Australian Government

Commonwealth Grants Commission

Report on
GST Revenue Sharing Relativities

2020 Review

DRAFT MAIN REPORT

Australian Government

Commonwealth Grants Commission

24 June 2019

The Hon Josh Frydenberg MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

As members of the Commonwealth Grants Commission appointed under the *Commonwealth Grants Commission Act 1973*, and in response to the terms of reference provided by The Hon Scott Morrison MP on 28 November 2016, we have pleasure in submitting to you the Commission's draft report for the *2020 Methodology Review of GST Revenue Sharing Relativities.*

The terms of reference asked the Commission to undertake a comprehensive review of all the methodologies underpinning the calculation of GST relativities and to provide a draft report in 2019. Once you agree, States will also be provided with a copy of this report as part of the ongoing consultation for the review.

The Commission will provide the final report for this inquiry, including both the revised methodology and the recommended relativities for 2020-21, by 28 February 2020.

Yours sincerely

G J Smith
Chairperson

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ACKNOWLEDGEMENTS

The Commission appreciates the ready co-operation extended to it and its staff during this review by staff of Commonwealth and State Treasuries and other agencies.

The Commission also acknowledges the commitment and capable contribution of its staff.

TERMS OF REFERENCE

TREASURER

Mr Greg Smith
Chairperson
Commonwealth Grants Commission
86-88 Northbourne Ave
BRADDON ACT 2612

Dear Mr ~~Smith~~ Greg

I am writing to you to convey the enclosed terms of reference for the Commonwealth Grants Commission's *2017 Update of GST Revenue Sharing Relativities* (2017 Update) and *2020 Methodology Review of GST Revenue Sharing Relativities* (2020 Methodology Review).

The terms of reference for the 2017 Update require the Commission to report by 24 March 2017, with an advance copy of the report to be provided to the Commonwealth and the States and Territories, under embargo, by 10 March 2017.

The terms of reference for the 2020 Methodology Review require the Commission to undertake a comprehensive review of all of the methodologies underpinning its calculation of the GST relativities. The final report for the review should be provided to the Commonwealth and the States and Territories by 28 February 2020. This will give the Commission more than three years to complete a wide-ranging review of its methods.

I expect the Commission to consult closely with the Commonwealth and the States and Territories, both in developing a work program to guide your methodology review as well as throughout the review process.

Yours sincerely

The Hon Scott Morrison MP

14 / 11 / 2016

Terms of Reference for the 2020 Methodology Review

COMMONWEALTH GRANTS COMMISSION ACT 1973

I, Scott John Morrison, Treasurer, pursuant to sections 16, 16A and 16AA of the *Commonwealth Grants Commission Act 1973*, refer to the Commission for inquiry into and report upon:

a) the methodological approach used to calculate the per capita relativities to distribute Goods and Services Tax (GST) revenue among the States, the Northern Territory and the Australian Capital Territory (collectively referred to as the States) from 2020-21 (*Methodology Review*); and

b) the per capita relativities recommended to be used to distribute GST revenue among the States in 2020-21 (*GST relativities for 2020-21*).

Methodology Review

2. The Commission should undertake a comprehensive review of all the methods that underlie its assessments to calculate the per capita relativities used to distribute GST revenue among the States (the GST relativities).

3. The Commission will consult with the Commonwealth and the States on:

   a) the development of a work program for the methodology review, including the provision of a draft report in 2019; and

   b) any substantive changes to the revised methodology following the draft report.

4. The outcome of the review will be a revised methodology for calculating the GST relativities, which the Commission will apply to its assessments of GST relativities from 2020-21. The revised methodology should be described in the final report for this inquiry.

5. In undertaking the review, the Commission should take into account the *Intergovernmental Agreement on Federal Financial Relations* (as amended), which provides that GST revenue will be distributed among the States in accordance with the principle of horizontal fiscal equalisation.

6. The Commission should also consider whether the supporting principles it uses to guide its work remain appropriate, including whether different weights should be given to different supporting principles. State views should be sought on the importance of each existing principle and any others considered important to the States and the appropriate balance between them.

7. In reviewing the methodology underlying its assessments, the Commission should:

   a) aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data;

   c) use the latest available data consistent with this; and

   d) ensure robust quality assurance processes.

8. In reviewing the methodology underlying its assessments, the Commission should treat Commonwealth payments to the States as follows:

   a) National Specific Purpose Payments (NSPPs), National Health Reform (NHR) funding, Students First funding (for government schools) and National Partnership project payments should affect the relativities, recognising that these payments provide the States with budget support for providing standard state services.

   b) National Partnership facilitation and reward payments should not affect the relativities, so that any benefit to a State from achieving specified outputs sought by the Commonwealth, or through implementing reforms, will not be redistributed to other States through the horizontal fiscal equalisation process.

   c) General revenue assistance, excluding GST payments, will affect the relativities, recognising that these payments are available to provide untied general budget support to a State.

   d) Notwithstanding subparagraphs 8(a) – (c), the Commission may determine that it is appropriate for particular payments to be treated differently, reflecting the nature of the particular payment and the role of the State governments in providing particular services.

   e) Those payments which, prior to its assessment of the 2020-21 relativities, the Commission had been directed to treat as having no direct influence on the relativities, including payments for which the Commission has been directed to apply a 50 per cent discount, should continue to be treated in that way. Where those payments are replaced, the treatment of the new payment should be guided by subparagraphs 8(a) – (d), unless otherwise directed.

GST relativities for 2020-21

9. The Commission should undertake an assessment of the per capita relativities to be used to distribute GST revenue among the States in 2020-21.

10. This assessment should be made on the basis of the revised methodology from the Commission's review of its methodological approach.

The Report

11. The Commission will provide the final report for this inquiry, including both the revised methodology and the recommended relativities for 2020-21, to the Commonwealth and the States by 28 February 2020.

12. The Commission will consult regularly with the Commonwealth and the States as it considers these terms of reference.

13. Supplementary terms of reference may be provided prior to finalisation of the inquiry outcomes.

SCOTT JOHN MORRISON

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PURPOSE OF THIS REPORT

On 28 November 2016, the Commission received terms of reference for a review of fiscal equalisation methodologies to inform the goods and services tax (GST) distribution from 2020-21. This report responds to the requirement that the Commission provide a draft report in 2019, in advance of the final report by 28 February 2020.

This report is a consultation draft on the data sources and methods the Commission proposes to adopt in its final report. These draft findings provide the basis for further consultation with the States and the Commonwealth. However, the Commission considers some assessments are more settled than others and has flagged the relevant considerations in the report.

This report does not include draft recommendations for relativities for the distribution of GST revenue. Much of the data needed for determining the recommended GST revenue sharing relativities for 2020-21 are not yet available. Accordingly, this report presents the illustrative outcomes of the methods as they stand for a single year, 2017-18, being the most recent year for which reliable data are generally available. Preliminary estimates (or placeholders) are included where data for this year are unavailable, or where assessments are still being developed.

The single year results for 2017-18 are presented for illustrative purposes only and caution should be used in their interpretation. When new data are available, the results included in this report may differ considerably from those to be included in the Commission's final report.

