

4 Improving HFE system governance

While Chapter 3 dealt with issues on which States' views are fairly evenly split and reasonably entrenched, there is a greater commonality of views about aspects of the system that do not go directly to the bottom line of GST shares. All States have concerns, for example, about the governance of the HFE system.

Effective governance (along with transparency, which is dealt with in the following Chapter) is essential for public confidence in the HFE system specifically and Commonwealth-State financial relations more broadly. While the financial aspects of this relationship can lead to disharmony, sound governance arrangements go a long way to reducing tensions. Therefore, it is vital that the Commonwealth and the States work together to improve these arrangements.

Strong governance arrangements are particularly important for a policy such as HFE, where a sense of 'joint ownership' or 'buy in' from both States and the Commonwealth is essential for the policy to be effective. While a situation where the policy is entirely 'owned' by the States would clearly not be workable, it is equally undesirable for the Commonwealth to act unilaterally. The active involvement of both is essential if this policy, and its associated processes, is to be effective.

Finding 4.1

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.

The recommendations in this Chapter aim to strengthen the existing governance arrangements by increasing the timeliness of, and accountability for decisions, as well as improving collaboration in the processes leading up to them.¹

After briefly explaining the existing arrangements, this Chapter examines five areas in which governance arrangements could be improved, relating to:

- endorsing and promulgating the definition of HFE
- reviewing the *Commonwealth Grants Commission Act 1973*
- reviewing the implementation of HFE
- setting priorities for CGC methodology reviews
- providing guidelines for the Commonwealth Treasurer and further guidelines for the CGC to govern the exercise of discretion in certain of their decisions.

¹ Of course, proposals put forward to improve one aspect of the system may have other benefits.

4.1 Current governance arrangements

The current governance structure is set up under a combination of legislation, agreements, executive power and custom.

The CGC is established under the *Commonwealth Grants Commission Act 1973* (the CGC Act), which empowers the CGC to advise the Commonwealth Treasurer on financial assistance to allow States to function, by reasonable effort, at a standard ‘not appreciably below’ that of other States.² Under the *Federal Financial Relations Act 2009* (the FFR Act), the Commonwealth must allocate GST revenue according to State population, adjusted by a relativity determined by the Treasurer in consultation with States, having regard to the 2008 Intergovernmental Agreement on Federal Financial Relations (IGA) and any other agreements with States.

The key requirements of the IGA are that:

- the Commonwealth must distribute GST according to the principle of HFE
- the Treasurer must determine relativities based on the recommendations of the CGC.

To give effect to this latter requirement, the Treasurer issues Terms of Reference to the CGC annually, requiring it to inquire into and report on relativities for the distribution of GST revenue. Periodically (typically, once every five years) the Treasurer also issues the CGC with Terms of Reference for a methodology review. The last methodology review was commissioned in 2005 and finalised in 2010.

The IGA also:

- sets out high level criteria for determining the treatment of Commonwealth payments, subject to the judgement of the CGC and the Treasurer
- specifies that the recommendations of the CGC must be subject to discussion by the Standing Council on Federal Financial Relations prior to the Treasurer’s determination of the relativities.

4.2 Endorsing and promulgating the definition of HFE

Despite the legislation referred to above, HFE is not strictly defined in any act or agreement, so the CGC has developed its own interpretation, in close consultation with States.³ While the CGC’s definition has the implicit approval of the Commonwealth — which could reject the CGC’s advice or specify its own definition of HFE in the CGC’s Terms of Reference, but has chosen not to — it has not expressly adopted or enacted it.

2 Keen students of Chapters 2 and 3 will notice an apparent inconsistency between the wording in the current CGC Act and the CGC practice of equalising States to materially the same capacities.

3 As noted above, the CGC Act requires the CGC to provide advice on assistance to allow States to function by reasonable effort at a standard not appreciably below that of other States. However, in the early 1990s the CGC came under pressure to be more specific about what this meant. Around this time the CGC adopted something similar to the current definition in preference to the words in the CGC Act.

