Northern Territory Government Submission to the Productivity Commission Draft Report on Horizontal Fiscal Equalisation

November 2017

NORTHERN TERRITORY GOVERNMENT

Contents

Preface

This submission outlines the Northern Territory's positions on the draft findings and recommendations of the Productivity Commission's (PC's) Draft Report on Horizontal Fiscal Equalisation (Draft Report). This submission builds on the evidence and views expressed in the Territory's first submission to the Inquiry into Horizontal Fiscal Equalisation.

The Territory strongly opposes the PC's major draft finding 2.1, which states:

> *While it has a number of strengths, there are also several deficiencies with the objective of Australia's horizontal fiscal equalisation (HFE) system. In particular, equalisation is always to the fiscally strongest state; it provides for limited consideration of efficiency; and it results in a complex system.*
>
> *The primary objective of the system may be better refocused to provide the states with the fiscal capacity to allow them to supply services and the associated infrastructure of a reasonable standard.*
>
> *This objective should be pursued to the greatest extent possible, provided that:*
>
> – *it does not unduly influence the states' own policies and choices beyond providing them with fiscal capacity*
>
> – *it does not unduly hinder efficient movement of capital and people between states*
>
> – *the process for determining the distribution of funds is transparent and based on reliable evidence.* (Draft Report, page 25)

The PC Draft Report fails to provide any evidence to support this draft finding. Importantly, the Draft Report fails to address the consequences for the nation in terms of equity in access to services if this finding is adopted. This finding conflicts with the PC's clear observations that the principle of equity has strong national support and recommends, without supporting evidence, this principle be weakened.

Appendix A provides a summary of the Territory's views on each of the draft recommendations and findings of the Draft Report.

Executive Summary

- Horizontal fiscal equalisation (HFE) has served Australia well and is working as intended.
- The objective of HFE is a simple one – equity, which is a cornerstone of the federation. HFE was never intended to be about a minimum funding guarantee for any state, or a mechanism to incentivise state tax reform, nor was it intended to be a budget balancing item or to distribute untied Commonwealth financial assistance to the states on an equal per capita basis.
- Under the Intergovernmental Agreement on Federal Financial Relations (IGAFFR) all states agreed the GST is to be distributed in accordance with HFE. The Productivity Commission's (PC's) proposed change to the definition without consensus of all states and the Commonwealth would fundamentally undermine this long-standing agreement on federal financial relations in Australia.
- HFE is not the fundamental objective. It is the delivery mechanism for equitable access to services for all Australians.
- Equity cannot be strengthened by deliberately weakening the way it is to be understood and implemented.
- Without HFE, the Territory and other small jurisdictions would not be able to provide school education, hospital treatment, community health services, community safety, roads or social housing at standards expected in Australia.
- The Draft Report fails to address or anticipate the consequences of its findings and recommendations for smaller jurisdictions. For the Territory, any reduction in its GST revenue will further constrain its ability to close the gap in outcomes between Aboriginal and non-Aboriginal Territorians.
- If the PC's recommendations are adopted, they will only benefit one state, to the detriment of all other states for the foreseeable future. The Territory absolutely rejects the proposal to change the definition of HFE to provide states with the fiscal capacity to supply a reasonable standard of services, or 'good enough' equalisation, which is an unacceptably vague definition that will erode equity across the federation.
- The Draft Report does not provide evidence to demonstrate the net gain to the Australian economy from the proposed change to the definition of HFE would outweigh the negative impacts on the small states from any move away from full equalisation, which would be very significant.
- The only apparent basis for the PC to recommend a change to a 'reasonable' level of equalisation is its unsubstantiated view that an increase in the redistribution task in recent times is problematic, whereas in the national and economic context, the redistribution is modest yet provides an unsurpassed level of equity across the federation.

- The past decade has clearly demonstrated HFE works over the economic cycle. All evidence from recent decades demonstrates this clearly, as do Western Australia's current circumstances. To move in the direction recommended by the PC will entrench inequality. There is nothing inherently wrong with the equalisation task increasing when external and temporary economic factors give rise to outliers.
- Western Australia's current fiscal constraints are predominantly the result of its failure to future-proof its budget position when the $7 billion GST windfall occurred at the start of the commodities boom. This is no justification to change the fabric of the federation in a way that would entrench inequality and result in one state's fiscal capacity being allowed to rise above national levels in response to a temporary economic event.
- In many cases, the issues with HFE identified in the Draft Report are methodological in nature, and can readily be addressed by the Commonwealth Grants Commission (CGC) through its regular review processes.
- The Territory would strongly support the promotion of a better understanding of HFE. A genuine conversation led by the Commonwealth is long overdue in this regard.

Horizontal fiscal equalisation in Australia

HFE is a cornerstone of the Australian federation, tasked with achieving the remarkable feat of providing all states and territories (states) with the fiscal capacity to provide the national average range and standard of government services.

The commitment to comprehensive HFE as the enabling feature of Australia's federal financial relations has ensured the continued achievement of equity between the states over time.

HFE is the mechanism that enables equity across Australian society, and its effectiveness should not be understated.

The CGC has been tasked with delivering interstate fiscal equity since the 1930s, in a sophisticated and regularly reviewed process. HFE has always been about achieving equity of access to services for all Australians. This has always been reflected in the definition of HFE.

> *…in 1936, the Commission articulated the principle of fiscal equalisation for the first time. Thereafter, the assessments of States' funding needs were to be based on their capacity to raise revenue and any abnormal expenditure influences they faced. (Alan Morris Luncheon Address, 'The Commonwealth Grants Commission and Horizontal Fiscal Equalisation', National Forum on Commonwealth-State Funding, Canberra, March 2002)*

The CGC has delivered on this task in close consultation with the states to ensure HFE, and the equity objective underpinning it, is achieved and it is best placed to continue to do so going forward.

HFE is underpinned by a comprehensive, robust, and detailed methodology. This is entirely appropriate given the importance of HFE to the federation through distributing tens of billions of dollars between the states. The Territory sees the detail and rigour of the CGC's methodology as a strength of the system, not a flaw. The CGC provides detailed reports, which clearly set out its approach and calculations, are publicly available and reviewed regularly. While the methodology is detailed, the principle is simple – provide all states with an equal capacity to provide government services. The CGC should be supported in continuing to strengthen HFE through the 2020 Review.

Despite claims that HFE is poorly understood, its central objective resonates with the Australian psyche and supports the Australian ideal of a fair go. As stated by Commonwealth Treasurer Scott Morrison in a recent public address:

> *…a per capita (GST distribution)…would violate that fair go principle…like our welfare system, HFE provides a safety net for all Australians, regardless of where they live. ('WA's per capita GST proposal not fair to all Australians, Treasurer Scott Morrison says", ABC News Online, 30 June 2017)*

The PC's recommendation to fundamentally change the form of equalisation and the principles underpinning it, is attempting to divert from the long-held historical practice. Equity cannot be strengthened by weakening it. Instead the PC should continue to promote the building and strengthening of the federation through genuinely upholding the equity HFE provides, and recognising its significance to national wellbeing.

The introduction of the GST represented a significant increase in the stability and predictability of the pool of untied Commonwealth funding to the states, and removed the Commonwealth's role in determining the quantum of funds for distribution. All states agreed at the inception of the GST that it would be distributed in accordance with HFE (Intergovernmental Agreement on Reform of Commonwealth State Financial Relations, June 1999, page 3) and in subsequent intergovernmental agreements, including the current IGAFFR. The only concept and definition of HFE is that produced by the CGC. Proponents of changing the definition of HFE are seeking to revise history without the consensus of the states.

Enshrining the principle of HFE in the distribution of the new GST was a key element in ensuring states' agreement to the reforms in 1999-2000, as states gave up tax bases to support the introduction of the GST, which increased vertical fiscal imbalance.

HFE has delivered equity through ongoing structural changes in the Australian economy, through the aftermath of the great recession in the 1930s, the post-war immigration boom of the late 1940s and early 1950s, the coal mining boom of the 1960s, stagflation in the 1970s, the property bubble of the 1980s, recession in the 1990s, the introduction of the GST in 2000, the global financial crisis in 2007-08 and the commodities boom of the last decade.

HFE is responsive, reliable and robust. This has been particularly evident over the past decade, where HFE has adapted and responded to the structural economic changes across Australia, most recently in Western Australia as a result of the commodities boom.

