Executive Summary

What has the Review been asked to do?[1]

The initial Terms of Reference

On 30 March 2011, the Commonwealth Government announced a review of Australia's system of distributing the GST amongst the States and Territories (collectively referred to hereafter as 'the States'). The Panel conducting the Review was asked to consider whether the current approach to distributing the GST (according to the principle of horizontal fiscal equalisation, hereafter referred to as HFE) would ensure that Australia is best placed to respond to the expected significant structural changes in the economy and would maintain public confidence in financial relationships within the Federation.

However, the commission was not given without restrictions. The Terms of Reference also state that the Review will be guided by a number of factors, including that:

- the long-standing practice of equalisation between States has served Australia well
- the GST will continue to be distributed to the States on the basis that they should have equal capacity to provide services and infrastructure to their citizens
- GST will be distributed as 'untied' payments
- the Commonwealth Grants Commission (CGC) will continue to make recommendations on the distribution of the GST.[2]

In addition, there is no extra Commonwealth revenue available with which to 'buy' reform, or smooth any transition. The Panel has therefore proceeded on the basis that States that are fiscally weaker at any given time must continue to have the capacity to provide substantially similar levels of services and infrastructure to their citizens from within the current revenue envelope.

The supplementary Terms of Reference

Supplementary Terms of Reference were issued on 17 November 2011, asking the Panel to consider possible changes to the form of equalisation to:

- ensure that HFE does not provide a disincentive to State tax reform
- utilise HFE to provide incentives and disincentives to promote future State policy decisions which improve the efficiency of State taxes and mineral royalties
- examine the incentives for States to reduce Minerals Resource Rent Tax (MRRT) or Petroleum Resource Rent Tax (PRRT) revenue through increasing mineral royalties.

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1 The full Terms of Reference for the Review are set out in Appendix A.
2 GST Distribution Review Terms of Reference, issued on 30 March 2011, paragraph 6.

These supplementary Terms of Reference initially caused consternation amongst the States. Resource States felt the need to defend their jurisdictions against Commonwealth expansion into resource taxation. Most States, while acknowledging the accepted tax reform direction, are keen to explore the incentive 'carrot', but have no time for the disincentive 'stick'. As to the general incentives of the HFE system on tax reform, some States claim to be dissuaded from improving policy by apparently minor and, in some cases, trivial GST effects, while others suggest the opposite.

Context of the Review

The economic outlook

While the Australian economy is performing very well by international standards, the Commonwealth's recent Mid-Year Economic and Fiscal Outlook reported that:

> *Global growth has weakened since Budget and the international outlook remains highly uncertain. The euro area has fallen back into recession, the recovery in the United States remains subdued and weakness in the major advanced economies is bearing on growth in the large emerging market economies, including China and India.*
>
> *Against this challenging global backdrop, the fundamentals of the Australian economy remain strong and the outlook remains positive. Economic activity is expected to grow at around its trend rate over the next two years, the unemployment rate is forecast to remain low and inflation is expected to be well-contained.*
>
> *Australia's favourable economic growth prospects are supported by a surge in business investment, strong growth in non-rural commodity exports and solid growth in household consumption.*
>
> *The challenging global environment, high Australian dollar, household deleveraging, changed household spending patterns and subdued expectations for asset price increases are weighing heavily on some parts of the economy, consistent with forecasts for moderate employment growth and a slight rise in the unemployment rate.*
>
> *Weaker global demand has also contributed to larger-than-anticipated declines in global iron ore and coal prices and in Australia's terms of trade. As a result, Australia's nominal GDP growth is expected to be a percentage point weaker in 2012-13 than forecast at Budget, with marked consequences for revenue collections.*[3]

Implications of the economic outlook and other recent developments

The growth outlook has implications for Commonwealth and State budget revenue. All Commonwealth and State Governments are expecting to deliver fiscal deficits, or at best, very modest fiscal surpluses, in the medium-term.

3 *2012-13 Mid-Year Economic and Fiscal Outlook*, page 13.

Of particular relevance to the Review, the Panel notes:

- While growth in GST revenue — the current vehicle for equalisation — has averaged 6 per cent since the introduction of the GST, for the next few years only 5.2 per cent pool growth per year is expected.[4] However, these figures mask a large difference between the period prior to the global financial crisis and the one after it. Up until 2007-08, the GST grew each year by around 8.3 per cent on average, far higher than the average 2.2 per cent increase between 2008-09 and 2011-12. Lower growth has had implications for the range of approaches the Panel has been able to recommend, as extra Commonwealth funding is not currently available to fund changes to Australia's equalisation system. Despite recent calls for Australia to reject the 'no losers' mentality that can impede reforms, the reality is that, in a world where revenues are weak, policy change is hard.

