# Chapter 5

## Horizontal fiscal equalisation

5.1 Another common problem for federations is the uneven capacity of jurisdictions at the same level of government, such as states or provinces, to provide the same level of services to their communities. Most federations address this problem through some form of Horizontal Fiscal Equalisation (HFE); a form of financial assistance that allows governments to reduce the inequalities in the capacities of sub-national governments arising from the differences in their geography, demography, natural endowments and economies.

5.2 Australia has had mechanisms in place to provide for HFE since the establishment of the Commonwealth Grants Commission in 1933.[1] Its objective is to provide full equalisation in a way that gives each of the six states, the Australian Capital Territory and the Northern Territory the same per capita fiscal capacity to provide services and the associated infrastructure to their residents.[2] According to the Commonwealth Grants Commission (CGC) this means that:

> State governments should receive funding from the goods and services tax revenue such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.[3]

5.3 Currently the funds distributed to achieve HFE are the revenues raised from the Goods and Services Tax (GST). The distribution of GST required to achieve HFE is decided by the Commonwealth Treasurer each year, on the basis of advice provided by the Commonwealth Grants Commission (CGC).[4]

### Distribution: Legislation and Commonwealth Grants Commission

5.4 The main point of contention around HFE is the extent to which GST revenue is redistributed among the States and Territories compared with an equal per capita distribution. Under the *Federal Financial Relations Act 2009* and preceding legislation governing distribution of the GST revenue, each state and territory's share is calculated using 'relativities' designed to ensure that each state has the same

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1 John Wilkinson, *Horizontal Fiscal Equalisation*, Briefing Paper No 21/03, NSW Parliamentary Library Research Service, 2003, p. 1.

2 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities – 2010 Review*, February 2010, Vol. 1, p. 22.

3 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities – 2010 Review*, February 2010, Vol. 1, p. 30.

4 Commonwealth Grants Commission, http://www.cgc.gov.au/fiscal_equalisation/navigation/4 (accessed 20 May 2011).

financial capacity (not necessarily the same total quantum or per capita quantum) to provide services to its residents.[5] There is no obligation on the states to provide the services for which these payments are funded.[6]

5.5 The specific calculation is reached by multiplying each state and territory's 'adjusted state population' by the available pool of GST revenue, and then dividing that product by the sum of the adjusted state populations of all of the states for the payment year. Thus:

$$\frac{\text{Adjusted state population x GST revenue}}{\text{Adjusted total population}}$$

5.6 'Adjusted State population' means the 'estimated population of the State on 31 December in the payment year...multiplied by the GST revenue sharing relativity...for the State for that year.'[7]

5.7 The 'GST revenue sharing relativity' is defined as being that determined in a legislative instrument by the minister after consulting each of the states and territories.[8] In practice, the relevant minister 'almost without exception, accepts the [advice of the Commonwealth Grants Commission] … and the Ministerial Council for Commonwealth-State Financial Relations does not exercise its option to dissent on the CGC's advice...The Commonwealth Treasurer allocates 100% of the GST revenue...between States using CGC relativities.'[9]

5.8 In practice, the relevant Commonwealth minister refers the matter of consulting with the states and territories and determining the appropriate relativities to the Commonwealth Grants Commission (CGC).[10] Consistent with the

5 *Federal Financial Relations Act 2009*, s. 5. Prior to 2009, the relevant provision was s. 13 of the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999.* That provision was repealed by Item 19, Schedule 1 to the *Federal Financial Relations (Consequential Amendments and Transitional Provisions) Act 2009*, which also retitled the earlier Act to become the *A New Tax System (Managing the GST Rate and Base) Act 1999*).

6 *Intergovernmental Agreement on Federal Financial Relations* (2008), Item 25, http://www.coag.gov.au/intergov_agreements/federal_financial_relations/docs/IGA_federal_financial_relations.pdf (accessed 30 June 2010). See also: *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999*, Sched. 2, *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, Item 7.

7 *Federal Financial Relations Act 2009*, s. 5.

8 *Federal Financial Relations Act 2009*, s. 8. For previous arrangements see s. 9 of the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999.*

9 Mr N. Warren, 'Reform of the Commonwealth Grants Commission: It's all in the detail', *University of New South Wales Law Journal*, vol. 31 no. 2 (2008), pp 530–552.

10 Under the *Commonwealth Grants Commission Act 1973*, ss 16, 16A, 16AA, the Commonwealth Grants Commission (the CGC) is responsible for inquiring into and reporting on matters relating to grants made to states and territories under s 96 of the Constitution, including matters referred to it by the relevant minister.

intergovernmental agreement (IGA) on Federal Financial Relations and the previous Intergovernmental Agreement on the Reform of Commonwealth-State Financial Arrangements,[11] the CGC calculates relativities using a principle of Horizontal Fiscal Equalisation.

