



NORTHERN TERRITORY VIEWS ON

CGC ISSUES PAPER 2006/03

***ARCHITECTURE OF
HORIZONTAL FISCAL EQUALISATION:
PRINCIPLES AND INTERPRETATION***

JUNE 2006

**COMMONWEALTH GRANTS COMMISSION
GENERAL REVENUE GRANT RELATIVITIES
2010 REVIEW**

Key Points of the Submission

- A key objective for Australian Government revenue distribution is to provide states with the capacity to meet service delivery responsibilities.
- There is a long standing commitment to equity and access in the provision of government services as a means of achieving interpersonal equity.
- HFE reflects this objective and the equity principle that all Australians should have access to equivalent government services and is strongly supported by Territory.
- However, HFE is not the only method of accomplishing equity or achieving Australian Government priorities and objectives and these alternative mechanisms need to be considered.
- There is a real risk that cloudiness in definition could alter the primacy of equalisation over simplification and result in legitimate differences between states not being fully accounted for. As such the Territory supports the current definition of HFE
- Outcomes based funding is unlikely to be consistent with untied grants and would be prone to a gamut of problems which in the Territory's opinion cannot be satisfactorily overcome without severely damaging the reputation of equalisation.
- The Territory considers that the existing three pillars provide a conceptually sound methodological framework to measure the fiscal capacities and relative advantage or disadvantage of states.
- The Territory acknowledges that simplicity, transparency, stability and predictability are all important in their own right but they are a means to an end not an end in themselves.
- The Territory believes the scope of equalisation should be as comprehensive as practically possible but should be limited to the general government sector.
- However, there may be circumstances where revenue from the Australian Government should be excluded in order for policy objectives to be achieved.
- In the Territory's view such exclusions should only apply where the payments are designed to overcome significant disadvantage or material variations in outcomes.
- The Territory does not support the use of global indicators. Global indicators such as gross household disposable income (GHDI) and gross state product (GSP) fail to reflect the relative needs of states and promote simplicity ahead of equalisation.
- A reference period of three years could provide an alternative to five years as it affords a degree of stability while more closely reflecting states fiscal position in the application year.
- If the reference period is reduced to three years it should be done so on the basis that it remains that way and is not subject to change in the future.
- The Territory supports the inclusion of relevant SPPs in the equalisation process.
- There may be other objectives for revenue distribution outside the scope of HFE.
- The Territory believes that the Australian Government and the states need to develop an interface between equalisation and improvements in outcomes so sections of the Australian population who face unpalatable social and economic disadvantage can begin to achieve some semblance of equity.

OBJECTIVES FOR REVENUE DISTRIBUTION

- A key objective for Australian Government revenue distribution is to provide states with the capacity to meet service delivery responsibilities.
- HFE reflects the equity principle that all Australians should have access to equivalent government services and is strongly supported by Territory.
- Another key objective of Australian Government revenue distribution is to provide the capacity to deliver appropriate services to those most in need. HFE partly meets this objective.
- However, HFE is not the only method of accomplishing equity or achieving Australian Government priorities and objectives and these alternative mechanisms need to be considered.

A key objective for Australian Government revenue distribution is to provide states with the capacity to meet service delivery responsibilities. In this context, the current definition of HFE that seeks to equalise states' fiscal capacity to provide a standard level of services meets this objective. It reflects the equity principle that all Australians should have access to equivalent government services and is strongly supported by the Territory.

HFE achieves this equity through a redistribution of revenue that represents less than one percent of total Australian and state government revenues. That such a relatively small redistribution is able to redress significant fiscal disparities between jurisdictions is testament to the strength of the current HFE arrangements.

Another key objective of Australian Government revenue distribution is to provide the capacity to deliver appropriate services to those most in need including redressing disadvantage and equalising outcomes. This objective is partly met by HFE as existing services supported by equalisation grants tend to gradually improve outcomes over time. However equalisation is not the only method of accomplishing equity or achieving Australian Government priorities and objectives and these alternative mechanisms need to be considered.

The Commission's paper referred to studies in Australia which have questioned whether equalisation is a desirable policy objective. The studies claimed:

- it constrains economic growth by discouraging the movement of capital and people to locations where their productivity are greatest;
- it constrains desirable economic reform; and
- it equalises the capacities of state governments and does not necessarily enhance equity between individuals.

