such, any agreement reached to change the averaging of the relativities might best be 'locked-in' for a period, if possible with support by all jurisdictions.
- 103. Whether States consider GST revenue stability to be more important than total State revenue stability?**
104. The stability of GST revenue is more important than the stability of total State revenue as the GST represents a growth tax and an increasing proportion of total revenue. Own-source revenues, many of which are dependant on economic cycles, are inherently volatile and are collected on a narrow base.
105. The higher rate of growth of GST revenues compared with own-source revenues, and the further narrowing of tax bases, due to the abolition of a range of taxes under the IGA, means that the significance of GST revenues is increasing. Accordingly, the stability of GST revenue is becoming increasingly important.
- 106. Whether any of the options raised in the Contemporaneity Issues Paper (CGC 2006/04) should be investigated further?**
107. Most of the options are not supported as they add an additional layer of complexity and increase the use of forecasting and judgement – including the '*more weight to most recent years*'; '*using forward estimates*'; '*moving from a relative to absolute assessment*' and '*full contemporary equalisation*' options.
108. Changing the treatment of SPPs is not supported as it would lead to inconsistency in approach, with assessed relativities being based on the relative share of SPPs for one year - the latest year, while the expenditure and revenue needs components would still be based on data for several years (most likely at least three years).
109. The view that '*relativities would no longer be dependent on States historical shares of SPPs*' under this new SPP treatment, may have implications for assessing the relativities, and is misleading, given the debt charges assessment partly relies on historical capital SPP shares to determine disabilities.
- 110. Should the Commission bring forward its consideration of contemporaneity?**
111. Given that changes to the averaging of the relativities and their application will have a one-off effect on States' assessed relativities, and in effect are due to a method change, it is preferable that contemporaneity be addressed as part of the 2010 Review and not in the annual Update process.

THE TREATMENT OF SPPS

112. What are States' views on the approach to dealing with SPPs?

113. The ACT supports the Commission's current treatment of SPPs through its criteria approach: 'out-of-scope', 'exclusion' or 'inclusion', on the grounds that it embodies fairness and the achievement of HFE.
114. Including all recurrent and capital SPPs is supported unless there are clear reasons for not doing so, such as according to the Commission's criteria or direction being provided by way of the ToR (often on the basis of an agreement with the Prime Minister or the Federal Treasurer). SPPs that assist States in funding standard State services should generally be included unless they assist with a State's unique circumstances.
115. If a State wishes to exclude an SPP that would normally be treated by the inclusion approach, such arguments should be referred to the Australian Government Treasury, and discussed between all parties, prior to the finalisation of the Commission's ToR.