Australian Government

Commonwealth Grants Commission

2020 REVIEW

THE PRINCIPLE OF HFE AND ITS IMPLEMENTATION

STAFF DISCUSSION PAPER
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Commission contact officer	Tony Nichols, (02) 6229 8812, anthony.nichols@cgc.gov.au
Submissions sought by	28 July 2017. Submissions should be emailed in Word format to secretary@cgc.gov.au . Submissions of more than 10 pages in length should include a summary section.
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BACKGROUND

Commission staff have prepared this discussion paper seeking State views on the objective and definition of HFE, and whether the supporting principles (and the way the Commission uses them) remain appropriate, or whether there are alternative approaches.[1] Some specific consultation questions are asked. Any other views in relation to these topics are also welcome.

Submissions are sought by **28 July 2017** and should be emailed to secretary@cgc.gov.au.

In addition, staff have prepared three accompanying research papers that provide quantitative analysis of particular issues raised in this discussion paper. These research papers may assist States in preparing their responses to this paper.

Please note that while this staff discussion paper, consistent with the terms of reference, is primarily directed at seeking the views of States, members of the public may also wish to respond to the questions posed.[2]

1 On 28 November 2016 the Treasurer gave the Commission terms of reference for a 2020 Methodology Review. The terms of reference require the Commission to undertake a comprehensive review of all the methods underpinning its calculation of the GST relativities.

2 In accordance with clause 3 of the terms of reference the Commission, in consultation with the Commonwealth and the States, has developed a work program for the review. This paper has been prepared consistent with the work program.

3 The Commission is also aware that the review by the Productivity Commission (PC) of the economic effects of horizontal fiscal equalisation (HFE) announced at the end of April this year could potentially affect how the HFE objective is implemented. The Commission considers that progressing its consideration of the HFE objective, and the issues associated with its implementation in the context of the 2020 Review, will complement and assist the PC's work in responding to its terms of reference.

4 In particular, the Commission believes it desirable to publish its views on the HFE objective and its implementation, based on the current IGA and terms of reference, as soon as possible and hopefully by the end of September.

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[1] References to the States in this paper include the six States, the Northern Territory and the Australian Capital Territory collectively, unless the context indicates otherwise.

[2] This paper contains terms that have a meaning specific to the Commission and presumes some knowledge of Commission processes. A glossary of Commission terms along with material on how the Commission performs its role can be found on the Commission's website (www.cgc.gov.au).

5 The Commission will provide a further opportunity for views on its approach to the review, the objective(s), supporting principles and their implementation to be expressed, after the PC has reported and the Government has dealt with its findings.

6 The paper is organised in eleven sections:

- Terms of reference
- Objective and definition of HFE
- Supporting principles
- What States do
- Policy neutrality
- Practicality
- Contemporaneity
- Alternative approaches to applying the contemporaneity supporting principle
- Treatment of other Commonwealth payments to States
- Bringing it together — the Assessment guidelines
- Conclusion.

TERMS OF REFERENCE

7 On 28 November 2016 the Treasurer gave the Commission terms of reference for a 2020 methodology review, requiring it to undertake a comprehensive review of all the methods underpinning its calculation of the GST relativities. The terms of reference direct the Commission to consult with the Commonwealth and the States, both in developing a work program to guide the review as well as throughout the review process. The Commission is asked to report to the Commonwealth and the States by 28 February 2020.[3]

8 There are two clauses in the terms of reference addressing HFE objectives and supporting principles, clauses (5) and (6). These clauses are reproduced below:

> 5. In undertaking the review, the Commission should take into account the Intergovernmental Agreement on Federal Financial Relations (as amended), which provides that GST revenue will be distributed among the States in accordance with the principle of horizontal fiscal equalisation.
>
> 6. The Commission should also consider whether the supporting principles it uses to guide its work remain appropriate, including whether different weights should be given to different supporting principles. State views should be sought on the importance of each existing principle and any others considered important to the States and the appropriate balance between them.

[3] The complete terms of reference for the 2020 Review can be found on the Commission's web site.

9 The terms of reference also ask the Commission (clause 7) to aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data, to use the latest available data consistent with this and to ensure robust quality assurance processes. In addition, guidance is provided on how the Commission should treat Commonwealth payments to the States.

OBJECTIVE AND DEFINITION OF HFE

What is the objective of HFE and its definition?

10 In 1978, the Commonwealth asked the Commonwealth Grants Commission to review States' shares of general revenue grants. It specified the principle[4] it wanted the Commission to apply in section 13(3) of the *States Personal Income Tax Sharing Amendment Act* 1976.

> The respective payments to which the States are entitled … should enable each State to provide, without imposing taxes and charges at levels appreciably different from the levels of the taxes and charges imposed by the other States, government services at standards not appreciably different from the standards of the government services provided by the other States.

11 This principle (the equalisation principle) was expressed in legislation or terms of reference until the 1999 Review. It was the principle the Commission was asked to implement when all States signed the Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations (the IGA) in 1999.[5] While the specific wording has evolved, the principle has continued to this day and remains in the terms of reference for the 2020 Review as the basis for the Commission's recommended distribution of GST revenue amongst the States.

12 In its 2015 Review Report the Commission articulated the 'principle of HFE' using the definition it developed in the 2010 Review:

> State governments should receive funding from the pool of goods and services tax such that, after allowing for **material** factors affecting revenues and expenditures, each would have the **fiscal capacity** to provide services and the associated infrastructure at the **same standard**, if each made the **same effort** to raise revenue from its own sources and operated at the same level of efficiency.

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4 This was similar to the equalisation principle the Commission had used in its State claimancy inquiries.

5 Later IGAs signed in 2008 and, most recently, in 2011 also specified for the GST revenue to be distributed according to the principle of HFE. In addition, the IGAs provide for the revenue collected from the GST to be paid to the States for them to use for any purpose. That is, GST revenue is provided to States as general revenue assistance. General revenue assistance was provided to States out of Commonwealth general revenues prior to being hypothecated as GST revenue.

13 The definition focuses on the main task of the Commission: to identify factors ('disabilities') affecting State finances that are beyond their direct control and which would cause their fiscal capacities to diverge. Using these, the Commission recommends a distribution of GST revenue which removes the impact of that divergence. As a result, States will have the same capacity to deliver services, provided they deliver them at the average level of technical efficiency and make the same effort to raise revenue.

14 The reference to material factors in the definition makes clear the Commission does not aim to achieve precise equalisation as not all disabilities are included, either because they cannot be reliably measured or they have only a relatively small effect on the GST distribution. This means that while precise (or complete) equalisation is the aspirational goal, in reality the Commission achieves proximate equalisation.

15 Material disabilities affecting revenue and expenditures mean differences in State circumstances outside their direct control that:

- give rise to differences in the capacities of States to raise revenue or differences in the cost of providing services or infrastructure, other than those that result from the policy choices of individual States
- can be measured or estimated reliably
- have an impact on the recommended GST distribution which differs from an equal per capita (EPC) distribution by more than the materiality thresholds.[6][7]

16 Capacity equalisation does not require States to follow any particular service or tax policies or to meet any particular targets. States are free to use GST revenue as they see fit. Capacity equalisation is consistent with the GST pool being untied assistance, which States can spend according to their own priorities, as agreed in the IGA.

What is the Commission trying to achieve?

17 The Commission's intention is, as far as is practicable, to identify the distribution of GST revenue amongst the States that would achieve HFE. Under the 2015 Review methodology, the Commission recommends a distribution of the GST based on its measure of States' GST requirements averaged over three assessment years. A State's GST requirement (or assessed deficit) in a year is its assessed expenses plus its assessed capital expenditure, less its assessed revenue less the payments for specific purposes (PSPs) it received. Therefore, a State's GST requirement can be thought of as a 'balancing item' so that the State has sufficient revenue overall from all sources to deliver the average level of services to its population.

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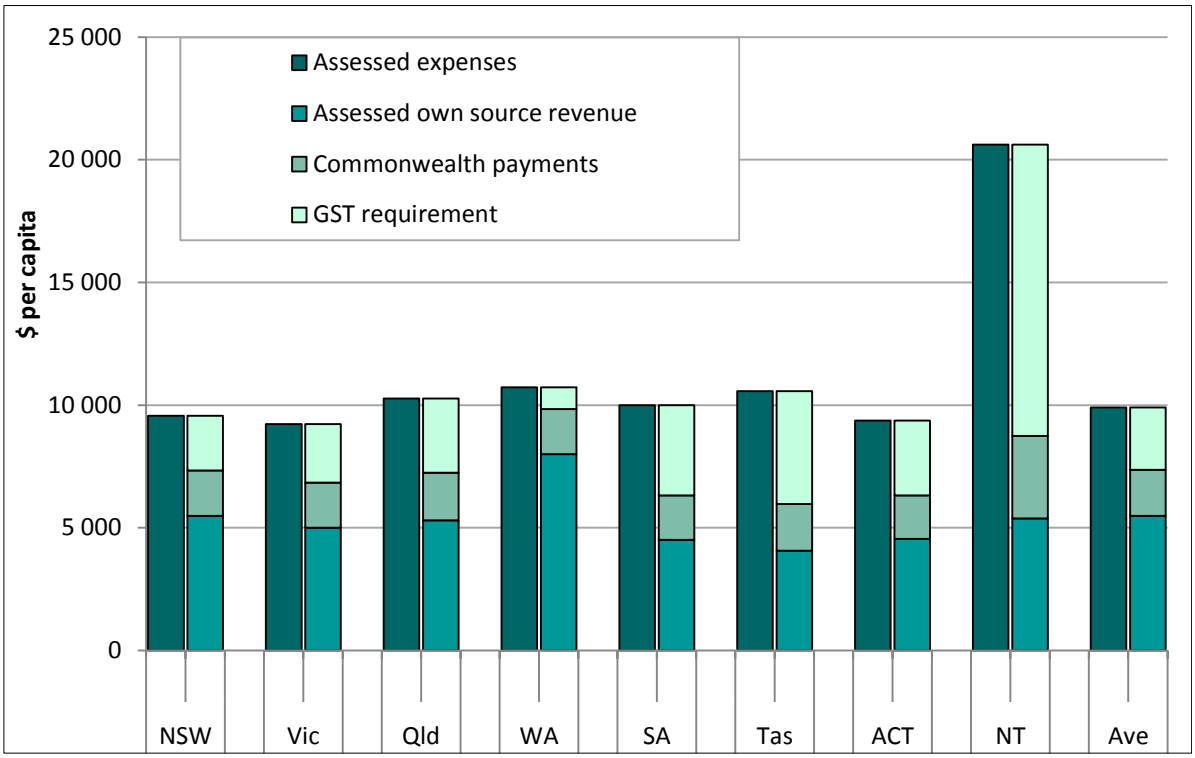
6 Under an EPC distribution each State would receive its population share of GST revenue.

7 Materiality thresholds represent a minimum change to the GST distribution that must be met before the Commission will recognise a disability. They are discussed in more detail in the Practicality section of this paper.

18 Figure 1 illustrates the GST requirement under this approach, which gives States equal fiscal capacities. It shows why States require different levels of GST revenue — they have different costs of providing the average service and different capacities to raise revenue. If a State has high costs of service provision (for example, the Northern Territory), it will have high assessed expenses and, other things being equal, it will require more GST revenue. If a State has high revenue capacity (for example, Western Australia), it will have high assessed revenue and, other things being equal, it will require less GST revenue.

19 It can be deduced from Figure 1 that if a State's revenue raising capacity increases, or its expenditure needs decline, the gap between its assessed expenditure and revenues reduces and, other things being equal, the Commission will assess it as requiring less GST revenue to deliver the average level of services.

Figure 1 GST payments as a balancing item, 2017-18



Source: 2017 Update.

Are the objective and definition of HFE still appropriate for the 2020 Review?

20 The 2020 Methodology Review terms of reference do not direct the Commission to review the objective or definition of HFE. Moreover, as noted above, the substance of the current definition has been in place for some time and the achievement of fiscal equalisation continues to be required by terms of reference and the IGA.

21 In the 2015 Review, some States said the operation of HFE should be limited by other policy objectives; for example, raising national productivity. Some States argued that a sole objective of HFE could result in disincentives for economic development, tax reform and service delivery efficiency.

