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Commonwealth Grants Commission

2020 REVIEW

THE PRINCIPLE OF HFE AND ITS IMPLEMENTATION

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EXECUTIVE SUMMARY

Background and purpose of this paper

This paper presents the Commission's interim positions on the objective of horizontal fiscal equalisation (HFE), supporting principles and guidelines, and addresses associated implementation issues. It has been informed by a first round of consultations with the States and Territories as part of the Commission's 2020 Methodology Review. The positions taken in this paper will provide initial guidance for the Commission's further work on assessment methods, but will remain open to further consultation and possible adjustment over the remaining course of the review.

The objective of HFE

The Commission will continue to recognise the 'principle of HFE' using the same general approach that has guided its work on general revenue sharing since 1978. For the 2020 Review, the Commission proposes to continue using the specific definition first articulated 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.

Subject to terms of reference, the Commission will continue to consider HFE as the sole objective that guides its choice of methodologies.

Supporting principles

The Commission's view is that the four existing supporting principles should be retained, but with some further clarification of their purpose and scope. The Commission considers that, wherever possible, methods should be chosen having regard to all of the supporting principles. The interaction and subsequent constraints between the supporting principles requires a balancing of competing considerations when determining the choice of methods. This balance may vary with the varying structural elements of the Commission's methodology and with the varying underlying circumstances in each area of assessment. The Commission does not propose to establish any prior ranking or weighting of the supporting principles.

What States do

This supporting principle ensures that the range of activities for which the States apply GST (and other) revenue are reflected in the Commission's recommendations. It applies

mainly to deciding the scope of assessments and to identifying relative needs. It refers to what States collectively do (rather than what each does individually) because the assessment of fiscal capacity is based on determining what State revenues and expenditures would be under a common policy. The common policy assessed by the Commission generally is the (weighted) average policy of all States combined.

What States do sets the standard, rather than an external judgment of what States should, or could, do. As the roles, functions, priorities and circumstances of the States change, so does the assessment of their fiscal capacities.

Policy neutrality

This supporting principle aims to ensure that State policy choices have minimal direct influence on HFE assessments and, conversely, that HFE has minimal direct influence on State policy choices.

Any equalisation has the potential to interact with policy choices, but these aims can be achieved satisfactorily in most cases through assessing fiscal capacity on the basis of the weighted average of the policies of the States. In most cases, each State has only a small influence on the average policy of all States.

However, exceptions can arise, and over the past decade these potentially have become significant in the case of State mining revenues. The Commission considers that its current assessments of mining revenues appropriately support the achievement of HFE. However, the assessment methods risk undue conflict with the policy neutrality principle in some circumstances — the Commission will aim to modify the operation of its assessments in those circumstances to secure greater policy neutrality. In particular, the Commission wishes to ensure its assessment methods do not distort a State's consideration whether or not to make a tax rate change.

Where practicable, the Commission will ensure that future discretionary revenue policy changes do not excessively change the GST distribution. It will do this by limiting the extent to which any discretionary change in royalty (or tax) rates by a State which has a dominant role in the production of a mineral (or tax base) flows through to the assessed revenue capacity of that State. The result generally will be that, after consideration of changes to its GST share, a dominant State will retain at least half of the own-source revenue effects of its tax or royalty rate change.

The Commission will also aim to strengthen application of the policy neutrality principle in two further ways. It will aim to ensure that assessments do not unduly penalise or reward States which, in similar circumstances, adopt very different policies towards potential mineral and energy developments (for example, coal seam gas production). For revenue assessments generally, the Commission will aim to minimise, to the extent practicable, tax reform disincentives arising from the effects on tax bases (elasticity effects) of tax policy choices.

Practicality

This supporting 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.

The Commission has decided to add a further element to the practicality principle, namely 'fitness for purpose'. States have emphasised to the Commission their need for transparent, reliable and, where possible, reasonably predictable relativities in time for their State budgets. The Commission therefore intends that this principle also support methods that provide relativities that are practical for States to incorporate into their budget management processes.

Contemporaneity

The main meaning of this supporting principle is that, subject to other practical considerations, the Commission should seek to minimise the lag between the years in which reliable data are available to make an assessment (for example by narrowing the assessment window) and the year in which the resulting relativities will be applied (the application year).

Since 2010, the assessment window has been the most recent three years for which reliable data exist. Instead, one State argues in favour of using estimates of the application year outcomes, on the basis that it seeks to have its GST share directly offset volatility in its own source revenues, thereby assisting its budget management. However the Commission is not attracted to using State, or independent, estimates or forecasts of revenues in the application year. These are unlikely to be sufficiently reliable for use as the basis of the GST distribution.

Conversely, most States support the current approach, on the basis that it provides greater predictability of GST shares, and hence assists with their budget management. Notwithstanding this, the Commission is not settled on whether the size of the assessment window should be changed, and will give further consideration over the course of the review as to whether the assessment window should comprise the most recent one, two or three years.

Implementation issues

Subject to terms of reference, the Commission will retain its current guideline for the assessment of Commonwealth payments to the States, namely that payments which support State services, and for which expenditure needs are assessed, will affect GST shares.

In support of simpler methods, the Commission will continue to assess State needs only where doing so makes a material difference to the distribution of GST revenue for any State. For this review, the Commission intends to increase materiality thresholds only to

the extent that they retain their value after adjusting for price and wages increases. The materiality threshold for a disability will be set at $35 per capita (an increase of $5 since the 2015 Review) while the threshold for data adjustments will remain at $10 per capita.

The Commission will continue its current approach of discounting its measurement of disabilities where there are substantive concerns about the data available. Three levels of discount may be applied – low (12.5%), medium (25%) and high (50%) – depending on the Commission's judgment about the reliability of the data for the purposes of the assessment.

Next steps

For the remainder of 2017 and through 2018, the primary focus of the Commission will be in applying the objective and principles to its specific assessments, identifying material factors beyond the control of States that affect their revenue raising capacities and expenditure needs. States will be invited to make further submissions on the definition of HFE and the supporting principles and guidelines later in 2018, having regard also to any Government decisions on the findings of the Productivity Commission review of the system of Horizontal Fiscal Equalisation.

1. THE OBJECTIVE OF HFE

Background

1.1 The Commonwealth Grants Commission (the Commission) makes recommendations each year for the distribution of GST revenue among the States. It completed its last comprehensive review of methods in 2015. On 28 November 2016, the Treasurer gave the Commission terms of reference for a 2020 Methodology Review (the review).[1]

1.2 Consistent with the *Intergovernmental Agreement on Federal Financial Relations* (the IGA), the Commission is required by the terms of reference to base its methods on the principle of horizontal fiscal equalisation (HFE). The first stage of the review is to adopt a clear statement of the definition of this principle, and to specify the supporting principles and guidelines that the Commission will use to develop its specific assessment methods.

1.3 This paper presents the Commission's interim positions on the definition of HFE and the supporting principles and guidelines for its implementation. It has been informed by a recently completed first round of consultations with the States.[2] The positions taken in this paper will provide initial guidance for the Commission's further work on assessment methods, but will remain open to further consultation and possible adjustment over the remaining course of the review.