The Panel's first interim report said that the Panel saw merit in separating the responsibility for determining the objectives of the GST distribution from the responsibility for interpreting and implementing HFE.⁴ Blurred or overlapping accountability was identified as a problem for two reasons. First, it is generally regarded as good governance to have a degree of separation between policy development and implementation, so that one does not dominate or subsume the other. Secondly, it is difficult for the public to have confidence in a system where the goal has not been explicitly endorsed by government. It is therefore important for the Commonwealth to be clear about what HFE is supposed to achieve. In this regard, Canada's 2006 expert panel on HFE took the position that, given equalisation is paid for by federal taxes, the federal government should take responsibility for its allocation between Provinces.⁵

If the definition of HFE was to be formalised and set out in a manner independent of the CGC, this could be done in a variety of ways — through the CGC's Terms of Reference, the IGA, the FFR Act, or the CGC Act. Some of these would also appropriately reflect the stewardship role of the Commonwealth Government.

Defining HFE in the CGC's Terms of Reference

The Treasurer currently issues Terms of Reference — asking the CGC for advice on the distribution of GST and giving direction on specific issues — for annual updates and five-yearly methodology reviews. It would be a relatively simple matter to define HFE in the Terms, but doing so would mean the definition could be revisited every time new Terms were issued. While this could be restricted to the five-yearly Terms only, and it is unlikely that the definition would change regularly, the Panel has concluded that such an approach could prove unnecessarily fragile.

Defining HFE in the IGA

The IGA sets out that GST must be distributed according to HFE, but HFE is not defined. A definition could be included in the IGA, but any changes would require unanimous State support and could be subject to review every time a new federal financial arrangement was struck, or an aspect of an existing one was varied. The Panel has concluded that such an approach could prove unnecessarily contentious.

Defining HFE in the FFR Act

The FFR Act says that GST must be distributed by State population, adjusted by a relativity determined by the Treasurer, but apart from requiring the Treasurer to consult with States and make decisions having regard to the IGA, it contains little other guidance. The definition of HFE could be included in the FFR as a guiding principle. However, as the outcomes of this Act are theoretically justiciable between States, that approach may add an unnecessary degree of 'appeal' to the system, which could lead to undue delay, further complication and uncertainty.

4 GST Distribution Review, *Interim Report*, March 2012, page 132.

5 While Provinces are accountable to their residents in terms of *how* the equalisation funds are used: Expert Panel on Equalization and Territorial Formula Financing, *Achieving a National Purpose: Putting Equalization Back on Track*, May 2006, page 43, <http://www.eqtff-pfft.ca>.

Defining HFE in the CGC Act

The CGC Act empowers the CGC to advise the Commonwealth Treasurer on financial assistance to allow States to function, by reasonable effort, at a standard ‘not appreciably below’ that of other States. This description, referring to the earlier system, could be replaced with an up-to-date definition. In this case, there would be minimal risk of litigation between States since the CGC Act is about the powers of the CGC, not the distribution of GST per se.

Recommendation 4.1

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

In reaching this recommendation it has come to the Panel’s notice that there are other inconsistencies between certain details in the CGC Act and the CGC’s current practice. Aligning the legislative framework and the practice is addressed below.

4.3 Reviewing the CGC Act

Inserting a definition of HFE in the CGC Act would provide the opportunity to thoroughly review that Act and update other sections that are no longer relevant to the current equalisation system. While a final decision on which sections to change would naturally be informed by legal advice, sections that could benefit from review include:

- The term ‘special assistance’
 - Section 5 refers to the granting of ‘special assistance’ to a State. While HFE in Australia was originally performed by means of special assistance to weaker States, the current system provides funding to all States to allow them to operate at the average standard. Given this, a term such as ‘financial grants’ or ‘financial transfers’ might be more appropriate.
- The concept of ‘applications for assistance’
 - Section 16 refers to a situation where a State makes an application for a ‘grant, under section 96 of the Constitution, of special assistance to the State.’ States no longer need to make such applications.
- The definition of ‘State’
 - Many other Acts define a ‘State’ as referring to the States and Territories, but this does not appear to be the case for the CGC Act. If this definition was included, several sections⁶ could be removed or significantly simplified.
- The remuneration and termination sections
 - Sections 8(6A) and 9 refer to the case where a former judge is appointed to the

⁶ For example, sections 5(1A), 5(2), 16A and 16B. Similarly, references to Jervis Bay Territory and Norfolk Island (sections 16B and 16C) may be able to be simplified.