The Territory believes that each of these criticisms is invalid, as outlined below.

It constrains economic growth by discouraging the movement of capital and people to locations where their productivity are greatest

It has been argued that fiscal transfers under HFE reduce incentives for resources (including people) to relocate from locations with low productivity and employment to locations with high productivity and employment. This argument represents a direct challenge to the principles of HFE, and to the rights of all Australian citizens to access common, comparable services within a context of similar levels of taxation.

It also implies reduction or withdrawal of government services from locations that do not meet a certain standard of economic productivity or efficiency. In the long term, both socially and economically, such a policy would ultimately prove costly, destabilising and counter-productive as it fails to recognise the detriment that arises if a population sub-group does not have access to normal government services such as education, health and law and order.

Likewise, it also runs counter to the internal policy decisions of all states, including the more populous states, where comparable services are provided to all residents, regardless of the efficiency or productivity of the location. This criticism ignores the reality of how HFE is implemented in practice in Australia. The Commission's assessments of GST revenue allocation based on its determination of relative need are not based on the economic productivity of a region. Indeed, a jurisdiction may have a high level of disabilities related to dispersion, isolation, wage input costs, and so forth, but may still be an area of high economic productivity. For instance, the Territory accounts for a higher than average Gross State Product per capita (economic activity that most accrues revenue to the Australian Government, other than the Territory) but is also characterised by the most pronounced disabilities in relation to factors such as dispersion, isolation and socio-demographic composition.

It constrains desirable economic reform.

The benefits of economic growth are widespread and generally supported in the electorate. If one state's growth rate is higher than in other states, additional benefits (such as increased business investment and a relative decrease in unemployment) may also accrue. For these reasons, elected officials in any jurisdiction would not implement policies that aimed to hinder economic development over the long term and are likely to prioritise the encouragement of economic growth (through reform and other mechanisms) above virtually all other considerations.

Further, the Territory is unaware of any empirical or practical evidence that exists to support the criticism that states may be impeding economic reform in order to maximise GST revenue.

It equalises the capacities of State governments and does not necessarily enhance equity between individuals.

This measure of the effectiveness of HFE is generally centred around income inequality which is incongruous to equalisation's aims in that the overwhelming majority of the state government services funded by GST revenue do not directly impact on residents' income but rather on non-income measures of well-being, such as health, education, public infrastructure and community services. As such, HFE aims to alleviate non-income disadvantage and inequality rather than income inequality.

The Territory believes that on the whole, these criticisms of HFE overstate any potential negative economic impact thereof and discount its economic and social benefits, which also promote increased output. Furthermore, HFE affects the provision of basic services that are critical to the social fabric of Australia and should not be measured in economic terms alone.

The Territory does not support an EPC distributive approach, as it would severely limit the budgets of the less populous states and result in either a significantly higher tax burden on residents in the less populous states and/or a diminished level of services in those states. Suggestion by some states for the abolition of the Commission in favour of a system whereby grants to needier states are independently determined is also not supported by the Territory, as it could encourage an arbitrary determination of GST revenue allocation that does not rigorously and accurately take relative need and the cost differentials of service delivery between states into account. As such, the Territory supports the maintenance of the role and responsibilities of the Commonwealth Grants Commission in its current form.

The Definition of Horizontal Fiscal Equalisation

- The Territory supports the current definition of HFE.
- In Australia the extent of VFI means that no state has the capacity to fund all of the services for which it is responsible.
- There is a long standing commitment to equity and access in the provision of government services as a means of achieving interpersonal equity.
- These have combined to produce the comprehensive form of equalisation that exists in Australia which other countries are examining as a model for achieving equity and consistency between sub-national governments.
- There is a real risk that cloudiness in definition could alter the primacy of equalisation over simplification and result in legitimate differences between states not being fully accounted for.
- Outcomes based funding is unlikely to be consistent with untied grants and would be prone to a gamut of problems which in the Territory's opinion cannot be satisfactorily overcome without severely damaging the reputation of equalisation.