Recent debate surrounding the objective of HFE has often solely focused on the dollar amounts received by each state. Some parties claim Western Australia's GST share has fallen too low or the increase in the amount of GST redistributed between the states has grown too much. Such debate fails to put equity at the centre of discussion. It fails to take into account the extraordinary own-source revenues generated by Western Australia from the sale of Australia's mineral resources. HFE works over the economic cycle. All Australians have rightly benefited from the commodities boom because of HFE. Additionally, the impact of a once-in-a-century commodities boom on the fiscal circumstances of a single state should not be used as the yard stick to evaluate HFE.

HFE was never intended to be about a minimum funding guarantee for any state, or a mechanism to incentivise tax reform, nor was it intended to be a budget-balancing item or distribute untied Commonwealth financial assistance to the states on an equal per capita basis, which the PC has found to be an inappropriate option (draft finding 8.2, Draft Report, page 178). HFE has always been about providing access to services and equity of service scope.

GST is a national tax collected by the Commonwealth, not a derivation tax where there is any sense the amount collected from one jurisdiction should be reflected in that jurisdiction's share of the tax. Nor is this amount measurable.

The PC has failed to recognise the benefits accruing to all Australians of a system based on equity and the damage that would result from weakening this principle. Rather the PC has entirely focused its findings on the fiscal outcome of the mechanism used to achieve equity. The Draft Report includes theoretical examples purporting to show this fiscal mechanism may impede efficiency and productivity. The PC then uses these theoretical examples as a means of justifying their recommendation to dismantle the system that achieves its sole objective of equity.

With diminished HFE, the ability of the Territory and other small jurisdictions to provide a standard of service expected by all Australians, would be compromised. Lower service standards and less access would be observed across school education, hospital treatment, community health services, police, roads, social housing or other important government services.

Given the substantial socioeconomic disadvantages experienced in the Territory, the Territory Government's primary interest is in maintaining a system based solely on equity. HFE works. As highlighted above, HFE has responded appropriately through decades of structural economic changes, including the recent commodities boom; Western Australia's reduced share of GST revenue is directly related to increases in its own-source revenue. HFE shares national economic booms and busts across the nation such that the differences in quality and scope of services between states are due to the policy decisions of governments, not to stark differences in states' fiscal circumstances, which would arise in the absence of HFE.

HFE puts all states on a level playing field and facilitates national participation in coordinated reform initiatives and policy discussions. The equity concept of HFE enables all states to enter into other financial arrangements with the Commonwealth, under national partnership agreements or major national reform initiatives, knowing that despite disparate funding shares between states, HFE will ensure all states are provided with the capacity to provide the national average level of services.

Australia's system of HFE is highly regarded internationally. It is the gold standard of equalisation, because of the equity it delivers. As noted by economists Jeff Petchey:

> *In many respects, Australia's model sets the benchmark by which others are measured. (Fiscal Capacity Equalisation of the Australian States, page 212)*

and Paul Spahn:

> *Despite shortcomings such as a high degree of complexity, the Australia system has become the model for an ideal equalisation system. The basic approach is sound, complete, feasible, and reasonably transparent…the unique benchmark against which all equalisation mechanisms have to be compared in terms of their vulnerability to manipulation and perverse incentives. (Equity and Efficiency Aspects of Interagency Transfers, page 93)*

The Territory's strong view is that HFE should be strengthened and defended. This is necessary in order to prevent incremental unwinding of the system by those who would put short-term self-interest, or confused attempts to achieve disparate policy objectives, higher on the national policy agenda than the long-term interests of Australia.

Northern Territory views on draft recommendations and findings

The Northern Territory welcomes the PC's finding that 'equity should remain at the heart of HFE' (Draft Report, page 45). However the Territory strongly rejects the PC's recommendation that this objective should only be partially pursued, through adopting a watered-down form of equalisation. It would have been logical for the PC to recommend means of strengthening the equity principle of HFE, to embed HFE more concretely in the fabric of the federation as an effective and long-standing policy that is working as intended, but it has not done so.

Counterintuitively, the PC is recommending 'strengthening' the HFE system by, in fact, weakening it. While the PC agrees the current HFE system is functioning reasonably well in regard to equity (Draft Report, Page 15), it recommends moving to a system that aims to achieve reasonable, or 'good enough' equalisation outcomes, away from the current system of full equalisation. This is a complete contradiction – the recommended change will weaken HFE and merely provide an increase in fiscal capacity to the fiscally strongest state or states, while simultaneously adversely impacting the majority of Australians.

The PC's recommendation does not put 'equity at the heart' of HFE as stated in the Draft Report (Page 45) but claims to be in the interests of national productivity and wellbeing, although no evidence is provided on how equalising to a 'reasonable' standard will aid the achievement of these or any other policy objectives.

In its Draft Report (page 59), the PC states that equalising to a reasonable standard would allow for:

- *consideration of broader objectives, specifically the efficiency implications of the system of HFE, as well as the risks associated with complexity and poor data.*
- *recognition of states' different circumstances and, particularly, whether the strongest state provides an optimal benchmark.*

However, it also finds that:

> *The potential to lose GST payments <u>could</u> discourage states from pursuing efficiency-enhancing reforms...*(page 11)

The PC has also found there are no significant distortionary impacts or impediments to economic growth attributable to HFE (Draft Report, Page 60).

It is unclear to the Territory why the PC considers its recommendation to dismantle a long-standing, effective federal financial system, under the guise of achieving unstated alternate policy objectives, is warranted. There is no evidence that the recommended change will result in improved national efficiency, but it will certainly result in interstate inequity.

Further, the PC has not provided any new evidence to justify changing the current form of HFE in Australia, over and above that which has already been considered (and dismissed) by previous reviews.

Prior reviews have defended the current form of equalisation and emphasised its role in achieving equity as the sole objective.

In relation to the findings of the 2002 Review of Commonwealth-State Funding Final Report former CGC Chair, Mr Alan Morris, stated:

> *A reduction in the application of equalisation as we know it would result in very uneven tax imposts as between states, or very uneven levels of service provision or both. These outcomes seem to be the opposite of the general community expectations that there will be a high level of uniformity in access to state-type services across the states.*

The 2012 Review of GST Distribution found:

> *In relation to proposals to do 'less equalisation' the Panel finds that none of the approaches canvassed would be simpler, more transparent or improve efficiency*. (GST Distribution Review Final Report, October 2012, page 5)

Given the issues being explored in this inquiry are not new and have been thoroughly canvassed in numerous previous reviews, and compounded by the absence of any new evidence in the Draft Report, the Territory is highly troubled that the PC would recommend such a significant change to the form of equalisation in Australia. The PC recommendations put at risk the expectations of Australians on the basis of unsubstantiated claims and hypothetical cameos that partial equalisation will achieve efficiency and productivity objectives.

Tasking the GST distribution with achieving: equity, efficiency and productivity objectives, while also ensuring HFE is widely understood and supported, simply implemented, contemporaneous, policy neutral and transparent, is an extraordinary task. There is no other fiscal mechanism in Australia where the Commonwealth is seeking to achieve all of these economic, social and administrative objectives simultaneously.

The PC's contention that 'absence of evidence is not evidence of absence' (Draft Report, page 13), is not a sound basis for fundamentally changing HFE, which does what it is asked to do and does this well.

The proposed alternative to the current form of HFE, equalising to a 'reasonable' standard is unacceptably vague and, unlike the current standard that equalises to a simple all-state average, would add significant complexity and uncertainty. Further, the proposed alternative relies entirely on the Commonwealth to determine the 'reasonable' standard most appropriate at any time. Given the level of investment in HFE demonstrated by the Commonwealth in recent years, the Territory has significant doubts that appropriate equalisation outcomes will occur on an ongoing basis under such a scheme, which is entirely exposed to ongoing politicisation at the expense of the nationally valued equity principle.

The CGC is an authoritative and independent expert body, with a clearly defined objective. Watering down the HFE objective and inserting greater scope for subjectivity is undesirable and will fundamentally weaken Australia's federation.

In many cases, the issues the PC has identified are methodological in nature. The PC has acknowledged these are already being examined by the CGC and they can readily be addressed by the CGC. Most notably, the CGC is already addressing policy neutrality issues in the mining revenue assessment and lack of policy consistency on coal seam gas extraction, as part of its rolling work program for the 2020 Review of State GST Revenue Sharing Relativities.

Despite this, the PC is of the view that HFE has 'gone too far', the form of HFE should be altered in the interests of national efficiency and wellbeing, there are policy neutrality issues when states' circumstances differ significantly, HFE creates theoretical disincentive for states to reform their taxes, and HFE is too complex.

Has HFE 'gone too far'?

