**Horizontal Fiscal Equalisation**

**Introduction**

The Commonwealth distributes GST revenue among the States on the basis of the per capita relativities that the Commonwealth Grants Commission (CGC) calculates. The calculations are based on the principle of horizontal fiscal equalisation (HFE) (defined below).

New South Wales, Victoria and Western Australia argue that HFE disadvantages them. In November 2001, they commissioned a Review of Commonwealth–State Funding to examine the methods used to allocate Commonwealth grants among the States including the application of HFE. This Research Note explains what HFE is and canvases surrounding issues.

**Definition**

The CGC defines HFE as follows:

> State governments should receive funding from the Commonwealth 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 standards.

Thus HFE seeks to ensure that each State has the capacity to provide services at national average levels at average levels of efficiency. HFE is grounded in the concept that citizens in different States should have access to equal standards of government services.

**Spending Needs and Revenue Capacity**

The States have different capacities to raise revenue and different spending 'needs'. For example, Western Australia has a relatively large capacity to raise revenue from the mining industry compared with Tasmania, and a State with a young population needs to spend relatively more on primary education. To provide the States with equal capacity to provide services, States with below average revenue-raising capacity or above average spending needs receive a larger share of GST.

HFE thus redistributes resources from States with the capacity to provide above-average services to the other States. Consequently, the amount of GST a State receives differs from the amount it would receive if GST were distributed on an equal per capita basis.

**Policy Neutrality**

When calculating spending needs and revenue-raising capacity, the CGC takes account of factors that a State cannot control. How a State raises revenue and spends it reflects policy choices. If the distribution of GST were based on actual spending and revenue, a State could (say) tax less to increase its share of GST revenue. The CGC therefore seeks to make its assessments of revenue-raising capacity and spending needs 'policy-neutral': a State receives a larger share of GST revenue if it can demonstrate that it is unable to provide services at the national average level for reasons that are beyond its control (disabilities). The CGC also takes account of 'revenue raising effort', which compares each State's actual revenue with its assessed capacity.

The CGC's assessment of spending needs take account of Commonwealth specific purpose payments (SPPs) to the States for functions such as education and health. The lower the SPP a State receives (on a per capita basis) for a function, the higher the share of GST revenue the State receives to bring it up to the national average.

**HFE Issues**

Criticisms of HFE relate to the principle, the CGC's assessments, and its consequences. For example, the NSW Government Submission to the Review notes that while HFE seeks to equalise States' fiscal capacity, this does not ensure equitable treatment of individuals in similar circumstances. The counter to this argument is that HFE does not seek this outcome. The submission also questions to what extent it is possible to distinguish between policy and non-policy factors.

By focusing on average levels of service and delivery, critics argue that HFE does not provide an incentive to improve efficiency. The Victorian Government submission claims that States that undertake reform to cut costs are penalised while inefficient States are 'compensated' for under-performance. There is, however, no consensus on how to integrate incentives that reward efficiency into HFE assessments.

A criticism of the CGC's relativity calculations is that they are based on questionable methodologies. The methodologies are very complex. For example, to calculate...
Intrinsically desirable. Law, order and public safety, for example, might fall into this category. But limiting the scope to merit goods would violate the concept of equality of capacity to provide a wide range of services that underlies HFE.

Because the HFE redistributes resources among the States, an issue is its economy-wide effects. For example, on the one hand, it is argued that HFE improves resource allocation by encouraging decentralisation and thus reducing the ‘diseconomies’ of large cities. On the other hand, it has been argued that HFE discourages efficient location. A study by the Centre of Policy Studies for the Review found that:

… a move…to an equal-per-capita basis would be likely to increase…welfare by between $150 million and $250 million a year. This is a small proportion of GDP.

Vertical Fiscal Imbalance

The focus of HFE is on the distribution of GST revenue among the States. Some of the tension surrounding this might be eased if the States were less reliant on the Commonwealth for revenue—the Commonwealth provides about half of total State revenue—and were able to raise more from their own sources. But the States have only a narrow base on which to draw. In contrast, the States are responsible for major areas of spending such as education and health.

Vertical fiscal imbalance—the imbalance between the spending responsibilities of each tier of government and the own-source revenue resources available to that tier—is a feature of Australia’s federal system. The last major attempt the States made to gain access to a large tax base was in the early 1990s, when they sought access to income tax. With the failure of that attempt the situation is that the Commonwealth makes grants to the States conditional on them not levying income tax.

Conclusions

With the States projected to receive almost $30 billion of GST revenue in 2002–03, the principle and application of HFE have important implications. But major change is unlikely. The States seem likely to remain divided over the use of HFE with New South Wales, Victoria and Western Australia seeking to have its application at least modified, and the other States resisting change that would allow these three States to receive a greater share of GST revenue. The Federal Treasurer has said that the Government will not change existing GST distribution arrangements unless the States reach consensus. And with no Commonwealth government apparently willing to address the issue of vertical fiscal imbalance, HFE’s future seems assured.