HFE is currently practiced within various federations around the world but there is no internationally agreed and accepted definition. This is not surprising as the level or extent of equalisation depends on differences in taxation powers between levels of governments as well as differences in revenue capacity, expenditure responsibilities and commitment to equity of services irrespective of location. In Australia the extent of VFI means that no state has the capacity to fund all of the services for which it is responsible.

There is also a long standing commitment to equity and access in the provision of government services as a means of achieving interpersonal equity. These have combined to produce the comprehensive form of equalisation that exists in Australia which is widely acknowledged as being relatively sophisticated by world standards. Indeed, many countries are examining Australia's approach as a model for implementation to achieve equity and consistency between sub-national governments. The current definition of HFE also provides a platform which facilitates that adoption of national standards by providing state governments with the capacity to implement nationally focused policies. Based on the objectives outlined above and the equity principle that all Australians should have access to equivalent services, the Territory supports the current definition of HFE.

At the November 2005 discussion between the Commission and Heads of Treasuries (HoTs) there was some discussion that the extent of equalisation be reduced in a number of ways:

- to equalise to standards that are 'not appreciably different from' or 'comparable to' other states;
- to provide extra assistance to only the financially weakest states; or
- to provide a 'safety net' approach to standards of services.

The Territory considers that equalisation should be to the same standard for all states. The definition has evolved to remove the subjectivity and uncertainty associated with practical implementation of the terms 'not appreciably different from' that existed with prior definitions of HFE.

The requirement for clarity in definition is heightened with the proposed use of aggregated assessments and materiality thresholds to achieve simplification. There is a real risk that cloudiness in definition could alter the primacy of equalisation over simplification and result in legitimate differences between states not being fully accounted for.

The use of weighted standards already averages different services within states and biases the standard toward the services that apply in the more populous states. It is difficult to see what additional benefit is to be gained by an unspecified further adjustment to achieve standards that are 'not appreciably different'. The implication is that this would result in a lower standard and consequent diminution of equalisation.

The existing approach to HFE effectively redistributes revenue to those states with greater than average expenditure and revenue needs. As states economies strengthen and populations grow, relative needs are likely to be reduced, effectively altering the amount of revenue that is redistributed. It is noted that recent trends in the redistribution of GST revenue suggest a convergence in the four largest and fiscally strongest states.

The option of providing assistance only to the financially weakest states has two major drawbacks. Firstly, there would be differing standards applying to those states deemed to require equalisation based assistance compared to the fiscally stronger states. Secondly, those states that are deemed to require assistance would not necessarily be equalised but would receive an arbitrary level of assistance.

A definition of equalisation based on a safety net approach to standards of services would result in a material deterioration of service levels or increase in taxes in the less populous states. Only the fiscally strongest states would be able to maintain service levels above the funded safety net, effectively dividing jurisdictions into fiscally advantaged states and welfare states. This would result in service levels falling and it is likely that the ensuing population migration toward the fiscally stronger states would further exacerbate budget pressures in the less populous states over time.

The Commission's paper also referred to an alternative approach to HFE which has been raised in the past that focuses on outcomes as the basis for equalisation. While the Territory supports equality in the achievement of outcomes where significant and sustained differences exist in outcomes for population subgroups, equalisation is not the optimal means available to respond to this issue. Further, outcomes based funding is unlikely to be consistent with untied grants and would be prone to a gamut of problems which in the Territory's opinion cannot be satisfactorily overcome without severely damaging the reputation of equalisation.

There are also likely to be many practical difficulties in implementing an outcomes based approach. Measurement would be difficult, largely subjective and would require a substantial increase in data from states and the Australian Government, most probably at the expense of service provision. Outcome based equalisation would require increased use of judgement by the Commission to determine the appropriate benchmarks, appropriate timeframes for outcomes and whether such an approach would reward those states achieving the benchmark or reward those states not achieving the benchmark. The added layer of complexity would also be contrary to the objective of simplification.

It should be noted that the concept of equalisation based on outputs and outcomes is not contemplated by the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (IGA) which states that GST revenue "will be freely available for use by the States and Territories for any purpose". It is considered imperative that equalisation of outcomes be seen as an important priority but it requires funding arrangements outside the of the equalisation framework.