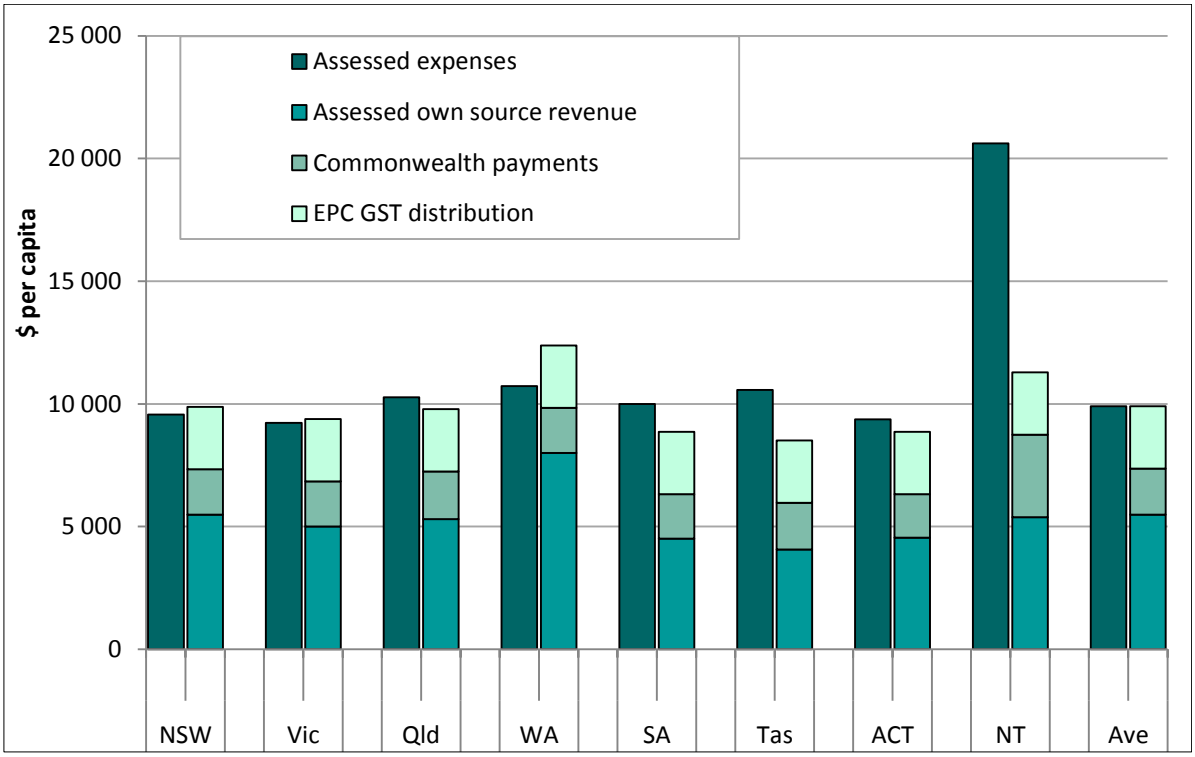
22 Similar to its position in the 2015 Review, the Commission could take the view that its terms of reference are clear: it is to recommend how the GST should be distributed in accordance with the 'principle of HFE' and the well accepted definition. Within the terms of reference, the Commission is not asked, nor given the discretion, to decide when other policy objectives or agreements between the Commonwealth and the States should moderate the achievement of HFE.

23 States seeking a change to the definition should make clear how achieving HFE can be made consistent with also facilitating other objectives or at least minimising any perceived adverse impacts of HFE on the operations of government and the economy in ways other than those dealt with by the supporting principles. For example, how can a distribution closer to EPC, or the introduction of a floor, or other changes, be consistent with equalising State fiscal capacities – the goal the Commission has been set?

24 Figure 2 reproduces Figure 1, except the GST payments are distributed EPC. It shows this distribution would leave New South Wales, Victoria and Western Australia over-equalised — their assessed revenue would exceed their assessed cost of providing the average service. The remaining States would be under-equalised. The GST Distribution Review described such an approach as one which would deliver 'less equalisation'.[8]

[8] *GST Distribution Review,* Australian Government, 2012, p46.

Figure 2 Equal per capita distribution of GST payments, 2017-18



Source: 2017 Update.

25 Similarly, the proposal to impose a floor on State relativities would have large consequences for the allocation of GST revenue. A floor of, say, 0.7 would benefit any State with an assessed relativity below 0.7 and those States with relativities above 0.7 would have reduced GST payments.[9]

26 Again, the GST distribution review described this approach as resulting in less equalisation, redirecting GST funding to the strongest State and reducing the GST funding received by the other States. It considered such approaches would potentially undermine confidence in the federation.

27 A research paper prepared by Independent Economics says that focussing on relativities confuses the fiscal equalisation policy with its current delivery mechanism (GST revenue). It says this highlights the arbitrary nature of setting a relativity floor applying to the GST pool.[10]

28 Staff research paper 2017-03-S *Achieving HFE — other approaches to distributing the GST* examines other approaches to distributing the GST revenue and quantifies the differences between these distributions and the current equalisation distribution.

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9 States with a relativity of below 1 have a stronger than average fiscal capacity. A relativity floor would ensure that States with a relativity below the floor retain a stronger fiscal capacity than other States. It would be akin to all States receiving a set amount of the GST pool distributed on an EPC basis. In this example, the set amount would be equivalent to 70 per cent of the GST pool being distributed EPC.

10 *Horizontal Fiscal Equalisation: Modelling update and Scenarios* (a report prepared for the South Australian Department of the Premier and Cabinet), Independent Economics, 19 May 2015, page (x).

Some consultation questions.

- Do the IGA and the ToR require the Commission to distribute the GST in such a way as to achieve HFE as the sole objective?
- Is the aim of HFE to achieve equal fiscal capacities?
  - If it is, then, how would different approaches to the achievement of HFE, such as including other desirable policy goals, be implemented consistent with this? How would the definition need to be modified to support them?
  - If not, what should HFE be achieving and what changes to the definition would be required?
- Are changes to the definition necessary, or are State concerns more about the way HFE and its current definition is implemented?

SUPPORTING PRINCIPLES

What is the task of the Commission?

29 The Commission has resisted calls for more rules-based approaches to the way in which it gives effect to the HFE principle because, in its view, equalisation cannot be achieved without making judgements about the methods to be used. The areas of difference between the States are not always sufficiently clear cut and the data to measure these differences not always sufficiently reliable. This means that judgments on what constitutes the best equalisation outcome must continue to be made. Making those judgments is a task of the Commission.

30 The Commission uses supporting principles through the course of a review to evaluate alternative approaches to each of the structural elements of the methodology. These elements include:

- decisions on scope (that is, identifying which revenues and expenditures to assess and how to categorise them)
- decisions on disabilities (that is, identifying the conceptual case supporting the existence of a disability)
- decisions on assessment methods (that is, how to give effect to, and measure, the disability).

31 Different supporting principles may apply to all, or some, of these structural elements.

Supporting principles and the HFE principle — 2015 Review approach

32 In its 2015 Review, the Commission said:

> In making and explaining decisions on the development of methodology to achieve HFE, the Commission has adopted certain supporting principles. They capture the main influences which experience suggests the Commission has to consider through the course of a review in evaluating alternative assessment methods.
>
> However, the principles remain subsidiary to the Commission's primary objective of achieving HFE and they should not override that objective. We do not agree with the view of some States that these principles should take precedence over HFE. We use them as guidance in how HFE should best be achieved in practice.[11]

33 The Commission decided in the 2015 Review to use the supporting principles to guide development of the 2015 methodology. As such, equalisation was implemented by methods that:

- ***reflect what States collectively do.*** This principle aims to ensure the GST distribution provides financial support for the activities of State governments – the services and infrastructure they are providing, given the revenues they are able to raise. It means neither the Commission, nor any other body, dictates what States should do and State autonomy is preserved.
- ***are policy neutral.*** This principle aims to ensure a State's own policies or choices, in relation to the services it provides, or the revenues it raises, do not directly influence the level of grants it receives. It also aims to ensure the GST distribution methodology creates no incentives or disincentives for States to choose one policy over another.
- ***are practical.*** This principle means that assessments should be based on sound and reliable data and methods and be as simple as possible while also reflecting the major influences on State expenses and revenues. It remains consistent with the terms of reference which say the Commission should prepare its assessments to distribute GST revenue in accordance with the principle of HFE (clause 5) and 'aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data' (clause 7(a))[12].
- ***deliver relativities that, as far as possible, are appropriate to the application year (contemporaneous relativities).*** This principle means that, as far as reliable data will allow, the distribution of GST provided to States

[11] Report on GST Revenue Sharing Relativities, 2015 Review, Chapter 1, page 29, paragraphs 34 and 35.

[12] These clauses from the 2015 Review terms of reference are repeated in the 2020 Review terms of reference.

> in a year should reflect State circumstances in that year. Without that, the capacity to provide services and the associated infrastructure at the same standard, if each State made the same effort to raise revenue from its own sources and operated at the same level of efficiency, would be compromised.

34 Clause 6 of the terms of reference for the 2020 Review asks the Commission to consider whether these supporting principles remain appropriate, including whether different weights should be given to different supporting principles (or some hierarchy should apply). It also asks the Commission to consider other principles that might be considered important by States.

35 State views were sought on the work program for the 2020 Review. As part of that process, States were asked:

> Should the review begin with a reconsideration of 'whether the supporting principles the Commission uses to guide its work remain appropriate, including whether new principles should be adopted and whether different weights should be given to different supporting principles'?

36 Victoria and the Northern Territory both consider that finalising the supporting principles (and objective and definition of HFE) is an appropriate place to begin the review. However these States, along with South Australia, Tasmania and the ACT, all express support for the existing objective, definition and supporting principles (what States do, policy neutrality, practicality and contemporaneity), with Tasmania saying that 'nothing has changed since the 2015 Review that would necessitate change to the supporting principles'. Notwithstanding these views, the Commission is directed in the terms of reference to reconsider its supporting principles.

37 These five States consider the current supporting principles appropriate and the flexible application of the principles using Commission judgment best to derive a balanced result. None of these States consider that there is a case for additional principles or for any weighting to be applied to the existing principles. Their collective position can be summed up by Victoria's views:

> The Commission currently has four supporting principles and has not noted the need for additional principles. It is unclear what the nature of additional principles could be, and whether additional principles are required. There is a risk that additional principles could complicate the task of achieving HFE, particularly if there is a conflict between the principles when undertaking assessments.
>
> Currently the Commission applies the supporting principles flexibly so that the best HFE outcome can be achieved. Victoria considers that this is the preferable approach. It would be difficult to determine a hierarchy or weighting for these principles and imposing an arbitrary weighting does not guarantee improved HFE outcomes.

38 Queensland said that while the Commission has a well-developed set of supporting principles, the mechanisms for exercising judgments and weighing competing

principles are comparatively less well understood. It said that a reconsideration of the supporting principles and the priorities attaching to them would help bring clarity and transparency to the Commission's processes.

39 New South Wales and Western Australia support a full review of the appropriateness and relevance of the supporting principles as a first step in the review.

Hierarchy of supporting principles

40 Ideally all methods would embody the attributes of all the supporting principles. In practice, the Commission often has to evaluate alternative methods which embody mixtures of these principles and has to decide trade-offs between them — for example, between methods that capture what States do in detail and methods that are policy neutral.

41 In the 2015 Review, the Commission did not set rules for how it would decide the appropriate approach in any such cases, nor did it establish a hierarchy among the principles. When circumstances required, the Commission reserved the right to exercise its own judgment on how best to achieve HFE. The Commission did not think that the need to achieve a balance between principles in some cases is an argument, as some States suggested, for diverging from HFE. Its approach was to develop methods which achieve HFE first, balancing the principles it had established to guide it among alternative methods.

42 In response to the Secretary's letter of 1 December 2016 to States asking for their input into the review work program and to identify any particular issues that they wanted the Commission to explore over the course of the review, two States responded by saying that the supporting principles should be either prioritised or weighted in some way.

- New South Wales considers that the Commission's judgment based approach to determining the appropriate trade-off between the principles, in place of a more rules-based approach, can lead to a lack of clarity and consistency. It said that a hierarchy of first order and second order supporting principles, rather than any system of weights, would be a workable approach.
- Western Australia said that introducing a hierarchy for the supporting principles should be considered and that in its view policy neutrality is the one on which to focus.

43 In contrast with these two States, the ACT said there was already an implicit weighting built in to the existing four supporting principles. It said the 'what States do' and 'policy neutrality' principles are critical to the HFE framework and that while one does not dominate the other, the failure of a method to match either principle would rule it out. The ACT said that common sense and the application of broad judgment would determine any trade-off between the supporting principles.