In forming its final views, the Commission will consider any further evidence presented by States and take into account any changes to policy affecting State fiscal capacities, or new or changed data that may become available.

CHAPTER 1

INTRODUCTION

1.1 This review has taken the 2015 Review methodology as its starting point. To assist States, the main proposals for changes to this methodology are summarised in this chapter, and at the beginning of the draft report attachments dealing with individual assessments.

1.2 Development of this draft report has benefited from substantial consultation with all States, including a program of visits by Commissioners to each State, along with detailed submissions from them. The Commission understands that the conduct of its reviews imposes a burden on States, and that the annual updates have a smaller, though not negligible impact as well. It appreciates the efforts of States in hosting the Commission's visits and in responding to the Commission's discussion papers in accordance with the work program. In the time now remaining, the Commission asks that States focus their responses to this draft report on their key areas of concern, supported by substantiating data and analysis.

1.3 From 2021-22, legislated changes will see a gradual move away from the current arrangements for distributing GST revenue (based directly upon the Commission's assessment of relative fiscal capacities), to new arrangements based upon a standard State, being the fiscally stronger of New South Wales and Victoria. This transition will be completed in 2026-27. The new arrangements are set out in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018,* which amends the *Commonwealth Grants Commission Act 1973* and the *Federal Financial Relations Act 2009*.

1.4 The Commission expects the methodologies determined in this 2020 Review will continue to form the basis for relativity assessments under the new arrangements. Accordingly, whilst the changes do not affect the work of the Commission until the update for 2021-22, this draft report includes a description of the Commission's understanding of how to give effect to the new legislation at that time.

WORK PROGRAM

1.5 The terms of reference required the Commission to develop a work program for the Review, in consultation with the Commonwealth and States.[1] This is set out in Table 1-1. Broadly, the work program included:

- in 2017, consultations with State Treasuries on the principles and methods which should be reviewed, followed by a Commission position paper on the principle of HFE and its implementation
- in 2018, Commission staff releasing discussion papers relating to each specific assessment, identifying material factors beyond the control of States affecting their revenue raising capacities and expenditure needs
  - followed by visits by the Commission to each State, along with the receipt from States of their detailed submissions. Further discussions have also taken place between State Treasury and Commission staff, for example through the Officer Working Party forum.
- in 2019, provision of this draft report to the Commonwealth and States
  - followed by discussions between Commission staff and State officials, a possible meeting between the Commission and the Heads of Treasuries (HoTs), along with keeping States informed of any significant changes to the Commission's views subsequent to the draft report[2]
- in 2020, provision of the Commission's final report, including the recommended per capita relativities to be used to distribute GST revenue among the States in 2020-21.[3]

1.6 In the 2015 Review, given its shorter timeframe, the Commission adopted an approach of focusing attention on areas where, in consultation with the States and consistent with the terms of reference, change was considered most warranted. While that resulted in significant changes in certain areas, it also showed that much of the existing methodology was robust.

1.7 Consequently, in this review, while changes to all aspects of the methodology were within the terms of reference, the Commission adopted the 2015 Review methodology as its starting point. Changes have been proposed where State circumstances have changed, better data have become available or where other evidence, including the work of consultants and in State submissions, has convinced the Commission to do so.

1 Clause 3(a) of the terms of reference for the 2020 methodology Review (ToR).
2 Clause 3(b) of the ToR.
3 Clause 1(b) of the ToR.

Table 1-1 2020 Review program

Date	Event
2016	
28 November	Terms of reference received.
1 December	State views on work program processes sought.
2017	
February-March	States and Commonwealth consulted and work program finalised.
April	Officer Working Party (OWP) of Commission and State officials commenced examination of specific issues. Work program agreed and work started.
Mid May	Staff released a paper on approach to the review, HFE, supporting principles and their implementation, including assessment guidelines. Series of supporting research/background papers released.
End July	State submissions received on staff paper on approach to the review, HFE, supporting principles and their implementation, including assessment guidelines.
Late August/Sept	Bilateral discussions between the Commission and States on submissions.
End September	Commission paper sent to States on approach to the review, HFE, supporting principles and their implementation, including assessment guidelines.
October-November	Staff and Treasury officer initial discussions on assessment issues for the 2020 Review.
2018	
End Feb	State submissions on approach to review, the objective(s), supporting principles and their implementation.
April	Preliminary staff paper released to States on the scope of HFE and assessment structure, treatment of Commonwealth payments, category and factor assessments.
June to September	Commission visits to States for discussions on assessment issues, including service delivery needs. Bilateral meetings with Treasurers/HoTs to cover key issues, if required.
June to December	OWP meetings to discuss/report on specific issues.
End August	State submissions on scope and structure, treatment of Commonwealth payments, category and factor assessments.
2019	
June/July	Release of draft report to the Commonwealth.
July/Aug	Commission staff bilateral meetings with States to discuss the draft report.
Aug/Sept	Possible multilateral meeting between Commission and HoTs to discuss draft report.
September	State submissions on draft report due.
End September	New issues paper issued by Commission staff.
Mid-November	State submissions on new issues due.
End November	Commission paper on significant changes since the draft report, as required by the terms of reference.
End December	Final State comments due on proposed changes to draft report.
2020	
28 February	Release of final report to the Commonwealth and States.

METHODOLOGY REQUIREMENTS OF THE TERMS OF REFERENCE

1.8 The terms of reference contains instructions and guidance on how the Commission should approach the task of developing the methodology for distributing GST revenue. They direct it:

- to take into account the Intergovernmental Agreement on Federal Financial Relations (as amended) which provides that the GST should be distributed among the States in accordance with the principle of horizontal fiscal equalisation (HFE)
- to aim for 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
- to ensure robust quality assurance procedures.[4]

1.9 They also ask the Commission to consider whether the supporting principles it uses to guide its work remain appropriate, including whether different weights apply to different supporting principles. In coming to a judgment, the terms of reference ask the Commission to seek State views on the supporting principles and the appropriate balance between them.[5]

1.10 Specific guidance is provided in relation to the treatment of Commonwealth specific purpose payments (SPPs) and national partnership payments (NPPs), collectively referred to as payments for specific purposes (PSPs). The terms of reference require the Commission:

- to ensure some specified payments including reward NPPs (or some part of specified payments, usually 50%), have no impact on the GST distribution (collectively these payments are usually referred to as quarantined payments)
- to treat national SPPs, National Health Reform funding, Quality Schools funding (for government schools), national partnership project payments 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.[6]

The terms of reference also give the Commission discretion to vary the treatment of the second group of payments where it is appropriate, ‘reflecting the nature of the payment and the role of State governments in providing services’[7]

1.11 Table 1-2 identifies the matters the terms of reference require the Commission to address and indicates where it has responded to them in this report.

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4 Clauses 5 and 7 of the ToR.
5 Clause 6 of the ToR.
6 Clauses 8(a) to 8(c) of the ToR.
7 Clause 8(d) of the ToR.