- Recent significant and rapid improvement in the relative financial position of Western Australia, at the same time that Queensland, another major resource State, has experienced temporary setbacks from major natural disasters, has led to greater divergence in State fiscal capacities and, therefore, substantial change in the distribution of the GST amongst the States. While the situation could prove to be temporary and less extreme than first thought, these recent rapid and significant changes have heightened scrutiny about the HFE process and its outcomes.[5]

- The Panel's Terms of Reference ask us to consider 'future challenges' and this requires having an eye not only on current and short term issues, but other pressures that are likely to affect States' budgets in a significant way in the longer term, such as the ageing population. Other longer term issues that may not be able to be predicted, but need to be contemplated, include the length of the mining boom and the countervailing or reinforcing circumstances that may apply.

- Several other special factors (of varying degrees of importance) have also contributed to recent heightened scrutiny, including large data revisions in a recent CGC Update, changes made in the CGC's 2010 Review, and a large one-off increase in the size of infrastructure payments to States as part of the Commonwealth Government's economic stimulus package from 2009. A series of recent moves involving substantial Commonwealth funding to States, either to produce special outcomes (e.g. 'closing the gap payments' to the Northern Territory and the Tasmanian health system payments), or to deliver uniform national outcomes (as in the recent health agreement and are in contemplation in the education arena) may also create tension with the HFE system unless managed carefully.

4 GST payments to 2011-12 have been sourced from Commonwealth Government *Final Budget Outcome,* various years. Forward estimates of GST entitlements have been sourced from *MYEFO 2012-13*, page 80. Growth is based on total GST entitlement.

5 See Appendix F for charts showing differences in State fiscal capacities since 1992-93.

The Panel's approach

The interim reports[6]

The Panel's first interim report, released by the Treasurer on 23 April 2012, outlined the Panel's thoughts on the matters set out in the initial Terms of Reference, taking into account the various positions and ideas put forward by States, academics and other interested parties in response to an initial issues paper. Various States and commentators expressed significant concerns about the theoretical model for GST distribution, the practical implementation of the model, the resultant outcomes and the inability of States to anticipate those outcomes with reasonable confidence.

The Panel's second interim report outlined the Panel's thoughts on the matters set out in the supplementary Terms of Reference, again taking into account such views as had been put by States and others in their submissions in response to a supplementary issues paper released in December 2011.

This final report has benefitted from further rounds of consultation along with thoughtful and detailed submissions from all jurisdictions and a number of other interested parties.

The consultation process

Over the past 18 months, the Panel has met with and consulted States (including Premiers, Treasurers and Shadows, as well as officials), the Commonwealth Grants Commission, academics with known interest in Commonwealth-State financial arrangements and other interested parties. Detailed information on the consultation undertaken by the Panel is in Appendix H.

All States have made submissions in response to the first and second issues papers and again following the release of the interim reports. While each State has put forward its individual perspective, the four smaller States have tended to share similar views, and the four larger States have also had a convergence of views — the latter group coming together to make a joint submission in response to the interim reports.

In our interim reports we were careful to demonstrate that we had paid detailed attention to the views of stakeholders and experts by quoting them extensively. This was done partly to ensure we were not inadvertently misconstruing submissions put to us, and partly to avoid the suggestion that we might be doing so with intent. However, the consultation process has been so comprehensive, open and constructive that we have not felt the need to repeat that approach here. While, no doubt, certain stakeholders will disagree with some of our conclusions, we trust that they will appreciate the *bona fides* of the motivation that has prompted them. Therefore, in this final report, we have opted to summarise the relevant key issues affecting our findings and recommendations, rather than setting out a verbatim account of the diverse positions and arguments.

6 The Panel's reports are available on the Review's website: http://www.gstdistribution review.gov.au/content/Content.aspx?doc=reports.htm.

Overview of findings and recommendations

Since federation, the Commonwealth Government has provided some form of financial support for fiscally-weaker States. The view was taken that, unless some type of intervention occurred, the Federation would be unsustainable, as States with weaker financial positions would have had to reduce services and/or raise additional revenue. To enable these poorer States to provide services to their residents at anything close to the same standard as the fiscally-stronger States, it was recognised that a mechanism was required to adjust their fiscal capacities through special grants.

Chapter 1 reviews the academic literature to conduct a detailed tracing of the theoretical debate around models of equalisation. It explains that the essential difference between the modern theory of equalisation and that adopted from shortly after federation to the mid-twentieth century is that the current system reflects the goal of allowing interpersonal horizontal equity via equalising States' capacities, whereas previous arrangements were based on more general concepts of fairness that left greater room for debate about the appropriate level of redistribution.

The Chapter concludes that, while modern horizontal fiscal equalisation (HFE) theory provides a conceptual model for determining the financial transfers between States in order to be fair to all citizens and avoid inappropriate migration incentives, the model has its critics and there are practical issues with it. The preference of some States for an outcome consistent with this theory, whilst others seek a simpler model, lies behind many of the differences between the positions put to the Panel by the States. While South Australia, Tasmania, the Australian Capital Territory and the Northern Territory support the current equalisation system, New South Wales, Victoria, Queensland and Western Australia see major problems with it. The significant concerns of this second group of States — representing 90 per cent of Australia's population — has caused the Panel to inquire closely into whether modifications could be made to the current practices that might produce tangible benefits outweighing any costs of change.