44 Three States did not support any weighting of the supporting principles.

- Victoria's view was noted above (paragraph 37).
- Tasmania said it supports the current approach adopted by the Commission, with no set rules for how each principle is traded-off and no hierarchy of the supporting principles. Commission judgment is used to devise the best overall equalisation result.
- The Northern Territory said that it does not consider explicitly weighting the supporting principles in order of importance would improve equalisation outcomes. It considers that the Commission's discretion in producing a robust and adaptable methodology that adheres as closely as possible to the supporting principles is preferable to weighting the importance of one principle against another.

45 In this review the Commission could take a different view to that taken in the 2015 Review. It could recognise that the weight of different principles changes depending upon which structural element of the methodology is being considered.

46 Table 1 describes such a view, which recognises an implicit hierarchy at two levels (first and second order) with the application of principles within the hierarchy varying with varying structural elements.

Table 1 Hierarchy of HFE and its supporting principles

Structural element	First order principles	Second order principles
Scope (which revenues and expenditure to assess)	HFE Practicality What States do	Policy neutrality Contemporaneity
Disabilities (which have a conceptual case)	HFE Practicality What States do	Policy neutrality Contemporaneity
Assessment method (technical operation of a disability)	HFE Practicality	What States do Policy neutrality Contemporaneity

Source: CGC.

47 As shown in Table 1, HFE is the primary principle in all structural elements, so as to ensure the Commission's methods achieve HFE first. To be consistent with clause 7 of the terms of reference, practicality could be thought of as a first order supporting principle at all levels.[13] That means that all methodology decisions, from scope, through defining category groupings, to identifying and measuring disabilities, are required by the terms of reference to be made through the practicality prism.

[13] Clause seven of the terms of reference states that '…the Commission should aim to have assessments that are simple and consistent with the quality and fitness for purpose of the data…'

48 What States do is a first order supporting principle in determining the scope of equalisation and also for the conceptual case in determining what influences on State spending or revenue raising might be considered to be a disability. On the other hand, what States do may not be so relevant in deciding the particular assessment method for a disability, for reasons of policy contamination or lack of reliable data. In this case proxies may be used, for example private sector wages in the wage costs assessment or triage category four and five occasions of emergency department (ED) service in the community health assessment.

49 Under this view of the supporting principles, the policy neutrality and contemporaneity principles could be considered to be second order, meaning that in some circumstances it may not be possible to achieve them fully, if other criteria are more dominant. For example, while in the majority of cases policy neutrality is sufficiently addressed through the Commission's all-State averaging approach, in a minority of cases it may be more problematic. This is particularly the case where a tax base or service user population is concentrated within a small number of States. In such cases, it is not clear how a system of weighted supporting principles would work in practice. In these circumstances any over-emphasis on policy neutrality may result in an inferior HFE outcome. For example, grouping all minerals together in a single mining revenue assessment, while maximising policy neutrality, would not recognise that some minerals attract quite different rates of royalties, thus failing to achieve the best overall HFE outcome.

50 In relation to contemporaneity, while in the 2015 Review the Commission said it aims to achieve equalisation in the application year, this aspiration is constrained by the need for robust and reliable data (the practicality principle). Given the salience of concerns about contemporaneity, State views on alternative approaches, that still achieve equalisation but that may better match State cyclical cash flow management priorities, will be considered during this review. Possible approaches are discussed in more detail in the section on Alternative approaches to applying the contemporaneity supporting principle.

51 Lastly, it is possible that using the language of the principle of HFE alongside references to supporting principles leads to some confusion as to the primary goal of equalisation and the relationship between HFE and the supporting principles. To that end, perhaps referring to 'guiding considerations' rather than 'supporting principles' would make clearer that achieving HFE is the priority and the core principle, with the 'guiding considerations', where relevant, applied to assist the Commission to choose appropriate methods with which to achieve that goal.

Some consultation questions.

- Should the Commission continue to adopt supporting principles (or guiding considerations) to assist it in developing methods to give effect to

the principle of HFE?

- Should HFE continue to be the priority, or are there circumstances under which certain supporting principles should take precedence over HFE?
- Should the supporting principles have a pre-determined hierarchy, or should the Commission seek to balance the supporting principles case by case in order to best achieve HFE?
- Should any of the 2015 Review supporting principles be removed, or any new supporting principles introduced? For any new principles, what is it that the new principle would achieve, not otherwise achieved?

WHAT STATES DO

52 This principle means that Commission assessments should, as far as is practicable, reflect what States collectively do. It leads to adopting what the Commission has called 'internal standards', which remove the need for judgments on what States could or should do. More specifically:

- the scope of the assessments reflect the average range of services provided by States and the average range of taxes imposed by them
- the level of services and associated infrastructure States are funded to provide, and the revenue raising efforts they are presumed to make, are an average of those actually provided or made
- the range of disabilities assessed reflects the material factors affecting the cost of delivering State services and the capacity to raise State taxes.

53 In this paper, we consider how this principle relates to the following issues:

- internal or external standards
- weighted averages and average policy
- scope of equalisation
- disability measurement.

Internal or external standards

54 In its 2015 Review report the Commission said that the level of services and associated infrastructure States are funded to provide, and the revenue raising efforts they are assessed to make, are an average of those actually provided or made. The supporting principle of 'what States collectively do' led the Commission to use the average of what it observes States collectively do — an **internal standard** — as distinct from what they could or should do — an external standard. For example, financial averages are derived by dividing the total collective State expenses, infrastructure or revenue by the total of State populations. Average revenue raising

efforts are derived by dividing the total collective State revenue by the total collective State tax bases. These averages are therefore influenced by what States do, to the extent each State undertakes the activity.

55 The Commission can interpret internal standards narrowly or broadly. A narrow interpretation focuses on the detail of State service provision and revenue raising policies. For example, under a narrow interpretation, States provide hospital inpatient services, outpatient services, community health services, disease prevention services and other public health services and so on. A narrow interpretation lends itself to more detailed disability assessments, both in number and in complexity. Under a broader interpretation, States provide health services to populations on the basis of clinical need. A broader interpretation supports a broader (and simpler) assessment of what States do.[14] A broader interpretation is more consistent with simple assessments.

56 In the 2015 Review, while having a preference for a broad view where possible, the Commission did not take a broad view where this was not consistent with what States did. For example, the Commission observed the bases States actually tax. Most often, this was the legislative base, with adjustments to derive average exemptions and thresholds, because this was what States collectively taxed.

57 The Commission said it did not believe global measures (such as household disposable income or adjusted gross State product), or broader measures of potential tax bases unadjusted for differences in tax free thresholds, progressive rates of tax or other exemptions, were good indicators of what revenue States could raise. It said they did not reflect State policies, the different revenue raising capacities relating to particular sources of revenue or where the burden of taxation actually fell.

58 The Commission said it preferred actual measures of what States tax rather than having to make judgments about what States intend to tax, such as would be required if it accepted a 'capacity to pay' approach. It said those judgments are much harder than making decisions on adjustments to legislative tax bases. For these reasons, in the 2015 Review the Commission did not adopt global or broad indicators of State revenue raising capacity, although some States argued they may be simpler, more policy neutral, remove disincentives to tax reform and better capture the capacity of the community to pay.

59 On the service delivery side, the Commission observed what the data told it about the different spending patterns States adopt for different groups in their populations – differentiated by characteristics such as age, socio-economic status and location. It recognised what each State would need to spend if it spent these average amounts on its own population groups.

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[14] For example, in the 2010 Review the Commission briefly considered whether State-wide morbidity rates could be used as a broad indicator of the need for health services.

60 In adopting this approach, States with a larger share of a revenue base or a population group to whom services are provided will have a larger impact on the average policy. For example, a State with more of the revenue base will have a larger effect on the average tax rate used to calculate revenue raising capacity, while States with the greatest number of Indigenous people will have a larger effect on the average State spending on services to Indigenous people.

61 In contrast, **external standards** are not affected by the policies of any State. They may be based on some 'ideal' level of services, a desired level of service delivery efficiency or an economically efficient tax policy. The Commission said that it does not consider its role to base recommendations on any normative view of service delivery or revenue policy. It said it considers the most relevant and neutral approach is to base recommendations on the actual average policy of the States as revealed in the data. The Commission said the only case when it may be appropriate to use a standard different from the one dictated by what States do could be to overcome policy neutrality concerns. In this case an external standard might be used. However the Commission said primacy should still be given to achieving HFE.

62 The Commission noted that, as changing internal standards in any way would destroy the relationships it observed, it did not discount or otherwise adjust standards as a means of more actively encouraging efficiency. It equalised States to the average cost of service delivery which incorporates the average level of technical efficiency. If a State is more efficient than average, its own budget benefits. If a State is less efficient than average, it must finance its inefficient practices itself.

63 Most States supported the Commission's approach, noting the importance of not making adjustments to standards as a way to promote economic development or efficiency.

Some consultation questions.

- Is the use of internal standards a sound approach to the achievement of HFE with no further consideration necessary?
- Alternatively, are there any circumstances in which it would be appropriate for the Commission to apply an external standard?

Weighted averages and average policy

64 Where States follow different policies, the Commission needs to exercise its judgment to determine the average policy used as a benchmark for its assessments. If the Commission decides a tax or service is part of what States do, it allows the differences in States' underlying capacities to raise the tax or deliver the service to affect their GST shares.

65 In the 2015 Review the Commission extended its approach to determining average standards to also determining average policy. It said its aim was to use what the data told it about what States do to decide what and how assessments were made.

66 Under the 2015 Review approach — the 'weighted average' approach — average policy reflects the average of what all States do, recognising that some States may make a zero effort. If even one State does something (raises a revenue or provides a service), that becomes a part of what States do collectively on a (population) weighted basis. However, a differential (to equal per capita) assessment will only be made if it will have a material effect on the GST distribution. The Commission said its preference was not to see average policy as a switch or toggle, where States collectively either do, or do not do, something. Rather, it saw average policy as a continuum, where:

- the effective tax rate on a base is a reflection of the share of the tax base taxed by States[15]
- the average per capita spending on a service will depend on the proportion of the population in States providing it.

67 In this way, the more States there are taxing a base, the higher the effective rate will be; the more States providing a service, the higher per capita spending on the service. The Commission then determines if a differential assessment is to be made solely on the basis that it could be done reliably and would be materially different from an equal per capita assessment.

68 The Commission observed that where only one State raises a tax or provides a service, the effective tax rate or national per capita spending is most likely to be very low and a differential assessment would be unlikely to be material. However, if one State raises a tax on a large tax base or spends a large amount on a service, a differential assessment could be material, in which case the impact on State fiscal capacities should be recognised.

69 The Commission considered that adopting this approach to average policy led to better HFE outcomes than the previous (2010 Review) approach, which required a majority of States and a majority of the tax or service base to be affected for an activity to be accepted as average policy.[16] The previous approach meant a unique tax or service had no impact on the GST distribution. It was regarded as above average policy and a State retained all of the relevant revenue or had to fund the unique

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15 The effective tax rate for a State is the actual tax raised by that State divided by the assessed tax base from which that tax is raised. The average effective tax rate is the sum of the revenues raised by each State, divided by the sum of the assessed tax bases from which that tax is raised by each State. Due to variances between States in the application of taxes and the corresponding tax base, the effective rate of a tax for a State is generally not the same as the legislative rate for that tax in a State.

16 In contrast to the 2015 Review approach, the 2010 Review (and earlier Review) approaches were designed to have a bias against assessing non-standard policies. This bias was based on the notion that unless a function is the usual practice in most States, it is not 'what States do'.

service. It was based on a view that if only one State did something, it was not part of the collective average policy. The Commission said under the previous approach, it ran the risk of not making an assessment of a material tax, if only one State chose to levy it, or of a service only one State decided to provide.

70 The Commission noted the 2010 Review approach — the 'double majority' approach — could be difficult to use if more than one State was involved. For example, it did not help to decide what was average policy if, say, four States imposed a tax and four did not; or if six States imposed a tax but these States had only 20% of the tax base. A judgment was required and there were times in the past when decisions on average policy were made on the basis of the number of States involved, the proportion of the tax or service base covered or what was easiest. In addition, in attempting to make its recommendations more contemporaneous, the Commission at times relied on State budget documents as a guide to determining average policy (based upon the number of States) in the application year.[17] When State decisions in that year varied from the budget position, the Commission's recommendations did not accurately reflect application year circumstances. Consistency in decision making was not always achieved.