CGC. This has not occurred for over twenty years. Section 9A, which requires that Commissioners' remuneration be determined by the remuneration tribunal is arguably sufficient. Section 12 should be reviewed to ensure it is consistent with termination provisions for similar bodies in other legislation.

- CGC taking evidence
 - As the CGC no longer operates along judicial lines, sections 20 to 24 referring to taking evidence from people under oath, with penalties for refusal and imprisonment for giving false evidence are no longer appropriate.

Recommendation 4.2

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.*

4.4 Reviewing the CGC's implementation of HFE

The Panel's first interim report said that the Panel saw merit in subjecting HFE outcomes to independent review. Defining HFE in the CGC Act would allow the CGC's recommendations to be reviewed more effectively against its Act from time to time.

Given the CGC's difficult role at the centre of a contested process, it may be useful to subject the system to some form of regular review to ensure that it is functioning as the legislated goal intends. This type of review is typically undertaken by the Australian National Audit Office (ANAO) in the form of a performance audit.⁷ While the selection of audit subjects is a matter for the Auditor-General, the Commonwealth Government could request that the CGC be considered for the ANAO's performance audit program.

Recommendation 4.3

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.

7 See ANAO website: http://www.anao.gov.au/uploads/documents/Performance_Auditing.pdf.

4.5 Setting priorities for future methodology reviews

As noted earlier, the CGC is instructed by the Treasurer to conduct reviews of its methodology for determining GST shares, typically every five years.

At each methodology review, decisions on which assessments should be re-examined need to be made. Currently, that decision is made by the CGC after it has consulted with the States. However, the CGC regularly faces pressure to re-examine more assessments or disabilities than may be necessary — usually resulting in virtually everything being reviewed — so as not to be seen to be favouring any State’s preferences.

If all assessments and disabilities — irrespective of their effect, or the likelihood that the underlying circumstances have changed — are re-examined at each review, it can result in a lack of focus, given the available resources. Reviews that cover all assessments and disabilities can create large workloads for the CGC and States, with limited return.

In addition, re-examining all assessments and disabilities can lead some to think that this occurs because they are all problematic, or need to be changed. While this is not the case, it would reduce an element of misunderstanding of the process if the CGC was more clearly empowered to prioritise its agenda. A greater focus by the CGC on the most important assessments and disabilities would lead to greater confidence in the CGC’s assessments and the outcomes these assessments produce.

Dealing with late emerging issues

Consultation is an important aspect of the CGC methodology review processes. The CGC consults with States on many aspects of the system, from determining what assessments and disabilities should be re-examined, through the methods to assess differences between States, to the appropriateness of particular datasets.

Input from States is important to develop more robust assessment methods, as States know about proposed changes to their policies and whether data that may affect the CGC’s methods is available. However, for States to provide considered input to CGC methods, adequate time for examination of issues is required. This can prove difficult when important issues emerge towards the end of the set review period. Therefore, where significant issues emerge close to the end of a review, the CGC ought to be able to ask the Commonwealth to allow it to separate that particular issue from the rest of the methodology review (so as not to delay the bulk of the review work). The CGC would report on all other issues in the timeframe set out in the Terms of Reference, but be given an extension (of say a year) to address the emerging issue.

Recommendation 4.4

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.