Chapter 2 examines the difference in practical impact between the modern HFE model and other approaches, making five key findings about the parameters of the right model for the future. These findings relate to:

- the advantages of a rules-based system over ad hoc negotiations
- the target for equalisation
- the precision with which any target can be achieved
- the comprehensibility of the HFE system to outsiders
- issues outside HFE that add to States' concerns.

Chapter 3 examines specific proposals and ideas to modify the system put by the large States in order to establish whether any of the approaches are viable in the short to medium term. For convenience, the Panel has categorised these into two groups:

- 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.

They would all require additional steps in the CGC's process, and additional steps would require additional explanation about how the distribution was determined, making the process less transparent.

- In relation to proposals to perform equalisation in a 'less precise' way, the Panel was initially drawn to the prospect of 'broad indicators' as a potential way to achieve the goal of reaching similar outcomes through simpler processes. Ultimately, however, we found this goal to be elusive. While there is no end of 'simpler' ways to allocate Commonwealth grants to States, very few could be adopted within the constraints of our Terms of Reference.

While the Panel has found that it is not possible to closely replicate the outcomes of the current system in a dramatically simpler way, we have recommended two small steps that can be taken relatively easily — increasing materiality thresholds and rounding relativities. Although these changes will only change GST shares in a minor way, the Panel believes the steps should be taken in order to act as resistance against the tension created by the contested nature of the current system, which can apply pressure on the CGC to adopt processes and assessments that are overly precise.

Chapter 4 considers improvements to the governance of the HFE system. The Panel has recommended a range of improvements designed to strengthen existing arrangements by increasing the timeliness and accountability for decisions, as well as improving collaboration in the processes surrounding them. The Panel recommends that:

- the governance arrangements reflect the need for the States and the Commonwealth to act more as joint stewards of the system rather than competitors or critics
- the definition of HFE be set out in the CGC Act
- the CGC Act itself be brought up to date with current practice
- the CGC be given clear authority to determine which assessments should be reviewed (and which ones should not) in its regular methodology reviews
- the Commonwealth Treasurer adopt guidelines governing the Commonwealth's decisions and consultation processes.

Chapter 5 examines ways to improve transparency and understanding of the system. The Panel has made recommendations designed to improve the way the HFE system is explained and communicated, thus increasing confidence in the system. The Panel recommends that:

- an additional presentation of relativities also reflect the full Commonwealth assistance to States
- both the projection of relativities and the interaction between HFE and Payments for Specific Purposes be clarified
- that the CGC engage more broadly.

Chapter 6 deals with improvements to the stability of GST shares by proposing changes to the treatment of Commonwealth capital payments to the States, so that all national network road infrastructure and rail based transport infrastructure payments be treated on a consistent basis, via 50 per cent of the payments affecting relativities. Changes to reduce the extent to which data revisions are incorporated are also recommended in order to further improve stability and potential methodology improvements are highlighted for the CGC to consider.

Reflecting the important role mining related issues have had in this review, Chapter 7 deals in detail with the assessment of mining revenue and expenditure. The Panel concludes that State mining revenue should continue to be equalised, but recommends that the CGC develop a new mining revenue assessment at the earliest opportunity to address policy neutrality concerns. The Panel also concludes that some mining related costs may not be properly recognised in the CGC's current assessments and therefore recommends that an amount equivalent to a three per cent discount to the mining revenue assessment be allowed as a temporary measure until the CGC conducts its next methodology review.

Chapter 8 deals with the interaction between States' mineral royalties and the Commonwealth's resource taxes. The Panel finds that the current impasse between the two levels of government on this issue is harmful and unsustainable, but that it won't be fixed by penalising States through the GST distribution system. The Panel concludes that what is needed is for the States and the Commonwealth to settle a negotiated outcome. Ideally, such an agreed position would enable State royalties to be lower and the revenue from the Commonwealth's resource taxes to be greater, with the Commonwealth guaranteeing to increase payments to each State to ensure its fiscal positions are maintained. The Panel's view is that the fiscal dividend from these improved arrangements should also be shared between the two levels of government, as occurred with the National Competition Policy reforms.

Chapter 9 examines concerns that HFE undermines efficiency or impedes tax reform. The Panel concludes that the current system creates perverse *theoretical* incentives in some instances, but they cannot be meaningfully reduced without significant reductions in equalisation outcomes, which would be unacceptable, given there is little practical evidence of efficiency losses. On tax reform, the Panel emphasises that a more broadly-based tax system is vital to Australia's future prosperity, but notes that equalisation is not an impediment, nor is it an appropriate tool to compel or encourage States to change their tax policies. The Panel concludes that if it ever became apparent that possible changes in GST shares were impeding tax reforms, specific and temporary adjustments should be made to the GST distribution in that context, rather than changing the equalisation system as a whole.

Chapter 10 examines *Indigeneity*, which is the disability responsible for the greatest redistribution on the expense side. The size of this factor has caused some States and commentators to conclude that removing it (in whole or part, or as a component of even larger changes) would improve the system. The Panel has not agreed with these calls. Chapter 10 sets out the Panel's reasons for deciding that there should be no change to the current approach to *Indigeneity* in the HFE system.