71 The Commission also noted that applying the conceptually stronger 2015 Review approach to determining average policy might at times need to be modified due to practical considerations. Data limitations can mean the approach may not always be implementable in a pure way. In these cases the Commission would use its discretion in deciding the methods to be adopted.[18]

72 As discussed, the approach used in the 2010 Review, with a 'double majority' requirement, did cause confusion and inconsistency. There was confusion about:

- whether four out of eight States was a majority
- what should happen if an assessment met one criteria but not the other?

73 If the Commission were to return to the 2010 Review approach, greater clarity would be required to resolve these issues. For example, a clearer definition could be:

- An assessment is not made unless both the following conditions are met:
  - at least half the States that could apply the policy do so
  - States applying the policy represented at least half the relevant service base or tax base.

74 It is important to note that a concept of a majority of States relates to a majority of States with the applicable tax or service base. It is not necessary for four States to tax a particular base, merely a majority of the States that have access to that tax base.

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17 For example, for the treatment of non-real property conveyance duty in the 2013 and 2014 Updates.

18 An issue with the weighted average approach to determining average policy is that there may be a conflict with policy neutrality. This is addressed in the following section on policy neutrality.

Differences in practice

75 It is worth noting that States do provide very similar services, and apply very similar taxes. It is rare for the choice of average policy definition to have a significant impact on the GST distribution. However, the 2015 Review and 2010 Review approaches may bring about different outcomes in the GST distribution under particular circumstances. There is also the question whether different approaches to determining average policy might be perceived to provide incentives to States to 'game the system'.

76 Practical examples of where the Commission faces issues in relation to determining average policy include where:

- one State has the majority of the tax base (e.g. iron ore royalties)
- only one or two States do something (e.g. provide general revenue grants for Indigenous local governments, or utilities subsidies in metropolitan areas).

Some consultation questions.

- Should the Commission retain the 2015 Review approach — the 'weighted average' approach — to determine average policy or is there a better alternative?
- How might the practical problems arising from the weighted average approach be handled to ensure HFE is achieved?

Scope of equalisation

77 In the 2015 Review the Commission said the GST distribution provides financial support to the activities of State governments. It said the relevance of the GST distribution is enhanced if it accurately reflects the services they provide, the infrastructure they are acquiring and the revenues they raise.

78 Therefore, the Commission said the range of activities covered by its assessments must be comprehensive and include all State general government type activities.

79 In the past some States have suggested limiting the range of activities or disabilities (for example, restricting expenses to the core services of education, health, law and order, or treating mining revenue differently to tax revenues). However as neither the IGA nor previous (or the current) terms of reference provided the Commission with a basis for discriminating between services or revenues, it considered there to be no logical basis for excluding particular activities. A comprehensive coverage is consistent with an aim of equalising (to the extent possible) the capacities of States to provide services at the same standard. This would not be achieved if major revenues,

expenses or disabilities were omitted from the assessments. A comprehensive scope does not, however, mean that all functions have to be differentially assessed.

Public non-financial corporations (PNFCs)

80 In the 2015 Review, the Commission changed its coverage of State activities to include the operation of public non-financial corporations (PNFCs) providing public housing and urban transport. In the 2010 Review, it treated these PNFCs as outside the scope of the general government sector and only dealt with subsidies and grants paid to them. The Commission noted a number of States had brought the functions previously provided by such PNFCs within the scope of their general government sectors. After giving careful consideration to the nature of these functions, it concluded that, for its purposes, they are best considered as general government sector activities. The States are responsible for delivering urban transport and public housing services, whether they are provided by government departments or through PNFCs. States decide the level of services to be delivered, set the revenues to be collected (often collecting them and reimbursing service providers) and meet deficits.

81 The prime difference between the 2010 and 2015 Review approaches resulting from the inclusion of these PNFCs was that their infrastructure acquisitions and depreciation came within the investment and depreciation assessments respectively. They were no longer included as part of State net financial worth (and their land holdings were treated as general government land). As a result, the impact of differences between the States in the capital required for these functions was directly recognised in the Commission's assessments under the 2015 methodology. There was no change to the allowances made for population growth.[19]

82 In the 2015 Review, the Commission decided to implement the equalisation objective as follows.

> Fiscal capacities are equal when each State has the capacity to hold the average per capita value of net financial worth (and earn income from it) after recognising their differential revenue raising capacities, different amounts received from Commonwealth payments and differential costs of providing the average level of services and holding the infrastructure necessary to provide them.[20]

83 This definition explicitly states that equalising net financial worth means that income from general government holdings of net financial worth is equalised. This means that there is a simplifying assumption that all holdings of financial worth have the

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[19] A further consequence of incorporating housing and transport PNFCs within the scope of general government activities is that the 'general government' net financial worth number to which States are equalised is not equal to the ABS Government Finance Statistics net financial worth, as it was under the 2010 approach.

[20] 2015 Review Report, Volume 2, Chapter 1, page 5.

same capacity to earn income, or else that State holdings of different mixes of financial worth are their policy choice.

Some consultation questions.

- Should the fiscal outcome of States the Commission equalises continue to be the same average per capita net financial worth?
  - If not, what fiscal outcome should the Commission equalise?

Local government

84 Constitutionally, local government is the responsibility of the States. States provide the legislative framework in which local government operates, and oversee its operations. State governments have a major role in determining the roles and responsibilities of their local government sectors but those roles and responsibilities differ between States.

85 In the 2015 Review as in previous reviews, the Commission decided not to include local government activities within scope, although transactions between States and their local governments — subsidies and grants — were included and assessed using category disabilities. Also, to the extent that local government provides State type services and this affects a State's need to provide similar services, we took those influences into account wherever possible and applicable through an assessment of non-State sector service provision. The Commonwealth's financial assistance grants (FAGs) to local governments have no impact on the GST distribution.[21]

Some consultation questions.

- Given current State circumstances, does the existing scope of equalisation (general government, plus urban transport and public housing PNFCs but excluding local government except for the interactions between it and the State sector) remain appropriate?
  - If not, what activities should the Commission equalise?

Disability measurement

86 In developing assessments, the Commission aims to accurately reflect what States do where it can.

[21] Since the 1993 Review, the Commission's justification for excluding local government from the scope of equalisation is that local government is subject to separate equalisation processes and terms of reference have not given the Commission a mandate to equalise local government activities. Most States have supported or at least accepted this view.

87 For revenue assessments, it can often do this easily. Many revenue assessments use the base that States actually tax, and apply actual (national average) tax rates to that base.

88 In expense assessments, the Commission typically relies on what the data tell us about what States do, including the populations to whom they provide services. It calculates what States spend on different population groups, such as Indigenous and non-Indigenous, different age groups, people living in different socio-economic status areas or different remoteness regions. It takes total spending by States on different population groups and divides by the national number of people in each of those groups. The resulting expense per person in each group is applied to the actual numbers of people in the group in each State to calculate what each State needs to spend if it applied the average policy (if it spent the average amount per person in each group).

89 While States may not develop or implement their policies by deciding how much to spend per person in different groups, the data capture the result of how States have implemented their policies. So, to that extent, the Commission measures what States do. For example, the Commission observes that for admitted patient hospital services States spend twice as much per capita on Indigenous people as non-Indigenous people, and nearly six times as much on people aged 75 years and over as those under 15 years, based upon clinical need rather than explicit client group policy goals. The Commission's assessments reflect these observations.

90 There are population groups that the Commission does not include in any differential assessment, for a variety of reasons.

- Some groups may have a higher cost per episode of service delivery, but lower use of services, so that overall the cost of servicing these population groups is not materially different to other population groups. There is some evidence that overseas born populations fall into this category.
- Some groups may be high cost, but the numbers of them are not large, or the interstate distribution is not sufficiently different from EPC to make a material impact ($30 per capita for any State). There is some evidence that the population of recent refugees falls into this category.
- Some groups may be high cost, but the Commission does not have reliable data on their interstate distribution. The population of students with disabilities currently falls into this category.

91 There are some assessments where the relationship between what States do and how the Commission assesses State needs is less direct.

- Bulkbilled Medicare services are a proxy for non-State provided health services.
- Private sector wage levels for comparable employees are a proxy for the pressure on public sector wage levels.

- Distances between towns are a proxy for the length of the rural road network States would provide under average policy.
- Population growth, and other aspects of the capital assessments, are proxies for the pressures States face in their capital requirements.
- The interstate location adjustment is a Commission judgment based assessment that proxies the costs of isolation of capital cities not captured by the regional costs assessment.

92 In each of these cases, the Commission's measurement is not directly tied to what States actually do, but reflects real disabilities and differences between States in the most reliable way it can measure them.

Some consultation questions.

- Should assessments reflect what States do on average?
- Should changes be made to the general approaches used by the Commission in the past?

POLICY NEUTRALITY

93 The intention of this supporting principle is to ensure a State's own policies or choices, in relation to the services it provides or the revenues it raises, do not directly influence its GST share. A second aspect of the principle is that Commission practices should not provide an incentive (or disincentive) for States to act in particular ways.

94 Under the 2015 Review approach the Commission implemented policy neutrality by undertaking assessments on the assumption that each State followed the broadly same (or average) policies in delivering services and raising revenue. As a result, its calculations were not directly affected by (were neutral to) the specific policies each State followed.[22] Since under this approach each State's share of GST funds is based on average policies, its incentive to change its own policies in the hope of gaining a greater share of GST (that is, engage in grant seeking behaviour) is limited to the effect of its policies on the average. Under the Commission's policy neutral approach, no allowance is made for the difference between the average policy and its own policy. To the extent those differences lead to increased costs, States are responsible for funding those additional costs. To the extent those differences lead to reduced costs, States retain the benefit of the cost savings.

[22] This is not true if State policies influence the observed level of activity — for example, if a higher rate of tax dampens the level of activity. These are known as elasticity effects and are being separately considered by the Commission.

95 Alternatively, the Commission could adopt a policy free approach. This means assessments would be completely free of State influence. This could be achieved, for example, by adopting an external standard, based on some 'ideal' level of services, a desired level of service delivery efficiency or an economically efficient tax policy. The difficulties with such an approach were discussed in the What States do section.

96 In the past some States have argued the Commission's approach was not policy neutral for the following reasons:

- Collectively, the policies of States set the standards. To be policy neutral the standards should be based on what States could do (a concept of policy-free).
- Some States can affect the average policies more than others. The more populous States have a greater effect on setting the average per capita revenues and expenses, States with high mineral production have a greater effect on average royalty rates, States with high proportions of the Indigenous population have a greater effect on the costs of providing services to Indigenous people, and so on.
- Equalisation can create incentives or disincentives for States to make particular decisions or act in particular ways.[23]

97 It is true that some States have greater influence on setting the average policy. That is because the average policy is a weighted policy and they have more people and, therefore, more weight on what the average is. In practice, it is more likely that State decisions are substantially based on more immediate considerations than the potential effect of equalisation on their GST distribution and there is no evidence that State decisions are overly affected by equalisation considerations. While the Commission accepts the potential for assessments to provide incentives for States to make certain decisions, it is not clear that the effects are material or potential solutions are reliable or simple.

98 However, the second round consequences of differential policy choice can be reflected in the GST distribution. For example, because the methodology uses observed tax bases to measure the capacity of a State to raise revenue, the indirect impact of State decisions can affect their GST shares. In the case where a State adopts a lower tax rate than other States, it would be expected that its tax base would be correspondingly increased. However, to date, the evidence available suggests that these indirect effects are small and in practice there appears to be no significant indirect impact on policy neutrality. In the 2020 Review the Commission may consider it prudent to evaluate assessments to see if such second round impacts (referred to

[23] For example, at various times in the past States have argued that equalisation reduces the incentive for a State to promote growth, reduces the incentive to improve efficiency of service delivery, provides incentives for States to over-provide services where they have above average costs of service delivery and vice versa, provides incentives for States to over-tax revenue bases where they have a revenue raising disadvantage and vice versa, and provides incentives for States to invest resources in identifying disabilities and developing more sophisticated ways of measuring them.

as elasticity effects) are material and, if they are, how they should be recognised, consistent with achieving HFE.