1.4 The terms of reference direct the Commission '…to 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.' An understanding of what HFE is and its purpose in Australia's fiscal federalism arrangements provides useful context when considering the Commission's approach to its task. This is discussed in the box *HFE in context*.

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[1] The complete terms of reference for the 2020 Review can be found on the Commission's website, (https://cgc.gov.au/).

[2] 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.

HFE in context

HFE ensures that each State in Australia has the same fiscal capacity to deliver services. Each State may pursue its own policies and priorities, but its fiscal capacity to do so is equalised, taking account of the differences between jurisdictions in their tax bases and their service delivery needs or costs. In practice most of the spending by the States delivers a broadly similar set of services across Australia, and HFE makes this possible because each State has the same fiscal capacity.

Major public services are delivered to Australians by both the Commonwealth and State governments. The Commonwealth collects most of the tax revenue for both levels of government. In addition to defence and customs, the Commonwealth also delivers most of the social assistance transfers (pensions, family allowances, Medicare payments and pharmaceutical benefits) and plays the major role in funding many service areas such as universities, child care and aged care.

These policies are generally applied on a common basis in all States, so that in all these areas there is effective fiscal equalisation operating throughout the Commonwealth. More Commonwealth tax is collected from taxpayers in States with stronger tax bases, and more Commonwealth spending occurs in States with higher needs, simply because the same Commonwealth policies (obligations and entitlements) apply across all States.

Over 80% of State spending relates to programs in five broad areas – health (mainly public hospitals), education (mainly public schools), justice services, roads and public transport and some remaining welfare and social housing services. While the Commonwealth has been playing an ever increasing role in most of these areas, the States retain major roles, including responsibility for service delivery. HFE makes it possible for every State to provide broadly similar standards of services in these and other areas.

Thus HFE achieves the benefits of equalisation that would otherwise require transfers of function to the Commonwealth, without losing the benefits of decentralised governance and administration provided by sub-national jurisdictions. The payment of HFE grants as general revenue assistance allows State governments to deliver services according to State specific needs and circumstances. The combination of fiscal equalisation with decentralised governance is a longstanding feature of the Australian federation (as well as many other federations).

Where equalisation is absent or limited, substantial differences in service levels or tax levels arise across States or provinces, with substantial consequences for spatial inequality. This is evident in a few federations, notably the United States of America, although even then there is some equalisation, either through federally funded support programs in areas like schools, or through ad hoc spending proposals adopted through legislative processes (described as ‘earmarking’).

Any substantial change in fiscal equalisation in Australia is likely to have far-reaching

consequences over time for the functioning of Australia's federation, including the relative roles of the Commonwealth and States.

The objective of HFE as now applied in Australia — that States should receive untied transfers from the Commonwealth such that they have capacity to deliver comparable levels of services after imposing comparable levels of taxation — has been in place for decades, in one form or another, and almost certainly has underpinned the evolution and current form of our federal arrangements.

Since 2000-01, the pool of funds set aside by the Commonwealth to achieve HFE between the States is an amount equivalent to that raised through the imposition nationally of the goods and services tax (GST).[3] Before 2000, a range of other pools of funds were used, particularly after 1942 when the Commonwealth assumed the sole right to levy income taxes, and 1978 when formal State tax sharing arrangements were legislated (then later modified and extended to the Territories).

State views

1.5 The Commission released Staff Discussion Paper CGC 2017-02-S *The principle of HFE and its implementation* on 12 May 2017, with submissions sought from States by 28 July 2017. Views attributed to States in this paper reflect the positions States expressed in those submissions and in subsequent discussions between the Commission and State Treasurers and State Treasury officials during August 2017.[4]

1.6 With the exception of New South Wales, States support the objective of HFE. Most States note that the 2020 Review terms of reference and the IGA clearly require the Commission to recommend a distribution of GST revenue in such a way as to achieve HFE and this is the sole objective. Some argue that the achievement of HFE among the States is a strength of the Australian federation, and translates into practice a belief that Australians should have access to similar standards of State services, with comparable levels of taxation, regardless of the jurisdiction in which they live.

1.7 New South Wales disagrees, arguing that the GST revenue should be distributed on a population share (or equal per capita — EPC) basis. New South Wales' view is that an EPC distribution would still involve some equalisation (in that even under an EPC approach, New South Wales would still receive less than its share of the consumption tax base). However, an EPC distribution it says would be simpler, more objective, more predictable and more easily understood. Further, New South Wales says that the Northern Territory (and arguably the ACT) should be excluded from the HFE process and funded separately by the Commonwealth.

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[3] Less an amount representing the administrative cost to the Commonwealth of raising the GST.

[4] State submissions are available in full on the Commission's website, (https://cgc.gov.au/). New South Wales advised the Commission that its submission to the Productivity Commission (PC) Inquiry into HFE represented its views on these issues. Accordingly, views attributed to New South Wales reflect those expressed in that submission.

1.8 Most States supporting the objective of HFE accept this means equal fiscal capacities should be the outcome. They therefore supported the continued use of the current definition in the 2020 Review.

1.9 While Western Australia considers the current definition reasonable, it states that assistance should provide States with the capacity to provide an 'acceptable' standard of service to their communities. This suggests Western Australia may not support full equalisation, at least as currently understood.

1.10 Queensland argues that the word 'same' (standard of service or revenue raising capacity) should be replaced. It argues that the 'same' is unattainable and the definition should reflect what is possible. Queensland suggests replacing the word 'same' with 'similar' as this would create the potential for a simpler and more transparent system.

Commission position

1.11 In 1978, the Commonwealth asked the Commission to review States' shares of general revenue grants. It specified the principle it wanted the Commission to apply in section 13(3) of the *States Personal Income Tax Sharing Amendment Act 1976*.[5]

> 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.

1.12 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 in 1999.[6]

1.13 The Commission takes the view that the terms of reference are clear: it is to recommend how the GST should be distributed in accordance with the 'principle of HFE' as clearly understood and accepted by all governments when they signed the 1999, and subsequent, IGAs. 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, nor is it given discretion as to which States the principle of HFE should be applied.

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

[6] 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.

1.14 It is not clear that 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. Distributions that advantage certain revenue bases over others (such as the calls for global discounting of mining revenue assessments), or distributions based solely upon State population shares (as proposed by New South Wales), are not consistent with equalising State fiscal capacities — the goal the Commission has been set. As required by its terms of reference, the Commission must seek to deliver as close as it can to 'full', not 'partial', equalisation. Accordingly, the Commission does not consider discounting certain revenue bases or an EPC distribution of GST revenue would deliver HFE or be consistent with the Commission's terms of reference. Rather, such a distribution would exacerbate differences in fiscal capacity between the States and so likely increase disparities in the provision of State services.

1.15 In summary, the Commission's view is that it must recommend a distribution of GST revenue on HFE grounds consistent with the IGA and its terms of reference. It intends to retain the definition of the HFE principle adopted in the 2015 Review. That definition is as follows:

> 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.

1.16 The definition focuses on the main task of the Commission: to identify factors (also referred to as 'disabilities') affecting State finances that are beyond their direct control and which would cause their fiscal capacities to diverge. Using these factors, 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.