Interpreting the equalisation principle

- The Territory considers the existing three pillars provide a conceptually sound methodological framework to measure the fiscal capacities and relative advantage or disadvantage of states.
- The Territory acknowledges that simplicity, transparency, stability and predictability are all important in their own right but they are a means to an end not an end in themselves.

The Territory considers the existing three pillars provide a conceptually sound methodological framework to measure the fiscal capacities and relative advantage or disadvantage of states. The pillars are fundamentally intertwined and provide a solid foundation for Australia's equalisation architecture.

Capacity Equalisation

The Territory supports equalisation on a capacity basis where it provides states with the scope to supply a standard level of services without requiring an increased taxation burden and without impinging on states' sovereignty. The ability to determine policy priorities independently of other states and the Australian Government demonstrates that HFE is constitutionally sound, is fundamental to states' sovereignty and is a key factor in an effective Australian federation.

Equalisation based on efficiency or outcomes implies restrictions (direct and indirect) on a currently untied revenue source. States are already subject to Australian Government policy priorities in the form of conditions (such as input controls) placed on SPP funding. Restrictions on GST revenue are inconsistent with the terms of the IGA and with HFE and reduce potential policy options open to states. Further, outcome based equalisation is problematic because although variations from the average outcome can usually be measured, there is often no quantifiable relationship between those variations and the inputs required to achieve the average outcome, particularly where multidimensional disabilities result in significant divergence in outcomes.

The question of what capacity is being equalised is implicitly dealt with through the use of internal standards which measure state government operating accounts and adjust for Australian Government funding in the form of SPPs. The Commission's calculations are a financial measure which uses Australian Bureau of Statistics (ABS) Government Finance Statistics (GFS) data to determine standards. ABS GFS data captures state expenses, is the most comparable and robust data source available, and can be easily applied to the Commission's methodologies and frameworks. Broadening the scope of equalisation to include communities within states would require additional data collection and the use of judgment to overcome comparability and reliability issues which would result in a less acceptable and more complex outcome. It would also seem to imply equalisation on a sub state government level which the Territory believes is inappropriate and beyond the scope of equalisation.

The Territory supports the use of per capita state government operating account deficits as the basis for capacity equalisation. The use of net debt or net worth is not appropriate to achieve equalisation as currently defined as these measures are heavily policy influenced reflecting the accumulated effect of policy over many years and given the scale differences between states could lend themselves to policies seeking to maximise grant share. Further, net debt and net worth do not measure economic flows, rather equalisation along such lines measures stock and would represent equalisation over a much longer period than the current five-year average. Finally, net worth is unlikely to be consistent across jurisdictions due to differing valuation practices allowed under accounting standards.

The use of per capita general government operating deficits accords with the notion of equalising recurrent operating expenses incurred in service provision and enables the model to capture expenses and revenues that are not subject to disabilities and treat them on an EPC basis. It plays no independent role in the Commission's calculation of relativities. This is because states are currently funded to enable them to achieve the standard per capita budget result, not to balance their budgets.

Internal Standards or What States Do

The use of internal standards ensures that the Commission is equalising on a relevant basis and provides a measurable identity of financial need. It also removes any element of judgment that would be required by the Commission if it had to estimate a standard basket of state government services.

Developing standards on the basis of an ideal or notional standard is problematic in that it requires judgment in terms of what represents the ideal level of services and taxation mix. Such an approach would limit the policy options of states that wish to follow their own path and develop policy independently of the notional ideal. It also does not allow for states that are outliers and necessarily require a different service mix.

The Territory supports the current approach which bases standards on the average of what all states do. This pillar links with policy neutrality in that by taking an average of what states actually do, the Commission's calculations are not affected by the specific policies of any one state. In the absence of this standards approach, states may have an incentive to change their policies in the hope of gaining a greater share of GST revenue.

The current standard is effectively a population weighted average of all states and this ensures that policy decisions of New South Wales are given more weight in the process than the policy decisions of the Territory. It reflects the notion that government activity and HFE is about providing services that are reflective of those provided to the Australian population. The alternative would be a standard based on a simple average of each state's expenditure. Thus the current rationale recognises that the national approach is more important than the policies of the average state.