Table 1-2 Requirements of the terms of reference and the Commission's response

2020 Review reference clause	Response
Per capita relativities for 2020-21	Not yet available
5 take into account the Intergovernmental Agreement on Federal Financial Relations … the principle of horizontal fiscal equalisation	Chapter 2
6 consider appropriate supporting principles and appropriate balance / weighting	Chapter 2
7 (a) aim for assessments that are simple and consistent with the quality and fitness for purpose of the available data	Chapter 3 and Attachments describing individual assessments
7 (c) ensure robust quality assurance procedures	The Quality Assurance Strategic Plan, which is available on the Commission website
8 Treatment of Commonwealth payments	Attachment 2 — Commonwealth payments

INFORMATION CONTAINED IN THIS DRAFT REPORT

1.12 This draft report contains the Commission's preliminary response to the terms of reference. It includes the Commission's position on the principles it has used and the assessments, including data sources, it proposes to make in preparing recommended relativities for the distribution of GST revenue in 2020-21. The report has been prepared on the basis of State circumstances as the Commission understood them following the 2019-20 Commonwealth budget. The Commission may need to reconsider its position in certain areas if there are changes to the budget outcomes. The final report and relativities to be applied in 2020-21 will be provided to the Treasurer in February 2020.

1.13 The data and evidence available to the Commission vary across assessments. In some cases, the Commission considers the evidence is such that an assessment is unlikely to change between the draft and final report. Elsewhere, it has been necessary to use preliminary estimates (placeholders) where final data to complete an assessment remain outstanding. State assistance in responding to data requests addressing these areas would be appreciated. In a small number of areas, the balance of evidence and analysis is not definitive and assessments are still under consideration. State responses to this draft report could see new data, evidence or analysis emerge, which could lead the Commission to reconsider its position. The Commission views this as a positive outcome of preparing a draft report and an intrinsic part of its approach to responding to the terms of reference.

1.14 The draft report does not document State arguments in detail. Instead, the Commission has responded to the issues States have raised, with State submissions allowed to speak for themselves. They can be found on the Commission website, (https://cgc.gov.au/), classified by the issue or discussion paper to which they are responding.

1.15 The Commission has not shown the full financial impact of its proposals, nor comparisons with assessments in the 2019 Update, because it is not possible to do so reliably in all cases. States can readily undertake any such comparisons as they see fit, using published material from the 2019 Update, noting however that care must be taken to consider any differences in category structure and where placeholder data have been used.

1.16 The report attempts to illustrate the effects of the Commission's assessments, including the effect of each fiscal disability assessed, for at least one year. The report shows the outcomes of the assessments for one year and the resulting measure of State relative fiscal capacities for the same year, namely 2017-18. This is to enable States to have a common understanding of these results.

1.17 In addition, Chapter 4 also describes how the Commission proposes to comply with the legislated changes to the distribution of general revenue assistance (GST revenue plus any additional top-up payments) by producing standard State capacity measures (based upon the fiscally stronger of New South Wales and Victoria).[8]

1.18 While the numbers in this report are all likely to change in the final report, the Commission considers that collectively there is sufficient information to allow States to provide meaningful feedback on whether the disabilities affecting State fiscal capacities are being appropriately captured.

1.19 The draft report addresses all aspects of the Commission's principles and assessments used to determine the relative fiscal capacities of the States. It comprises the following.

- The main report, which:
  - explains the requirements of the terms of reference
  - discusses the equalisation objective and how this has been implemented
  - discusses the major proposals for changes to the 2015 Review methodology, along with other areas the Commission has considered extensively over the review, even where this has not resulted in changed assessments
  - outlines the Commission's preliminary understanding of the requirements for its future work to implement the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018*.
- Attachments contain the assessments for each category, as well as each disability that affects a number of category assessments (for example, wage costs). There is

8 The *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* detail these requirements.

also an attachment that sets out how the Commission has used population data in the assessments (Attachment 27 — Population).

1.20 The Commission's final report will provide information on:

- the recommended GST revenue sharing relativities for 2020-21, why they have changed and why they differ between States
- other contextual information, such as how equalisation works
- additional technical and supporting information available in Excel workbooks providing details on population estimates, the treatment of Commonwealth payments, the adjusted and assessed budgets for each assessment year, revenue and expense ratios for each assessment year and the various sets of fiscal capacity measures.

SUMMARY OF APPROACH AND METHOD CHANGES

1.21 As in the 2015 Review, in determining State relative fiscal capacities the Commission has been guided by the HFE principle, along with the supporting principles – what States do, policy neutrality, practicality and contemporaneity. Chapter 2 explains the HFE principle adopted by the Commission and supporting principles, including a consideration of the appropriateness of any particular balance or weighting of the supporting principles, along with implementation issues such as discounting.

1.22 The Commission has rigorously evaluated potential method changes and data, using the assessment guidelines, which set out strong reliability and materiality criteria. These and how they have been used are also set out in Chapter 2.

1.23 Chapter 3 includes a short discussion on each of the areas where there has been a major change from the approach adopted in the 2015 Review. This chapter also discusses instances where the Commission has considered an issue in some depth over the course of the Review, even where the outcome has been not to change existing methods.

1.24 Changes to assessments in this review are largely evolutionary, as improved knowledge of service delivery approaches and better data have led to changes in how disabilities are measured. For example, updated data from States on spending on police services, and from the Independent Hospital Pricing Authority (IHPA) on the costs of hospital services, have improved the Commission's recognition of the effects of increasing remoteness on the costs of service delivery. Overall, the Commission has been able to measure directly the effects of remoteness across more categories in this review compared to the previous Review.

1.25 In other changes, feedback from States on the drivers of funding for schools has led to changes in the characteristics recognised as leading to differential costs in providing these services. Continued progress toward full implementation of the

National Disability Insurance Scheme (NDIS) has changed the way disability services needs are recognised. Further work with States has enabled the Commission to review and revise the synthetic rural road network.

1.26 Table 1-3 summarises the changes in this review – in each category and to each disability. Changes that are presentational in nature or are due to changes made by data suppliers have not necessarily been included.

1.27 Finally, implementation of the requirements outlined in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* will change the way in which the Commission's assessments of State relative fiscal capacities translate into distribution of general revenue assistance, in particular GST revenue and any associated top-up funding. Chapter 4 outlines the Commission's preliminary understanding of the requirements of the new legislation for its future work.