The PC is concerned the current objective of equalisation goes too far because the redistribution has increased in recent years due to Western Australia's outlier status. This implies there is an ideal level of redistribution between the states that has now been exceeded.

The Draft Report states the Western Australian fiscal situation was not envisaged and the system cannot cope with Western Australia as an outlier. This is not the case. Western Australia has acknowledged it expected a significant reduction in its GST share as a result of surging iron ore production. Further, the current fiscal ranking of the states reflects cyclical changes in global economic conditions affecting Western Australia's revenues.

Western Australia's share of GST is now expected to increase over the forward estimates as its declining iron ore production and associated royalties enter the assessment year data. Therefore, Western Australia's outlier status is temporary. As the commodities boom progressed, the HFE system responded through an increased redistribution of GST away from Western Australia and now, with the boom coming to an end, the system will again respond, through an increasing redistribution of GST towards Western Australia, in response to its decreasing fiscal capacity. This demonstrates that HFE is functioning entirely as intended. Far from being an indicator of stress in the current approach to equalisation, the Western Australia case proves that HFE works. While Western Australia's relativity may not reach 1 in the foreseeable future, this reflects that its resource sector is now a larger component of its economy.

It appears the primary basis for the PC to recommend a change to a 'reasonable' level of equalisation is its view that an increase in the redistribution of GST from around 8 per cent of the GST pool prior to the commodities boom to 13 per cent in 2017-18, as Western Australia's fiscal capacity has risen far above the other states', is problematic and affected national economic efficiency.

The Territory notes that the increase in the redistribution is equivalent to less than 2 per cent of states' total expenditure and compares to an increase in the GST pool of around 49 per cent over the same period, yet it provides a level of equity that enables the smallest states to provide services for their citizens at nationally comparable levels. In the context of strengthening equity across the nation, the sums involved are critical at the margin. This is an outcome that should not be understated and is achieved with a very modest quantum of funds in the national context.

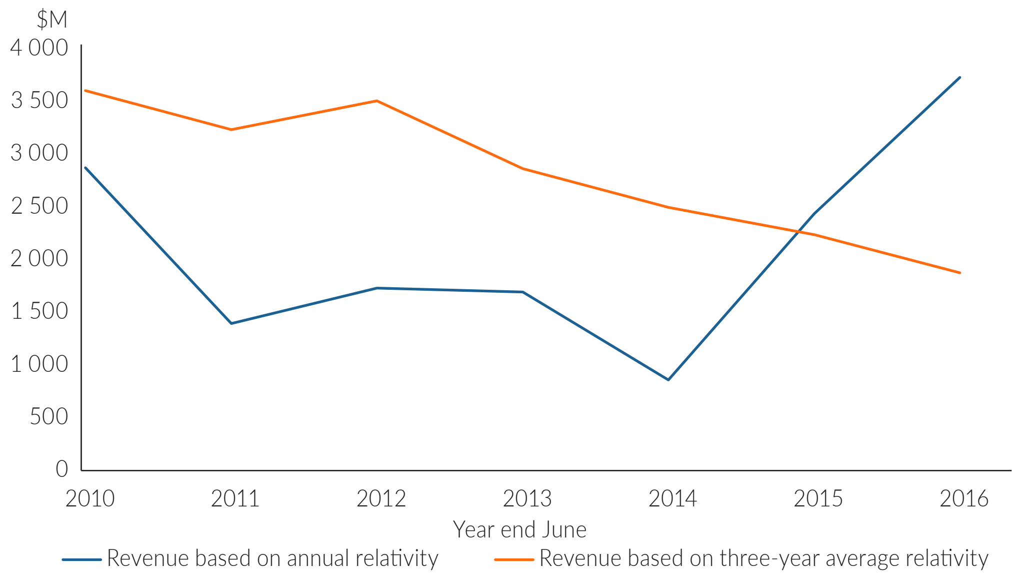
An increase in the redistribution task does not provide evidence that HFE has 'gone too far' – it is a reflection of changes in states' relative fiscal capacities arising from factors outside of their control and shows HFE is working as intended. The Territory considers that changing the whole HFE system due to a temporary outlier, the exception to the rule, would be a knee-jerk reaction to cyclical changes in state circumstances flowing through the HFE system.

As noted in Tasmania's first submission to this inquiry, the Organisation for Economic Co-operation and Development's (OECD's) Report on Fiscal Equalisation In OECD Countries, showed that in 2004, fiscal equalisation as a percentage of gross domestic product (GDP) was the lowest in Australia at 0.49 per cent (Tasmania's Submission to PC Inquiry, 'Horizontal Fiscal Equalisation: an equitable approach to GST distribution', page 7). While the equalisation task has increased since then as a portion of the GST pool, it has actually reduced in terms of the size of the national economy since 2004, to 0.43 per cent of Australia's $1.8 trillion GDP in 2016-17.

The PC has also claimed that the current level of equalisation is to a 'volatile standard' due to major changes in Western Australia's fiscal capacity over the past decade. The Territory's view is this is not volatility but rather a cyclical reflection of structural change in Western Australia's economy as a result of the commodities boom. Volatility implies rapid change and unpredictably. Western Australia's situation was neither rapid nor unpredictable. In this regard, the recommendation to move to a 'reasonable standard' has the potential to introduce greater levels of volatility and increased uncertainty.

As shown in Chart 1 and acknowledged in the Draft Report (page 122), before the upturn of the commodities boom flowed through the HFE system, Western Australia benefited to the tune of $7 billion due to the data lag effect.

Chart 1 Difference between HFE outcome and fully contemporaneous HFE, Western Australia 2009-10 to 2015-16



Source: CGC Reviews and Updates Reports 2010-2017, Commonwealth Final Budget Outcome 2016-17, Northern Territory Department of Treasury and Finance

The Territory also notes that Western Australia had forecast the increase and decline of iron ore prices and the subsequent impact on its royalty revenue in its Budgets, and was able to clearly anticipate the resulting impacts on its assessed GST needs. As stated in Western Australia's 2009-10 Budget:

> *By 2012-13, the State's share of national GST revenue is projected to decline to just 5.7%... Unfortunately, this structural deterioration in the State's finances has been anticipated for some time.* (Western Australia 2009-10 Economic and Fiscal Outlook, Budget Paper 3, page 4)

The Territory reiterates increased volatility would most likely be introduced if the PC's recommendation that the Commonwealth Treasurer should annually determine the appropriate level of equalisation be adopted. This will present a more problematic, uncertain and volatile fiscal situation for the states than currently exists.

National efficiency and wellbeing

As stated in the Territory's first submission to this inquiry, state governments' pursuit of economic growth is driven by the need to support employment, create a conducive operating environment for businesses and ensure ongoing improvements in incomes and living standards. This was recognised by the CGC in a discussion on the impact of equalisation on economic growth and efficiency:

> *State governments are not corporations driven by a profit motive. They seek to improve conditions for residents and a strong and growing economic base is seen as an important element in that approach.* (Commonwealth Grants Commission The Last 25 Years, CGC 2008, page 11)

As stated above, the PC has not explained its expectations around the impact the move to partial equalisation would have on the national economy. This leaves the Territory unable to fathom the policy imperative behind the PC's major recommendation, to move to a partial HFE system.

The Territory strongly supports the PC's finding that HFE does not distort migration and investment decisions. The Draft Report states the efficiency effects of equalisation on the national economy 'are relatively small' and the size of the redistribution is 'small relative to total government revenue (just over 1 per cent)' (page 15), and it is unlikely to have a significant impact on migration or investment decisions of individuals (page 141).

However, despite this finding, the PC has included the qualifier that the revised form of HFE should be pursued provided that '...it does not unduly hinder efficient movement of capital and people between states' (Draft Report, page 17).

In the absence of any modelling to suggest otherwise, this raises concerns that the PC's recommended changes to HFE may in fact have undesirable distortionary impacts on migration of labour and capital.

This supports the Territory's view as stated in its first submission to this inquiry, that is, the current form of HFE supports efficient migration and investment decisions and partial equalisation may lead to distortions through creating significant differences in the quality and scope of government services across state borders, as well as significant incentives for fiscally stronger states to reduce own-source tax rates below the national average to increase competitiveness, distorting efficient investment.

Further, it is not clear how allowing some states to have a higher fiscal capacity than others is intended to improve national economic activity or productivity. But, in any event, this misses the point. HFE is the delivery mechanism for equitable access to services. The focus must be on equity in services, not dollar amounts.