Chapter 11 looks at the GST pool itself, and its role in providing both the basis for untied grants to the States and for delivering HFE. While parts of the current arrangements work well for States, GST collections have been both less buoyant over recent times and more volatile than expected when the GST was introduced. In this Chapter the Panel suggests ways of ensuring the GST pool is as robust and stable as possible, including by preventing online imports from eroding the GST base and by allowing the States greater flexibility in relation to assisting first home buyers.

Chapter 12 sets out the Panel's thoughts about how HFE might be approached in a longer term scenario in which other aspects of federal fiscal relations are simultaneously in play. Chapter 12 discusses spending pressures and how they might be managed, how future tax reforms might better align Commonwealth and State revenue raising capacity with service responsibilities, and how this might lead to a reduced level of vertical fiscal imbalance. The Panel considers that under such a long term scenario, the current concept of HFE need not necessarily apply, but notes that any modified system would still need to recognise and accommodate the needs of the fiscally weaker States.

Summary of findings and recommendations

Chapter 2 — The contrast between models of equalisation

Findings on factors affecting the choice between models of equalisation:

Finding 2.1 on a rules-based system of allocating funds

Experience shows that a politically indifferent, rules-based, system of allocating finances to States has advantages over the ad hoc negotiation of special deals, especially, but not only, when governments of opposite persuasions are involved. An independent system even arguably has advantages for the 'donors', as New South Wales and Victoria might recall from their experience in the 1980s, when they began to do better from the first full equalisation process than they had under the previous process of considering the claims of individual States.

Finding 2.2 on the principle of horizontal fiscal equalisation

The purpose of a federation is to bring disparate constituent parts together and so the concept of bringing the weak up to the capacity of the strong has much to be said for it. However, the zeal with which an exact calculation of equalising all States' fiscal capacities must be pursued, the precision with which the target can be determined and the effect it will have are disputed. While there is no reason to argue against providing States with the capacity for horizontal interpersonal equity (i.e. equality) amongst their citizens, inequality is tolerated in many features of government if there are identifiable benefits to be gained.

Finding 2.3 on the current HFE system

The current HFE system — requiring material equality and being guided by internally referenced principles and pillars, standards and capacities — is well established and internally consistent. It works satisfactorily if the goal and definition of equalisation as currently set out is accepted and one accepts (as we do) that the CGC does a good job of making its judgements and producing its numbers in the circumstances. However, by recognising that the CGC is often obliged to make decisions that turn on fine judgements and occasionally reverse direction, one is obliged to accept that there is a margin for error in the outcome. Despite the 'conservative bias' arguably applied by the CGC in its judgements, the margin for error could result in over-equalisation, or equalising for things that are effectively within a State's control.

Finding 2.4 on people's understanding of the current system

Outside of a small core group, very few people, politicians included, have a good understanding of the background to, or the features of, the current system. This lack of understanding, compounded by the 'zero sum' nature of the exercise and the capacity of all to view the arguments through the lens of a geographic perspective, means that debate about the system can be frustrating if not futile. If a simpler system allowed the democratic processes to operate in a better informed environment, that would be beneficial to transparency and good government. Decision-makers should not be captive to the advice of a very narrow pool of experts, especially when the objectives of the system are contested amongst those experts and, because of the relative nature of the calculations, its effects are hard to predict and sometimes counter-intuitive.

Finding 2.5 on issues connected to HFE

Apart from HFE itself, there are closely connected issues that aggravate the concerns of some States. Concerns about the size of GST shares because the GST has not 'kept pace' with the State taxes it replaced, has not grown at the expected rate, or is shrinking as a proportion of consumption, compound and conflate concerns about HFE. When HFE issues intersect with questions of tax reform and State and Commonwealth rights, the aggravation becomes extreme.

Chapter 3 — Examining alternative equalisation approaches

Finding 3.1 on proposals to do 'less' equalisation

Despite our initial desire to provide incentives to States to deliver services more efficiently, the Panel has concluded that the HFE system as currently manifested cannot achieve this through efficiency discounts, as there are factors beyond a State's control that lead to higher than average expenditure. While it might theoretically be possible to overcome this deficiency if the CGC were to fully separate cost and use elements of its assessments, that result is not guaranteed, and the additional process would risk complicating the CGC's assessments further.

Nevertheless, the Panel encourages States to continue to seek efficiencies wherever they can. In particular, we note that, under the present system, whenever large States such as New South Wales, Victoria and Queensland are able to reduce their costs of service delivery, their contribution to the average calculation (over 75 per cent) will drive the average to which all States are equalised.

Finding 3.2 on approaches to address confidence in the federation

Approaches to address confidence in the federation would only make sense if there was a real likelihood of a strong State seeking to leave the federation. In the Panel's view, whatever concerns States may have about the delivery of HFE, they are not sufficient for them to realistically contemplate leaving the federation and we do not see the need to pursue these approaches. If a situation arose where the risk of a State seeking to leave the federation became realistic, this type of approach might be considered as an 'emergency break glass' option to apply in the short term to allow time for a negotiation of broader Commonwealth-State financial relations issues.