Table 1-3 Proposed 2020 Review changes to 2015 Review methodology

Category/disability	Main changes
Payroll tax	• The assessment method is unchanged.
Land tax	• Revenue from fire and emergency levies on property is now offset against Other expenses. • The other land based taxes have been moved to Other revenue. • The level of discount has been reduced from 25% to 12.5%.
Stamp duty on conveyances	• Stamp duties on the transfer of motor vehicles have been moved to Other revenue. • No adjustment is made for concessional rates of duty relating to first home owners. • Land rich transactions by listed corporations are differentially assessed with other conveyance duties. • Non-real property transactions have been moved to Other revenue. • Conveyance transactions that are not differentially assessed have been moved to Other revenue.
Insurance tax	• Revenue from fire and emergency levies on insurance products is now offset against Other expenses. • Revenue from workers' compensation duty is now included in the category and assessed using the general insurance revenue base. • The capacity measure no longer includes premiums paid to public insurers or premiums paid to private insurers for CTP motor vehicle insurance.
Motor taxes	• The assessment method is unchanged.
Mining revenue	• Revenue from grants in lieu of royalties is assessed with other Commonwealth payments. • Nickel royalties are now assessed in the other minerals component.
Other revenue	• The assessment method (EPC) is unchanged. However, the composition of the category has changed.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-3 Proposed 2020 Review changes to 2015 Review methodology (continued)

Category/disability	Main changes
Schools education	• The regression models used to estimate cost weights for Indigenous status, socio-economic status, service delivery scale, and remoteness have been respecified. • Commonwealth funded spending on non-government schools is now out of scope. • Expenses for transport of school children are now assessed in Transport. • Pre-year one student data are now incorporated in the assessment without being imputed from year one student data.
Post-secondary education	• Regional costs are now measured directly using State data. • The grouping of socio-economic status quintiles has been revised.
Health	• A block-funded hospital loading is applied to the national weighted activity unit (NWAU) data for block funded hospitals in the admitted patients (AP), emergency department (ED) and community health to ensure appropriate recognition of regional and service delivery scale (SDS) costs. • The regional costs factor for the non-admitted patients (NAP) assessment is based on ED data. An SDS factor based on ED data has been included. • The 25% discounts applied to the socio-demographic composition (SDC) assessment and non-State sector adjustment for community health have been removed. • The SDC assessments for all components (except non-hospital patient transport) will disaggregate remote and very remote populations. • The assessment of Indigenous grants uses AIHW data. A regional costs factor based on ED data is applied. • A cross-border capital stock factor has been included in the health infrastructure assessment. • The ACT's cross-border allowance for community health has been reduced. • Annual expenditure data for ED and NAP services from the National Hospital Cost Data Collection have been used to split outpatient expenses. • The non-State sector substitutability levels for NAP and community health are 35% and 60% respectively. • The non-State sector indicator for NAP is based on bulk-billed medical operations and specialist services. • Expenses for pharmaceuticals, medical aids and appliances and health administration not elsewhere classified are included in the admitted patients component.
Welfare	• Non-NDIS disability and aged care related expenses are assessed EPC in the same component. • The SDC assessment for the other welfare component uses the *Experimental Index of Household Advantage and Disadvantage* as an indicator of low SES. • A cross-border disability is no longer assessed for welfare services.
Housing	• Concessional rates of conveyance duty for first home owners are assessed in the Stamp duty on conveyances category.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-3 Proposed 2020 Review changes to 2015 Review methodology (continued)

Category/disability	Main changes
Services to communities	• Electricity subsidies and water subsidies are separately assessed. • For the electricity subsidies assessment: – the definition of remote communities includes communities in a remote or very remote area with a population of over 50 people and a population density of at least 60 persons per km^2 – the regional costs assessment applies a cost weight to people in very remote communities, which is derived from regression analysis of State subsidy data – the proportion of remote community electricity subsidies and other electricity subsidies is updated annually using State data. • For the water subsidies assessment: – the definition of small communities includes communities in an inner regional, outer regional, remote or very remote area with a population of over 50 but less than 1 000 people and a population density of at least 60 persons per km^2 – the regional cost assessment applies a cost weights to people in small communities, which is derived from State subsidy data discounted by 50% – the proportion of small community water subsidies and other water subsidies is updated annually using State data. • Indigenous community development expenses are derived using State data and includes general revenue grants to Indigenous councils. • Changes to GFS classifications mean that national parks and wildlife expenses are now included in this category.
Justice	• The split between 'specialised' and 'community' expenses has been removed, including the discount previously applied to specialist policing expenses. • Police costs are assessed using cost weights by region and assessed offenders, derived from an econometric model using State provided data. • The courts component has been split into separate criminal courts and other legal services components. • For criminal courts, Indigenous status non-response has been allocated in relation to the ERP distribution, rather than responding criminal court defendants. • In courts and prisons, regional costs have been measured directly from State provided court and prison cost data. • The grouping of socio-economic status quintiles has been revised. • Non-zero use rates for the 0-14 and 65+ year age groups are now applied.
Roads	• Rural road length has been re-estimated. New road connections have been added to link significant areas, including mines, ports and national parks. The number of lanes on roads is also taken into account. The adjustment for unsealed roads has been removed. • Local roads expenses have been reallocated proportionately to the urban and rural road components. • Bridges and tunnels are now assessed using actual lengths of bridges and tunnels that are State managed, measured across comparable structures. • The number of heavy vehicle classes has been reduced from five to three. Light commercial vehicles are now classified with passenger vehicles. • Other services expenses have been reallocated proportionately across the rural roads, urban roads and bridges and tunnels components.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-3 Proposed 2020 Review changes to 2015 Review methodology (continued)

Category/disability	Main changes
Transport	• A new urban transport assessment is introduced. Instead of urban centre population alone, the new assessment also uses population density, passenger numbers by mode of transport, the presence of ferry services, distance to work and topography to measure State needs. The former assessment has a weight of 25% and the latter a weight of 75%. • All student transport expenses are now included in the urban transport component. • The transport infrastructure assessment uses the model developed for the expense assessment (75% weight) and the 2015 Review assessment (25% weight). • Non-urban transport expenses are now assessed on an EPC basis.
Services to industry	• Mining regulation expenses are assessed in a separate component. • Major project expenses are no longer assessed. • New State data have been used to weight regulation and business development expenses for each industry. • All user charges are deducted from regulation expenses for agriculture, mining and other industries. • A single broad indicator is used to assess agriculture and mining regulation respectively. • Other industry regulation has been assessed using sector size (75%) and population (25%).
Other expenses	• The natural disaster relief expense assessment excludes net local government expenses. • A cross-border disability is no longer assessed for recreation and culture expenses within the service expenses component. • Capital grants to local government are no longer assessed. • Pipeline expenses are assessed in the Transport category. National parks and wildlife expenses are assessed in the Services to communities category, reflecting new GFS functional classifications. • The roads allowance in the national capital assessment has been discontinued and national capital planning allowances have been revised. • User charges, mainly fire and emergency services levies, are netted off expenses. • No adjustment has been made for interstate non-wage costs. • Proxy regional costs are now based on admitted patients and schools data.
Investment	• Investment and depreciation expenses are assessed together in the Investment assessment. • Investment associated with each category is now measured directly. • 3 year averaging of stock disabilities has been removed. • Administrative scale is no longer assessed in the Investment assessment.
Net borrowing	• The 12.5% discount has been removed.
Administrative scale	• Administrative scale costs have been re-estimated for all expense categories. • The Northern Territory dual service delivery adjustment has been removed. However, an adjustment of $1.8 million for the Northern Territory is included. • The wage costs proportion of administrative scale expenses has been reduced from 80% to 60%.
Wage costs	• The assessment method is unchanged.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-3 Proposed 2020 Review changes to 2015 Review methodology (continued)