The Territory's view is that the proposed change to HFE will also introduce inefficiencies arising from the divergence in outcomes and economic growth in the smaller states, compared to the larger states, through further constraining small states' fiscal capacities, compounded by an acceleration of the 'race to the bottom' effect on state tax rates by the fiscally strongest states, in order to attract business investment and increase population.

The Territory is extremely concerned that the PC has not articulated the implications of partial equalisation for the small states. While the PC has recommended consideration of transitional impacts, these transitional arrangements will not be permanent. If adopted, the PC's recommended changes to equalisation will lead to a two-tiered society whereby citizens of larger, fiscally stronger states become increasingly more advantaged, while the smallest, fiscally weaker states see a proliferation of entrenched social and economic disadvantage among their populations, in the absence of significant additional Commonwealth funding.

Table 1 shows that the smaller states will contribute more than their population share of the redistribution task under the PC's proposed 'equalisation to the second strongest state' approach to equalisation, contributing 26 per cent of the $3.2 billion increase in GST revenue to Western Australia, if applied in 2017-18, compared to a population share of 12 per cent.

Table 1: States' contributions to redistribution to Western Australia under proposed 'Equalising to the second strongest state' method of partial equalisation, 2017-18

	Large states	Small states	Western Australia
Change in GST ($M)	- 2 816	- 428	3 244
Contribution to Western Australia's Revenue increase (%)	74	26	0
Population share (%)	77	12	11

Source: Northern Territory Department of Treasury and Finance, Table C.3 Draft Report, page 227

As noted by the CGC in its submission to the Draft Report, the 'equalising to the second strongest state' proposal:

> *...would affect states unequally. It would provide additional assistance to the fiscally strongest state and, therefore, create a system with: one playing field for seven states, with less than full equalisation among them, and a different playing field for the fiscally strongest state, which would attract a 'strong state premium'.* (CGC Paper CGC 2017-22, Submission on the Draft Report From the Commonwealth Grants Commission, page 5)

The proposed 'equalising to the average of all states' approach is an even further move away from full equalisation and would require significantly increased contributions from all states to provide Western Australia with an additional $3.6 billion in GST revenue if applied in 2017-18 (Table C.2 Draft Report, page 227). Under this approach, all states except Western Australia would forgo an equal per capita amount of GST to the fiscally strongest state, Western Australia.

These reverse ‘Robin Hood’ approaches to equalisation whereby the fiscally weaker states arbitrarily provide additional GST revenue to the fiscally strongest states, will see the smaller states forgoing major budget items in order to provide Western Australia with additional capacity beyond all other states. Under the proposed ‘equalising to the average’ approach:

- the $557 million reduction in GST to South Australia if it was applied in 2017-18 would be equivalent to the state being forced to abandon its $528 million state of the art Adelaide Women’s Hospital
- the $168 million reduction in GST to Tasmania exceeds its entire 2017-18 infrastructure budget for schools and education, tourism, and recreation and culture
- in the Territory, the $79 million reduction in GST revenue would mean 176 new houses for remote Aboriginal communities would no longer be built to relieve the substantial overcrowding in Territory Aboriginal communities
- the $3.6 billion increase in GST to Western Australia would allow it to build two new Perth stadiums and associated transport infrastructure in one year.

There appears to be an underlying assumption that Western Australia is more efficient than the other states, such that providing Western Australia with an ongoing $3.2 to $3.6 billion budget increase will have a significant productivity and efficiency-enhancing impact on the national economy, while the other states forgo major expenditure items such as hospital infrastructure and social housing.

The factors contributing to Western Australia’s strong fiscal capacity are the inheritance of a significant share of mineral resources due to historically determined state boundaries and a surge in global demand for iron ore, not the efficiency enhancing reforms or strategic infrastructure investments undertaken by Western Australia. It was simply the prevailing economic conditions that provided a surge in mining royalties to Western Australia.

The PC’s recommendation will provide Western Australia with a fiscal capacity well beyond that of all other states. There is no guarantee, or even likelihood this will have any impact on national wellbeing, productivity, efficiency or economic growth beyond what would occur under the current form of HFE.

Despite the Draft Report correctly concluding that source-based fiscal advantages like mineral resources should be equalised (page 19), it still recommends approaches that will effectively prevent this through allowing Western Australia to retain significant revenues generated from its mineral wealth.

There is no clear, desirable policy outcome that will result from the PC’s recommended changes.

Equalising to the fiscally strongest state

The two major approaches to implementing partial equalisation proposed by the PC: equalising to the second strongest state and equalising to the average fiscal capacity of all states, do nothing to address the perceived deficiencies of HFE. As a result, there is no clear policy imperative supported by robust evidence driving these two options or the broader recommendation to equalise to a ‘reasonable’ standard. In fact, and as reiterated by the CGC in its submission to the Draft Report, the two are essentially relativity floors, which provide a maximum level of redistribution away from the fiscally strongest state equal to the fiscal capacity of the second strongest state or the average of all states. Ironically, the PC rejected the imposition of relativity floors proposed by Western Australia on page 28 of the Draft Report.

The Territory takes issue with the claim that full equalisation is flawed because it is always to the fiscally strongest state. The Territory's view is the PC finding in this regard is misleading and will lead to further public misunderstanding of the objective of HFE. While the Territory accepts the CGC has also referred to the equalisation task in this manner in one report, it is not a widely used, nor is it an intuitive description of the equalisation task or the process. That is, the 'strongest state' terminology fails to reference what HFE is really seeking to do, which is to equalise states' capacities to provide the national average level of services.

The PC claims that 'equalising to the strongest state – particularly when the strongest state is so much stronger – has meant equalising to a benchmark that is relatively volatile' (Draft Report, page 17). The standard is determined by national average revenue or expenditure per capita. This is the standard to which states are equalised. Some states require less than the national average expenditure to provide the national average level of services, and some states require more. Some states have the capacity to raise above-average revenue, and some less. This is the standard that states are being equalised to, not the prevailing conditions in the fiscally strongest state, which is implied by the PC's finding.

The redistribution from an equal per capita distribution of GST revenue is the underlying mechanism of HFE. This is not a volatile standard. It is entirely driven by the national average expenditure and revenue decisions of states. When one state deviates significantly from this national average, the level of redistribution may increase, however it is not clear how or why this is seen as a problem, let alone a major reason to dismantle the current form of HFE.

The 'equalising to the strongest state' claim merely highlights that each state has at least as high a relativity as the fiscally strongest state, as every state receives an equal amount of GST per capita up to that point. But, this description of equalisation would not hold if one state's fiscal capacity rose so significantly that it would be assessed as not requiring any GST revenue. In this scenario, the limited size of the GST pool would likely mean that it was insufficient to bring all states up to the fiscal capacity of the strongest state.

The Draft Report also states:

> *...taking the concept of HFE as replicating a unitary government, it is unlikely that any unitary government would raise and lower the level of services it provided based on revenue fluctuations in only one part of the country. Instead, it would likely provide a level of services to all residents that remained relatively consistent from one year to the next, and which may likely be closer to the average across the nation.* (page 54)

The current form of HFE does precisely what the PC states a unitary government would do. While the level of GST redistributed to Western Australia has decreased, this is offset by increases in mining royalties, which provides Western Australia with a consistent (but increasing) revenue capacity over time, in line with the national average. The PC has misrepresented the mechanism of HFE in this regard and has not recognised HFE's role in the national economy as an automatic stabiliser.

The PC has not stated how the two proposed approaches to partial equalisation would better achieve economic efficiency, improve productivity, induce state tax reforms or improve national wellbeing. These approaches are merely means of giving the fiscally strongest state or states more GST than they receive under the current equity-based system, at the direct expense of the smaller and fiscally weaker states.