## Views on HFE in Australia

5.9 There were a range of views on dealing with the issues presented by horizontal fiscal equalisation. It was generally acknowledged that Australia's level of HFE was high but that this was to be expected given the corresponding high vertical fiscal imbalance.

5.10 Dr Zimmermann and Mrs Finlay argued that:

> [w]hile some level of equalization is broadly accepted as being in the broader national interest and as the price of being a member of the Federation, there does seem to be a point at which the costs outweigh the benefits, the disincentives limiting growth-creating policies and investment begin to negatively affect our future economic prosperity, and where there is a real risk of a growing resentment amongst citizens in the fiscally stronger States that may undermine national unity.[12]

5.11 The link between effective HFE processes and national unity was also raised in the paper by the Business Council of Australia. They note that:

> [a]s the Commonwealth comes increasingly to hold the purse strings, another area of contention between Governments will grow. Australia has a long history of horizontal fiscal equalisation, that is, adjustments in the level of payments to the States to provide additional financial support to those States thought to be in weaker financial positions. As States come to rely more on financial support from the Commonwealth, the level of that support will become an increasingly political issue.[13]

5.12 At the time of writing, there is some evidence to support the theory that HFE can be a focus of political friction. Writing in *The Australian* on 27 May 2011, Henry Ergas, noted that:

> The states' abject financial dependence on the commonwealth causes constant conflicts and inefficiencies, while the redistribution of tax revenues from richer to poorer states has reduced the states' incentive and ability to adjust to changing circumstances.

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11 *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999*, Sched. 2, *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, Item 8.

12 Dr Augusto Zimmerman and Mrs Lorraine Finlay, *Submission 17*, p. 48.

13 Business Council of Australia, *Modernising the Australian federation, A discussion paper*, 2006, p. 11–12, http://www.bca.com.au/Content/101346.aspx (accessed 1 June 2011).

> It was therefore inevitable that a resource boom, shifting the power balance between states and between the boom states and the commonwealth, would cause trouble.

5.13 He goes on to argue that any reform of Australia's fiscal federalism should be guided by 'two realities':

> First, the policy of systematically redistributing wealth between states was put in place during the Great Depression.
>
> But already by the 1980s, income divergence between states was one-third to one-half lower than it was in the 1930s.
>
> And population mobility and a more flexible economy have since reduced the spread in growth rates between the states by about one percentage point per decade.
>
> This fiscal redistribution has therefore largely lost its purpose. It is now a form of middle-class welfare, in which West Australian miners subsidise Tasmanian greenies and arts festivals in South Australia. And worse, it is positively counterproductive.
>
> Second, while being weaned off fiscal redistribution, the states need more efficient revenue sources of their own.
>
> An increase in the GST, offset by cuts in income taxes and in inefficient state taxes, would be an important step in that direction. Unfortunately, with all GST revenues flowing to the states, raising its rate and widening its base is all pain, no gain from the commonwealth's perspective. [14]

5.14 Suggesting a way forward, the NSW Business Chamber proposed that:

> the Australian Government should ask the Productivity Commission to independently review the way in which the Commonwealth Grants Commission manages the HFE process. In particular, the Productivity Commission could investigate whether the "five pillars" adopted by the CGC are the most appropriate framework within which to manage HFE. The Commission could make recommendations on the models that preserve the principle of HFE but incorporate it into a modern economic context. It is proposed that such a review would be limited to the appropriateness of the distribution formula, and not look at the split of responsibilities between State and Federal Government or other fiscal transfers between the levels of Government (such as NPPs).[15]

## Incentives and disincentives

5.15 A key issue that needs to be considered is the issue of incentives embedded in the HFE process for states and territories to maximise their revenue raising.

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14 Ergas, H. 'The fiscal fighting turns feral', *The Australian*, 27 May 2011, http://www.theaustralian.com.au/national-affairs/commentary/the-fiscal-fighting-turns-feral/story-e6frgd0x-1226063672790 (accessed 2 June 2011)

15 NSW Business Chamber, *Submission 30*, p. 9.

5.16 The committee heard that the CGC has no remit to look at whether states and territories should have raised as much revenue as they could. Rather, the CGC aims to give all jurisdictions the same fiscal outcome. This matter was highlighted in an exchange between a member of the committee Senator Chris Back, and the Chair of the CGC, Mr Spasojevic:

> **Senator BACK:** But it is not clear to me where in the guidelines the states and territories should be aiming to act as responsibly and effectively as possible to maximise revenue and contain expenditures.
>
> **Mr Spasojevic:** I think those constraints fall outside the gamut of what the commission is asked to do, in that if we think of the states collectively we are asked to distribute a given amount of money amongst them. We are not asked, for example, to determine what a good state policy or a good state fiscal position is and distribute the GST to somehow make that happen. We just give them all the same fiscal outcome. You may think that the states should have a tighter or lower average outcome. It is beyond the commission to comment on whether that is appropriate or not.[16]

5.17 The NSW government in their submission focused clearly on the way the current HFE system works against increased efficiencies.