Category/disability	Main changes
Geography	• Regional costs have been assessed directly in a broader range of categories. • The general gradient for regional costs, which is extrapolated to categories without other direct measures, is based on the average of the regional cost gradients measured in admitted patients and schools. • Allowance has been made, where possible, for differences between where a service is delivered and where the recipients reside. • SDS is assessed using remoteness areas. • The interstate non-wage costs assessment has been discontinued and no adjustment is made to the Accessibility and Remoteness Index of Australia (ARIA) based remoteness area outcomes.
National capital	• Planning allowances have been revised. • Allowances for wider roads, above average urban space, above average urban/bush interface and bus subsidies are no longer assessed.
Cross-border	• The general method for estimating cross-border costs will be discontinued and a cross-border factor will no longer apply. • The remaining cross-border assessments will be considered in their relevant assessment categories.
Native title	• The native title and land rights components is assessed as a single component. • Land rights expenses are assessed for all States (not just the Northern Territory) using the actual per capita (APC) method of assessment.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

CONSULTATION AND FINAL REPORT

1.28 During the review, States have argued for a large number of changes to the Commission's assessments, ranging from requests to include new disabilities to changes in the way existing disabilities are measured. Western Australia in particular argued for major changes in the way equalisation is conceptualised, approached and implemented by the Commission. In general, the Commission has not acceded to these requests, considering they fail on at least one criterion of the assessment guidelines. For a disability to be recognised, the Commission requires there to be a conceptual case, supporting evidence, reliable data upon which the disability can be measured and for the disability to be sufficiently large as to be worth including (that is, material). Table 1-4 describes for each category the major requests for change from States and the Commission's response. Greater detail is included on each of these issues in the relevant assessment attachments.

1.29 The Commission asks that States identify any areas in this draft report where they have concerns about the strength of the conceptual cases for the proposed assessments, the logic of the proposed methods, their reliability and the quality of the supporting data. The Commission seeks State assistance to ensure it has:

- correctly interpreted State submissions and the supporting data and evidence
- developed reliable methods; for example, whether all material disabilities that are conceptually sound and measurable have been included.

1.30 State views will carry the most weight where alternative proposals come with supporting data and methods, and evidence that an assessment is likely to be material.

1.31 After an opportunity to discuss this report with the States, including any feedback from the Heads of Treasuries (HoTs), and the receipt of a further round of State submissions by September 2019, the Commission will finalise its recommendations. As part of this process, Commission staff will circulate a new issues discussion paper and collect data for the final assessment year, 2018-19. By the end of November, the Commission will advise States of any significant changes to methods set out in the draft report. Any final comments on these changes will be due by the end of December, with the Commission producing its final report by the end of February 2020.