Finding 3.3 on the 'effort' approach

The effort approach provides an interesting and credible basis for adjusting the present system. However, the discounts indicated could only be considered to be minimal — perhaps even symbolic — from the large States' point of view, while having a significant impact on small States. After deep deliberation, the Panel has decided, on balance, not to recommend adopting discounts to reflect the minimum effort.

Finding 3.4 on approaches that address State 'property rights'

Whether any of the approaches examined above would improve the HFE system is ultimately a matter of judgement, depending on one's point of view. On balance, the

Panel has come to the conclusion that we can neither recommend very small changes that would deliver only symbolic benefits to the large States (at the cost of even less simplicity), nor are we prepared to recommend larger changes that would have major negative impacts on small States.

However, if governments were minded to make changes, the Panel considers that the 'effort' approach would be the best way of determining the size of those changes.

Finding 3.5 on broad indicators

The Panel concludes that the ultimate goal of improving simplicity by adopting broad 'cut-through' indicators that can produce closely comparable results to those under the present arrangements remains elusive. That does not mean that we have concluded that no break-through simplification via broader indicators is possible, but just that it cannot be achieved in one bold stroke.

Recommendation 3.1 on materiality thresholds

To ensure the system is not driven to become falsely precise, the Panel recommends that materiality thresholds for the next methodology review be set at:

- *category total expense or revenue average of $200 per capita*
- *category redistribution $120 per capita for any State*
- *disability $40 per capita for any State*
- *data adjustments $12 per capita.*

Recommendation 3.2 on rounding relativities

To ensure the system does not appear to be falsely precise, the Panel recommends that relativities produced from the CGC's process be rounded to two decimal places in the annual Updates and Reviews.

Chapter 4 — Improving HFE system governance

Finding 4.1 on governance arrangements

Governance arrangements for the HFE system should reflect the need for the States and the Commonwealth to act as joint stewards of the system, rather than competitors or critics.

Recommendation 4.1 on endorsing the definition of HFE

The Panel recommends that the definition of HFE be set out in the CGC Act.

Recommendation 4.2 on reviewing the CGC Act

The Panel recommends that the CGC Act be thoroughly reviewed (by the Commonwealth in close consultation with the States) with a view to updating its provisions to bring it in line with the practice of HFE today. In particular, sections to be *updated include those that relate to:*

- *'special assistance' and 'applications for assistance'*
- *the definition of a State, and separate provisions for the Australian Capital Territory, Northern Territory, Jervis Bay Territory and Norfolk Island*
- *remuneration and termination of CGC members*
- *the operation of the CGC along judicial lines, such as giving evidence on oath.*

Recommendation 4.3 on reviewing the CGC's implementation of HFE

The Panel recommends that the Commonwealth formally request the Auditor-General to consider conducting an audit of the CGC's administration of HFE within three years of the implementation of the outcomes of this Review, or following the next methodology review, whichever comes first.

Recommendation 4.4 on setting priorities for future methodology reviews

That the CGC be given clear authority to identify the assessments it regards as high priority for re-examination in the review and determine which lower priority assessments should be deferred until a future review.

Where significant issues arise late in a review, the CGC should be able to seek an extension from the Commonwealth for that element, to ensure there is adequate time for consultation.

Recommendation 4.5 on guidelines for the Treasurer's consultation with the States

That the Treasurer develop and publish guidelines governing consultation with the States along the following lines:

- *In consulting with the States in relation to the draft Terms of Reference for a CGC annual Update, the Treasurer shall:*
  - *finalise draft Terms of Reference by early November of the year prior to which the Update applies*
  - *allow a minimum of three weeks consultation by States on the draft*
  - *ensure all key elements are included in the draft provided to States*
  - *provide final Terms of Reference to the CGC by, at the latest, the end of December of the year prior to which the Update applies.*

Recommendation 4.6 on guidelines for the quarantining of payments

That the Treasurer develop and publish guidelines governing the quarantining of Commonwealth payments, along the following lines:

- *The Treasurer shall only quarantine payments to States on an exceptions basis,* *recognising that most payments are properly included in the HFE process. Exceptions that may warrant quarantining a payment include:*

- *where a payment is made solely and expressly for the purpose of allowing a State to temporarily provide above average services in a particular area*
  - *in particular, where a payment is made for the purpose of allowing a State to provide above average services to address Indigenous disadvantage.*

- *The Treasurer shall avoid quarantining payments for reasons already considered by the CGC, including where:*
  - *the payment is being made 'through' the State to a third party*
  - *the payment is a purchase of services by the Commonwealth*
  - *the Commonwealth distribution is assumed to reflect States' needs*
  - *the relevant expenditure needs are not able to be assessed.*

Recommendation 4.7 on the timing of the Treasurer's decisions

That the Treasurer develop and publish guidelines governing the timing of decisions relating to quarantining of Commonwealth payments, along the following lines:

- *In relation to the timing of decisions on quarantining Commonwealth payments, the Treasurer will announce whether or not he or she intends to quarantine a payment as soon as the payment is announced, or as soon as practicable after the announcement.*

Recommendation 4.8 on the timing of the CGC's decisions

That the Treasurer instruct the CGC to make a decision on the treatment of all new Commonwealth payments in its Update immediately following the Budget in which the payments are first announced, or as soon as practicable thereafter.

