# Horizontal Fiscal Equalisation in the Australian Federation

This fact sheet offers an introduction to the principle of horizontal fiscal equalisation (HFE) and its operation within Australia.

The principle of HFE underlies the fiscal equalisation arrangements of all federations. Broadly, it seeks to reduce fiscal disparities between sub-central governments. Each federation decides how to give effect to the principle and no two federations have the same arrangements.

In Australia, the Commonwealth government, in consultation with State and Territory governments (The States), is responsible for deciding the form of equalisation.

The Commonwealth Grants Commission is the body responsible for measuring the relative fiscal capacities of the States and recommending the relativities for distributing goods and services tax (GST) revenue in accordance with the government's fiscal equalisation policy.

### Commonwealth and State funding responsibilities

- The Commonwealth and State governments have responsibility for delivering major public services to Australians.
- The Commonwealth collects most of the tax revenue for both levels of government. In addition to defence and other national functions, the Commonwealth also delivers most of the social assistance transfers (pensions, family allowances, Medicare payments and pharmaceutical benefits) and plays the major role in funding many service areas such as universities, childcare and aged care.
- Commonwealth funding policies generally apply on a common basis in all jurisdictions, so that in these areas there is effective equalisation operating throughout the Commonwealth. The Commonwealth collects more revenue from taxpayers in States with stronger tax bases, and more Commonwealth spending occurs where there is higher need, simply because the same Commonwealth policies (obligations and entitlements) apply across all States.
- Over 80% of State spending relates to programs in several broad areas — health (mainly public hospitals), education (mainly public schools), justice, roads, public transport and some remaining welfare and social housing services.
- While the Commonwealth has been playing an ever-increasing role in most of these areas, the States retain major roles, including responsibility for service delivery. HFE makes it possible for every State to have the financial resources to provide the same standards of services in these and other areas for which they are responsible.

The HFE arrangements in Australia since the 1980s have sought to ensure that each State has the same fiscal capacity to deliver services. Each State may pursue its own policies and priorities, but its fiscal capacity to do so is equalised, taking account of the differences between jurisdictions in their tax bases and their service delivery needs or costs.

In practice most of the spending by the States delivers a broadly similar set of services across Australia, and HFE makes this possible.

HFE seeks to retain the benefits of decentralised governance and administration provided by sub-national jurisdictions, without requiring the transfer of functions to the Commonwealth. The combination of fiscal equalisation with decentralised governance is a longstanding feature of the Australian federation.

The payment of HFE grants (that is, GST revenue) as general revenue assistance allows State governments to deliver services according to their State's specific needs and circumstances.

States have different fiscal capacities prior to equalisation, and the larger the divergence in State fiscal capacities, the more GST is required to achieve equalisation.

The Commission's objective is not to 'level up' seven States to the fiscal capacity of the fiscally strongest State. Rather, it seeks to ensure that every State, including the fiscally strongest, has the same capacity to provide the average standard of State services.

### The changing role of mining revenue in Australia's fiscal equalisation arrangements

- Over the past decade, the role of mining revenue in fiscal equalisation has significantly increased. State mining revenues, mainly from iron ore and coal, have increased more than four-fold since the early 2000s.
- The expansion of mining has had major implications for the structure of Australia's economic development. It has also resulted in some divergence and greater volatility in the fiscal capacities of the States.
- The continuing emergence of China and other Asian countries as leading growth engines of the world economy has driven the expansion of Australia's mineral and energy industries. Australia's endowments are key inputs to the rapidly expanding Asian supply chain.
- While there has been some cyclical element in the price of commodities, the mining expansion is largely long term and structural. It has transformed the fiscal capacity of Western Australia, the main mining State.
- Throughout most of the 20th century, Western Australia received above average per capita Commonwealth funding under fiscal equalisation arrangements. However, it now requires much less than average funding under the same arrangements, due overwhelmingly to its high share of State mining revenues, which have greatly increased its fiscal capacity.
- During consultation for the 2020 Review, the assessment approach generated some concerns regarding policy neutrality. Through supplementary terms of reference, the Commission was instructed by the Australian Treasurer not to change the approach to assessing mining revenues it developed in the 2015 Review.

Further information about the most recent review is available in separate fact sheets, including summaries for each State. Detailed analysis of the assessment of Mining revenue is included in Chapter 11, Volume 2 of the 2020 Review final report.

For more information about the 2020 Review, see the Commission website.