Table 1-4 Commission responses to State proposals, 2020 Review

Proposal	State	Adopted	Explanation
Commonwealth payments			
Apply backcasting to all Commonwealth payments	ACT	No	Forward estimates published in Commonwealth budget papers are not reliable.
Apply a standard 50% discount to all Commonwealth infrastructure payments	WA	No	This does not achieve equalisation. Payments for Infrastructure where the Commission assess needs should affect the relativities.
Cease applying the 50% discount to National network roads and National rail network	ACT	No	These projects have national objectives that are not captured in road and rail infrastructure assessments. 50% discount achieves the appropriate balance between equalising State fiscal capacities and meeting national objectives.
Assess capital funding and related expenditure over time	TAS	No	Agrees in principle but collecting information on expenditure of each infrastructure payment is problematic.
Payroll tax			
Remove remuneration paid by non-profit organisations	ACT	No	No reliable data source of non-profit remuneration by State.
Change data source of the assessment	ACT	No	Current data set is best available at this time.
Land tax			
Broader revenue assessment	WA	No	Does not produce a more reliable indicator of States' capacity to raise revenue.
Remove revenue base adjustments	WA	No	They reflect what States do and are material.
Adjustment for annual land valuations	Vic	No	All States try to keep their land valuations contemporary through valuations or benchmarking.
Different disability for other land based taxes	WA	No	Not material to separately assess.
Size of CBD for parking space levies	ACT	No	Not material to separately assess.
Not use land values	WA	No	No evidence that State policy differences are having a material effect on land values.
Assess all land revenue together	ACT	No	States impose land tax differently to other land based taxes. The difference is material.
Reduce discount	6 States	Yes	There appears to have been some improvement in comparability of SRO data in the last decade.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
Stamp duty on conveyances			
Broader revenue assessment	WA	No	Does not produce a more reliable indicator of States' capacity to raise revenue.
Remove revenue base adjustments	WA	No	They reflect what States do and are material.
Adjustment because Victoria records its off-the-plan transactions according to dutiable value rather than purchase price	NSW	No	Commission does not have the data to make this adjustment. It will work with Victoria to determine whether it can provide its transactions by purchase price.
Assess all concessional rates of duty as grants	ACT	No	The Commission does not intend to treat concessional rates of duty as an expense.
Assess duty on sale of major State assets APC	Vic	No	Duties from the sale of major State assets arise because of policy choice.
Differentially assess duty on windfall gains from State asset sales	ACT	No	Duties from the sale of major State assets arise because of policy choice.
Assess non-real property transactions APC	Vic	No	An APC assessment is not appropriate as the IGA is not binding.
Assess land rich transactions by listed corporations EPC	WA	No	Seven States impose these duties and their capacities differ.
Insurance tax			
Remove CTP premiums from measure of the revenue base	NSW	Yes	Removed due to CTP premiums being influenced by individual State policies.
Assess CTP duty EPC	NSW	No	Practicality grounds. Revenue cannot be reliably identified and unlikely to be material.
Remove workers' compensation insurance revenue	NSW, SA	No	Practicality grounds. A separate assessment of workers' compensation is not material. Not including the associated premiums in the revenue base avoids policy neutrality concerns.
Motor taxes			
Broader revenue assessment	WA	No	Does not produce a more reliable indicator of States' capacity to raise revenue.
Remove revenue base adjustments	WA	No	They reflect what States do and are material.
Make an adjustment for the progressive rates of duty on passenger vehicles	5 States	No	The stamp duty on motor vehicle assessment is not material and the adjustment is not material.
Assess all concessional rates of duty as grants	ACT	No	The Commission does not intend to treat concessional rates of duty as an expense.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
Mining revenue			
Discount the mining assessment	Qld, WA	No	Not possible to identify how much of the revenue might be attributable to above average revenue effort.
Discount the NWS payment	WA	No	Not possible to identify how much of the payment might be attributable to above average revenue effort.
Adjustment for differences in development efforts	WA	No	Not possible to identify how much of any expanded revenue base might be attributable to above average revenue effort.
Adjustment for differences in compliance efforts	WA	No	More likely that diminishing tax receipts have a larger effect on compliance policy than GST effects.
Differences in the cost of production and profitability	Tas	No	The profitability of the Tasmania's mining sector does not appear to differ from other States.
A global revenue assessment	WA	No	Does not produce a more reliable indicator of State revenue raising capacity.
A uniform fixed standard royalty rate	WA	No	Does not produce a more reliable indicator of State revenue raising capacity.
A policy neutral capacity measure (land area)	WA	No	Does not produce a more reliable indicator of State revenue raising capacity.
Blend value of production data with land area	WA	No	Does not produce a more reliable indicator of State revenue raising capacity.
A rotating standard	WA	No	A rotating standard would add unnecessary complexity to the task of assessing capacity.
Other revenue			
Differentially assess gambling taxes	SA, ACT	No	A reliable capacity measure could not be found.
No differential assessment of Other revenue	WA	Yes	Other revenue assessed EPC.
Schools			
Early childhood education	Vic	No	Unlikely to be material.
Apply school disabilities to centrally managed costs	NSW, NT	No	ACARA data appropriately allocates centrally managed costs across schools.
CALD disability	NSW, Vic	No	Not material.
Students with disabilities	NSW, QLD, NT	No	Unable to find reliable data to support this disability.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
Post-secondary education			
Course mix	SA, Vic	No	Unlikely to be material, and concerns over policy neutrality.
Qualification level	5 States	No	Unlikely to be material, and unable to find reliable data to support this disability.
Public/private provision	Vic	No	Unlikely to be material, and concerns over policy neutrality.
Health			
Revert to the subtraction approach	WA	No	Not consistent with what States do or the scope of fiscal equalisation.
Consider subtraction approach for the community health assessment	NT	No	Concerns relate to implementation issues with the 2015 Review direct approach that have been addressed.
Include adjustment for culturally and linguistically diverse (CALD) patients	NSW, Vic	No	IHPA costing study indicates a CALD patient adjustment would not be material.
Ensure all remoteness and SDS costs are recognised	Qld, WA, Tas, NT	Yes	A block-funded hospital adjustment is applied to NWAU data to better recognise remoteness and SDS costs. An additional regional cost/SDS loading is applied in the NAP SDC assessment.
Re-test materiality of splitting the 75+ age group	Vic, SA, Tas, ACT	No	Not material. The small number of people aged over 85 offsets their higher cost.
Assess NAP and community health together	NSW, Tas	No	Keeping NAP and community health separate aligns with funding arrangements/associated IHPA data.
AP substitutability – consider if this can be based on NWAU for the private sector	Vic	No	NWAU data are not available for private hospital services.
Lower substitutability level for ED services	NSW	No	Evidence does not support proposition that time of day affects presentation of GP-type patients at ED.
Low level substitutability (15%) for NAP allied health services	Tas	No	Access to NAP allied health services must be linked to a hospital admission. Presence of private allied health services unlikely to affect level of State provision.
Review why bulk billed services (rather than total MBS) used to measure non-State sector	NT	No	Bulk billed services are more similar to State provided services as the cost constraint is removed.
Review Indigenous grants non-States sector adjustment	NT	Yes	AIHW data is used to assess the use of Indigenous health services instead of ED data sourced from IHPA.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
Health (continued)			
Reduce substitutability level of community health	Vic	Yes	Level has been reduced from 70% to 60%.
Substitutability level for community health is higher in remote areas	Qld	Yes	Already recognised. Substitutability levels are an average level and already account for regional differences of service availability. This is also recognised through the high use of State services in remote regions.
Bulk billed GP data should not include services eligible for the Section 19(2) Exemption Initiative	NT	No	Concern related to double counting. It does not occur because the MBS refunds are not deducted from State spending.
Consider capital cost associated with providing cross-border hospital services	ACT	Yes	A cross-border capital stock factor has been introduced.
The assessment does not consider regional hospitals treating fly-in fly-out workers and tourists	WA	No	2018-19 NWAU will include patient treatment remoteness adjustments which should include these types of patients.
Welfare			
CALD cost weight	NSW, NT	No	No data to reliably calculate cost weight.
Indigenous cost weight	NT	No	No data to reliably calculate cost weight.
New measure for the SES assessment of the other welfare component	NSW	No	The new measure proposed by the Commission is considered superior.
Combine New South Wales child protection data with AIHW data for the other States	NSW	No	New South Wales has been requested to provide the data to AIHW to ensure it is compiled on a consistent basis for all States.
Assessment of homelessness and other welfare costs	WA	No	EPC is not a suitable assessment as homelessness has a significant association with low SES characteristics.
Apply a cross-border disability to category expenses	ACT	No	Insufficient evidence to support a disability.
Housing			
Higher costs associated with higher land prices	NSW, Vic	No	There is little evidence linking house prices to social housing costs.
CALD cost weight	NSW	No	A CALD cost weight based on language proficiency is not material.
Indigenous adjustment to rental revenue	QLD	No	An assessment of the cost of differential rental arrears rates between Indigenous and non-Indigenous households would not be material.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
Housing (continued)			
Recognition of clients with a disability	QLD, Tas	No	No data to reliably calculate cost weight.
Update Indigenous and maintenance cost weights	WA, NT	Yes	Current cost weights are dated and the Commission intends to update them.
Services to communities			
Continue applying a regional cost weight and SDS to electricity subsidies	NT	Yes	The new method includes a regional cost weight. State data show that SDS is captured by the new regional cost weight.
Electricity subsidies for large remote and very remote communities	WA	Yes	Data show that these communities receive subsidies to offset higher costs.
Implicit electricity subsidies for the South West Interconnected System	WA	No	This network is not subsidised, and if it were, it would be considered a policy choice.
Water quality	SA	No	Unable to find data to support an assessment of this disability.