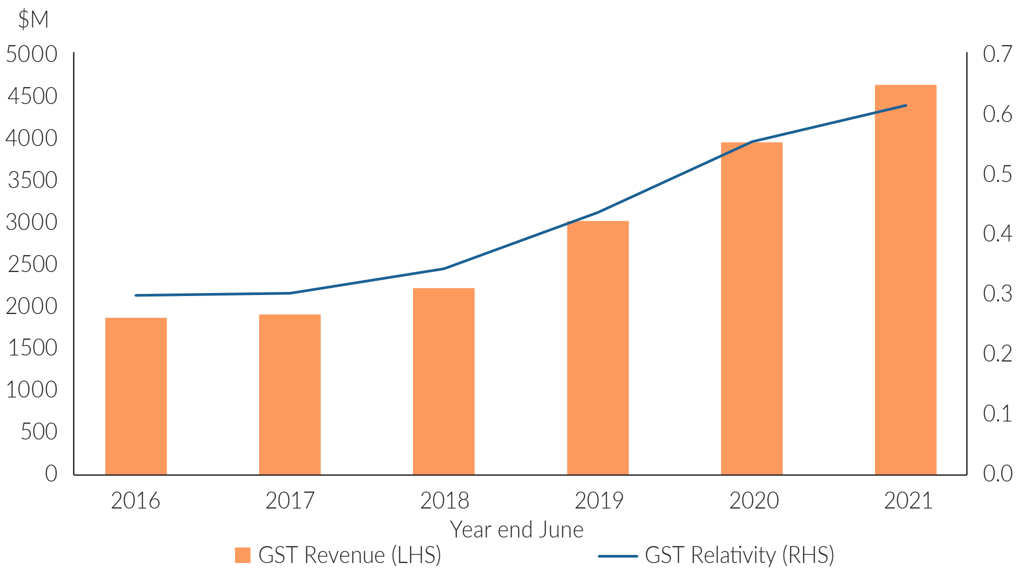
The question is, does Western Australia need a fix?

The GST is a national tax, and the concept of derivation does not apply. Western Australia has not been 'cheated' out of its 'fair share' of GST revenue. The fact that Western Australia has been able to successfully prosecute this case in the local and national media reflects the poor level of understanding of how HFE is designed to work. GST revenue is provided to all states on the basis of HFE, as agreed under the IGAFFR.

It is unlikely another commodities boom to the magnitude of the one recently experienced, is on the horizon. HFE, if left to run its course, will ensure states' fiscal capacities converge over time, as the effects of the commodities boom are factored out of the HFE system. This is evidenced by Western Australia itself forecasting a decline in mineral royalties over the forward estimates period.

By the time the PC's recommendations, if adopted, begin to be implemented, likely in 2020 to coincide with the CGC's Methodology Review, Western Australia's relativity is expected to have nearly doubled. Chart 2 shows Western Australia's Budget estimates of its GST revenue over the forward estimates period under the current form of HFE, as well as its increasing relativity forecasts over the period.

Chart 2: Western Australian GST revenue and relativity forecasts, 2017-18 to 2020-21



Source: Western Australia 2017-18 Budget, Northern Territory Department of Treasury and Finance

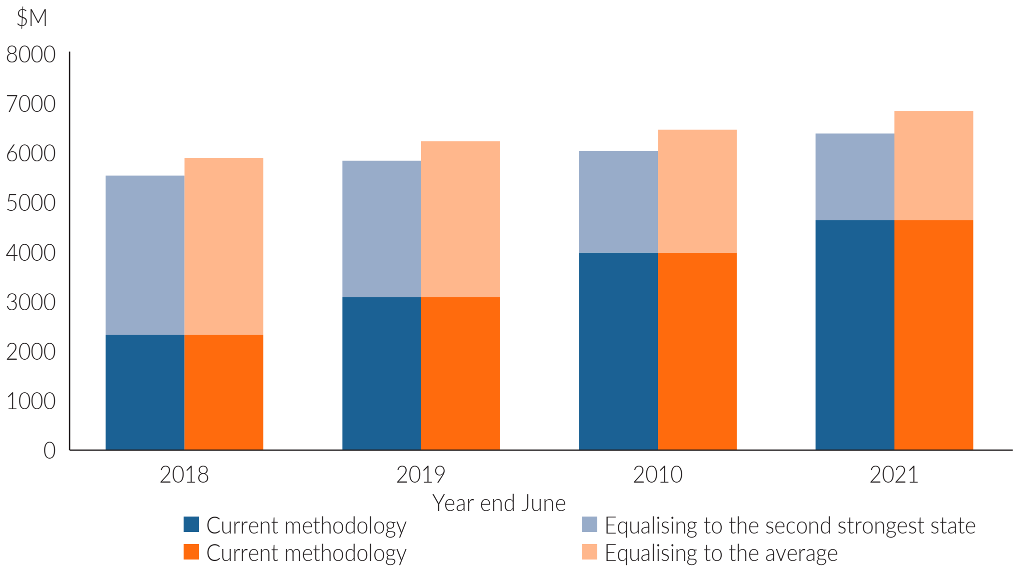
Changing the system that has served Australia so well to cater to an exceptional circumstance experienced by one state, is not considered a basis for national policy decisions, which would have very broad-reaching consequences on the rest of the nation. It is clear HFE is working as intended and will respond to Western Australia's changing fiscal circumstances over time.

As acknowledged by the PC (Draft Report, page 117), Western Australia's current fiscal constraints are predominantly the result of its failure to future-proof its budget position when the $7 billion GST windfall occurred at the start of the commodities boom. Of particular concern was Western Australia's assumption, built in to its budget forward estimates, that the form of HFE would be altered, with a relativity floor imposed.

While the PC has highlighted this, it now appears the PC is recommending a modification that fulfils Western Australia's desired and forecast change to HFE, which will reward Western Australia to the detriment of Australians in all other jurisdictions, through the proposed imposition of a relativity floor, equal to either the fiscal capacity of the second strongest state or the average of all states.

Chart 3 shows the additional GST revenue to be redistributed to Western Australia under both of the PC's proposals – equalising to the second strongest state and the average fiscal capacity of all states, which equate to an additional $9.8 billion or $11.4 billion, respectively over the forward estimates period.

Chart 3: Additional GST revenue to Western Australia under proposed approaches to partial equalisation



Source: Western Australia 2017-18 Budget, Commonwealth 2017-18 Budget, Northern Territory Department of Treasury and Finance

In addition to the significant windfall that would accrue to Western Australia under either of these proposals, and the $7 billion windfall received at the beginning of the commodities boom, Western Australia has also secured $1.2 billion in additional Commonwealth infrastructure funding in response to its continued complaints regarding its share of GST.

This clearly shows that changing the fabric of the federation in a way that would entrench inequity and result in one state's fiscal capacity being allowed to rise above national levels as the result of a one-off economic event, will create a great divide in the level of equity between Western Australia and the rest of Australia.

While the PC stated that one option is for a transitional arrangement where HFE could revert back to its current form once states' fiscal circumstances converge, such a transitional arrangement would entrench permanent inequity, is arbitrary and does not provide any certainty beyond a short-term arrangement, leaving this decision entirely at the discretion of the Commonwealth. Small states are concerned with long-term viability and will face extreme uncertainty going forward if the PC's recommendations are adopted. Any transitional arrangement will risk embedding permanent inequality, as it may not be a temporary transition but a permanent step down in the provision of Commonwealth financial support through HFE.

The Territory's view is the past decade has clearly demonstrated that HFE is working. There is nothing inherently wrong with the equalisation task increasing when there are outliers. Western Australia's outlier status has been almost completely due to changes in global commodity markets. Mineral resources are part of the national wealth and the proceeds of their sale should be shared across the nation through HFE, particularly, due to their finite supply. It is unclear whether or not Australia will experience a commodities boom comparable to that experienced over the past decade. Therefore, a diminution of HFE in order to provide short-term budget relief to one state at the risk of national equity is an irresponsible proposition.

The other outlier

The Territory notes the PC has effectively ignored the other outlier – the Northern Territory, which is a long-term outlier with structural impediments to reducing service delivery costs to national levels.

While the current public debate focuses on the claim that some states, particularly Western Australia, are receiving too little GST, the PC has not discussed the prospect the current system under-equalises the Territory. HFE does not provide states with the capacity to address unmet need and will never provide the Territory with the fiscal capacity to address its entrenched levels of disadvantage compared with other states.

Disadvantage in the Territory caused by historical legacies and factors not experienced to similar levels in other states is an important issue, but HFE is not designed to address this matter. Weakening the equity principle will only exacerbate the extreme levels of disadvantage the Territory faces.

The implications of the introduction of partial equalisation for the Territory would be more significant than for any other state, given its exposure to changes in GST revenue and its reliance on GST for 50 per cent of its total budget.

Table 2 shows the GST revenue impact of a 10 per cent reduction in each state's relativity. It shows the impact on the Territory would be 2.5 times greater than the next most affected state, Tasmania.

Table 2: Per capita impact of a 10 per cent reduction in each state's relativity, 2017-18

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
$ per capita	- 164	- 185	- 235	- 84	- 331	- 441	- 297	- 1 131

Source: Northern Territory Department of Treasury and Finance

Without equalisation, the Territory would not be able to function as an independent, self-governing jurisdiction and would not be able to provide state-like services to its population without increasing taxes to levels that would make it unviable. Any move away from full equalisation would move Australia's system of federal financial relations even further away from the high level principle of 'equal treatment of equals'.