99 An option that is not State policy free but that could improve policy neutrality would be to introduce a State rotating average. A version of this approach was originally adopted by the Commission in the 1981 Review and remained until replaced in the 1993 Review by the weighted average of all States approach. The effect of using the rotating standard approach is that for any particular State, the standard to which its disabilities are applied is derived from the weighted average of the other seven States, so that the State has no influence on the standard used for it. However the approach would increase complexity, as in effect, standards would have to be calculated eight times instead of once. In addition, the approach could introduce technical complications. It would be unlikely for the sum of the assessed outcomes for each State under this approach to match the States' total actual outcome. The Commission would have to make decisions on how to treat the difference.

100 Some States have said that HFE acts as a disincentive to tax reform. Western Australia said a new principle, 'that assessments are implemented in a way that avoids creating disincentives for States to improve their own revenue generation or to make the reforms necessary to improve the operation of their economies' should be introduced.[24]

101 The GST Distribution Review considered this issue in some detail. The Review found that the current system creates theoretical perverse incentives in some instances, but that 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.[25]

102 As a case in point, the New South Wales Financial Audit (the Lambert Report) recommended a switch from insurance taxes to payroll tax. Despite the recommendation and though at the time New South Wales would have gained GST share by switching from insurance tax to any other tax, it chose not to do so.[26]

103 Not knowing what activities other States might pursue (and therefore the relative change in fiscal capacity resulting from a State's own policy change) along with the effects of the lag between introducing a policy change and any resultant effects on the GST distribution, tends to mitigate the risk of States making deliberative policy decisions largely on the basis of the effect they will have on their GST shares.

104 That is not to say that States do not consider the GST consequences once policy decisions are made. For example, both Western Australia and the Commonwealth

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24 Letters from Western Australia in response to the letter from the Commission's Secretary of 1 December 2016 seeking comments on the review work program.

25 *GST Distribution Review — Final report*, page 140.

26 *GST Distribution Review — Second interim report*, pages 35-36.

were well aware of the potential GST effects that might result when Western Australia increased the royalty rate applying to iron ore fines earlier this decade.[27]

105 However, there is an argument that extending the weighted average approach to determining average policy may affect this aspect of policy neutrality. For example, a State may consider the introduction of a new tax policy based upon whether its potential share of the tax base is likely to trigger a material assessment by the Commission. Smaller States, or States with a smaller share of the potential tax base for a new tax, can be more confident that it is unlikely a material assessment will result.

106 Situations where a tax base is very unevenly distributed across States, so that a particular State has a large effect on the standard and average policy, can prove problematic for the Commission. In contrast to the 2010 Review approach, which placed a greater emphasis on policy neutrality, the 2015 Review approach to assessing mining revenue placed less weight on policy neutrality, with the Commission considering that an improved HFE outcome was achieved by so doing. However, the Commission indicated that it would closely monitor developments in the mining sector and that 'if we do observe a significant change in behaviour which raises policy neutrality concerns, we will revisit the assessment in a future update'[28].

107 More generally, an increased weight on policy neutrality would suggest a move to broader indicators less directly connected to the ways in which States raise revenues (and deliver services). For example, States' capacity to raise revenue might be proxied by an indicator such as Gross State Product (GSP). Such an approach would also be much simpler. On the other hand, such a proxy may have little relevance to some tax bases, for example mining royalties. The Commission has previously adopted a proxy approach in some assessments to improve policy neutrality. For example, the wage costs assessment measures the prevailing public sector wage levels of each State by reference to wage levels in the private sector, since public sector wages are strongly policy influenced.

108 A related but slightly different issue that can be a problem for the Commission is where revenue is raised from a revenue base, possibly large enough that an assessment is material, but the distribution of that revenue base across States is unclear. For example, while Queensland, Western Australia and South Australia currently have no restrictions on onshore oil and gas exploration and development, New South Wales, Victoria, Tasmania and the Northern Territory all either ban coal seam gas exploration and/or development, or have a moratorium on fracking. The

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27 This is reflected in the 2011 Update terms of reference (clause 11) which directed the Commission not to move iron ore fines between mineral royalty rate groups, despite the relevant year the increase first took effect (2010-11) not entering the Commission's assessments until the 2012 Update.

28 2015 Review Report, Volume 1, Chapter 2, page 37.

resultant effect is that it is difficult for the Commission to determine from observed activity what a policy neutral revenue base for the States with bans would be.[29]

109 In these circumstances, the Commission could take the view that all States that have onshore gas have the opportunity to exploit it and whether they do or not is solely policy choice. This view would lead to an equal per capita assessment of States' capacities to raise royalty revenue from onshore gas production, meaning that the royalties raised on onshore gas would not lead to a redistribution of GST revenue away from an equal per capita distribution (that is, would have no effect on the GST distribution). Further work will be undertaken through the review to address this issue.

110 Staff research paper 2017-04-S *State mining policies* reports on changes in State mining policies since the 2015 Review and identifies two circumstances — when a State dominates a tax base and when a State prohibits a tax base being accessed — which raise issues for the development of the mining revenue assessment in this review.

Some consultation questions.

- Do States consider that a rotating State average would improve policy neutrality? If so, how could such an approach be implemented in practice?
- Does HFE act as a disincentive to tax reform? If so, how does it do so — in reality as opposed to theory — and could such effects be mitigated in practice?

PRACTICALITY

111 Practicality is an umbrella principle that covers:

- Simplicity — the Commission's assessments should be as simple as possible while being conceptually sound and reflecting the major influences on State expenses and revenues.
- Reliability — the methods for making assessments should use reliable data, including the use of discounting where there are specific concerns about the degree to which data are fit for purpose.
- Materiality — assessments will only be made where they have a significant impact on the GST distribution.

[29] The assessment of gambling revenue is similarly a challenge for the Commission. State policies in this area are very different and the Commission has been unable to reliably determine the relative capacities of States to raise gambling revenue.

- Quality assurance — processes have been put in place to ensure data have been used and methods developed in a robust way and in accordance with HFE and the supporting principles.

112 This principle originated from the emphasis in the 2010 Review terms of reference on simplification, reliability and materiality and quality assurance and was continued in the 2015 Review. The practicality principle is operationalised in the Commission's assessment guidelines and quality assurance plan, which are discussed in other sections of this discussion paper.

113 Practicality recognises that, while State fiscal capacities are affected by a wide variety of factors, the suitability and acceptability of the recommended GST distribution may not be improved by including factors when sufficient data are not available to measure their effects or where effects are small. This effectively limits the extent to which the Commission can achieve full fiscal equalisation.

114 The Commission considers that the practicality principle applies in all stages of the development of assessments, including:

- the scope of the revenue and expenditure that should be part of fiscal equalisation and how they are grouped into categories and components
- the disabilities that should be assessed — this covers the conceptual case and the assessment of disabilities.

115 The terms of reference (clause 7) ask the Commission to aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data and to ensure robust quality assurance processes. The existing practicality principle means the Commission's assessments should comply with these requirements. Whether there would be any further value in having explicit simplicity or transparency principles is a question for States.

Discounting assessments

116 When developing assessments, sometimes data are incomplete, dated, unreliable, not fully fit for purpose or a combination of all these. In these cases, the Commission has to exercise judgment about whether to make an assessment or not. Judgment is guided by the quality of the available data.

117 The Commission is often in the position where it considers there is a conceptual case for including a particular influence that would materially affect State fiscal capacities. The Commission has a choice of either letting the data influence the GST distribution in proportion to its quality or ignoring the data and the particular influence completely.

118 In the 2015 Review the Commission considered a better HFE outcome was achieved by recognising the disability, but discounting its impact on the GST distribution to reflect the confidence it had in the data.

119 State views on discounting varied, with some States arguing for no discounting to be applied, while others argued that in such cases no assessment of the disability should be made. However, the Commission considered discounting an important tool in achieving HFE. It did not use it to introduce conservative bias or to allow unreliable assessments, but to achieve its best estimate of HFE where it had concerns about data.

120 While the Commission considered that discounting was a tool to enable it to better achieve HFE, it said there were certain times when discounting was not appropriate. For example, the Commission did not discount the best available estimates of national spending, such as those derived from ABS Government Finance Statistics. In the 2015 Review the Commission said that discounting was also not appropriate for judgment based estimates, such as the proportion of expenses to which a disability should be applied, because in making that judgment it had already incorporated all relevant information and weighted it according to its reliability.

121 The Commission also said it should not discount otherwise reliable assessments because of possible policy neutrality or general uncertainty, as proposed by some States in the 2015 Review. Those States considered all revenue bases should be discounted to reflect the uncertainty about how well the observed revenue bases reflected the average policy. While the Commission agreed that, conceptually, differences in tax rates or State development policies may affect the observed bases, it did not consider discounting them necessarily moved assessments in an appropriate direction in terms of HFE.

122 In the 2015 Review, the Commission considered three levels of discounting were appropriate – low (12.5%), medium (25%) and high (50%) – depending on its judgment about the reliability of the data. The discounts were applied as follows:

- 12.5%, if there was not full confidence about the size of an effect because of a low level of concern with the data on which it was based
- 25%, if there was a medium level of confidence about the size of an effect or a medium level of concern with the data
- 50%, if an effect on States was known to be large and there was confidence about its direction but there was limited confidence in the measurement of its size due to a high level of concern with the data
- if there was little confidence in the direction of an effect or its size, no differential assessment would be made (100% discount).

123 Discounting allows the Commission to partially recognise the influence of a disability when the presumptive case for the disability has been established but there are concerns with the data. A discounted or partial assessment would only be retained if it improves the HFE outcome. In other words, discounting allows the Commission to

achieve the HFE objective while taking into account practical issues which affect the measurement of State fiscal capacities.

Materiality thresholds

124 Materiality thresholds were introduced in the 2010 Review to help achieve greater simplicity. They were retained with higher thresholds in the 2015 Review. Materiality thresholds were set with reference to the impact an assessment had on the per capita GST distribution for at least one State. In the 2015 Review, there were materiality thresholds to handle three circumstances.

- ***Disability assessment.*** A disability was considered material if it redistributed more than $30 per capita for any State, across all categories. The disability was included in all assessments where there was a conceptual case for including it and this could be done so reliably, regardless of its materiality in individual assessments. For example, because location was material across all categories, it was assessed in all categories where there was a conceptual case that location had an impact on the use and cost of a service, and if reliable data on use by location were available.
- ***Disability disaggregation.*** The Commission applied a $30 per capita materiality threshold for disaggregating a disability. For example, the Commission started with broad age groups (say 0-14; 15-64; 65 and over) in an individual category and disaggregated them further only if it were material to do so.
- ***Data adjustment.*** Data were adjusted where necessary to improve interstate comparability, only if the adjustment redistributed more than $10 per capita for any State.

125 An issue for the 2020 Review is whether the materiality thresholds should remain at the 2015 Review levels or whether they should be increased. If they are to be increased, by how much should they be increased?

126 In the 2015 Review, the materiality thresholds were increased markedly from those used in the 2010 Review (from $10 to $30 for disabilities and from $3 to $10 for data adjustments) because it was considered that the 2010 Review thresholds were conservative. The size of the increases was intended as a signal that the Commission not only wanted to retain the simplicity gains of the 2010 Review but saw further scope for simplicity.

127 In this review, the Commission has three options:

- retain the 2015 Review materiality thresholds
- increase them to account for price and wage increases — over the last five years (2010-11 to 2015-16), the State and local general government final

consumption expenditure implicit price deflator grew by 8.5%, which would increase the threshold to $37 for recognising disabilities

- make a significant increase to, say, $50 for disabilities, to further simplify the assessments.

128 The Commission may consider that the thresholds should, at least, retain their original values and be adjusted for price and wages increases. In practice, this likely would have no impact on the assessments because, on current data, they all redistribute well above $40 per capita in at least one State.

129 The threshold could be increased further. A $50 per capita threshold would possibly only affect the insurance tax assessment, which redistributed $46 per capita to Tasmania in the 2017 Update. Given this, a significant increase in the $30 per capita materiality threshold is possibly not warranted in this review. The large increase in the 2015 Review achieved its goal of further reducing the number of disabilities assessed by the Commission. Those that are left are highly material.

130 Adjusted for price and wage increases, the $10 per capita threshold for data adjustment would become $11. As the purpose of this materiality threshold is to avoid making very small adjustments, changes to it are probably not necessary.

Some consultation questions.

- A further aspect of practicality is the transparent use of data. In the 2015 Review the Commission made use of data that were in some cases confidential. Should assessments be made using confidential data?
- Are the three levels of discounting appropriate? If not how could discounts be changed?
- Should the materiality thresholds remain at the 2015 Review levels or should they be increased? If increased, to what levels?