1.17 The Commission does not consider there is any benefit in changing the wording to 'similar', or 'acceptable', rather than 'same', as it would potentially lead to debates about how 'similar' standards of service and revenue raising capacity should be, or what 'acceptable' means. 'Same' is aspirational but the Commission will deviate from this only for reasons of practicality. The Commission prefers to have a clear objective and does not consider changing the definition would lead to a simpler or more transparent system.

1.18 The reference to material factors in the definition makes it 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.

1.19 Material factors 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.[7,8]

1.20 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.

[7] Under an EPC distribution each State would receive its population share of GST revenue.

[8] 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 section on Implementation issues.

2. SUPPORTING PRINCIPLES

2.1 The Commission has developed supporting principles to guide its approach to achieving HFE. Clause 6 of the terms of reference asks the Commission to consider whether the supporting principles it uses remain appropriate, including whether different weights should be given to different supporting principles.

2.2 The supporting principles are neither separate objectives nor necessarily pre-conditions for methodological choices. The Commission considers that wherever possible, methods should be chosen with regard to all of the supporting principles. The interaction and subsequent constraints between the supporting principles requires a balancing of competing considerations when determining the choice of methods. This balance may vary with the varying structural elements of the Commission's methodology and with the varying underlying circumstances in each area of assessment. The Commission does not propose to establish any prior ranking or weighting of the supporting principles.

State views

2.3 All States except New South Wales and Western Australia expressed support for retaining the supporting principles from the 2015 Review. In addition, Victoria, South Australia, Tasmania and the Northern Territory do not consider a hierarchy of principles should be developed and argue the Commission should use its judgment to determine the relative priority of the principles on a case-by-case basis. These States consider the supporting principles assist the Commission to implement HFE in a consistent and coherent way.

2.4 The ACT considers that there is already an implicit weighting built into the current listing of the principles and that 'what States do' and 'policy neutrality' are the most important. It argues the Commission should make trade-offs on the basis of HFE.

2.5 Queensland advocates a hierarchy (and supports renaming the principles as guiding considerations) to help States better understand the Commission's decision making processes. It emphasises the importance of:

- practicality, particularly simplicity, which helps to build the credibility and robustness of the system
- what States do, which is critical in determining the scope of HFE and the factors affecting State finances
- policy neutrality, because the HFE process should not be allowed to be a significant consideration for policy makers.

2.6 Queensland does not suggest how a hierarchy might be developed or used.

2.7 Western Australia argues for a new set of principles and argues the following:

- HFE cannot be achieved without policy neutrality, because it is integral to a GST distribution that reflects States applying the same effort and not having their policy decisions distorted
- the way the 'what States do' principle is used leads to a micro approach to assessments which increases complexity and bias, leading the Commission away from HFE
- the practicality principle is used to override HFE rather than guiding sensible responses to assessment issues
- contemporaneity is not achieved due to the use of average historical assessments and this causes significant budget management difficulties.

2.8 Western Australia proposes the following fundamental principles.

- Policy neutrality, proposing that broader indicators should be used, particularly for revenue assessments, so that GST grants are not affected by revenue or spending mixes or differences in policies that affect revenue bases and spending needs.
- Equity, so that underlying disabilities are recognised (rather than their detailed manifestations), consistent with policy neutrality, broadly reflecting State policies.

2.9 Western Australia further proposes the following principles to guide implementation.

- Contemporaneity — by using forward estimates volatility would be recognised as it occurs (using budget estimates and later corrections), or long run capacity should be recognised.
- Conservatism — a State's fiscal capacity should be presumed to fully or partly reflect its own effort if there is no, or partial, evidence to the contrary, so that the Commission should use caution in redistributing away from EPC.
- Accountability, simplicity and transparency
  - High level implementation decisions should reflect a consensus view of Governments or decisions of the Commonwealth Treasurer (where consensus cannot be reached). The Commission should be responsible for implementation, not policy.
  - The Commission's methods should undergo regular peer review, which could possibly be made up of a number of independent experts commissioned to conduct reviews.
  - There needs to be full documentation of methods which should be clearly described and simple.

2.10 New South Wales did not discuss the current supporting principles. Instead, it proposes a new set of principles to guide an appropriate distribution of the GST.

2.11 New South Wales argues that a well-designed and carefully targeted system of HFE, achieved in its view by an EPC distribution, must be consistent with the following principles.

- Fairness — the distribution of GST revenue should be fair in the eyes of Australians. The system should provide sufficient revenue for States to provide minimum levels of selected critical services – health, education, law and order and infrastructure. No single State should bear an unreasonable burden that would detract from their responsibilities towards their own constituents.
- Efficiency — the distribution of GST should not create disincentives for economic adjustment and reform relating to expenditures or taxes. The benefits of pursuing equity should be greater than the efficiency cost.
- Simplicity — the mechanism should be simple to understand and administer. It should be easy to replicate.
- Accountability — should apply to both the body making the calculations of GST distribution and to the Commonwealth and State governments who must be responsible to their citizens for the spending and revenue choices they make.
- Stability — GST revenue distribution needs to be more predictable so that State governments can confidently budget to provide essential services.

Commission position on the role of supporting principles

2.12 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).

2.13 The supporting principles are guiding considerations for the Commission in determining its methodologies. They are neither separate objectives nor pre-conditions for methodological choices. In most cases all or most of the supporting principles apply concurrently and so each is constrained by the others. Their relevance and role inevitably varies according to the issues and circumstances under consideration.

2.14 The Commission's view is that for the 2020 Review the four existing supporting principles should be maintained, but with some further clarification of their purpose and scope. It considers that wherever possible methods should be chosen with regard to all of the supporting principles. Accordingly it does not propose to establish any

prior ranking or weighting of them. The balance of considerations may vary with the varying structural elements of the Commission's methodology and with varying underlying circumstances in each area of assessment. The four supporting principles are:

- what States do
- policy neutrality
- practicality
- contemporaneity.

Commission position on 'what States do'

2.15 This supporting principle ensures that the range of activities for which the States apply GST (and other) revenue are reflected in the Commission's recommendations. It applies mainly to deciding the scope of assessments and to identifying relative needs. It refers to what States collectively do (rather than what each does individually) because the assessment of fiscal capacity is based on determining what State revenues and expenditures would be under a common policy.

2.16 Following the 'what States do' supporting principle means that the common policy assessed by the Commission generally is the (weighted) average policy of all States combined. What States do sets the standard, rather than an external judgment of what States should, or could, do. As the roles, functions, priorities and circumstances of the States change, so does the assessment of their fiscal capacities.

2.17 More specifically, as a result of following this supporting principle:

- the scope of the assessments reflect the average range of services provided collectively by States and the average range of taxes and other general purpose revenues imposed by them in order to fund 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 actually affecting the cost of delivering State services and the capacity to raise State taxes.[9]

Scope of equalisation

2.18 The Commission intends to retain the existing scope of equalisation — general government, plus urban transport and public housing public non-financial

[9] 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 section on Implementation issues.

corporations (PNFCs) and excluding local government (except for the interactions between it and the State sector).

2.19 The Commission considers neither the IGA, nor terms of reference, provide it with a basis for discriminating between services or revenues. Therefore it considers 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.