4.6 Providing further guidelines for the Treasurer and CGC

Guidelines for the Treasurer on consulting with the States

Under the FFR Act, the Treasurer must consult the States prior to determining the relativities. This usually occurs via a meeting of all Treasurers in March or April each year (currently called the Standing Council on Federal Financial Relations). The Treasurer also consults with States on the Terms of Reference for the CGC's annual update, however consultation on the Terms is often less formal than on the relativities.

Concerns have been raised by States that the time allowed for consultation on the Terms of Reference is too brief, and that all matters are not always included in the draft. The joint large States' submission argues that the 'marginalisation of effective State involvement in the system weakens State 'ownership' and support.'⁸ The Victorian submission goes further, suggesting that the Terms for the CGC's annual updates and reviews should be subject to agreement between Commonwealth and State Treasurers.

Given the importance of consultation on the Terms of Reference (as the relativities once calculated are almost always adopted), it seems reasonable to expect the Treasurer to allow States an adequate period to raise any concerns with the draft. While requiring unanimous agreement might not be practical, a more robust system of consultation on the Terms of Reference should go some way towards addressing State concerns.

Further on the consultation theme, while negotiation on draft Terms of Reference between the Treasurer and the CGC actually begins well before the Update, on occasions the CGC has only formally received the final Terms of Reference shortly before the Update is released.⁹ In the interests of transparency, the Terms of Reference should be finalised well before the Update is due.

Recommendation 4.5

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.*

8 Joint Submission by the States of New South Wales, Victoria, Queensland and Western Australia to the GST Distribution Review, August 2012, page 7.

9 For example, the covering letter to the CGC's 2011 Update demonstrates that the Terms of Reference and the Update were both provided on 15 February 2011.

Guidelines to be followed by the Treasurer when determining the treatment of Commonwealth payments

The Treasurer has the power to ‘quarantine’ Commonwealth payments from HFE calculations. Quarantining has the effect of removing payments from the calculation of fiscal capacity — benefiting the State that receives the payment by effectively allowing it to keep the full value of the payment rather than losing the equivalent of all but its population share in GST, while still giving it a population share of non-quarantined payments made to other States. This one-sided result brings great scrutiny and controversy to bear on quarantined payments. If no payments were quarantined, each State would effectively end up with its population share of every Commonwealth payment, no matter which State it was paid to.

While few payments are quarantined in practice, a decision to quarantine can have a material impact on the total Commonwealth funding a State receives — particularly in the case of a large payment to a small State.

The CGC also makes decisions on whether to include or exclude particular Commonwealth payments from the assessment of State fiscal capacity. Even if the Treasurer has decided not to ‘quarantine’ payments in the CGC’s annual Terms of Reference, the CGC can itself decide to ‘include’ or ‘exclude’ it from the process.

As part of the 2010 review, the CGC published guidelines outlining how it makes decisions on whether to include or exclude Commonwealth payments from the calculations. While inevitably leaving some judgment to the CGC, these guidelines are a valuable aid to transparency. The guidelines clarify that, while most payments will be included (as they are an important source of budget support for States), certain categories will generally be excluded, including:

- payments made ‘through’ States to other entities
- the purchase of services by the Commonwealth
- expenditure needs that are not able to be assessed
- where the Commonwealth distribution is assumed to reflect States’ needs.¹⁰

Given the CGC has public guidelines relating to its decisions to exclude, the question naturally arises — should there be similar guidelines for the Treasurer?

At present, the Treasurer has not established (or at any rate, has not published) any guidelines or principles governing the treatment of payments. The development and publication of such guidelines would aid transparency, and may also improve predictability (by making it clear to States when a payment would, or would not, be expected to be quarantined). At the very least, it would remove a point of understandable irritation for the States — who sometimes view the Treasurer’s decisions to quarantine a payment as arbitrary and unpredictable.

¹⁰ See *Supporting Information – Treatment of Commonwealth payments* for the 2012 Update, available on the CGC’s website.