Quality assurance

131 An important way of ensuring the Commission's assessments are as reliable and accurate as possible is through a quality assurance process. As noted earlier, the terms of reference for the 2020 Review ask the Commission to 'ensure robust quality assurance processes' (clause 7d) are adopted in preparing assessments. The Commission has responded to similar terms of reference in the past (in both the 2010 and 2015 Reviews) by undertaking a risk assessment and preparing quality assurance strategic plans and action plans.[30]

[30] The 2015 Review plans are on the Commission's website.

132 The 2020 Review quality assurance (QA) strategy and its implementation will be based on those adopted in the 2015 Review and the following updates. The Commission wants to ensure assessment methods are:

- conceptually sound
- based on robust and reliable data
- built using consistently applied principles
- implemented without error.

133 After receipt of any State comments on the 2015 Review Plans, staff will prepare the 2020 Review QA Strategic Plan and send a draft copy to States for further comment. The Commission will then consider State comments and produce the 'final' Plan to be used in the 2020 Review.

Some consultation questions.

- Is this an acceptable way to ensure 'robust quality assurance processes'?
- Are there any new risks that the Commission should take into account from a State perspective?
- How might the 2015 Strategic Plan be changed to deal with those risks?
- Should any other changes be made?

CONTEMPORANEITY

134 Terms of reference ask the Commission to provide relativities for distributing GST revenue in an application year (the year in which its recommended relativities are applied)[31]. Commissions have interpreted this as meaning recommending relativities appropriate to equalising State fiscal capacities in the application year.

135 A fully contemporaneous approach would equalise State fiscal capacities in the application year. However, implementing this approach would require application year data, which are not available in a robust, tested way until the application year has passed.[32] In the absence of such data, past Commissions have based recommendations on historical data.

[31] For example, the application year for the relativities recommended by the Commission in its 2017 Update Report is 2017-18. These relativities were derived from the average of the relativities calculated for the 2013-14, 2014-15 and 2015-16 assessment years.

[32] It would require application year data on State revenues, spending and associated State disabilities.

A lagged HFE system

136 The absence of application year data has been an issue for the Commission since its earliest inquiries. In its third (1936) Report, the Commission decided it would not try to estimate conditions in the application year but would base its recommendations on historical data — the year of assessment. In deciding to use historical data, the Commission built lags into the special grants it recommended for claimant States.

137 In its fifteenth (1948) Report the Commission accepted that one-off factors (for example, natural disasters) could cause the circumstances of the application year to diverge from the year of assessment. It addressed this in its following report by making two changes. It:

- allowed a suitable margin of safety when calculating advance grants[33]
- assessed a completion grant.[34] Thus, any divergence in circumstances was corrected two years later.

138 With the introduction of all-State equalisation (in the 1981 Review), assessing a margin of error ceased and completion grants were discontinued.[35] The latter meant there was no redress if the circumstances estimated for the application year (as captured by the relativities) diverged from States' actual conditions. To partially balance this, the Commission moved from a one year assessment to assessments based on three (and subsequent terms of reference expanded this to five) years of data — extending the lags in the HFE system.[36]

139 The implicit assumption under the 2015 Review approach, and for previous approaches using lagged data, of applying relativities based upon historical years to a future (application) year, is that the historically based needs grow by the growth in the pool from those historical years to the future year (with minor adjustments for changes in population share). Lags have a consequence when this implicit assumption does not hold. The issue for the Commission is whether, and if so how, the Commission should deal with those consequences.

140 In the 2015 Review the Commission said its only objective was to recommend relativities so as to achieve HFE. Supporting principles for the development of assessment methods were always to be read in the light of that single objective. The Commission also said it drew a distinction between the operation of HFE (which

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33 In the special grants era, the Commonwealth financed these margins of safety.

34 The completion grant was the difference between two assessments of special grant. The first was when a year was the application year and before the conditions of that year were known (its advance grant). The second assessment occurred two years later, when the conditions of that year were known.

35 States rather than the Commonwealth would have to fund these margins of safety, meaning margins of safety could not be provided to every State.

36 The advantage of extending the assessment period was to provide greater smoothing to relativities. It meant an aberrant year received less weight in the calculation of relativities, but it also meant it remained in the assessment period longer and so influenced two additional inquiries.

relates to the fiscal capacities of States recognising the average revenue and expenditure policies of States), and the budgetary circumstances of States (which reflect their individual policy choices on revenues and expenditures). From an HFE perspective the GST distribution seeks to equalise fiscal capacities, not States' budgetary circumstances.

141 The Commission said that having adopted a contemporaneity supporting principle, this meant that, bearing in mind its objective and other supporting principles such as policy neutrality and practicality, the distribution of GST provided to States in a year should reflect State circumstances in that year as far as possible. It said it considered that a three year lagged assessment was, at least in most circumstances, the most reliable practical approach to providing a reasonable estimate of State circumstances in the application year.

142 In adopting as the basis for all assessments the data for three historical years, the Commission said it accepted that fiscal equalisation is achieved over a run of years with a lag. It said while imperfect, this approach recognised that State fiscal capacity in any one year must take account of the operation of the system over a run of years. In the 2015 Review the Commission was concerned that making a change for any one State or one category without regard to the fiscal position over a run of years would compromise HFE.

143 The Commission said it recognised that there was a trade-off between contemporaneity and data reliability. However, it did not consider that State, or independent, forecasts of revenues in the application year were sufficiently reliable for it to use them as the basis of the GST distribution. In recent years, the errors in these forecasts have been very large. It said an approach using such unreliable data raised a range of issues, including that it would almost certainly require consequent GST adjustments in future to compensate for errors. This could, itself, then undermine the contemporaneity of GST distributions in future years.

144 The Commission also considered whether an alternative treatment, such as a lagged five year average approach, would be more appropriate for a volatile revenue such as iron ore royalties. However, it said an analysis of this approach did not give it confidence that five year averaging would provide an unambiguously improved HFE outcome compared with three year averaging in all future circumstances.

145 On balance, the Commission's view was that HFE was best achieved by assessing all aspects of State activity in the same way. It said not to do so risked the coherence of the system as a whole.

Backcasting of payments for specific purposes (PSPs) in certain circumstances is the exception

146 In the 2015 Review there was a limited exception to the use of historical data, which was in the case of backcasting major changes in Commonwealth-State financial arrangements. However this approach was used only where the change was reliably known, with the Commission noting the considerable difficulties in extending this approach beyond such cases.

147 'Backcasting' is an approach used to improve the contemporaneity of the relativities when major changes in Commonwealth-State financial arrangements occur. The Commission's view was that reflecting a major change in Commonwealth-State arrangements in the application year was desirable if the relativities were to give meaningful and contemporary outcomes. States could be considerably over or under equalised in the application year, if such backcasting did not occur. However, on practicality grounds, only large and known changes were backcast.

148 All States agreed the Commission should continue to backcast major changes in Commonwealth-State financial arrangements for contemporaneity reasons. They agreed such changes should only be made if they can be made reliably.

ALTERNATIVE APPROACHES TO APPLYING THE CONTEMPORANEITY SUPPORTING PRINCIPLE

149 In this Review the Commission seeks State views on whether the emphasis of the GST distribution should be on achieving more or less contemporaneity. Less contemporaneity would aim to achieve equalisation over time rather than in the application year, and depending on the methods adopted, could result in States' GST shares changing more slowly. In these cases GST shares would have greater stability. Backcasting may no longer be relevant under an equalisation over time approach.

150 Against this, State fiscal capacities would not be equalised at one time under an equalisation over time approach. Another way of framing this issue is whether States see GST revenue as just another budget line item (with no regard to the interaction of GST revenue and State own-source revenue lines), or as a whole of revenue balancing item (so that there should be counter-cyclicality of movements in GST revenue and State own-source revenues).

151 Some alternative approaches to achieving contemporaneity, for State comment, are provided below. These range from continuing to use historical data, but reducing the gap between assessment and application years, to using forecasts of conditions in the application year. In the latter case, further adjustments to compensate for errors would be required.

152 Staff research paper 2017-05-S *Options for improving contemporaneity* provides the results of the staff analysis of the effects on the GST distribution of the different alternatives, for particular years.

Overview of alternative approaches

153 In the 2010 and 2015 Reviews the Commission's intention was to provide States with the GST revenue that, as closely as is possible, matched the conditions they would face in the application year. It is arguable that this goal has been overly ambitious. Data availability and reliability constraints mean that HFE is achieved over time, albeit as closely as practicable to the application year.

154 Currently, the Commission's recommendations are expressed in the form of relativities. The effect of applying relativities (based upon the assessment years) to the application year is that States' assessed deficits (GST requirements) are inflated in the application year by the growth in GST revenue between the assessment years and the application year. When State circumstances are changing slowly, this approach can provide them with the GST revenue they require in the application year. When their circumstances are changing rapidly, this approach can generate over- or under-estimates of States' GST requirements and produce over- or under-provision of GST in the application year compared with when that year becomes an assessment year, referred to as the 'gap'.[37] The 'gap' is a measure of the extent to which the Commission's relativities are not fully contemporaneous.

155 There are approaches that can potentially reduce the size of these discrepancies, such as estimating application year financial data or treating volatile revenues by absorption.[38] There are also approaches that have a corrections process to adjust for any discrepancy, such as an advance and completion approach. Alternatively, the Commission may accept that achieving its aspirational goal of equalisation in the application year is not practically possible. In this case equalisation would be considered to be achieved over time and conceptually there would be no discrepancies.

156 Different approaches provide different trade-offs in terms of contemporaneity, accuracy and stability of GST shares. Some require another layer of calculations, increasing complexity. The terms of reference would appear to allow the Commission to change from its current three-year lagged average relativity approach, should it consider that a new approach offers advantages (in terms of these trade-offs) in how HFE is achieved.

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[37] Technically, the 'gap' is the difference between the GST payment received by a State in an application year and its assessed GST requirement for that year when it subsequently becomes an assessment year.

[38] Under an absorption approach the distribution of grants in the application year, rather than their distribution in the assessment years, is used to derive State GST shares in the application year.

Completion approaches

157 The lagged three year average approach to determining relativities to apply in the application year can be thought of as an averaged set of completion grants each year, with no advance grants having been made. The completion grants relate to the average of the three years that together are two, three and four years prior to the application year. This approach recognises a trade-off between the contemporaneity and practicality supporting principles, with contemporaneity being subordinate to practicality. That is, the Commission in the 2015 Review considered the lagged three year average approach as being the most contemporaneous possible given the practicality constraints relating to using reliable and consistent data.

158 The issue then becomes whether a one year, or three year average, assessment is more appropriate under the contemporaneity principle. The Commission could aim to recommend a distribution of GST revenue on the basis of its best assessment of the fiscal capacities of the States two years prior to the application year, that is, by using only the most recent assessment year of the three assessment years under the 2015 Review methodology.

159 Such an approach would be more contemporaneous to the extent that relativities for the application year would be based on States' circumstances closer to that year. On the other hand, there is no certainty that that year will more closely represent the circumstances in the application year. Also, a GST distribution based upon a single assessment year could be expected to be more volatile than for a three year averaged assessment year approach. However, outrider years would affect the GST distribution for only one year, as compared to three years under the 2015 Review approach.

160 A further consideration is that the data for the final assessment year are a little less reliable than for the earlier years, for example because data provided by States are used for the adjusted budget instead of ABS Government Financial Statistics (GFS) data. This concern could be addressed by delaying the final calculation until closer to the application year. One approach could be for the Commission to provide an initial estimate of relativities for budgeting purposes at the end of February, with a final calculation made in June incorporating more recent data relevant to the assessment year.

161 In considering a move from a three year to a single year approach, in essence the judgment for the Commission, in consultation with States, would be whether the three year lagged average approach using more reliable data is worth more to HFE than greater contemporaneity.

162 Alternatively, a stability supporting principle could replace the contemporaneity principle. Such an approach may even lead to a return to relativities based on a five year lagged average of assessment years. While this approach could not be expected necessarily to produce relativities consistent with State circumstances in the

application year, it could be expected to produce less volatility in States' GST shares compared with the three year lagged average approach. This is because each new year coming into the Commission's calculations would have less impact on the relativities, in comparison to the three year average approach.

Advance approaches

163 Other types of approaches would be to advance the assessment year by one further year, or two further years (to the application year). This would entail the Commission using estimates and thus the payment of advance grants, rather than effectively paying completion grants based upon actual data.