2.20 A comprehensive scope is also fully consistent with a policy framework that encourages innovation in service delivery or revenue raising. It would make no sense, for example, for the Commission to consider only service delivery spending in the general government sector where some of that category spending, in some States, is delivered through PNFCs. A comprehensive scope limits the risk of inadvertently favouring or prejudicing certain ways of doing things through the creation of artificial distinctions.

2.21 The Commission intends to continue to equalise the fiscal outcome of States so that they have the same average per capita net financial worth. That is, as in the 2015 Review, the equalisation objective will be implemented 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.

2.22 This approach 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 same capacity to earn income, or else that State holdings of different mixes of financial worth are their policy choice. Some States raised methodological issues associated with this approach. These will be considered in more detail through the development of the capital assessments.

Internal standards

2.23 The Commission continues to have a strong preference for internal standards. However, in circumstances of extreme policy non-neutrality, where it is difficult to determine what average policy would be, the Commission may consider the use of external standards, if another suitable resolution cannot be found.

2.24 Average State expenses, infrastructure and revenues will be derived generally by dividing the total collective State expenses, infrastructure and revenues by the total

of State populations. Average revenue raising efforts generally will be derived by dividing the total collective State revenue by the total collective State tax bases. These averages will therefore be influenced by what States do, to the extent each State undertakes the activity.

2.25 In relation to service delivery, the Commission intends to continue to observe what the data tell 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. In this way the Commission will recognise what each State would need to spend if it spent these average amounts on its own population groups.

2.26 The Commission notes that, as changing internal standards in any way would destroy the relationships it observes, it does not intend to discount or otherwise adjust standards as a means of more actively encouraging efficiency. The Commission will equalise 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 this above average inefficiency itself.

2.27 The Commission observes that different tax bases in States attract different (sometimes nil) rates of tax. These differences reflect constitutional, historical and economic conditions over the course of the development of States. The Commission's view is that differences in States' fiscal capacity cannot be appropriately recognised without taking account of these differences.

2.28 The Commission acknowledges that the problems of data quality and policy neutrality associated with a detailed approach could potentially be solved or reduced with the use of a broad indicator. However, the Commission would only consider adopting a broader indicator if it were judged to be a more reliable indicator of States' capacity to raise revenue than any alternative approach.

Weighted averages and average policy

2.29 Where States follow different policies, the Commission needs 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.

2.30 In adopting internal standards, 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. The more populous States, New South Wales and Victoria, generally have the largest effect on standards, but this is not always the case. A State with more of a revenue base (for example, Western Australia in regard to iron ore and Queensland in regard to coal) will have a larger effect on the average tax rate used to calculate the relevant revenue raising capacity if these minerals are assessed

separately. Similarly, States with the greatest number of Indigenous people (New South Wales and Queensland) will have a larger effect on the average State spending on services to Indigenous people.

2.31 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. The Commission intends to continue to adopt this 'weighted average' approach as its general approach, where average policy reflects the average of what all States do, recognising that some States may make a zero effort.

2.32 Under this approach to average policy, if even one State does something (raises a revenue or provides a service), the revenue raised or spent becomes a part of what States do collectively. However, a differential (to EPC) assessment will only be made if it will have a material effect on the GST distribution. In this way, average policy is not a switch, where States collectively either do, or do not do, an activity; rather it is a continuum, where:

- the average effective tax rate on a base is a reflection of the share of the tax base taxed by States[10]
- the average per capita spending on a service will depend on the total amount of money spent on that service, regardless of in which States that money is spent.

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

2.34 The Commission observes that, where only one State raises a tax or provides a service, the average effective tax rate or national per capita spending is most likely to be very low and a differential assessment is 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.

2.35 The Commission notes that applying this approach to determining average policy might at times need to be modified due to practical considerations; for example, where reliable assessments cannot be made. Data limitations can mean the approach may not always be implementable in a pure way. In these cases the Commission intends to use its discretion in deciding the methods to be adopted.

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[10] 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.

Disability measurement

2.36 The Commission intends to continue to use the general approaches it has used in the past and for its assessments to reflect what States do on average.

2.37 For revenue assessments, it can often do this easily. For example, in the case where a revenue assessment uses the base that States actually tax, actual (national average) tax rates can be applied to that base.

2.38 In expense assessments, the Commission typically relies on what the data tell it about what States do, including the populations to whom they provide services. 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 is calculated. The Commission then takes total spending by States on different population groups and divides that 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).

2.39 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.

2.40 There are population groups that the Commission may not include in any differential assessment, for a variety of reasons. For example, 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.
- 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. There is some evidence that the population of recent refugees falls into this category.
- 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.

2.41 Under the 2015 Review approach there are some assessments where the relationship between what States do and how the Commission assesses State needs is less direct. For example:

- 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.

2.42 Population growth, and other aspects of the capital assessments, are proxies for the pressures States face in their capital requirements.

2.43 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.

2.44 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. Similar approaches in the 2020 Review will be considered in detail over the course of the review as individual assessments are developed.

Commission position on policy neutrality

2.45 This supporting principle aims to ensure that State policy choices have minimal direct influence on HFE assessments and conversely, that HFE has minimal direct influence on State policy choices.

2.46 Any equalisation has the potential to interact with policy choices, at least indirectly. However, minimising direct influences can be achieved satisfactorily in most cases through assessing fiscal capacity on the basis of the weighted average of the revenue and expenditure policies of the States. The Commission does not consider that any policy neutrality improvements that might flow from adopting a rotating State average approach would offset the increase in complexity that would flow from operationalising such an approach. A rotating standard approach was not supported by any State.

2.47 Each State's GST requirement will be based on average policies, so that a State's incentive to change its own policies in the expectation 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 in calculating GST shares for the difference between the average policy and a State's 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.

Dealing with policy neutrality of State revenue raising capacity

2.48 The Commission accepts that adoption of broader indicators, particularly for revenue assessments, would improve policy neutrality, but it does not agree that this would necessarily result in an improved HFE outcome when appropriate regard is had to all supporting principles. The Commission does not agree with the view that HFE can only be achieved with complete policy neutrality, and that policy neutrality can only be achieved with a 'long term view' of what States do, as argued by Western Australia.[11]

2.49 Western Australia has again raised the issue of its investment in the North-West shelf as representing a policy influence on its mineral reserves that should be recognised in the Commission's mining revenue assessment. While the revenue associated with this project can be identified, what cannot be determined is how much of the revenue from the North-West shelf can be attributed to Western Australia's efforts, and how much of Western Australia's efforts were above the average effort across all States. Similarly, any additional revenue that may be attributable to various economic development projects (reflecting above the average effort) in other States cannot be identified.

2.50 In the absence of evidence that certain States have invested more, or invested more effectively, in the development of their State's economic base (leading directly to enhanced State revenue bases), the Commission cannot separately identify revenue raised due to the effects of above average effort on the revenue base. There is no reason to assume that a discount (as proposed by some States) would produce a more reliable HFE measure as this would assume that in all cases, States with higher than average revenue raising capacity are in this position because of greater, or more effective, historical State development policies. Similarly, a discount would assume that States with lower than average revenue raising capacity have so because of lesser, or less effective, historical State development policies. A discount would assume, for example, that the ACT's lack of a mining industry is due, at least in part, to its own lack of effort to develop such an industry, not to a lack of mineral resources.