Other means of estimating standards such as using a best practice approach or minimum cost are not supported by the Territory. It is unlikely that a consensus could be reached in regards to what is best practice and who is currently achieving it and a minimum cost approach is not appropriate as low cost does not necessarily equate to quality of service. Both of these approaches would require increased use of judgement by the Commission, which is in contrast to the objective of simplification.

Policy Neutrality

The Territory supports the policy neutrality pillar. The policy choices of an individual state should not directly influence the level of grants it receives. By adopting a standard approach the Commission's processes are neutral to the specific policies each state follows. In the absence of policy neutrality there would be an incentive for states to engage in grant manipulation which the Commission terms grant design inefficiency.

The concept of basing standards on what states could do involves further judgement by the Commission. It also ignores the cultural and historical precedents that have shaped states policy decisions. The Territory does not support equalisation on the basis of what states could do as it does not represent the actual fiscal capacities of states nor does it recognise the political right of states to make their own policy and fiscal decisions. Further, defining what states could do is impractical given the vast array of theoretical options open to state governments, which in reality may be politically impossible.

States have an incentive under the current interpretation of HFE to promote growth and become more efficient as they retain a proportion of any cost savings. It has been argued that the current HFE process retards growth and provides states with perverse incentives to over-tax and over-provide services in which they have comparative revenue raising disadvantages and above average costs. However, there is little evidence that fiscal decisions made by state governments involve such grant manipulation.

The Commission's paper notes that HFE has been criticised for encouraging rent seeking behaviour within the public sector. The argument is that states are using resources to try to maximise grant share. The Territory acknowledges that state government resources are invested in the ongoing improvement of the Commission's methodology but such an investment is inherent in any redistributive process. Further, there is little evidence to suggest public sector resources are being diverted in an attempt to engage in grant manipulation.

Additional Pillars

A number of potential additional pillars such as; efficiency, simplicity, robustness, transparency and stability or predictability were identified in the Commission's paper. The Territory is supportive of these objectives but believes that they should be consequential to the implementation of equalisation and do not necessitate additional pillars.

For example, efficiency is already imbedded within HFE as part of the existing definition. Further, as part of the 2010 Review work program there is stakeholder agreement to focus on simplicity and transparency which suggests that these objectives are likely to be met as part of the 2010 Review process.

The inclusion of robustness as a pillar of HFE would achieve little. The Commission has already embarked on a program of data improvement and has released a draft framework for dealing with assessments with unreliable data in an effort to enhance transparency. Further, the Commission correctly realises that certain assessments are difficult to quantify (such as freight related isolation costs and some Indigenous weights) and correctly applies judgement to conceptually sound arguments. The Territory does not support a robustness pillar on the basis that it may lead to solid conceptual assessments being discontinued due to data limitations.

Over sixty per cent of the Territory's budget is funded by GST revenue. Fluctuations in this revenue have significant implications for the Territory Government and its ability to deliver services. Therefore the Territory places considerable weight on stability and predictability. However, the Territory believes that stability and predictability are a means to an end not an end in themselves. The Territory acknowledges that simplicity, transparency, stability and predictability are all important in their own right but they are a means by which HFE is implemented and achieved. They constitute a principle or foundation of equalisation upon which the existing pillars rest.

The Scope of HFE

- The Territory believes the scope of equalisation should be as comprehensive as practically possible but should be limited to the general government sector.
- However, there may be circumstances where revenue from the Australian Government should be excluded in order for policy objectives to be achieved.
- In the Territory's view such exclusions should only apply where the payments are designed to overcome significant disadvantage or material variations in outcomes.
- The Territory does not support the confinement of equalisation to merit goods or any other basket of goods or functions not based on the average policies of states.

The Territory believes that to enhance the accuracy of equalisation, the scope should be as comprehensive as practically possible but should be limited to the general government sector. However, there may be circumstances where revenue from the Australian Government should be excluded in order for policy objectives to be achieved. In the Territory's view such exclusions should only apply where the payments are designed to overcome significant disadvantage or material variations in outcomes. This generally only applies to some Indigenous programs.