Estimating application year data

164 The Commission could partially anticipate the conditions likely to exist in the application year. For example, it could estimate application year financial data (but not disabilities) using State budget paper forecasts, or project assessment year financial data into the application year. Such an approach would carry the risk of policy contamination through the different budgeting practices of the States.

165 In the 2015 Review, the Commission considered the use of forecasts and concluded that State, or independent, forecasts of revenues in the application year were not sufficiently reliable. It also said an approach using such unreliable data might require 'consequent GST adjustments in future to compensate for errors'. These adjustments would be completion grants and would add a layer of calculations to the HFE process, increasing complexity, with the risk that any such adjustments would be counter to the contemporaneous outcome in the year they were made.

Using a different rate of growth

166 By its design, the current relativities approach assumes the ratio of States' per capita assessed deficits to the per capita pool continues into the application year. Effectively, this approach inflates States' assessed deficits by the growth in the pool (and any differential population growth). It will generate 'gaps' if State spending, revenue raising or receipt of PSPs do not grow in line with GST growth.

167 The Commission could use a different growth rate (or none) between the assessment years and the application year. Options include the Consumer Price Index and State and Local Government Final Consumption Expenditure Deflator. In recent years, both of these options experienced slower growth than the GST pool.

Treating volatile revenues by absorption

168 An approach the Commission used in the past (when so directed by terms of reference) was to treat PSPs by 'absorption'.[39] Under the absorption approach the distribution of grants in the application year, rather than their distribution in the assessment years, was used to derive State GST shares in the application year. Such an approach could be extended to volatile revenue streams, such as mining revenue or conveyance duty.[40]

169 This option increases contemporaneity because States' GST revenue would depend on an application year revenue assessment of the volatile revenue stream. A disadvantage of this option is that it could increase year to year volatility in GST shares as it uses a revenue assessment from one year rather than an assessment averaged over three years.

170 Adopting this approach would mean that different revenue streams would be treated in different ways, creating an asymmetric approach that could create problems within the HFE system overall. In addition, there would be increased uncertainty as to the level of GST revenue States would receive in a year, as this amount would vary as the assessment of the relevant revenue stream was revealed over the course of the application year.

Building in a margin of safety

171 The Commission last used an advance and completion model in the State claimancy era. In this era, a claimant State's need for assistance was assessed twice — a preliminary assessment in the form of an advance grant and a final assessment after the relevant year had passed and when actual data were available (two years later). The completion grant was the difference between a State's preliminary assessment (its advance grant) and its final assessment. If its advance grant was too low, its completion grant was positive and vice versa.

172 The advance and completion approach allowed the Commission to build a margin of safety into a State's advance grant in the knowledge that, if it was not required, it could be recouped in the subsequent completion grant.

173 A margin of safety would allow States to ask the Commission to allow for an advance grant in anticipation of a change in their circumstances (compared to the assessment years). This happened in the 2015 Review when Western Australia asked the Commission to adjust the mining assessment to anticipate falling commodity prices and reducing North West Shelf payments. The Commission did not agree to the

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39 Absorption ceased from the 2009 Update, where it was applied to the Health Care Grants.

40 PSPs are another potentially volatile revenue for States — for example transport infrastructure payments — where there may be large differences between the assessment and application year payments received.

proposal because there was no correction process (such as a completion grant) to reverse the adjustment if it was subsequently found not to be required.

174 This approach would be less mechanistic (relying on how future estimates flow through to individual assessments) and be more judgment based. A framework could be developed so that on occasion States could seek (say as part of the New Issues process so that it would be subject to consultation and comment by other States) an advance grant. This grant would be in addition to the following year's GST revenue entitlement as calculated on the lagged three year average (or whatever completion process had been adopted), on the basis that their application year circumstances would be exceptionally different from their assessment year circumstances.

175 Unlike in the claimancy era, when the Commonwealth funded the advance grants and they had no effect on other States, under the all-State equalisation model, it would be the other States that would have their GST reduced to give a larger advance grant to a State. Therefore any misallocated advance grant should then be returned to the other States (completed) as the relevant application year became an assessment year.

Further considerations

176 In supporting any of these alternative options States would have to make the logic of their case clear. The Commission said in its 2015 Review Report that from an HFE perspective the GST distribution seeks to equalise fiscal capacities, not States' budgetary circumstances (which include their policy choices). In that situation the case for applying the principle of HFE to the GST distribution through advance grants is that States cannot manage cyclical budgets directly but rather require that GST grants be paid in cash terms on a contemporaneous basis. The previous Premier of Western Australia, Mr Colin Barnett, made this argument when he said 'This year Western Australia will lose $4.7 billion [in GST] to the other States — I mean that is outrageous in terms of sensible economic management at a national level. But because of the bizarre nature of the GST our share will actually start to go up now. It will go up at the time the economy is recovering instead of going up when we actually needed it in the 2015 and 2016 years.'[41]

177 In contrast to Mr Barnett's position, States have often expressed preferences for predictability and stability in GST allocations rather than counter-cyclicality. However, since the introduction of all-State equalisation in the 1980s, it has been accepted that States have the ability to anticipate cyclical or temporary developments and manage budgets accordingly. For example, in its 2013-14 Budget Western Australia said 'Overall, GST grants are forecast to decline from $2.9 billion in 2012-13 to just $500 million in 2016-17, mainly due to the significant increase in Western Australia's

[41] Excerpt from an interview between Leigh Sales and Colin Barnett on the *7:30 Report*, 8 March 2017.

mining royalties in recent years and the full equalisation of these royalties over time by the CGC (i.e. with lags).'[42]

178 Under the case for changing the approach to determining application year relativities to better facilitate cyclical cash flow management, the test of whether an approach is an improvement over the current lagged three year average approach is whether (without unduly adding to complexity) it results in a lower gap (between States' GST payments received in a year and their assessed GST requirements for that year) overall across the States. It is unlikely however that even where this is the case, all States would experience a lower gap than under the current approach.

179 However, gaps are irrelevant if the specification of the goal relates to a completion year rather than a (later) application year. Under a completion year approach HFE is still being achieved (albeit over time rather than in respect of a particular year). However, contemporaneity can still be seen to be improved by reducing the lag between the assessment year and the application year.

180 If the view of the approach to HFE changes to being more on a completions basis, a further question is whether backcasting should continue, given that it can only be undertaken under limited circumstances and is generally dependent upon the reliability of future distributions of Commonwealth payments.

Some consultation questions.

- Should the Commission maintain the aim of achieving a GST distribution relevant to the application year, or should the aim be varied to achieve equalisation over time using historical assessments?
- Does the current three year lagged average approach present undue difficulties to managing your State's cyclical cash flows?
  - If so, which of the approaches discussed would result in an improvement to cyclical cash flow management and why, noting the concerns about using reliable and consistent data, the unreliability of forward estimates and the risk of policy contamination through the different budgeting practices of the States (with the consequent likelihood of increasing complexity through a completions type process)?
  - If none of the proposed approaches appeals, what approach would your State propose and why?
- Under any contemporaneous approach, should backcasting in its current limited form continue? If so, can/should backcasting be expanded to

[42] Western Australia 2013-14 Budget, Economic and Fiscal Outlook (Budget Paper no. 3), page 96. Following declines in actual mining royalty receipts compared with those forecast in its 2013-14 Budget, Western Australia's share of GST revenue in 2016-17 is expected to be around $2 billion.

cover a wider range of Commonwealth payments or other volatile revenues?

TREATMENT OF OTHER COMMONWEALTH PAYMENTS TO STATES

181 In the 2015 Review, the Commission adopted the following guideline to decide the treatment of all payments on a case by case basis:

> payments which support State services, and for which expenditure needs are assessed, will have an impact on the relativities.

182 The Commission considered that all Commonwealth payments which could be used to completely or partially offset the fiscal consequences of disabilities leading to differential assessed expenses should be recognised in assessing State GST requirements. If this were not done, some States would have the capacity to deliver above average services and others below average services.

183 The Commission also considered that Commonwealth payments not used to address differences it did not take into account in its calculations should not affect the GST distribution (that is, not redistribute GST revenue away from an equal per capita share).

184 This approach was consistent with the terms of reference provided to the Commission in the 2015 Review and also with the IGA. They asked the Commission:

- to ensure that some specified payments (usually referred to as quarantined payments), including all reward National partnership payments (NPPs), have no impact on the GST distribution
- to apply a 50% discount to specified payments for major roads[43]
- to treat National specific purpose payments (SPPs), National health reform (NHR) funding, project NPPs and general revenue assistance (GRA), other than the GST, so that they would affect GST shares, but treat facilitation NPPs so that they would not.

185 However, the Commission was given discretion to vary the treatment of the third group of payments where it was appropriate, 'reflecting the nature of the particular payment and the role of the State governments in providing particular services'. It concluded that in exercising its discretion it could be guided only by the objective of the GST distribution, which is the principle of HFE.

186 States appeared to support this approach, mainly debating the treatment of particular payments.

[43] In finalising the 2015 Review the Commission extended this treatment to major rail payments.

187 In this review, with the same clauses included in the terms of reference, it seems appropriate to ask if simpler approaches can be taken in deciding the treatment of other Commonwealth payments. For example, on simplicity grounds but still consistent with achieving HFE, could all payments:

- have an effect on the GST distribution, regardless of whether needs have been assessed
- not have any effect.

188 It may also be simpler if a materiality threshold were applied to deciding any treatment other than the default set out in the terms of reference. Otherwise the default would apply.

189 Over recent years, on average, around 3% of payments have been quarantined by terms of reference while around 60% have affected State GST shares, with the balance having no effect. This suggests that taking a simpler approach and adopting one treatment for all payments (other than quarantined payments) could result in a large change to State GST shares, as the distribution of the two groups of payments could be materially different.

190 In the last review, the Commission and most States did not consider the use of materiality thresholds consistent with the achievement of HFE. Neither did they consider that such an approach would necessarily increase simplicity – checking materiality would add another layer of complexity.

Some consultation questions.

- Are changes needed to the way other Commonwealth payments will be treated?

THE ASSESSMENT GUIDELINES

191 Since the 2010 Review the Commission has used guidelines to assist in the implementation of HFE. The guidelines allow the Commission to give effect to the HFE objective having regard to the supporting principles including what States do and practicality. They have been developed in consultation with the States.

192 The guidelines also form a key part of the quality assurance process. They allow the Commission to be confident all relevant steps in the decision making process are followed. They allow external parties to follow the Commission's decision processes and to form conclusions about whether due process has been observed.

193 The guidelines cover the following implementation processes:

- the steps for establishing and measuring disabilities

- when and how discounting decisions are made and applied
- the threshold change in the GST distribution for recognising a disability.

194 While the guidelines are used to inform the Commission's decision making processes, it retains the right to exercise judgment if its best endeavours to build a reliable assessment do not lead to an outcome consistent with its observations and understanding of State circumstances. Where the Commission deviates from the guidelines it will explain its reasoning.

195 The Assessment guidelines for the 2015 Review are included at Attachment A.

196 The application of the assessment guidelines resulted in a series of individual assessments of State revenue, expenditure and PSPs. The Commission brought these individual assessments together via the GST distribution model to calculate each State's GST requirement. The distribution model was based on the relationship between expenditure and revenue in the Government Finance Statistics (GFS) Operating Statement. The distribution model adopted by the Commission in the 2015 Review is described at Attachment B.

Establishing and measuring disabilities

197 An important purpose of the assessment guidelines is to set out how the conceptual case for recognising a disability should be established, when a method can be judged reliable, what is meant by data that are fit for purpose and of suitable quality. They also describe how an assessment should be adjusted if there is uncertainty about how fit for purpose are the data used in the assessment.

198 The Commission will include a disability in a category when:

- a presumptive case for the disability had been established, namely:
  - a sound conceptual basis for the disability exists
  - there is sufficient empirical evidence that the disability results in differences between States in the levels of use and/or unit costs in providing services or in their capacities to raise revenues
- a reliable method can be devised that is:
  - conceptually rigorous (for example, it measures what is intended to be measured and is, as far as possible, policy neutral)
  - simple to implement
  - easily understood
- data are available that are:
  - fit for purpose — they capture the influence the Commission is trying to measure and provide a valid measure of States' circumstances
  - of suitable quality — the collection process and sampling techniques are appropriate, the data are consistent across the States and over time and not subject to large revisions.