2.51 Western Australia also argued that the current approach can result in a high loss of GST grants from increased tax compliance. This is because increasing compliance will increase the size of a State's tax base, increasing its relative revenue raising capacity for that tax. The Commission's view is that States mainly settle on a level of compliance activity that balances tax receipts with the costs of collection. It is more likely that diminishing returns, resulting from when collection costs increase at a

[11] Western Australia said that the effects of past policies on current revenue bases should necessarily be recognised in some manner, including by applying a discount.

faster rate than tax receipts increase, would have a larger effect on compliance policy than GST effects.

2.52 Other assessment issues raised by States, such as proposals to determine revenue bases as the sum of individual revenue bases, with adjustments to convert motor vehicle numbers and land values from stocks to flows, will be considered through the course of the review as assessments are developed.

2.53 The legislative incidence of State revenue raising policies affects rates of tax, as well as the tax base to which those rates are applied. In applying a common policy to determine States' revenue raising capacities, the Commission adopts different approaches depending upon the circumstances.

2.54 There are a number of circumstances where the Commission has had to address policy neutrality concerns relating to the comparability of States' revenue rates and bases.

Dealing with policy neutrality concerns relating to revenue rates

2.55 In most cases, each State has only a limited influence on the average rate policy of all States. However, exceptions can arise, and over the past decade these have become potentially significant in the case of State mining revenues. Where a tax base is concentrated in one or two States (such as iron ore in Western Australia and coal in Queensland), the policies of those States have a dominant role in determining average policy for assessments, particularly where minerals are assessed separately.

2.56 The Commission considers that its current assessments of mining revenues appropriately support the achievement of HFE. However, the assessment methods may conflict with the policy neutrality principle in some circumstances — the Commission will aim to modify the operation of its assessments in those circumstances to achieve greater policy neutrality. In particular, the Commission wishes to ensure its assessment methods do not distort a State's consideration whether or not to make a tax rate change.

2.57 The Commission indicated in the 2015 Review that any policy change by States in the case of mining revenue would lead it to review the assessment approach, but this gives little guidance on how the Commission would respond. For the 2020 Review, the Commission will make its approach clearer and more predictable. Where practicable, it will ensure that future discretionary revenue policy changes do not excessively change the GST distribution. It will do this by limiting the extent to which any discretionary change in royalty rates by a State (which has a dominant role in the production of a mineral) flows through to the assessed revenue capacity of that State (see the discussion in the box on *HFE and mining revenue policy* for further details).

2.58 This recognises (as do the Commission's methods more generally) that discretionary changes in tax or royalty rates do not necessarily represent equivalent changes in

fiscal capacity. The result generally will be that, after consideration of changes to its GST share, the State will retain at least half of the own-source revenue effects of its policy change.

Dealing with States applying a nil rate to a revenue base

2.59 A State may apply a nil rate to a revenue base in circumstances where reliable data are available to estimate the revenue base for that State. This occurs in the case of the Land tax assessment, where the Northern Territory does not raise this tax. For the purposes of the Commission's assessment of the Northern Territory's capacity to raise land tax if it followed average policy, the Commission imputes for it a land tax base.

Dealing with uncertain distributions of State revenue bases

2.60 Revenue may be raised from a revenue base in circumstances where the distribution of that revenue base across States is unclear because specific policies relating to that activity are highly variable among the States. Gambling revenue is an example of this circumstance, where the legal framework for gaming varies considerably across the States, on the numbers and placement of gaming machines in particular. In the case of gambling revenue the Commission has taken the view since the 2010 Review that, because it cannot identify comparable revenue bases across States, it cannot construct a reliable and materially differential assessment. Therefore it makes an EPC assessment of gambling revenue (which does not influence GST shares).

2.61 The Commission in the 2020 Review will consider whether similar considerations arise in certain potential mineral and energy developments. One such possibility may occur in the case of the mining of coal seam gas (CSG).[12] While Queensland and South Australia currently have no restrictions on onshore oil and gas exploration and development, New South Wales, Victoria, Western Australia, Tasmania and the Northern Territory all at present either ban coal seam gas exploration and/or development, in some or all areas, or have a moratorium on fracking.

2.62 In these circumstances, the Commission could take the view that all States that have CSG have the opportunity to exploit it and whether they do or not solely reflects policy choice. Similarly to gambling revenue, this view could lead to an EPC assessment of States' capacities to raise royalty revenue from CSG production, meaning that the royalties raised on CSG gas would not lead to a redistribution of GST revenue away from an EPC distribution. The Commission will address this issue in the 2018 Update (if it is material) and further in the relevant category assessment over the course of the 2020 Review.[13]

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[12] Similar considerations also apply to the mining of uranium.

[13] To date the Commission has not yet had to decide these issues because neither CSG nor uranium royalty revenues have been sufficiently large as to result in a material assessment.

2.63 In situations such as the CSG case, the Commission is not attracted to imputing a base for the banning States, based say on known gas reserves. This is because where exploration has been banned or discouraged known reserves may be incomplete, and not all known reserves have the same economic value. The economic value of mineral reserves depends upon a range of factors, such as the grade of the mineral deposit along with the ease (or otherwise) of access to the deposit (affecting production costs). The relevant commodity price is a major influence on whether a deposit is viewed as economic.

Dealing with tax rate effects on a revenue base

2.64 For revenue assessments generally, the Commission will also aim to ensure, to the extent practicable, tax reform disincentives arising from the direct effects on tax bases (elasticity effects) of tax policy choices are minimised.

2.65 The general approach of the Commission is to assess revenues on the basis of a common (average) revenue policy. It is reasonably straightforward to estimate the average rate of tax to apply in such assessments, but it is less clear what the tax base of each State would be under such a common policy. In the past, the Commission's assessments have in some cases reflected elasticity adjustments of tax bases, but these have not been continued due to the difficulty of finding reliable and material estimates of elasticity effects.

2.66 In this review the Commission is undertaking further research on this issue, and will consider whether elasticity effects can be reliably estimated and are material and, if they are, how they should be recognised, consistent with achieving HFE.

HFE and mining revenue policy

This section addresses the issue of how the supporting principle of policy neutrality should be reflected in the Commission's assessment of mining revenues.

The changing fiscal role of mining revenue

Over the past decade, the role of mining revenues in fiscal equalisation has significantly increased. States' mining revenues, mainly from iron ore and coal, have increased more than four-fold since the early 2000s. The expansion of mining has had major implications for the structure of Australia's economic development and for the distribution across Australia of State fiscal capacities.

The expansion of Australia's mineral and energy industries has been generated mainly by the continuing emergence of China and other Asian countries as leading growth engines of the world economy. Australia's endowments have made it possible for it to enter into the rapidly expanding Asian supply chain, mainly as a provider of raw materials, particularly iron ore and coal.

While there has been some cyclical element in the price of commodities, the mining expansion is largely long term and structural. The fiscal capacity of Western Australia, the main mining State, has been transformed: while it received greater than average per capita Commonwealth funding throughout most of the 20th century under fiscal equalisation arrangements, it now requires much less than average funding under the same arrangements, due overwhelmingly to its high share of State mining revenues, which have greatly increased its fiscal capacity.