Subject to these policy objectives, the Commission should cover all the operating transactions of the state general government sector, as defined by the government finance statistics. Activities of other levels of government, other sectors (including public trading

enterprises) and states' capital activities should be excluded with the exception of any impacts these activities have on a state's general government sector.

Public trading enterprises should be excluded from the standard budget as these services are intended to be commercially based or not funded by tax revenues except to the extent that community service obligations are provided for. Rather, states provide subsidies to facilitate these services and may receive income such as dividends from their operation. The impact of any subsidies or income on states general government sectors should be accounted for in the equalisation process to enable equitable equalisation.

The removal of activities which are currently assessed from the scope of HFE would dilute equalisation. Exclusion would be inconsistent with the pillar of 'what states do' and fail to provide all states with the capacity to provide the average level of services. Furthermore, any dilution of the scope of HFE is unnecessary given that an EPC assessment results in the same outcome as exclusion from the standard budget and this is likely to become more prevalent as part of the simplification process.

The Territory does not support the confinement of equalisation to merit goods or any other basket of goods or functions not based on the average policies of states. The implementation of the merit goods or core function concept would involve further judgement as to what constitutes a merit good or core function. It would also result in states only receiving adequate levels of funding for a selection of services they provide and diminish the overall capacity of some states to provide comparable services.

Use of Broad Indicators

- The Territory does not support the use of global indicators. Global indicators such as gross household disposable income (GHDI) and gross state product (GSP) fail to reflect the relative needs of states and promote simplicity ahead of equalisation.
- The Territory believes there is no global or sub-global measure that can better reflect state revenue capacities than a tax by tax approach.

The Territory does not support the use of global indicators. Global indicators such as gross household disposable income (GHDI) and gross state product (GSP) fail to reflect the relative needs of states and promote simplicity ahead of equalisation.

The use of a global revenue indicator implies that equalisation is about measuring the capacity of a community to pay taxes, rather than the capacity of states to raise revenues and does not recognise the constitutional restrictions that apply to states revenue bases. Global revenue indicators fail to accurately illustrate the realistic revenue bases available to states and fail to measure the volume of taxable transactions and existing stock of wealth. This approach grossly understates the capacity of states with relatively large capital (including property) markets at the expense of smaller states. They also assume there are no constitutional, intergovernmental or other restrictions that limit states' taxable capacities.

The Territory believes that a tax-by-tax approach better captures the differences between states in the wealth of their populations, the type of economic activities engaged in and the mix of household and personal income. There is no global or sub-global measure that can better reflect state revenue capacities than a tax by tax approach.

Global expenditure indicators are even more problematic than their revenue counterparts. Using indicators such as population, remoteness, age and indigeneity, ignores other important drivers that influence the use and cost of service provision such as input costs, scale and the economic and physical environment. A global expenditure indicator based only on one or a combination of population and remoteness characteristics is essentially a modified socio-demographic composition (SDC) assessment which clearly ignores significant aspects of the differences between states in the use and cost of service provision.

Averaging the Relativities and their Application

- The current five year assessment period provides for a higher weight to be placed on stability than contemporaneity
- A reference period of three years could provide an alternative to five years as it affords a degree of stability while more closely reflecting states fiscal position in the application year.
- If the reference period is reduced to three years it should be done so on the basis that it remains that way and is not subject to change in the future.

Given its reliance on Australian Government grants, stability of income is critical to the Territory. The Territory does not support a single year assessment due to the lack of stability that it would provide. Thus the Territory supports a trade off between stability and contemporaneity in the assessment of relativities.

The current five year assessment period provides for a higher weight to be placed on stability than contemporaneity and also seeks to smooth out fluctuations in GFS data. A five year period also has the ability to smooth out short term movements in economic parameters however will not smooth out effects arising from prolonged economic effects. Ideally an average relativity should not reflect either a high or low point in an economic cycle. It does however mean that there is a significant lag between the application year and the five year average and can produce results that are counterintuitive particularly during periods of directional change in the economic cycle.