199 These guidelines aim to ensure the Commission takes a consistent approach in developing assessments and that the assessments are conceptually sound, reliable and as transparent and simple as possible.

Discounting

200 The 2015 Review guidelines required that the Commission make assessments consistent with the strength of the conceptual case, fitness of purpose and quality of the data and suitability of the method used to make the assessment. In some cases, the Commission chose to make an assessment but discount its effect on the GST distribution. It did this when it had some concerns about the measurement of a disability but a clear indication of the appropriate direction of the assessment.

201 The set of discounts used by the Commission were discussed in more detail in the Practicality section.

Materiality

202 The 2015 Review guidelines said that the Commission would include a disability in its assessments if it made a material difference to the distribution of GST revenue for any State. Materiality thresholds were first set in the 2010 Review to ensure only the main influences on State fiscal capacities were recognised and the assessments kept as simple as possible. For the 2015 Review the materiality threshold for a disability was set at $30 per capita meaning the disability had to redistribute more than $30 per capita for any State in the assessment period. The materiality test considered the total impact the disability had on the GST redistribution across all categories in which it was assessed. Options for updating the materiality threshold for a disability were discussed in more detail in the Practicality section.

Data sources

203 Public confidence in the measurement of State fiscal capacities and the equalisation outcome requires that the Commission use high quality data which are suitable for the intended purpose. As far as possible the Commission attempts to use data from national collections compiled by independent sources such as the ABS, the Independent Hospital Pricing Authority (IHPA) and the Australian Curriculum, Assessment and Reporting Authority (ACARA). These are more likely to be comparable across States and reliable.

204 The States are also important sources of data and, with the States, the Commission has developed a protocol for the provision of data. That protocol includes the development of standard definitions in requests for data, the collection of information on the extent to which data provided by States complies with the requirements, State and staff checks on the internal integrity of the data and explanations for unexpected movements in the data.

205 By using data from national collections and independent sources as much as possible, and establishing a protocol ensuring the quality of State data, the Commission aims to build and maintain confidence in the HFE process and outcome.

Implementing the guidelines

206 The assessment guidelines describe the Commission's process for establishing and quantifying disabilities arising from differences in the economic, socio-demographic, environmental and geographic characteristics of the States while having regard to practical considerations which affect the measurement of State fiscal capacities.

207 Revenue assessments aim to measure the revenue each State would raise if it applied the Australian average tax rates to its tax bases — that is, if it made the average effort to raise revenue. Revenue can be raised from taxes, user charges, fees and fines, mining royalties, interest and income from public authorities. Tax bases are generally measured using the value of transactions or goods in each State that would be taxed under the average tax policy. For example, the tax base for property transfers is the value of property sold and for mining revenue it is the value of mining production. A State has a revenue raising advantage if its share of the national tax base exceeds its share of the Australian population. In that case, making the average tax effort will yield above average per capita revenue.

208 Expense assessments aim to measure how much each State would spend to provide the average level of service to its population, given its characteristics, if it followed average expense policies. The average level of service is represented by the average expenses per capita, which encapsulates the average policies, service delivery efficiency and circumstances of the States. The average expenses per capita are adjusted up or down to allow for the financial impact of differences in State circumstances — but only to the extent that those circumstances are beyond the direct control of individual State governments. These adjustments reflect the effects of disabilities on State expenses. Differences in national spending levels arise because of differences in the service use patterns of particular groups and differences in unit costs of service delivery. For example:

- Hospital services are used more intensively by some age groups and by Indigenous people. States are assessed to have a disability if the groups that make most use of a service are a larger proportion of their population than they are of the national population. Conversely, they have an advantage (negative disability) if the size of the group is smaller than the national average.
- Higher costs might be incurred in providing services in large cities or in remote areas. States with relatively large populations in the groups that cost more (or living in regions that cost more) are assessed to have disabilities. Wage rates may also vary between States for reasons beyond the control of individual States and some States face diseconomies of small scale. However, higher costs

arising from a State's decision to provide a higher level of service do not constitute a disability.

209 In some cases, the Commission adopts an EPC assessment if it considers State capacities or spending depend on State shares of population alone, disabilities do not exist or it has not been possible to measure a material disability reliably.

Some consultation questions.

- Are changes needed to the assessment guidelines?

SUMMARY

210 On 28 November 2016 the Treasurer gave the Commission terms of reference for a 2020 Methodology Review. The terms of reference require the Commission to undertake a comprehensive review of all the methods underpinning its calculation of the GST relativities.

211 In the 2015 Review the Commission adopted certain supporting principles to assist it make and explain decisions on how it seeks to achieve HFE. However, the Commission made clear that the principles remain subsidiary to its primary objective of achieving HFE and they should not override that objective.

212 The four supporting principles identified in the 2015 Review were:

- What States do
- Policy neutrality
- Practicality
- Contemporaneity

213 Clause 6 of the terms of reference asks the Commission to consider whether the supporting principles it uses to guide its work remain appropriate. The Commission has identified contemporaneity and policy neutrality as being important issues for this review.

214 Commission staff have prepared this discussion paper seeking State views on the objective and definition of horizontal fiscal equalisation (HFE), and whether the supporting principles (and the way the Commission uses them) remain appropriate, or whether there are alternative approaches. In addition, this paper seeks State views on the implementation of the supporting principles, including policy neutrality, alternative approaches to achieving contemporaneity, discounting, materiality thresholds and the assessment guidelines.

215 Some specific consultation questions are asked in the paper. Staff seek State views on these. Any other views in relation to these topics are also welcome.

ATTACHMENT A — ASSESSMENT GUIDELINES

ASSESSMENT GUIDELINES FOR THE 2015 REVIEW

1 The Commission organises its work by making assessments for individual categories. Separate assessments will be made when they are materially different from other assessments or if the assessment is easier to understand if undertaken in a separate category.

2 The Commission will include a disability in a category when:

- a presumptive case for the disability is established, namely:
  - a sound conceptual basis for these differences exists
  - there is sufficient empirical evidence that differences exist between States in the levels of use and/or unit costs in providing services or in their capacities to raise revenues
- a reliable method has been devised that is:
  - conceptually rigorous (for example, it measures what is intended to be measured, is based on internal standards and is policy neutral)
  - implementable (the disability can be measured satisfactorily
  - where used, consistent with external review outcomes
- data are available that are:
  - fit for purpose — they capture the influence the Commission is trying to measure and provide a valid measure of States' circumstances
  - of suitable quality — the collection process and sampling techniques are appropriate, the data are consistent across the States and over time and are not subject to large revisions.

3 Data will be adjusted where necessary to improve interstate comparability. The Commission will not make data adjustments unless they redistribute more than $10 per capita for any State.

4 Where a case for including a disability in a category is established but the Commission is unable to make a suitable assessment of its impact, the options are:

- to discount the impact that has been determined
- to make no assessment.

5 The option chosen will reflect the specific circumstances of the assessment. It will depend on:

- the particular concerns about the assessment
- the strength of the conceptual case for assessing the category or the disability

- the reliability of the method and data
- the sensitivity of the assessment to the data used, measured in terms of the likely impact on State GST shares of an error in the data
- consistency with State circumstances.

6 When the assessment is to be discounted to improve the equalisation outcome, a uniform set of discounts is used, with higher discounts being applied when there is less confidence in the outcome of the assessment or more concern attached to the information. The discounts are:

- 12.5%, if there is not full confidence about the size of an effect because of a low level of concern with the information on which it is based
- 25%, if there is a medium level of confidence about the size of an effect or a medium level of concern with the information
- 50%, if an effect on States is known to be large and there is confidence about its direction but there is limited confidence in the measurement of its size due to a high level of concern with the information
- if there is little confidence in the direction of an effect or its size, no differential assessment would be made (100% discount).

7 The Commission will include a disability in its final assessments if:

- it redistributes more than $30 per capita for any State in the assessment period (the materiality test will be applied to the total impact the disability has on the redistribution of funds across all revenue or expense categories in which it is assessed)
- removing the disability has a significant impact on the conceptual rigor and reliability of assessments.

8 However, the disability may not be assessed in a category, if the amount redistributed in that category is very small and it is impractical to do so.

ATTACHMENT B — THE GST DISTRIBUTION MODEL

BRINGING THE ASSESSMENTS TOGETHER

1 A State's GST allocation (its equalising requirement) is the difference between its assessed spending on service provision and asset acquisition and its assessed revenues. More specifically, it is calculated as:

- the expenses it would incur to provide the average services (its assessed expenses) plus
- the investment it would make to have the infrastructure required to provide the average services (its assessed investment) less
- the net borrowing it would make to finish the year with the average per capita net financial worth (its assessed net borrowing) less
- the revenue it would raise if it made the average revenue raising effort (its assessed revenue) less
- the revenue from Commonwealth payments which are available to fund its spending requirements.

2 A per capita relativity is derived for each State by expressing its per capita GST allocation as a ratio of the national average per capita GST distributed in the year.

3 This calculation is undertaken for each of the three assessment or reference years. The per capita relativities recommended for use in 2015-16 (the application year for this review report) are the average of the annual relativities for the three assessment years 2011-12 to 2013-14.

4 A relativity below one indicates a State requires less than an EPC share of GST revenue; a relativity above one indicates it requires more than an EPC share. No State can have its relativity increased without one or more of the other States having theirs reduced. The box below explains what a relativity is.

5 A State's relativity changes from year to year for several reasons, including:

- its inherent characteristics change — for example, if its tax base grows more than the average, the State will become relatively stronger and its relativity will decline
- the characteristics of the other States change, affecting the State's relative position — for example, if the tax bases of the other States grow, the average will increase, the State will become relatively weaker and its relativity will increase

- the structure of State budgets change — for example, if State spending grows relative to State revenue, revenue differences will become less important, while differences in the cost of delivering services will become more important.

What is a relativity?

If States had the same economic, social and demographic features and Commonwealth payments were distributed uniformly among them, the Commission would recommend that the GST be distributed equally per person. Each State would be allocated the same (average) amount per resident.

However, some States are fiscally stronger than others — they have stronger tax bases, lower service delivery costs or receive above average Commonwealth payments. They need less GST revenue than other States if all States are to be fiscally equal.

That relative strength (or weakness) is measured by the State's need for GST revenue, compared to the average and is summarised in its relativity.

A stronger State might be assessed as needing only 90% of the average GST available on a per capita basis — its relativity would be 0.9. A weaker State might be assessed as needing 110% of the average, its relativity would be 1.1.

Some people have misinterpreted a relativity to be the proportion of the GST revenue raised in a State which is returned to that State. This would only be true if the GST collected per person were the same in every State, which given differences among the States is unlikely.

AN ALGEBRAIC PRESENTATION OF THE GST DISTRIBUTION MODEL

6 The algebraic identity underlying the GFS Operating Statement is used to bring together the Commission's revenue and expenditure assessments and derive the assessed GST revenue.

7 The model is based on the following budget identity.

$$(G_s + O_s + R_s) - (E_s + I_s) = N_s \qquad (1)$$

8 This identity occurs in all State budgets and says that the revenue States receive (from the GST, Other Commonwealth payments and from their own sources) that they do not use (as recurrent expenses or on new infrastructure) is saved.[44]

9 The budget identity can be rearranged to make the GST the dependent variable:

$$GST_s = (E_s + I_s + N_s) - (O_s + R)_s \qquad (2)$$

[44] Where 'N' is negative, States are net borrowers rather than net savers.

10 Working from the basic budget equation in (2) the assessed GST revenue a State needs can be calculated as the difference between what it needs to deliver the average level of services and if it made the same revenue effort.

$$\mathrm{AGSTR_i} = (A\mathrm{E}_i + \mathrm{AI}_i + \mathrm{AN}_i) - (AO_i + AR_i) \qquad (2)$$

Where:

i, s	subscripts used to denote an individual State (i) or all States (s)
N, E, I, R	net lending, expense, net investment and own-source revenue respectively
GST	GST revenue
O	other Commonwealth payments. These include Payments for Specific Purposes (PSPs) which the Commission has decided should impact on relativities.
AN,AE,AI,AR	assessed net lending, expense, net investment and own-source revenue respectively
AGSTR	assessed GST revenue requirement. The Commission's approach ensures States' assessed GST revenue requirement sums to the total GST revenue available ($\sum_{\mathrm{i}} \mathrm{AGSTR_i} = \mathrm{GST_s}$)

11 More information about the GST distribution model is available on the Commission's website.