Applying the HFE supporting principles to mining revenues

Mining differs from most other State tax bases for the following reasons.

- Mineral activity is highly unequally distributed across the States.
- Each mineral product has long had a different effective tax (royalty) rate.
- The conceptual driver of the tax base is unclear — royalties probably are set with regard to the underlying profitability of mining activities but the royalty base itself is generally the gross value of production rather than profit. States have adjusted some royalty rates in recent years to reflect the higher profitability of many major mining developments, but royalty rates otherwise have tended to be relatively stable over time.

The unusual features of the mining revenue base in Australia present unique challenges in applying, and appropriately balancing, the supporting principles for HFE. In general, the 'what States do' and practicality principles have been applied reliably to mining revenues in much the same way as to other assessments, while the issues raised by some States due to the interaction of the contemporaneity supporting principle with budget management processes are well-known (and addressed separately in the

contemporaneity section of this paper). However, the assessment approach has also generated policy neutrality concerns in some circumstances.

The Commission's judgment has been that differences in royalty rates for different minerals mainly reflect differing circumstances, including underlying profitability, of the different mining sectors, rather than discretionary policy choices. This favours assessing revenue capacity separately for each major mineral, which is the approach the Commission has adopted since 2015. The Commission considers that its current mining assessments reliably assess fiscal capacity and contribute appropriately to achieving HFE. However, where one State has a dominant role in the production of a mineral, this approach means that State's own royalty rate largely determines the average rate applied in assessments of revenue capacity. This carries a risk to policy neutrality since any future consideration of discretionary royalty rate changes in those circumstances may be influenced by expectations of resultant off-setting effects on GST shares (that is, a State's choice of changes in own-source revenues may have differentially significant GST effects).

The Commission was aware of this potential difficulty and therefore said in its 2015 report that it would review the assessment approach if there were any major changes in State mining revenue policies. However, the Commission did not provide advance guidance on what action it might take in the event of such policy changes.

Giving appropriate weight to policy neutrality

For the 2020 Review, the Commission considers that it should articulate more explicitly, and in advance, how it would respond to discretionary changes in effective tax or royalty rates applied to mining.[14]

In doing so, the Commission must ensure that the other supporting principles continue to appropriately inform its method choices and that HFE is achieved. It must also retain sufficient flexibility to deal in the future with possible major changes in mining industry circumstances or the revenue policies States apply to the mining industry.

A key feature for almost all revenue assessments (apart from some mining assessments) is that any State that makes a discretionary change in its tax rates retains the major part of the net fiscal consequences of its decision. That is, the GST effects (positive or negative) are small compared to the own-source revenue effects flowing from the policy change. This contributes to appropriate fiscal incentives for policy choices in each State. For fiscal capacity assessments, averaging rates across the States means that the GST consequences of discretionary policy changes by any one State are rarely, if ever, more than say half of the own-source revenue effect for that State, and most often much less.

In mining, particularly with mineral-by-mineral assessments, in the absence of any adjustment to the assessment, cases may arise where the GST effect is much larger, for

[14] Consistent with its position in the 2015 Review, the Commission may respond to discretionary changes in effective royalty rates prior to completion of the 2020 Review.

example exceeding 50% of the own-source revenue effect of discretionary policy change for that State. For example, a State with 100% of a mining revenue base will find that (apart from the temporary benefit of assessment lags), after equalisation, it retains only its population share of any revenue changes. The smaller a State's population share, the larger the (negative) effects on its GST share will be. For example, where the State's population share is 10%, then 90% of the changed revenue will be redistributed through the equalisation process.

For the 2020 Review, the Commission considers that its methods should ensure each State retains, after equalisation, at least half of the own-source revenue effects of the discretionary policy changes that it makes. This will ensure that for any discretionary rate change, no more than half of the changed revenue will be affected by the equalisation process, thereby removing the potential for cases to arise where the equalisation effects outweigh the effects of discretionary policy change.

Existing weighted average policy methods already meet this objective in almost all cases – with exceptions only being likely where a State with a small population is a dominant producer of a separately assessed mineral. The Commission considers that ensuring that this outcome is achieved in all major mining revenue assessments appropriately balances the competing considerations, including due weight to policy neutrality, arising from the several supporting principles and the HFE objective itself.

This approach to policy neutrality could be achieved for the mining assessments in several ways. One possibility is to revisit options for grouping minerals, as was the approach adopted by the Commission in the 2010 Review. The effect of grouping is that any discretionary change in royalty rates by one State has a less than complete impact on the average royalty rate used to assess revenue capacity – so the change in its royalty revenues has a correspondingly lesser effect on its GST share. In the example above, in a grouped assessment, a State with 100% of a particular mineral base may have only 60% of the base of the group in which that mineral is placed. In this case, where the State's population share is 10%, then 50% of the changed revenue will be redistributed through the equalisation process.

However, given the problems previously identified for grouping options, another approach may be required, based on retaining the approach adopted in the 2015 Review of mineral-by-mineral assessments. This could be done by directly reducing the effect of a discretionary change in effective mining tax rates by the dominant State on the rate of tax used for the calculation of revenue capacity. This would apply only to the extent necessary to meet the at least 50% objective.

The specific methods to be adopted by the Commission to give effect to this approach will be considered in consultation with the States over the course of the review.

The Commission may need to exercise its discretion and make changes to its approach in the event of major changes in economic or policy circumstances. These could include a major reform of mining taxation (for example, a shift to rent or profit based taxes could

require a change in methods) or a major change in circumstances in the mining industry such as a major long term fall in commodity prices (so that changes in royalty rates may more fully represent reductions in fiscal capacity).

Commission position on practicality

2.67 This supporting 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.

2.68 Practicality is an umbrella principle that covers the following.

- 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 sufficiently large impact on the GST distribution.
- 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.
- Fitness for purpose — the Commission's relativities are practically useful for States to incorporate into their budgets.

2.69 This principle originated from the emphasis in the 2010 Review terms of reference on simplification, reliability, materiality and quality assurance and was continued in the 2015 Review. The practicality principle is put into practice in the Commission's assessment guidelines (including a discounting framework and determination of materiality thresholds) and quality assurance plan, which are discussed in the section on Implementation issues.

2.70 Practicality recognises that, while State fiscal capacities are affected by a wide variety of factors, an improved HFE outcome may not be achieved 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.

2.71 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.

2.72 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.

2.73 Following consultations with States, the Commission has further developed its view on the practicality principle, to make explicit the need also for recommendations to be formulated and delivered in a way that is 'fit for purpose' for State budget processes.

2.74 All States have identified the Commission's recommended relativities as being a key component in the preparation of their budgets, including across the forward estimates. All States except Western Australia have said that what they seek in this regard are fixed relativities available in February, prior to the presentation of State budgets (for the following financial year) and which are to the extent possible predictable and reasonably stable over the period of the forward estimates. These States seek to minimise forecasting errors across the forward years, which could be greater if relativities are based on a narrower assessment window, or are based upon forecasts and estimates which are subject to correction. While the Commission does not consider that stability or predictability are necessarily relevant to achieving HFE itself, it recognises these considerations are of some practical relevance in its choice of methods, through their impact on State budget processes.