The Territory acknowledges that HFE alone will never address the historical deficits and gaps in infrastructure and outcomes of the Territory's Aboriginal population. The incredible level of disadvantage in the Territory, and its infancy in terms of economic development relative to the other states, is completely understated and unacknowledged. The Territory is assumed to have the average level of disadvantage in its population, which is driven by the largest states.

The Territory strongly supports the PC's view that indigeneity should not be removed from the equalisation process, as has been proposed by some parties in the past. Indigeneity is an issue that affects all states, impacting particularly on the cost of service delivery. Consequently, having it assessed by the CGC is valid and important. To the extent that HFE does not address serious levels of unmet need, and it is well understood that HFE does not do this, this calls for a response outside the HFE framework, including quarantining tied funding aimed at closing the gap in outcomes between Aboriginal and non-Aboriginal Australians, such as the National Partnership Agreement on Remote Housing and the National Partnership Agreement on Northern Territory Remote Aboriginal Investment.

Any proposal to remove indigeneity is founded in increasing the accountability of states as to how they expend their shares of GST revenue. This is inconsistent with the untied nature of GST revenue and fails to take into account the repeated explanations by the CGC that its assessments are not a recommendation of the expected, targeted, or ideal level of expenditure by state, program, location or intended service recipient.

The Territory has the largest Aboriginal proportion of its population, at around 30.9 per cent, this compares to 3.1 per cent nationally. Notwithstanding the untied nature of GST, the 2017 National Indigenous Expenditure Report, consistent with previous reports, shows that the Territory continues to spend over 50 per cent of its total budget on services to Aboriginal people, equivalent to its entire share of GST revenue. In 2015-16, while all states spent more per capita on Aboriginal people than non-Aboriginal people, the Territory had the highest per capita expenditure on services to Aboriginal people of all states at $41 899, which compares with total states expenditure figure per capita of $25 189.

Aboriginal Territorians are significant users of mainstream government services. Therefore, it is critical that indigeneity remains in the assessment of the Territory's share of the GST pool. To remove indigeneity would create added complexity and would risk creating a divergent system for different population groups. This is consistent with the Draft Report, which questions what would be achieved by removing indigeneity from HFE, given it is a significant driver of state expenditure (page 14).

The current equalisation process is not the appropriate vehicle to address shortfalls in outcomes between population groups, however, unlike Western Australia, the Territory has not responded to this extremely challenging situation by arguing to dismantle or weaken the existing federal financial system. Addressing Aboriginal disadvantage requires additional direct effort from the Commonwealth and states outside the equalisation process.

Similarly, HFE does not provide states with the fiscal capacity to address previous underinvestment in infrastructure or the capacity for small states to 'catch up' to the largest, most developed states' level of economic development. The Territory is a developing jurisdiction compared with the other states and has a long way to go in establishing economic infrastructure to drive future development. It is vital for the Territory that the Commonwealth invest in the Territory outside of the HFE process in order to ensure the Territory and its population, particularly its remote Aboriginal population, can reach its potential, and continue to grow in strategic importance to the national economy, particularly through initiatives such as Developing the North.

Policy neutrality and tax reform

This inquiry has been commissioned in part due to suggestions HFE creates disincentives for states to undertake reforms to increase their revenue-raising capacities. The Territory notes the PC discussion that theoretical disincentives to major tax reforms may exist under the current form of HFE, however, these are only theoretical and are not a robust basis to make changes to current HFE principles and practices. In cases of significant changes to tax policy, states have demonstrated they act multilaterally where appropriate, such is the case with the current implementation of the place of consumption tax on wagering and bank levies.

The Draft Report states:

> *…the current HFE system struggles with state circumstances that differ markedly from the other jurisdictions. The potential for HFE to distort state policy is pronounced for major tax reform exercises (especially first-movers) or in relation to mineral and energy resources (including royalty policies and restrictions on extraction).* (page 16)

However, the PC also acknowledges there is:

> *…no direct evidence that GST effects have played into specific policy decisions in the past.* (Draft Report, page 100)

The Territory's view is that microeconomic reform and tax reform are best pursued on a multilateral and nationally coordinated basis, in order to best achieve and promote national efficiency. The Council on Federal Financial Relations and Council of Australian Governments are best placed to promote and pursue these reforms. It is not the role of HFE, noting that in accordance with the IGAFFR, reward payments provided under national partnership agreements for implementing microeconomic reforms have been quarantined from HFE.

The Territory considers that if major tax reforms, such as the abolition of stamp duty on conveyances by one state were being seriously contemplated, there are several simple methodological approaches to resolving any perverse equalisation outcomes, which would remove first-mover disincentives, as well as being GST revenue-neutral.

The CGC is highly responsive to changes in average policy and acknowledged that while theoretical disincentives to reform exist, they are unlikely to be borne out in reality due to the adoption of materiality thresholds, whereby the amount of revenue generated by a new tax would need to be significant in order to be assessed.

Nonetheless, the Territory would expect that if a large state, such as New South Wales or Victoria, was seriously considering abolishing a major tax in favour of a more efficient alternative, the Commonwealth could direct the CGC to ensure it was not penalised through HFE for doing so. This would be similar to the Commonwealth's approach to ensuring non-participating states were not rewarded through HFE for refusing to enter into National Education Reform Agreement funding arrangements in 2013.

One simple methodological solution to the 'first mover' issue would be to revert back to the 2010 Review definition of average state policy, which requires four or more states to adopt a policy before it is assessed. In this case, the only HFE effects of tax reform would be the theoretical difference between the reforming state's assessed capacity to raise the abolished tax and its assessed capacity to raise the new tax. These types of issues are best left to the CGC (and the states), to consider and develop appropriate solutions over the course of the 2020 Review.

The Draft Report suggests (page 12-13 Cameos) disincentives to desirable policies, when viewed cumulatively over time, could be a considerable cost to the Australian economy, however the cumulative effect argument does not take into account that the HFE system is not static, nor is it a significant consideration of states in developing policy. There are many drivers of need and, after weighing up all the pros and cons of reform including a move to a more efficient tax, a comparison of the costs and benefits of reform will determine whether the move is justified, not HFE.

Tax decisions also factor in states' relative competitiveness in the national context, as well as the prevailing political and economic climate. The PC arguments around the disincentives for tax reform are highly theoretical and not supported by evidence. States have pursued tax reform, which was not based on HFE considerations, including New South Wales abolishing stamp duty on non-land business assets, unquoted marketable securities, and mortgage duty in 2016-17 and the Australian Capital Territory abolishing stamp duty on property over 20 years and increasing general rates and land tax in the interests of its constituents.

The Territory also notes if draft recommendation 9.1 – that the CGC should provide advanced notice of its treatment of a major tax reform (Draft Report, page 201), is adopted, this would provide states with an additional information source for consideration, but it is unlikely to be sufficient to induce major tax reforms in the absence of additional measures by the Commonwealth.

Simplicity

The Territory acknowledges that some detailed methodological aspects of the current approach to HFE are complex, however it is not clear why this is a significant issue. The Territory's view is that one of the largest impediments to public acceptance and understanding of Australia's form of equalisation is a lack of public defence of the system by the Commonwealth Government, as the only impartial player involved. This has also contributed to a lack of informed understanding of HFE by the general public, which allows mischievous information, such as Western Australia promoting that it has been cheated out of GST, to gain support.

As the Territory stated in previous submissions to this and other inquiries into HFE, there is little public understanding of the mechanics of many fiscal and economic arrangements, such as the impact of money supply on interest rates, calculation of the consumer price index, detailed tax settings for the superannuation system, or public hospital and schools funding arrangements.

In none of the above examples would the PC consider compromising the policy intent of the arrangements in order to make them more publicly understandable. This confuses the principle of HFE with the methodology adopted to implement it. It is not imperative that a member of the public be able to replicate the CGC's task. What is important however, is the public defence of the equity objective of HFE in Australia and an understanding of this by the public at a high level. Equity is the cornerstone of Australia's federal system. Weakening this principle in any way should be the result of a national discussion and debate, not the by-product of a politically motivated process driven by the circumstances of a single state, created by a once-in-a-lifetime commodities boom.

The Draft Report seeks input on methodological means of increasing the simplicity of HFE, such as aggregating assessments and applying simple cost benchmarks. The CGC already undertook a substantial simplification campaign for its 2010 Review, significantly reducing the number of assessment categories. Further, the use of materiality thresholds means only major factors affecting the costs of delivering services or capacities to raise revenues, are adopted, with a significant portion of expenditure and revenue assessed on an equal per capita basis.