Where a decision to make a payment to a State is announced outside of the Budget, the CGC should make and announce its decision on treatment of that payment within six months of the payment being announced or, where this is not possible due to the details of the payment not being finalised, as soon as practicable after payment details are finalised.

Chapter 5 — Improving communication and transparency

Recommendation 5.1 on the presentation of relativities

The Panel recommends that:

- *the CGC clarify that relativities do not represent a State's share of the GST collected* *within its borders or from its residents*

- *when publishing the GST relativities, the CGC also show relativities based on total Commonwealth assistance*
- *the Commonwealth continue to publish relativities based on total Commonwealth assistance in its budget papers.*

Recommendation 5.2 on clarifying the projection of relativities

That the Commonwealth should either cease publication of the GST relativities for out years in the forward estimates period or very clearly explain the nature of the projections in the Budget papers.

Recommendation 5.3 on improving the projection of relativities

That, to enable more accurate forecasting of relativities, States provide the following information to all other States bi-annually:

- *revenue estimates for the next four years, by revenue line, with details in line with CGC assessments*
- *details of the impact of announced policy changes on revenue estimates and*
- *expenditure estimates for the next four years, by CGC assessment category.*

The Commonwealth should ensure it provides the States, on a bi-annual basis:

- *GST pool forecasts/estimates for the next four years*
- *SPP pool forecasts/estimates for the next four years*
- *Other PSP forecasts/estimates, by State, for the next four years.*

Recommendation 5.4 on broadening the engagement of the CGC

That the CGC engage with governments more broadly. Expanded engagement activities should include:

- *an annual public address following the release of the year's relativities*
- *briefing sessions for State and Commonwealth parliamentarians (including non-Treasury ministers and shadow ministers)*
- *staff briefing for State non-Treasury officials*
- *appearance by Commissioners before an appropriate Senate Committee.*

Recommendation 5.5 on the treatment of National Partnership Payments

The Panel recommends that apart from the listed exceptions, all National Partnership Payments should affect the relativities. The exceptions are:

- *payments quarantined by direction of the Commonwealth Treasurer*
- *reward payments*
- *payments otherwise determined by the CGC following its guidelines that should not affect the relativities (COPEs, needs not assessed and so on)*
- *certain capital payments for transport infrastructure (see Chapter 6).*

Recommendation 5.6 on the interaction between HFE and SPPs

The Panel recommends that, when finalising future national reform agreements, the Commonwealth and States clearly state whether the payments (or part thereof) should be included or excluded from the HFE process. This statement should be reflected in the relevant national reform agreement and the corresponding words repeated in the IGA and relevant CGC Terms of Reference.

Chapter 6 — Greater stability of GST shares and methodology improvements

Recommendation 6.1 on the treatment of Commonwealth payments

In recognition of the inter-related nature of transport networks and the national benefits that accrue from increasing the efficiency of these integrated transport networks, the CGC should identify all Commonwealth payments relating to national network road infrastructure and rail based transport infrastructure.

All identified payments should affect the relativities on a 50 per cent basis, to recognise their dual national/State purpose. To ensure that States that have previously received rail based transport payments are not disadvantaged, this change in treatment should apply from the CGC's 2013 Update.

Recommendation 6.2 on data revisions

Where data are updated or released annually with a lag, or updated or released less frequently than annually, the CGC should allow the newly available data to only inform changes in States' circumstances in the most recent assessment year and not be used to revise previous estimates of earlier inter-survey years.

Recommendation 6.3 on a simplified assessment framework

That the CGC examine the merits of adopting a simplified and integrated assessment framework in its next methodology review.

Recommendation 6.4 on cost equalisation

That the CGC investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis. This investigation should occur in the context of the assessment of other cost disability factors including costs of remote locations, and administrative scale.

Chapter 7 — Assessing mining revenue and expenditure

Finding 7.1 on the treatment of mining revenue

States' mining revenue should continue to be equalised through the HFE system, on the same basis as other own-source revenue.

Finding 7.2 on the mining revenue assessment

The current two-tier mining revenue assessment can produce excessively large GST share effects when a commodity moves between groups.

Finding 7.3 on the mining revenue assessment

The Commonwealth Treasurer's previous directions to the CGC to keep iron ore fines in the low-rate group appropriately ensured Western Australia was not unfairly penalised for removing its concessional rate.