2.75 In contrast, as a State subject to considerable volatility in own-source revenue (which in turn affects its GST requirement), Western Australia would prefer GST outcomes that are much more contemporaneous, to offset movements in its own-source revenues, leading to greater stability in its overall revenues. It regards the lag arising from the historical assessment window as creating difficulty for its budget processes. Western Australia supports the use of forecasts (potentially updated during the financial year) followed by a final correction in the following year to reflect final outcomes. In setting out this view, Western Australia is also advocating a radical change to current assessment methods more generally. These issues are addressed further in the following section on contemporaneity.

Commission position on contemporaneity

2.76 The 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).[15] Past Commissions have interpreted this as meaning recommending relativities appropriate to equalising State fiscal capacities in the application year.

2.77 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.[16] In the absence of such data, past Commissions have based recommendations on historical data, regarding that as providing a result which is reasonably appropriate for the application year, notwithstanding that changes in State circumstances are reflected in assessments only with some lag.

2.78 Since 2010 the assessment window has been the most recent three years for which reliable data exist. In this review the Commission has considered a range of alternative approaches. These have ranged from continuing to use historical data while reducing the gap between assessment and application years, to treating volatile revenues by absorption, or by using forecasts of conditions in the application year.[17]

2.79 After consideration, the Commission's view is that for this review, subject to other practical considerations, it should continue to maintain the established approach while seeking to minimise the lag between the years in which reliable data are available to make an assessment (for example by narrowing the assessment window) and the year in which the resulting relativities will be applied (the application year).

2.80 The Commission's view is that, whatever the size of the assessment window, be it one, two or three years, HFE can still be achieved albeit with different effects on the accuracy and stability of GST shares depending on the quality of the data used under the different assessment windows. However, as discussed in the practicality section, the Commission will take note of what size assessment window is of most practical use to States.

2.81 Accordingly, the Commission is not settled on changing the size of the assessment window from the current (lagged) three years but will give further consideration over the course of the review to whether the window should comprise the most recent one, two or three years. In doing this, the Commission recognises the trade-off between increased contemporaneity versus smoother, more predictable GST shares.

2.82 In the case where the assessment window is greater than one year, the Commission also is not inclined to finesse the required average of years by applying any differential weighting to them. The Commission does not consider that such fine gradations would be useful or warrant the increased complexity.

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15 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 (the assessment window).

16 It would require application year data on State revenues, spending and associated State disabilities.

17 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.

2.83 The Commission is not attracted to using State, or independent, estimates or forecasts of revenues and expenditure in the application year. These are unlikely to be sufficiently reliable as the basis of the GST distribution. In addition, there is no basis for forecasting what disabilities should be applied in the application year. Historically, errors in forecasts have at times been large, particularly for volatile revenues. The Commission's view is that an approach using such unreliable data raises a range of issues, including that it would almost certainly require consequent GST adjustments in future to compensate for errors. This ex-post correction could, of itself, undermine the contemporaneity of GST distributions in future years. Most States expressed concerns that the use of forecasts would merely introduce unwarranted complexity, uncertainty and volatility.

2.84 Currently, the Commission's recommendations are expressed in the form of relativities. The effect of applying relativities (based upon the assessment window) to the application year is that States' GST requirements are inflated by the growth in GST revenue between the assessment window and the application year.

2.85 In principle, some other form of indexation (or no indexation) could be applied, such as growth in gross State final demand expenditure or some similar deflator. However, applying any indexation to State GST requirements other than growth in the GST pool would mean that the sum of GST requirements in the application year would not match the pool. That is, there would be a 'gap' and judgment would be required on how that gap should be distributed amongst States.

2.86 As a matter of practicality the Commission considers that the relativity approach continues to be the appropriate approach, regardless of the size of the assessment window.

Commission position on applying the supporting principles

2.87 In general, wherever data are adequate, the Commission follows clear methods that can be readily understood and replicated. However, 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. The Commission seeks to make its judgments as consistent and understandable as possible, and rejects suggestions that its judgments are arbitrary or inexplicable.

2.88 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.

2.89 As in past reviews, as circumstances require, the Commission has no practical alternative but to reserve the right to exercise its own judgment on how best to achieve HFE. The Commission does not think that the impracticality of giving full weight to all supporting principles in every situation is an argument, as some States suggested, for diverging from HFE.

2.90 The Commission's approach is to develop methods which achieve HFE, balancing the principles to guide it among alternative methods. For example, the weighted average approach to determining revenue and expenditure standards incorporates aspects of all the supporting principles:

- what States do – the standards reflect the actual revenue raising or spending practices collectively of the States, with each state contributing on the basis of its weight in the tax or spending base
- policy neutrality – the averaging process means that (in the vast majority of cases) no one State's policy decisions directly drive the standards
- practicality – reliable and comparable data on State revenue raising and spending practices are readily available when assessments are based on what States do
- contemporaneity – the actual revenue and spending as revealed in the assessment window are those upon which assessments are based, and are updated each year.

2.91 The Commission considers that its supporting principles, together with the HFE objective itself, are sufficient to guide all relevant methodological issues and that the addition of further supporting principles, including those suggested by Western Australia, would not be operationally useful. Particular issues are as follows.

- An equity principle incorporates elements of other existing supporting principles, such as policy neutrality, while conservatism appears likely to be interpreted as leading to partial equalisation. In both cases the Commission's Assessment guidelines (addressed later in this paper) act to ensure that disabilities are only recognised where a conceptual case exists and where the effects of the disability can be measured using sufficiently reliable data.
- Suggested accountability and transparency principles appear to relate more to processes or governance of the arrangements (of the Commission or of other bodies) rather than to guiding assessment methodologies to achieve HFE. As distinct issues, insofar as they relate to the Commission's task they are covered separately in the terms of reference. For example, in accordance with clause 3 of the terms of reference, the Commission regularly consults the Commonwealth and the States on its methods. Clause 7 directs the Commission 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. Some matters (such as simplicity) referred to by Western Australia in suggesting these

further principles may relate in part to assessment methods, but are already covered in the existing practicality principle.

2.92 In the case of an EPC distribution, as proposed by New South Wales, supporting principles are largely superfluous (perhaps other than contemporaneity), as such a distribution does not meet HFE and so is not consistent with the Commission's terms of reference.[18]

2.93 Specific implementation issues are addressed in the following section. Finally, a number of States raised issues relating to administrative arrangements or the Commission's communication processes. These are not relevant to the supporting principles for interpreting HFE discussed in this paper and (where within the scope of the Commission's terms of reference) will be addressed separately over the course of the review.

[18] Under an EPC approach, no consideration of either what States do, or policy neutrality, is required. Reliable population estimates are available, negating the need for further practicality considerations, while using the version of these estimates relating to the year in which the GST revenue is paid to States, arguably negating the need for any further consideration of contemporaneity.

3. IMPLEMENTATION ISSUES

Discounting assessments

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

3.2 Measurement of the effect of a disability can be affected when the associated data are incomplete, dated, unreliable, not fully fit for purpose or a combination of all these factors. In these cases, the Commission has to exercise judgment about whether to make an assessment of the disability or not. Judgment is guided by the quality of the available data.