> The HFE system is designed to flatten as much as possible the differences between the states. Above average revenues are equalised away and there is no incentive to improve efficiency. There is a disincentive against expanding the revenue base, either through increasing activity in the state or through undertaking additional expenditure to fund economic development, as the increased revenue capacity will result in lower GST revenue.[17]

5.18 A slightly contrary point of view is put by the Tasmanian government. They argue that the policy neutral stance of the CGC is actually a strength of the system.

> Without HFE, there would be much greater disparities in the quality of life of Australians living in different states. The CGC process for determining each state’s share of GST revenue is transparent, objective and policy-neutral. It does not compensate states for any economic or financial mismanagement, and states cannot directly affect their share of GST revenue.[18]

5.19 The differing position of the two states probably reflects the position put by NSW that '[t]he consequences of Australia's attempt at total and comprehensive fiscal equalisation are large cross-subsidies paid by the larger to the smaller states.'[19] This position is supported by Twomey and Withers who argue that the extent of HFE

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16 Mr John Spasojevic, Secretary, Commonwealth Grants Commission, *Committee Hansard*, 5 May 2011, p. 19.

17 NSW Government, *Submission 39*, p. 8.

18 Tasmanian Government, *Submission 40*, p. 6.

19 NSW Government, *Submission 39*, p. 10.

'provides greater disincentives for sub-national governments to seek and provide efficient delivery of government services'. They advocate that, '[a]t a minimum, more transparent and less complex equalisation processes with improved incentives for efficiency could be developed.'[20]

### *Review of GST Distribution 2011*

5.20 In 2010, the CGC completed a five-year review of its methodology and the relativities used to formulate each state's share of the GST revenue. As a result, the relativities being used from 2010-11 differ significantly for those used for 2009-10, a change which contributes to the extent to which there have been changes in the per capita redistribution of GST.

5.21 In the report of the review, the CGC recognised the complexity and shifting nature of the landscape against which the GST is distributed:

> This review recognises that the equalisation landscape has been radically transformed. At the time of the 2004 Review, the two most populous States — New South Wales and Victoria — had above average fiscal capacities and together shared the cost of equalisation, while other States' capacities were below average, and the Northern Territory well below average. Now the two most populous States lie close to average and the two faster growing States — Queensland and Western Australia — have seen their fiscal capacities strengthen relative to the other States at unprecedented rates and to historically high levels. These four now share the cost of equalisation. The other four States — South Australia, Tasmania, the ACT and the Northern Territory — remain below average, with the Northern Territory still well below average.
>
> Achieving equalisation in this environment, which sees the strong and growing revenue capacities of Western Australia and Queensland effectively shared with other States, requires a clearer recognition that this level of, and growth in, revenue capacity also increases the need for those States to spend to build the infrastructure required and acquire other assets in keeping with their population growth. Both have to be adequately recognised at the same time for equalisation to be achieved.[21]

5.22 On 30 March 2011, the Australian Government commissioned a review of the distribution of revenue from the GST to the states and territories. This is due to provide a final report by September 2012.

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20 Dr Anne Twomey & Dr Glenn Withers, *Federalist Paper 1: Australia's federal future. Delivering growth and prosperity.* A Report for the Council of the Australian Federation, April, 2007, p. 49.

21 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities – 2010 Review*, February 2010, Vol. 1, p. 1.

5.23 The Terms of Reference of the review acknowledge that Australia is facing a number of long term trends that are driving pronounced and challenging structural change in the economy, as well as ongoing challenges in tackling the entrenched disadvantage of many Australians, especially indigenous Australians.[22] It will consider, as part of its objectives and scope:

> whether the distribution of the GST and the current form of horizontal fiscal equalisation will ensure that Australia is best placed to respond to these challenges and public confidence in the financial relationships within the Australian Federation is maintained.[23]

### *Committee view*

5.24 The Committee recognises that a mechanism to implement HFE is a long standing feature of Australian federal-state relations and that it is widely regarded as an essential component in managing Australia's national economy. While long standing, the committee notes that HFE has been a highly controversial element in federal-state relations and that this has generated widespread debate over the need for reform. Given the intense nature of this debate, the committee acknowledges that making improvements to the current fiscal settings is neither easy nor likely to happen in the short term.