Recommendation 7.1 on the mining revenue assessment

That, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to:

- *continue to ensure that Western Australia's removal of iron ore fines royalty rate concessions in 2010 does not cause iron ore fines to move into the high royalty rate group in the 2010-11 or 2011-12 assessment years*
- *consider the appropriate treatment of iron ore fines for the 2012-13 assessment year and future years, in light of Western Australia's decision to bring the iron ore fines royalty rate to the same level as that for iron ore lump.*

Recommendation 7.2 on the mining revenue assessment

That the CGC and other stakeholders develop a new mining revenue assessment at the earliest opportunity. The new assessment should:

- *avoid excessively large GST share effects, such as when a commodity moves between groups under the current assessment*
- *treat iron ore, coal and petroleum differently to minerals that are not subject to Commonwealth resource rent taxes.*

Recommendation 7.3 on mining related expenditure needs

The Panel recommends that, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to add an amount to its expenditure assessments equivalent to a 3 per cent discount of the mining revenue assessment in order to compensate for the fact that some mining related needs of the resource States are not fully recognised. This interim assessment should remain in place until the next methodology review is completed.

Chapter 8 — State mining royalties and the MRRT

Finding 8.1 on State royalties and Commonwealth resource taxes

The States and the Commonwealth both have legitimate roles in obtaining mining revenue on behalf of the community. The challenge is to reconcile these interests.

Finding 8.2 on State royalties and Commonwealth resource taxes

The Commonwealth's decision to fully credit State royalties under the MRRT and PRRT has created an incentive for States to increase these royalties. This situation is neither desirable nor sustainable.

Finding 8.3 on an interim measure

As an interim measure, the Commonwealth could announce that it intends to direct the CGC to assess any revenue raised from royalty increases on MRRT and PRRT commodities after a particular date on an actual per capita basis.

This would reduce, but not remove, individual States' incentives to increase their mineral royalties, while also potentially providing a windfall to other States. It would not represent an effective substitute for a negotiated outcome.

Recommendation 8.1 on a cooperative Commonwealth-State approach

The Commonwealth and the States should acknowledge that a cooperative approach to resource charging will produce a superior outcome to any available alternative.

Accordingly, the Commonwealth should actively seek to engage the States with a view to reaching agreement on the taxation of resource projects. The States should be receptive to such a request for negotiations.

Recommendation 8.2 on revisiting the design of the MRRT and PRRT

If the Commonwealth and the States are unwilling or unable to reach an accommodation regarding resource charging, the Commonwealth should amend the design of the MRRT and PRRT to remove the open-ended crediting of all royalties imposed by the States.

Recommendation 8.3 on the form an agreement should take

A negotiated outcome adhering to the following principles would secure and build upon the benefits of resource tax reforms already undertaken.

- *The MRRT and PRRT should be amended to sever the link between the royalty allowance provided and prevailing State policies. This would restore full accountability to the States for their royalty policy settings.*
- *State royalties on iron ore, coal and petroleum should be reduced (perhaps by around one-third).*
- *The Commonwealth should guarantee to increase payments to each State so as to offset the royalty revenue foregone.*

- *Most of the revenue to do this will come automatically through increased MRRT and PRRT collections. The Commonwealth should consider tightening aspects of its resource taxes to ensure an approximately revenue neutral overall result is achieved.*

- *The Commonwealth and the States should jointly commission a credible, independent estimate of the fiscal dividend expected to flow over time as a result of these improved arrangements. This amount should be shared between the Commonwealth and the States following a similar approach to that used for the National Competition Policy reforms.*

Chapter 9 — State tax reform and efficiency

Finding 9.1 on the relationship between HFE and efficiency

The current system creates perverse theoretical incentives in some instances, but there is little evidence that they have any effect in the real world. In particular, there is no evidence that HFE acts as a material disincentive to State tax reform.

There may be some merit in addressing perverse incentives on principle alone. However, after exploring the alternatives, the Panel has concluded that they cannot be meaningfully reduced without significant reductions in equalisation outcomes. As there is little evidence of efficiency losses in practice, the Panel is not convinced that this would be a worthwhile trade-off.

One area where there may be merit in further investigation by the CGC is in relation to the impact of tax rates on the size of State tax bases.

Finding 9.2 on tax reform

The Panel is convinced that it is vital for all levels of government to pursue a tax system that favours broadly based taxes with fewer exemptions over narrow and distortionary transaction based taxes. Ideally, this would occur on a multilateral basis — amongst the States and including the Commonwealth — but it would not be a bad thing if some States chose to take a leadership role.

In relation to each of the supplementary Terms of Reference specifically:

- *There is no clear evidence that the current system of HFE is impeding State tax reform. If it ever became apparent that possible changes in GST shares were impeding tax reforms, specific and temporary adjustments should be made to the GST distribution in that context, rather than changing HFE.*

- *While our second interim report canvassed the possibility of GST grants being used to reinforce incentives to undertake agreed upon reforms, the Panel has concluded that the GST distribution should not be used to compel or encourage States to change policies — HFE should be policy neutral and GST should remain untied and freely available.*

- *A national agreement is needed in relation to resource taxation. Chapter 8 of this Report describes how such a deal might be reached. HFE is not a barrier.*

Chapter 10 — The role of horizontal fiscal equalisation in Indigenous service provision

Finding 10.1

The current HFE system seeks to address only the costs to States that are the average policy, including those associated with service provision to Indigenous communities. On that basis there is no rationale for removing Indigeneity from the HFE system.