A reference of three years could provide an alternative to five years as it affords a degree of stability while more closely reflecting states fiscal positions in the application year. It would also be more responsive to changes in economic circumstances, however, it would incorporate a greater economic effect than is currently the case with a five year assessment period. A change in reference period from five years to; four years, three years or another period would result in some states being advantaged over others. Therefore, the Territory believes that changes in this respect should be kept to a

minimum to achieve consistency overtime rather than chopping and changing each review. If the reference period is reduced to three years it should be done so on the basis that it remains that way and is not subject to change in the future.

ABS GFS data is the only robust and comparable source of data currently available which suits the Commission's equalisation methodology. The use of this data necessitates a lag between the reference years and the application year. The use of projections based on historical trends would add further complexity to the existing framework with little tangible benefit.

The proposal to incorporate weights into the reference period to improve contemporaneity will have a similar effect to shortening the assessment period but with added complexity and would result in greater weight being placed on more recent yet generally less accurate data. The Territory sees little benefit in this approach and reiterates its desire for a stable reference period.

There may be some merit in further investigating the impact of using absolute needs as opposed to relative needs in the Commission's calculations. However, this approach does raise the issue of increased judgement in the form of indexation decisions which may result in a loss of transparency for little tangible benefit.

The Treatment of SPPs

- Funding mechanisms and sources should be irrelevant when assessing a state's capacity. On this basis the Territory supports the inclusion of relevant SPPs in the equalisation process.
- There may be other objectives for revenue distribution outside the scope of HFE.
- Where these objectives are sought through the provision of specific purpose payments or other Australian Government grants, these payments should continue to be excluded from the calculation of relativities.

Ultimately HFE is about equalising states capacities to provide services. Generally, a comprehensive approach covering all activities and including all revenue sources is required in order to ensure states fiscal capacities are effectively equalised. Funding mechanisms and sources should be irrelevant when assessing a state's capacity. On this basis the Territory supports the inclusion of relevant SPPs in the equalisation process. Failure to capture the effects of SPPs on state finances would diminish equalisation.

However, as noted earlier, there may be other objectives for revenue distribution outside of the scope of HFE such as SPPs designed to overcome backlogs. Where these objectives are sought through the provision of specific purpose payments or other Australian Government grants, these payments should continue to be excluded from the calculation of relativities.

Is Equalisation being asked to do too much?

- HFE should not be considered in isolation from other objectives of Australian Government revenue distribution.
- HFE is not the only mechanism available to the Australian Government in their pursuit of national priorities and objectives.
- It is unnecessary and unwise to burden the equalisation process with additional layers of complexity
- The Territory believes that the Australian Government and the states need to develop an interface between equalisation and improvements in outcomes so sections of the Australian population who face unpalatable social and economic disadvantage can begin to achieve some semblance of equity.

HFE satisfies one objective of Australian Government revenue distribution between states in that it is designed to provide states with the capacity to provide a standard level of services to its residents. However, to the extent that there are other objectives of revenue distribution, HFE should not be considered in isolation from these objectives. It should also be noted that HFE is not the only mechanism available to the Australian Government in their pursuit of national priorities and objectives. As such it is unnecessary and unwise to burden the equalisation process with additional layers of complexity (e.g. outcome based equalisation) when there maybe other more suitable avenues to progress.

Whereas an equalisation based distributive process should achieve improvements in outcomes to the extent that standard services produce such improvements, the current definition of HFE does not imply equalisation of outcomes. To the extent that above average services are required to overcome severe disadvantage, or there is a backlog in needs, HFE, in the absence of alternative funding streams, arguably does no more than maintain the status quo and thus perpetuates disadvantage.

For example, the Territory acknowledges that HFE does not fully address the disadvantage faced by certain population sub-groups, in particular the Indigenous population. Indicators show the profound nature of this disadvantage which from the Commission's perspective would be termed outliers in the model. Many of these outliers do not lend themselves to solution through equalisation due to their long-term nature and the significant social and economic issues which underpin them. It is therefore not clear that HFE is an adequate or appropriate mechanism to solve these unique problems and imposing an outcomes based framework in an attempt to do so would likely result in little more than significant stakeholder dissatisfaction.

The Territory believes that while equalisation should be as comprehensive as practicable, the Australian Government and the states need to develop an interface between equalisation and improvements in outcomes so sections of the Australian population who face unpalatable social and economic disadvantage can begin to achieve some semblance of equity.