On the expenditure side this is particularly evident for the Territory. Often the use of national datasets such as Census, and Medicare data, which predominantly reflect the circumstances of the most populous states, fail to accurately reflect the service use patterns of remote and Aboriginal populations in the Territory, reducing the GST redistribution to the Territory compared with using Territory-specific use rates. In every sense, the Territory is an outlier and different on almost every metric to other states. What is a 'reasonable standard' for the larger more homogenous states is unlikely to be reasonable for the Territory.

The proposal to use simple cost benchmarks has been examined by past reviews, most recently the 2012 Review of GST Distribution. That review found that equalisation would not be appropriately achieved through this approach, which would conflict with state sovereignty, would be a significant departure from equalisation reflecting what states do on average, and would introduce the concept of an 'ideal' level of services.

Further, the use of cost benchmarks is inappropriate because it fails to recognise that the cost of service delivery is driven by the characteristics of a state's population. For example, more unhealthy states need to spend more on health, but this is not due to inefficiency necessarily. Not all factors affecting cost are within states' control. For example, the adequacy of the Commonwealth's tax and transfer system in addressing interpersonal inequality has implications for outcomes and costs of state-provided services. States do not have absolute control over their populations, and each state is at a different stage of economic and social development.

Conclusions

HFE has been the subject of continued criticisms on a number of different grounds, including that it reduces national efficiency and productivity, distorts efficient labour and capital migration and supports or encourages less-than optimal policy outcomes. The Draft Report quite comprehensively rejects these arguments or has shown there is no supporting evidence of these effects.

The PC has strengthened the case for HFE in a number of ways. It has shown there is no evidence that HFE impedes state tax reform, dismissed the proposal to introduce a relativity floor or distribute GST on an equal per capita basis, recommended against the use of broad indicators, and found that states are unlikely to be discouraged by HFE to pursue growth-enhancing strategies or address structural disadvantages. This is an important conclusion for the Territory, which is often criticised for not eliminating its structural disadvantages with its share of GST. The PC recognised what the Territory has always understood, that this is not the role of HFE.

By omission, the conclusion from the information provided in the Draft Report is that HFE in its current form works and supports equity of the federation. The PC has examined the repeated arguments alleging weaknesses and failures ascribed to HFE and found they have very little merit. The PC found, however, that HFE is an effective means of achieving equity. Its primary objective.

Equity has been a cornerstone of the federation and HFE is its delivery vehicle, which ensures all Australians have access to comparable levels and standards of services. This principle has been supported by successive governments for almost a century. Given the effectiveness of HFE, there is no logic demonstrated or justification for weakening this objective.

The PC's recommendations would be an abrogation of a fundamental principle of the federation. It is ironic the CGC was originally established to resolve Western Australia's complaints that it was unfairly treated and required additional Commonwealth financial support to enable it to deliver services or levy taxes more in line with other states.

The PC has acknowledged the lack of understanding of HFE among governments and the community, but the Territory's firm view is that HFE is not beyond comprehension.

While the Territory agrees that HFE is not well understood by the public, this is largely due to the absence of a public defence and advocacy of HFE by an impartial party. The largest impediment to public acceptance and understanding of the role of HFE in the federation is a lack of public defence of the system by the Commonwealth Government. Promoting an understanding of the national benefits of HFE should be the key focus of a public education campaign. This is essential in dispelling the myths and misrepresentations of HFE in political and media dialogue.

The Territory also acknowledges that states often take issue with specific methodological aspects of the CGC's approach to implementing HFE over time. This is an important aspect of HFE and one that state Treasuries are strongly engaged in during annual updates and through the course of methodological reviews. However, implementation issues should not be confused with or misrepresented as dissatisfaction with the underlying principles of HFE.

In its response to a recent CGC discussion paper – HFE its Principles and Implementation, Western Australia supported the existing definition of HFE but proposed including additional objectives of conservatism, accountability, simplicity and transparency.

The Commonwealth already has the capacity to shape the CGC's task, through issuance of Terms of Reference. However, no Commonwealth Government to date has sought to dilute the fundamental objective of HFE, equity, and for good reason.

Despite this, the PC has proposed an approach that *requires* a significant increase in political interference in the HFE system and foresees Commonwealth Governments determining the appropriate level of HFE from year to year. Equalising to a 'reasonable' standard is difficult, messy, and does not provide a basis to take a longer-term view of the end goal. The subjectivity of a 'reasonable' standard is unacceptable for such an important mechanism as HFE. It will provide significantly increased complexity, uncertainty, risk of politicisation and above all, inequity. In comparison, and when left to its own devices, the current form of HFE will deliver a fairer, more equitable result, in both the short and long term.

In the Territory's view, the proposal to adopt a 'reasonable' standard is an attempt to provide a political fix, while masquerading as good policy. It is neither. It is not a political fix because it will exacerbate inequity, which will require further subsequent fiscal contributions by the Commonwealth. It is clearly not better policy to weaken a system that works.

Notwithstanding that further simplification may increase public understanding of HFE, it is not clear that it is necessary for the methodological aspects of HFE and its current implementation by the CGC to be publicly understood in detail, down to minutiae, outside the realm of intergovernmental financial relations. Strong advocacy by the Commonwealth of the CGC and its task is required and would help in promoting greater understanding of HFE in the Australian community. A lack of public understanding has not been raised in any other fiscal space, such as determinants of interest rates, calculations underpinning consumer price indices, or the inner workings of superannuation systems, as a means of justifying a change that would compromise the policy intent of these arrangements.

The Territory would strongly support the promotion of a better understanding of HFE. A genuine conversation led by the Commonwealth is long overdue in this regard. Identifying ways to simplify the methodology is also an important step in strengthening what matters: equity of access to quality government services.

The Territory also proposes the CGC be strengthened through its membership. The Territory notes that states have previously been consulted on appointments to the CGC, which has not occurred recently. There should be an HFE advocate on the CGC, responsible for public communication and increasing understanding by interested parties, most particularly, members of governments and the media. This proposal could be implemented immediately and would ensure the CGC's 2020 Methodology Review, which provides a platform for any and all methodological and principles-changes to be considered, to be better understood and followed by the broader public.

Appendix A – Summary of Northern Territory views on draft findings and recommendations

No.	Draft finding/recommendation	Northern Territory position
2.1F	While it has a number of strengths, there are also several deficiencies with the objective of Australia's horizontal fiscal equalisation (HFE) system. In particular, equalisation is always to the fiscally strongest state, it provides for limited consideration of efficiency and results in a complex system. The primary objective of the system may be better refocused to provide the states with the fiscal capacity to allow them to supply services and the associated infrastructure of a reasonable standard. This objective should be pursued to the greatest extent possible, provided that: • it does not unduly influence the states' own policies and choices beyond providing them with fiscal capacity • it does not unduly hinder efficient movement of capital and people between states • the process for determining the distribution of funds is transparent and based on reliable evidence.	Strongly disagree with this finding. The PC has not provided any robust evidence that there are deficiencies with the objective of Australia's HFE system. All evidence indicates HFE has served Australia well and is broadly supported across the nation. Importantly, the PC has not addressed the implications and consequences that would result from weakening the current arrangements. Its focus should be on strengthening access to and enhancing quality of services across jurisdictions and communities. The PC's finding will result in greater inequity. HFE works. It delivers what it is asked to do.
2.1R	The Commonwealth Government should clearly articulate the objective of HFE. This objective should aim for reasonable rather than full equalisation (as envisaged in draft finding 2.1). The objective should be established through a process led by the Commonwealth and involving consultation with the states and should be reflected in the Intergovernmental Agreement on Federal Financial Relations. The objective should also be reflected in the terms of reference, which the Commonwealth Government issues for the yearly update and five-yearly methodology review. The *Commonwealth Grants Commission Act 1973 (Cwlth)* should also be updated to reflect the adopted objective.	Strongly oppose the proposed change in definition of HFE. The proposed change would create deliberate inequity. The Territory supports the proposal that the Commonwealth should promote better public understanding of HFE, its role in the federation and defend it to the broader public.
3.1F	Australia achieves a high degree of horizontal fiscal equalisation and to a much greater extent than other countries.	Agree. This is to be lauded, not criticised.