APC assessment of water subsidies, net of average revenue, discounted	WA	No	Policy influences actual subsidy levels.
Pipeline disability for water subsidies	WA	No	No evidence of a consistent relationship between distance from the nearest surface water source and costs.
Water subsidies for large remote and very remote communities	WA	No	On average, States do not subsidise large communities.
Land area disability for land management expenses and related services to industry, national parks and environmental protection expenses	WA	No	Land area is not the only driver for these expenses and data are not readily available to identify these expenses.
Exclude common tariff costs for electricity subsidies in remote areas	NSW	No	These costs are not material and removing them would overly complicate the assessment.
Reassess the community size cut-off for electricity subsidies	NSW	Yes	Data are available to reassess the size limits.
Apply different population groupings to electricity subsidies	NT	No	Community size is not a significant predictor of expenses.
Apply different population groupings to water subsidies	NT	No	Data support a community size of less than 1 000 people.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
Services to communities (continued)			
Reassess the split between small community and other water subsidies	WA	Yes	Data are available to determine the split.
Discount the Indigenous community development assessment if using GFS data	NSW	No	Assessment uses State expense data which should be more comparable, and the disability is considered reliable. A discount is not warranted.
Exclude general grants to Indigenous councils	Vic	No	The Indigenous community development disability is the most appropriate driver for these expenses.
Do not apply regional costs to Indigenous community development	NSW	No	Regional costs are relevant as the Indigenous community development expenses are mostly incurred in situ in communities.
Do not apply regional costs to environmental protection, excepting national parks and wildlife	SA	Yes	There is insufficient evidence to support applying regional costs to these expenses.
Apply regional costs to all environmental protection expenses	NT	No	Many expenses may be incurred centrally or in urban areas, such as research and development or pollution abatement.
Net off user charges	SA, ACT	No	Disabilities for user charges are unlikely to be the same as those for expenses.
Justice			
Major city effects, including terrorism & complex crime	NSW	No	No reliable assessment can be made and other indicators suggest it would not be material.
Border patrol	Qld	No	Data indicate any potential costs are not material and costs of remote policing are considered.
Cross-border	ACT	No	Data determine no cross-border case for Justice.
Separate SDC assessments of higher and lower courts	Vic	No	Separate assessment of courts is not material given the way Indigenous status non-response is distributed on an ERP basis.
Cost weights associated with culturally and linguistically diverse population	NSW	No	Data are not available to make a reliable assessment. Data also suggest any potential higher costs weight would be offset by lower use rate.
Separate SDC assessment of custodial and non-custodial corrective services	Vic, Qld	No	Separate assessment is not material.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
Justice (continued)			
Use State budget data to determine SDC/EPC split of courts	Vic, ACT	Yes	Data provided directly from States are more accurate.
Discount SES data by 25% for prisons	ACT	No	Data and conceptual case suggest a mark-up, rather than discount, is warranted. However, it cannot be reliably measured and is unlikely to be material.
Community drug consumption	WA	No	No reliable assessment can be made.
Administrative scale for circuit courts	NT	No	The administrative scale assessment gives States the capacity for minimum size of magistrates' courts. It is double counting to also provide a separate amount for the same service in a different model.
Assess user charges within Justice assessment	ACT	No	It is simpler to assess user charges in the other revenue category given that it is not differentially assessed.
Incorporate regional costs of offenders in police model	NSW	No	Such a model is confounded by remoteness of offender and remoteness of offence and produces counter-intuitive patterns.
Roads			
Physical environment	Qld, Tas, NT	No	Cannot capture all relevant influences, further attempts at measuring the impact are not likely to deliver an improved outcome.
Disaggregation of articulated trucks into at least two categories	WA	No	Data are not available, and disability would be policy influenced.
Congestion	NSW	No	Traffic volume and heavy vehicle use would capture a large proportion, if not all, of the effect of congestion.
Urban density	ACT	No	A conceptual case has not been established.
Roads to hydro power stations, wind farms, grain bins, mining exploration, mines of lesser significance	WA, SA, Tas	Under review	Subject to reliable and comparable data being available the Commission will seek to include such roads where appropriate.
Not make adjustment for unsealed road length	WA	Yes	No reliable cost or road length data to make an assessment.
Assess more connections to urban centres of less than 1 000 people	WA, ACT	No	Two connections reflect what States do on average and incorporating additional connections tended to result in over-counts of road length for most States.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
Transport			
States requested that the urban transport assessment be expanded to capture additional disabilities, such as urban form and topography	Most States	Partially	Some disabilities requested were not included because either no data were available (for example, foreign students) or their inclusion did not improve the model (for example, waterways).
States requested that the non-urban transport assessment be reviewed to ensure that all material drivers are captured	Vic, Qld, ACT	Yes	No material drivers could be identified.
Change the definition of urban centre and/or include satellite cities as part of capital city	Qld	No	The analysis by the consultants did not support this change.
Assess urban transport expenses EPC	WA	No	Evidence shows that there are significant non-policy differences between States in the cost of providing urban transport services.
Assess non-urban transport expenses EPC	WA	Yes	No material drivers could be identified.
Services to industry			
Consider the impact of Commonwealth assistance to industry on State business development spending	ACT	No	The interstate distribution of these payments is unknown and it would be difficult to determine how these affect State fiscal capacities.
Restrict the EPC assessment to expenses that develop new industries — for existing industries, use industry activity measures to assess needs	WA	No	States have considerable discretion over the amount and types of programs that receive funding. Population remains the appropriate driver of business development expenses.
The absence of a well-established private sector is a driver of State spending on business development	NT	No	As above.
A regional costs factor should be applied to business development expenses	WA	No	A significant proportion of business development expenses are incurred in capital cities or provided as grants.
Use a regression approach to determine disability weights	WA	No	There is significant policy influence on the expense data, and volatility in the annual value of agricultural production.
Major projects disability to include Commonwealth non-dwelling construction, rather than just private non-dwelling construction	ACT	No	Including this indicator is appropriate and is material for the ACT. However, major project expenses will no longer be assessed.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
Other expenses			
Assess natural disaster mitigation expenses APC	ACT	No	Unable to isolate expenses and identify an appropriate disability.
Assess natural disaster mitigation expenses APC, with 50% discount	NSW	No	As above.
Apply a cross-border disability to recreation and culture expenses	ACT	No	Insufficient evidence to support a disability.
Assess natural disaster relief expenses EPC	Vic	No	Insurance and mitigation measures considered to be sufficiently consistent between States for an APC assessment due to the common national framework.
Investment			
Physical environment	NT	No	Current capital cost measure captures some influences. It is not possible, with the data available, to further refine the assessment.
Volatility of population growth	WA	No	The conceptual case is weak, a reliable assessment cannot be produced. Any assessment is likely to be immaterial.
Cost of construction on Indigenous owned/managed land	NT	No	Data are not available.
Ability to attract PPPs	TAS, ACT	No	Unlikely to be material.
Higher land costs in urban areas	NSW, VIC	No	Unlikely to be material.
Separate depreciation assessment	WA, TAS, NT	No	More transparent to assess depreciation with investment in a gross assessment.
Net borrowing			
EPC assessment	VIC	No	States hold net financial assets on average and faster growing States have higher GST requirements.
Administrative scale			
Review the administrative scale cost estimates	All States	Yes	The cost estimates had not been reviewed since the 2004 Review.
Wage costs			
National labour market	Vic, SA	No	No evidence for large impact of national market over and above impact of competition for labour from other sectors within a State.
Productivity adjustment	SA	Partially	Comparison with HILDA model does not indicate bias, but contributing factor to retention of discount.
PSS adjustment	ACT	No	Not material under specified conditions.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
Wage costs (continued)			
Health wage costs adjustment	WA	No	Would introduce policy choice concerns and increase the requirement for Commission judgement in the assessment.
Tasmania specific adjustment	Tas	No	Most recent model results for Tasmania lay within reasonable bounds, reducing the concerns.
Not use private sector wages	Qld, SA	No	Consultants found that public sector wages respond to the same pressures as private sector wages.
Model specifications	Vic	No	There is a strong conceptual case for the existing model.
Remove the discount	WA, Tas, ACT	No	There are still low levels of concerns over how well private sector wages may proxy government sector wages and how well the model controls for productivity.
Reduce model volatility	WA	No	The current three year averaging process sufficiently reduces the volatility in the single year estimates.
Geography			
Difference between place of residence and place of receipt	NSW, Vic	Yes	A strong conceptual case for these allowances.
Further differentiation of very remote areas	WA, NT	No	No practical way of doing so, and not clear what basis upon which to do it.
Cease interstate non-wage cost assessment	NSW, Vic, NT	Yes	Convinced by State arguments that assessment is unreliable.
Cost of construction in brownfield areas	VIC	No	Not material.
Incorporate housing costs into measure of socio-economic status	NSW	No	Not material, but intend to follow ABS if ABS adopts this approach.
Use remoteness areas to measure Service delivery scale	ACT	Yes	This represents a simplification of the assessment.
Adopt State specific regional cost assessment	WA	No	It is not clear how this could be assessed without introducing major opportunities and incentives for States to game the system. It is not clear that any material disabilities are not currently being captured.
Use category specific data to measure regional costs where possible	NSW, Vic, Qld	Yes	This improves the reliability of the assessment.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