5.25 The committee notes, however, the Gillard Government's recently announced review of the distribution of revenue from the Goods and Services Tax to the States and Territories. The committee regards the review as an important step in addressing many of the controversies that currently surround the administration of the HFE arrangements in Australia. It considers however, that the value of the review could be increased if its scope were expanded to include an examination of the incentives for states and territories to increase their revenue raising.

### Recommendation 10

**5.26 The committee recommends that the recently announced review into the distribution of revenue from the Goods and Services Tax give particular attention to the issue of incentives and disincentives to states and territories to maximise their revenue.**

22 *Terms of Reference, Review of the GST Distribution*, Commonwealth Grants Commission, http://www.cgc.gov.au/__data/assets/file/0015/21930/GST_Distribution_Review_Terms_of_Reference.pdf (accessed 23 May 2011).

23 *Terms of Reference, Review of the GST Distribution*, Commonwealth Grants Commission, http://www.cgc.gov.au/__data/assets/file/0015/21930/GST_Distribution_Review_Terms_of_Reference.pdf (accessed 23 May 2011).

## Financial Assistance Grants – Local Government

5.27 A second, less high profile, HFE problem concerns the distribution of Financial Assistance Grants (FAGs) among local governments. Mandurah City Council explained what it sees as an inequity in the system for distributing general purpose grant moneys to local governments:

> Under the current distribution model, the General Purpose grant component is apportioned by the Commonwealth Grants Commission to State and Territory Grants Commissions on a per capita basis i.e. based on the population of each State and Territory. However, when the intra-State distribution occurs, these grants are then apportioned to Local Governments based on the principles of full horizontal equalisation and the minimum grant.
>
> As a result of the existing Commonwealth-State-Local distribution method, outer metropolitan and inner regional Councils in populous States such as NSW and Victoria automatically receive significantly larger grants – up to five times the grant received by similar sized WA Councils - regardless of their actual need.[24]

5.28 As an example, Mandurah compared the grant outcomes for three regional cities of similar size: Shepparton, Coffs Harbour and Mandurah. Despite their similar nature and populations, Mandurah's grant in 2006-07 was around $1 million, while the other two received closer to $5 million each.[25]

5.29 It was suggested that the CGC take on an expanded role in undertaking national horizontal fiscal equalisation amongst councils, rather than merely amongst states:

> [t]he Commonwealth Grants Commission should introduce a ‘national distribution’ model, providing General Purpose grants directly from the Commonwealth to Local Governments (bypassing the States), based on their relative ‘need’ (horizontal equalisation), rather than their State’s population. If the Australian and State Governments are serious about achieving an equitable national distribution of funds to all Local Governments, then it is only fair that each Council should be assessed against all other Australian Councils when competing for FAGs funding, rather than against only those Councils in their state.[26]

5.30 This would clearly represent a radical reshaping of local government finance. Other submitters, including the Australian Local Government Association (ALGA), did not address this issue. The committee expects that, as ALGA represents all councils, including those that would stand to lose from such a restructuring, it would not be in a position to reach a policy position on the proposal. The committee

24 Mandurah City Council, *Submission 35*, p. 6.

25 Mandurah City Council, *Submission 35*, p. 6.

26 Mandurah City Council, *Submission 35*, p. 6.

recognises the issue that concerns Mandurah City Council, and agrees that it is an issue that could be considered in more detail by an inquiry directed specifically at the funding of local government. It notes that ALGA and Mandurah City Council are both advocating such an inquiry.

5.31 The issue of the suitability of the current approach to general purpose grants for local government was highlighted in an earlier 2008 Productivity Commission report, *Assessing Local Government Revenue Raising Capacity*. The Productivity Commission received submissions from a number of participants who questioned the appropriateness of the existing arrangements for distributing Commonwealth general purpose grants. While the Productivity Commission noted that the appropriateness of the current distribution of financial assistance grants was beyond the scope of their terms of reference, they did go on to note that '[t]o the extent that full equalisation remains a policy objective of the Australian Government there is a case for more work in this area.'[27]

### *Committee View*

5.32 The committee recognises the concerns raised in submissions about the absence of equalisation at the local government level and notes the various suggestions for reform. Most of the proposed changes would have significant impact on the funding received by local government, creating winning and losing shires and municipalities in the process.

5.33 Nevertheless, the committee is of the view that the conclusion reached by the Productivity Commission, and the position advocated by ALGA amongst others has merit and that the issue requires closer investigation. Other matters relating to local government are considered in chapter 6.

### Recommendation 11

**5.34 The Committee recommends that the Joint Standing Committee proposed in Recommendation 17 of this report be asked to inquire into the extent of and need for reform of the arrangements for horizontal equalisation that currently exists between local government shires and municipalities across Australia.**

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27 Productivity Commission, *Assessing Local Government Revenue Raising Capacity*, 2008, p. 94.