While the final adoption of any guidelines will inevitably be left to the Treasurer and COAG, ideally, guidelines would make it clear that Commonwealth payments:

- would only be quarantined as the exception (not the rule)
 - As Commonwealth funds are a large source of general budget support for States, quarantining significant amounts would undermine the policy of HFE.
- should only be quarantined for reasons not considered by the CGC
 - Obvious circumstances where exclusion or quarantining is appropriate are already covered by the CGC (such as when payments are made ‘through’ the States to separate entities). To avoid duplication, and because the CGC is best placed to make decisions in these circumstances, the Treasurer should not seek to quarantine payments for reasons already considered by the CGC.

As a result of later recommendations in this report, payments for national network roads and rail-based transport infrastructure need no longer be considered by the Treasurer for quarantining purely on the basis of part national economic benefit, as this should now be done by the CGC as a matter of course.¹¹

While this approach largely reflects the practice now, the benefit of issuing public guidelines would be to make this practice explicit and transparent.

Recommendation 4.6

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.*

¹¹ See Chapter 6.

Timing of decisions on the treatment of Commonwealth payments

The current process does not require a timely decision on the treatment of Commonwealth payments either by the Treasurer or the CGC, as a decision is only required once the payment enters an ‘assessment year’. In some instances, this can result in a delay of several years between when the payment is announced and when States finally know how the payment will be treated.

This delay can cause unnecessary uncertainty for States, especially because in many cases a decision would be a fairly straightforward matter for both the Treasurer and the CGC. As an example, consider a hypothetical payment of \$100 million to State X announced by the Commonwealth in the 2010-11 Budget (handed down in May 2010), to be made in the year 2012-13. The CGC’s calculations are based on three assessment years. The first time that 2012-13 will become an assessment year is in the 2014-15 annual Update. As this Update would not be released until February 2014, no decision on the treatment of the payment would occur until then — almost four years after the payment was announced.

Of course, where a payment is announced only shortly before it is actually paid to a State, the delay will not be as long. Nevertheless, there could still be an unfortunate element of retrospective characterisation of the payment required. While most States are alert to this and seek to establish the HFE treatment at the time of negotiating the payment, surprises (or the risk of them) can be minimised by requiring both the Treasurer and the CGC to make and announce their decisions earlier.

Treasurer’s decisions

As the Treasurer should determine whether or not to quarantine a payment based on much the same information needed to decide to make it in the first place, he or she should be in a position to announce their decision on quarantining when the payment is first announced (which will often be in the Commonwealth Budget or mid-year budget update). In the event that some negotiation with a State is required over details of the payment, some delay may be required, but this should be short.

While there might be political pressure for the Treasurer to delay the announcement or, having made it, later revisit it before the year of first receipt becomes an ‘assessment year’, the pressure to abide by the published guidelines may mitigate this risk.

Recommendation 4.7

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.*

CGC's decisions

The CGC, on the other hand, cannot be expected to make a decision on the treatment of a payment until sufficient information on the nature of the payment is available to it. In some cases, where national partnerships and implementation plans are required to be developed, this may take six months or longer.

Where payments are announced in the Commonwealth Budget (usually handed down in May), if it is assumed that six months is required for the details of the payment to be worked out, a CGC decision on these payments could then practically be sought by the following February (when the next CGC Update is released). This would allow nine months from the announcement of the payment to the publication of the CGC's decision on treatment. As such, the Panel considers that the CGC could reasonably be asked to make and publish its decision on Commonwealth payments in the normal course in the Update immediately following the Budget in which the payment is announced.¹²

Where a payment is announced outside of the Budget, the CGC should follow a similar procedure — it should explain in its Update why it has not been able to make a decision, and publish a decision as soon as sufficient information becomes available.

Recommendation 4.8

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.

¹² Of course, in those (hopefully rare) cases where the details of the payment are not yet worked out sufficiently before the February update, the CGC may have to postpone its decision. In these cases, it should publish its reasons for not making a decision (including what information or detail of the payment is required to enable it to make a decision) and should then publish its decision as soon as this information is available.