However, precisely because the current system equalises to the average, it cannot overcome the disadvantage experienced by some Indigenous communities. Improving outcomes for these communities will require a concerted effort by Commonwealth and State governments. Where additional measures are required, they would best be undertaken outside the HFE system and excluded from it, so that the HFE system does not frustrate the desired change.

The Indigenous Expenditure Reports (IER) are important as a means to understanding differences in service provision costs between Indigenous and non-Indigenous people. It would assist the long term assessment of Indigeneity if stakeholders could expand the IER reporting process to include measures of revenue as well as expenditure.

Chapter 11 — Ensuring the GST pool is robust and stable

Finding 11.1 on GST revenue growth

GST revenue grew fairly strongly prior to 2007-08. Since then, like most other taxes, GST collections have grown only modestly. Some of this softness is cyclical, but it also appears that certain structural factors will continue to dampen GST growth into the future. If left unaddressed, this will place increasing strain on States' budgets.

Finding 11.2 on fluctuations in GST revenue collections

The GST revenue pool received by the States grew fairly steadily until 2007-08. Since then it has been highly volatile, contributing to the difficulties faced by States in managing their fiscal positions.

Recommendation 11.1 on the protection of the GST revenue base

As the Commonwealth exercises its responsibility for GST compliance and protection of the base on behalf of the States it should ensure that it vigilantly approaches this task. GST compliance should not be cross-negotiated with other Commonwealth-State issues.

Recommendation 11.2 on the low value import threshold for GST

That the low value import threshold for GST be lowered to prevent the ongoing erosion of the GST pool.

Initially, the threshold should be lowered so that it does not exceed $500. This should occur as soon as practicable.

Recommendation 11.3 on other overseas suppliers

That the Commonwealth and the States jointly examine as a matter of priority ways to secure the GST revenue base against its continuing erosion through the growth in imports purchased online.

This examination should include considering amendments to the GST law so as to make overseas suppliers to Australian residents liable for remittance of GST on all supplies of both goods and services that would otherwise be subject to GST if purchased from a domestic supplier. Such an approach would enable the GST exemption threshold for physical parcels to be reduced to a nominal level, no more than $20 or $50.

Recommendation 11.4 on the First Home Owners Scheme

The Panel recommends that the States be relieved of the obligation to make a universal FHOS grant. It should become a matter for States' own policy decisions as to what financial assistance should be offered for new home buyers.

Recommendation 11.5 on applying an automatic stabiliser to the GST pool

That the Commonwealth and States jointly consider modifying existing arrangements to provide States with increased short-term certainty regarding the GST pool.

One potentially useful approach would be for the Commonwealth to underwrite a growth in the pool each year of no less than the increase in population and consumer prices (that is, maintenance in real per capita terms). Any additional funds transferred from the Commonwealth to the States in this way would then be recouped in future years, by withholding some part of the growth in GST collections above the base level.

Chapter 12 — The longer term

Finding 12.1 on the long term vision

In the longer term, citizens must make important decisions about the size of the government sector they expect and the taxes they pay for it. Maintaining government service delivery at about the same levels as currently will place increasing pressure on governments to raise taxes. On the other hand, maintaining taxes at about the same levels as currently will place increasing pressure on governments to reduce services.

In any future where revenues are tight, ensuring the most efficient and effective combination of taxes is vital to maximising the citizens' return from taxation. Tax reform — at State and Commonwealth level — to put greater focus on more efficient taxes and reduce reliance on less efficient taxes, would be an important response.

Along with decisions about the size of government overall, roles and responsibilities for services and revenue-raising may need to change between the levels of government. A closer matching of revenue-raising capacity with expenditure responsibilities could lead to improvements in the efficiency of service delivery and make all levels of government more accountable and responsible for their actions.

Such a change in roles and responsibilities would likely lead to, or could complement, a reduction in the Federation's VFI.

While the Commonwealth continues to have greater budget capacity than the States it would be best placed to take on the funding of equalisation payments to the smaller States to ensure they continue to have the capacity to provide comparable (State) services to those of the larger States. Commonwealth transfers to States could then largely address VFI, and be weighted more towards general revenue assistance (funded by GST) than tied funding (PSPs). In such a world, the simplest way of allocating the general revenue assistance would be on an EPC basis. No additional Commonwealth support need be provided to the larger States, other than that consistent with Commonwealth policy priorities.

The amount of equalisation funding for the smaller States could be a guaranteed proportion of GDP. The Commonwealth would fund the smaller States collectively the difference between this guaranteed amount of GDP and their EPC share of general revenue assistance. The expectation would be that this funding would be tied, depending upon policy priorities at the time. In order to reflect changing circumstances between the smaller States, the CGC could recommend how the guaranteed equalisation funding should be allocated across the smaller States.