contnued

No.	Draft finding/recommendation	Northern Territory position
8.1F	Fiscal equalisation to address disparities in the fiscal capacity of sub-central governments is common among OECD countries. But other countries' approaches to fiscal equalisation are inextricably linked to their unique institutional frameworks — this limits those schemes' applicability to Australia. Despite this, overseas experience provides lessons that can inform the elements of our system in order to better meet the objectives of our fiscal equalisation scheme. Australia is the only OECD country with a federal government that totally eliminates disparities in fiscal capacity between sub-central governments.	The Australian system is widely admired and respected internationally. Australia has the gold standard of HFE and should seek to maintain this. The Draft Report provides no evidence of how overseas approaches to HFE would enhance Australia's system. The Territory disagrees that adopting elements of other federations' equalisation systems would improve HFE in Australia.
4.1F	For the most part, states considering tax reforms would generally not be deterred by the effects on GST redistribution. However, there are circumstances where the GST effects can be material — such as for a state undertaking large-scale tax reform — and act as a significant disincentive to states implementing efficient tax policy. These disincentives are likely to be exacerbated where the state is a first mover on reform or there is uncertainty about how significant tax changes will be assessed by the CGC.	Agrees that states considering tax reforms are not generally deterred by HFE effects. There is no practical evidence to support claims that HFE is a disincentive to tax reform, (which the PC has itself acknowledged) and therefore there is no basis to change HFE on such grounds. Addressing these issues through the CGC's methodology is a more appropriate and effective means of addressing these issues, if evidence suggests that there is a basis to do so.
4.2F	Changes in state service delivery policies can impact on GST payments but the impacts are mostly trivial. HFE is unlikely to discourage — nor encourage — states from pursuing growth strategies or addressing their structural disadvantages given the broader and more significant benefits of doing so to the community.	Agree.
4.3F	The potential for HFE to distort state policy is pronounced for mineral and energy resources. While there is no direct evidence that GST effects have influenced specific policy decisions, the incentive effects are large and have the potential to undermine state policy neutrality over time. However, making adjustments to the HFE system specifically to add incentives for resource exploration policies deemed to be desirable would be an intentional breach of policy neutrality and state autonomy, be a source of additional complexity and come at the expense of equity.	HFE is not the appropriate means to address national energy or productivity policy concerns. CGC methodological changes can address 'theoretical' disincentives affecting states' mineral and energy royalty regimes if evidence warrants a methodology change.

contnued

No.	Draft finding/recommendation	Northern Territory position
5.1F	Features of Australia's HFE system detract from its contemporaneity. While this works to smooth out changes in GST payments, it can exacerbate the fiscal impact of economic cycles when states experience large economic shocks. Such a situation has occurred in Western Australia in recent years. However, offsetting cyclical factors is not the primary objective of HFE and alternative approaches do not offer unequivocal improvements. Reducing the length of the assessment period would have mixed impacts across states, and reducing the lag due to delayed data availability would introduce additional scope for dispute, volatility and the potential for unintended consequences.	Agree.
5.2F	GST payments are less volatile than other major sources of state government revenue. While some states have reported difficulty forecasting GST payments, others consider GST payments to be no less unpredictable than other sources of revenue.	Agree.
6.1F	The redistribution that arises from Australia's system of HFE is small in magnitude relative to total government revenue for most states. As such, the GST distribution and net fiscal benefits are unlikely to be a significant driver of interstate movement of people.	Agree.
7.1F	Removing mining from the HFE process, or the use of a discount factor within the mining assessment, is inequitable and not justified. However, there is a need to consider potential improvements in the assessment method in light of problems with policy neutrality.	Agree.
7.2F	The introduction of a minimum relativity floor would blunt extreme equalisation outcomes and might theoretically introduce greater incentives for states to pursue development opportunities. But a floor will likely prove a band-aid solution as it does not address the identified deficiencies of HFE, and may even introduce greater uncertainty and unpredictability into the HFE system.	Disagree that a relativity floor would introduce greater incentives for states to pursue development opportunities. There is no evidence to support this assertion. Agree that a relativity floor would not address the identified deficiencies of HFE and may introduce greater uncertainty and unpredictability into the HFE system.
7.3F	The introduction of a broad indicators approach for assessing fiscal capacity could potentially deliver benefits in terms of simplicity but would also have significant costs in terms of loss of accuracy, and may not achieve a 'reasonable' level of equalisation. The broader the indicators that are used, the more such risks may arise.	Agree.
7.1R	The Commonwealth Government should direct the CGC, through the terms of reference it receives, to consider approaches to assessment that deliver significant simplification and 'good enough' equalisation outcomes. The use of more highly aggregated assessments should receive detailed consideration as part of the current CGC process.	Disagree. The Territory strongly opposes any move away from full HFE, which would seriously affect access to services and erode interstate fiscal equity.

contnued

No.	Draft finding/recommendation	Northern Territory position
7.4 F	The use of externally defined benchmarks for efficient service delivery within the HFE process would encourage greater efficiency and reduce the potential for gaming the system. However, it faces daunting practical difficulties and involves a high degree of scope for dispute.	Agree. External benchmarks would be contrary to the established principles underpinning Australia's intergovernmental financial arrangements as outlined in the IGAFFR, and would violate state sovereignty.
7.2 R	The Commonwealth needs to develop clear guidelines detailing the basis on which Commonwealth payments are to be quarantined from HFE by the Commonwealth Treasurer, so that they do not unnecessarily erode the efficacy of the CGC's relativities. The guidelines should be based on the principle that quarantining of payments ought to occur only in exceptional circumstances.	Agree, although clear guidelines are already in place through the CGC's principles, however the Commonwealth Treasurer exercises discretion through issuing the Terms of Reference each year.
8.2 F	An equal per capita approach to distributing GST revenue is incapable of equalising the fiscal capacities of states. This approach is thus inimical to achieving the core equity rationale underpinning horizontal fiscal equalisation.	Agree.
8.3 F	An equal per capita with top-up funding approach would provide all states with the fiscal capacity to deliver a similar level of services. While this would meet the equity rationale underpinning horizontal fiscal equalisation, the top-up funding would always be hostage to fiscal constraints faced by the Commonwealth Government and, thus, this approach poses uncertainty for the fiscally weaker states. Such an approach should only be meaningfully considered as part of a broader reform of Commonwealth–state financial relations.	Disagree that this approach would meet the equity rationale, it would still provide the strongest states with greater capacity to provide services than the smaller, fiscally weaker states. Starting with a base of equal per capita is not consistent with HFE and ignores the equity principle underpinning Australia's intergovernmental financial arrangements.
8.4 F	An actual per capita approach (which is similar to the current system except that it uses actual revenue and expenses rather than assessed revenue and expenses) would provide all states with the fiscal capacity to deliver a similar standard of services and, in doing so, would meet the equity rationale that underpins horizontal fiscal equalisation. However, this approach has significant risks for adverse efficiency effects (less incentive to contain costs and pursue efficient service provision) — and on those grounds is an unacceptable alternative to current arrangements.	Agree.
8.5 F	Equalisation can be designed to provide a spectrum of fiscal equalisation outcomes — for example, from equalising to the average fiscal capacity across the states up to equalising to that of the strongest state. The extent to which this approach would meet the equity rationale underpinning horizontal fiscal equalisation therefore depends on the level of equalisation this approach is intended to deliver.	Anything less than full equalisation is a departure from the equity principle.

contnued

No.	Draft finding/recommendation	Northern Territory position
9.1 R	The CGC — through its Chairperson and Commission members — should provide a strong neutral voice in the public discussion on the HFE system. The CGC should also enhance its formal interactions with the state and Commonwealth governments. In particular, it could provide draft rulings to state Governments on the potential HFE implications of a policy change.	Agree.
9.2 R	The CGC should make the data provided by the states publicly available on its website, along with the CGC's calculations on these data. Where there are risks identified with this approach, mitigating steps should be identified and taken.	Disagree. The CGC's current processes are open and consultative. The Territory strongly supports transparency but considers that providing public access to the CGC's simulator may be excessive and will result in further confusing the public's understanding of the underlying data. Further, the CGC already publicly publishes key data tables as part of each review and update and the ABS publishes all states' financial data in its regular Government Financial Statistics publications, in addition to states' budgets.
9.3 R	The Commonwealth and state governments, through the Council on Federal Financial Relations, should develop a process that would work towards a longer term goal of reform to federal financial relations. In the first instance, it should assess how Commonwealth payments to the states — both general revenue assistance and payments for specific purposes — interact with each other today, given the significant reforms to payments for specific purposes that have occurred in recent years. The process should also work to a well-delineated division of responsibilities between the states and the Commonwealth, and establish clear lines and forms of accountability. Policies to address Indigenous disadvantage should be a priority in this regard.	Agree.