3.3 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 measurement of that disability. 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.

3.4 In this review, the Commission intends to utilise the discounting framework adopted in the 2015 Review. This framework consists of three levels of discounting — low (12.5%), medium (25%) and high (50%) — depending on the Commission's judgment about the reliability of the data. The discounts are applied as follows:

- 12.5%, if there is 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 is 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 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 data
- if there is little confidence in the direction of an effect or its size, no differential assessment is made (100% discount).

3.5 The Commission notes that some States have concerns regarding the appropriateness of having discounts and with the consistency of their application. These issues will be considered as they arise over the course of the review as assessments are developed.

3.6 While the Commission considers discounting as a tool to better achieve HFE, there are instances when the Commission does not consider discounting to be appropriate. For example, the Commission does not intend to discount the best available

estimates of national spending, such as those derived from ABS Government Finance Statistics. Similarly to the 2015 Review, the Commission considers in this review that discounting is 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 the Commission will already have incorporated all relevant information and weighted it according to its reliability.

3.7 In addition, the Commission does not intend, as argued by some States, that the use of discounts should be expanded to include issues which the existing framework is unable to deal with adequately, such as policy neutrality or general uncertainty. As discussed under policy neutrality, while conceptually differences in tax rates or State development policies may affect the observed bases, the Commission's view is that discounting does not necessarily move assessments in a direction appropriate to achieving HFE.

3.8 Other assessment issues raised by States, such as on the use of confidential data, will be addressed as they arise over the course of the review. States will be encouraged to share confidential data at the Treasury level to facilitate the review of assessments.

Materiality thresholds

3.9 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.

3.10 The Commission considers that maintaining materiality thresholds is an effective way of maintaining simplicity in its assessments and to ensure that attention is focused on the major drivers of differences between the States. The large increase in the disability threshold applied in the 2015 Review achieved its goal of reducing the number of disabilities assessed by the Commission to those that have a substantive effect on the GST distribution.

3.11 Therefore the Commission intends to increase the threshold only to the extent that it retains its value after adjusting for price and wages increases. Consistent with this, the Commission intends to use a disability threshold of $35 per capita (up from $30 per capita) for any State for this review. As the increase is small, no change will be made to the threshold for data adjustments, which will remain at $10 per capita. The Commission views the materiality thresholds as a guide to making assessments. Each case is considered separately.

3.12 In summary, the Commission intends to apply materiality thresholds to handle three circumstances.

- ***Disability assessment.*** A disability will be considered material if it redistributes more than $35 per capita for any State, across all categories. The

disability will be included in all assessments where there is a conceptual case for including it and this can be done reliably, regardless of its materiality in individual assessments.

- ***Disability disaggregation.*** The Commission intends to apply a $35 per capita materiality threshold for disaggregating a disability. For example, the Commission may start with broad age groups (say 0-14; 15-64; 65 and over) in an individual category and only disaggregate them further if it is material to do so.
- ***Data adjustment.*** Data will be adjusted where necessary to improve interstate comparability, but only if the adjustment redistributes more than $10 per capita for any State.

Quality assurance

3.13 An important way of ensuring the Commission's assessments are as reliable and as 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.[19]

3.14 The 2020 Review quality assurance (QA) strategy and its implementation will be based on those adopted in the 2015 Review and the ensuing updates, along with suggestions from the external audit of the Commission's decision making and other processes in the 2015 Review. The Commission wants to ensure assessment methods are:

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

3.15 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.

3.16 The Commission's view is that its terms of reference task it as the body, in consultation with the States and the Commonwealth, to address all necessary methodological considerations in developing the relativities the Commission recommends for the distribution of GST revenue. Any additional accountability

[19] The 2015 Review plans are on the Commission website, (https://cgc.gov.au/).

controls over and above those put in place by the Commission, such as the Quality Assurance Strategy, are at the discretion of the Commonwealth.

Backcasting

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

3.18 Most States continue to support backcasting, where changes can be made reliably and they are material.

3.19 In this review the Commission intends to use backcasting but, to avoid situations where renegotiations of Commonwealth-State agreements can lead to uncertainty in application year funding distributions, only in exceptional circumstances. These circumstances include where there are major changes in Commonwealth-State relations, such as transfers or changes in function, and where the budget implications of any such changes are known.

Treatment of other Commonwealth payments to States

3.20 The terms of reference (clause 8) direct the Commission to take account of Commonwealth payments in making its assessments. They asked the Commission:

- to treat National specific purpose payments (SPPs), National health reform (NHR) funding, project National partnership payments (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
- to ensure that some specified payments (usually referred to as quarantined payments), including all reward NPPs and payments for which the Commission has been directed to apply a 50% discount (certain infrastructure payments), have no (or the appropriately reduced) impact on the GST distribution.

3.21 However, the terms of reference (clause 8d) also give the Commission discretion to vary the treatment of the first group of payments where it considers appropriate, 'reflecting the nature of the particular payment and the role of the State governments in providing particular services'. The Commission interprets this clause as meaning that in exercising its discretion, it will be guided only by the purpose of the GST distribution, which is the objective of HFE.

3.22 In this review the Commission intends to adopt the following guideline, as in the 2015 Review, 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.'

3.23 Under this approach, all Commonwealth payments which could be used to completely or partially offset the fiscal consequences of disabilities leading to differential assessed expenses will be recognised in assessing State GST requirements. Similarly, Commonwealth payments not used to address differences the Commission has taken into account in its calculations will not affect the GST distribution (that is, not redistribute GST revenue away from an equal per capita share).

3.24 In considering whether needs are assessed for the activity for which the payment has been made, the Commission will have regard to the rationale (or driver) applied by the Commonwealth in determining the distribution of the payment. Where there is a particular driver applied by the Commonwealth for the distribution of the payment among States, the Commission will consider whether this driver is sufficiently reflected in its assessments as to warrant that 'needs are assessed'. Where this is not the case, the payment will not affect GST shares.

3.25 Most States support this continuation of the current treatment of other Commonwealth payments. The Commission notes that some States have raised issues in relation to the varied treatment of infrastructure payments, with some such payments quarantined from affecting GST shares, some having a 50% effect on GST shares and some fully affecting GST shares. The Commission will consider the appropriate treatment of Commonwealth payments as they arise over the course of the review.

The Assessment guidelines

3.26 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. They have been developed in consultation with the States. The Commission intends to maintain the Assessment guidelines developed in the 2015 Review in this review. The Assessment guidelines for the 2020 Review are included in the following box.

3.27 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.

3.28 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.

3.29 While the guidelines are used to inform the Commission's decision-making processes, the Commission 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 aim to clearly explain its reasoning. The Commission notes the views expressed by some States that it could improve the way its deliberations and decisions are documented by providing additional information on how the supporting principles are applied to reach conclusions for individual assessments including discounting decisions.

Assessment guidelines for the 2020 Review

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.

The Commission will include a disability in a category when:

- a case for the disability is established, namely:
  - a sound conceptual basis for these differences exists
  - there is sufficient empirical evidence that material 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.

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.

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.

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.

When the assessment is to be discounted to improve the equalisation outcome, a uniform set of discounts will be 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).

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

- it redistributes more than $35 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.

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.