Table 1-4 Commission responses to State proposals, 2020 Review (continued)

Proposal	State	Adopted	Explanation
National Capital			
National Capital Plan on planning and development activities	ACT	Yes	A strong conceptual case for these allowances.
National Capital Plan on the ACT's capital works program	ACT	Partially	An allowance for the administration costs related to capital works is accepted but the capital costs are not.
National Capital Plan on the ACT's light rail project	ACT	Partially	An allowance for the administration costs related to light rail works is accepted but the capital costs are not.
National Capital Plan costs incurred due to leasehold system	ACT	Yes	The ACT does not have an option to end the leasehold system and move to a freehold system.
The additional costs of maintaining above average urban space	ACT	No	Insufficient evidence ACT faces above average costs beyond its control.
Additional ACTION costs	ACT	No	Considered in Transport assessment.
Above average urban/bush interface	ACT	No	Insufficient evidence ACT faces above average costs beyond its control.
Additional services provided to the Commonwealth - suspicious packages	ACT	No	Relates to a federal agreement between States and is outside the scope of this assessment.
Wider arterial roads	ACT	No	Sufficient time has passed for the road network to be restructured and no longer impose additional costs.
Native title and land rights			
Further consideration of a differential assessment	NSW, ACT	No	States tend to provide these services in cost effective ways and any differences in the level of expenses reflect their circumstances.

Note: Acronyms used in this table are spelt out in the relevant attachments.
Source: Commission decisions.

CHAPTER 2

MEASURING RELATIVE FISCAL CAPACITY

2.1 In September 2017, the Commission released a position paper, The Principle of HFE and its Implementation (CGC 2017-21), which set out its interim views on the principles and guidelines for implementing horizontal fiscal equalisation (HFE).[1]

2.2 This chapter sets out the principles and guidelines the Commission has applied in the draft report for developing the methodology for measuring State fiscal capacities. The Commission has had regard to State views in response to *CGC 2017-21*.

THE COMMISSION'S TASK

2.3 On 28 November 2016, the Treasurer gave the Commission terms of reference for a review of the methodology for calculating the GST relativities from 2020-21. A copy of those terms of reference is at page iv and is available on the Commission website, (https://cgc.gov.au/).

2.4 The Commission expects the 2020 Review methodology will provide the basis for measuring State relative fiscal capacities under the current and new arrangements for determining the GST distribution.[2]

The terms of reference and the principle of HFE

2.5 Chapter 1 set out the requirements of the terms of reference for this review. The terms of reference require the Commission to base its methodology on the principle of HFE. In the 2015 Review, the Commission articulated the HFE principle for determining the GST revenue as follows.

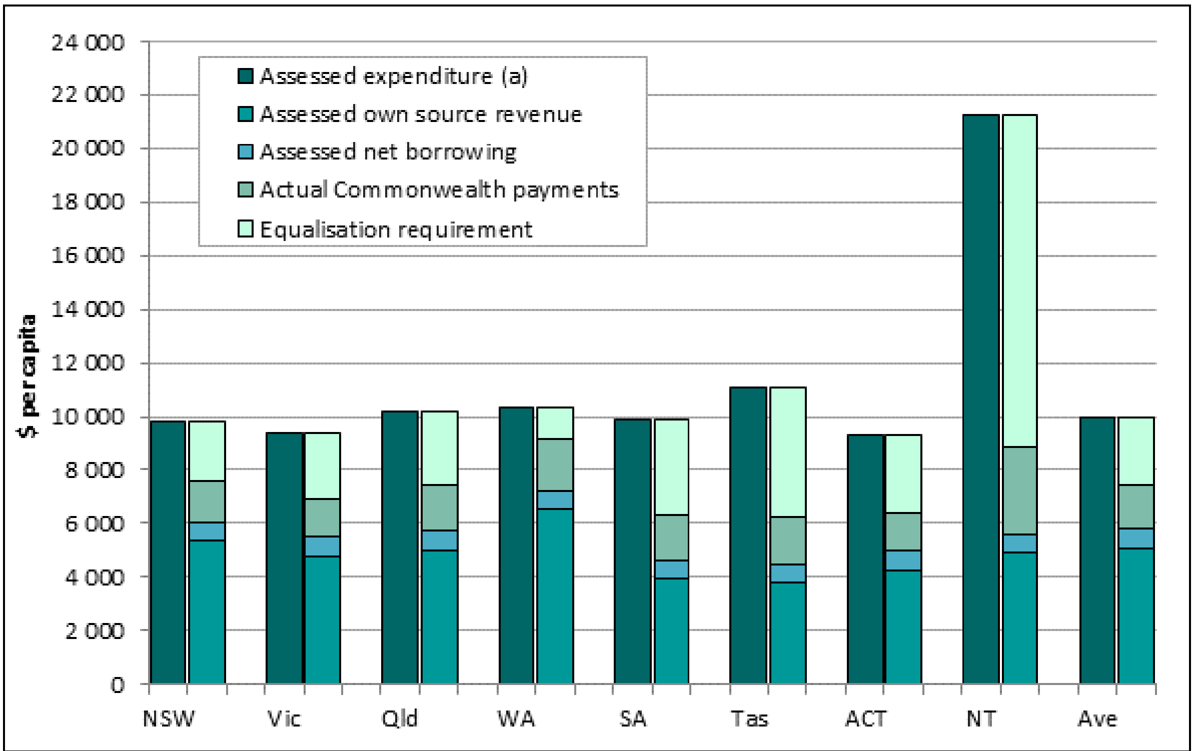
1 *CGC 2017-21 — The Principle of HFE and its Implementation* is available on the Commission website, (https://cgc.gov.au/).

2 Chapter 4 describes the new arrangements for determining the GST revenue sharing relativities from 2021-22. The reference to current arrangements is to those that currently apply and will continue to apply until 2021-22. Chapter 4 refers to these as the 'previous arrangements'.

State governments should receive funding from the pool of GST 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.

2.6 This definition reflects the Commission's approach to measuring the relative fiscal capacities of the States. Figure 2-1 illustrates the approach.

Figure 2-1 Equalisation requirement, 2017-18



(a) Includes expenses and investment.
Source: Commission calculation.

2.7 A State's equalisation requirement is the difference between the sum of its assessed expenses and assessed investment, and the sum of its assessed own source revenue, assessed net borrowing and Commonwealth payments for specific purposes (PSPs). That is:

- a State's assessed expenses are the expenses it would incur if it were to follow average expense policies, allowing for the disabilities it faces in providing services, and assuming it provides services at the average level of efficiency[3]
- a State's assessed investment is the expenditure on infrastructure it would incur if it were to follow average policies, allowing for disabilities it faces in

[3] A disability is an influence beyond a State's control that requires it to spend more (or less) per capita than the average to provide the average level of service, or to make a greater (or lesser) effort than the average to raise the average amount of revenue per capita. See also paragraph 2.12.

providing infrastructure, and assuming it requires the average level of infrastructure to deliver the average level of services

- a State's assessed revenue is the revenue it would raise if it were to apply the average policies to its revenue base, and raise revenue at the average level of efficiency
- a State's assessed net borrowing is the amount a State would require to achieve the average net financial worth at the end of each year
- a State's Commonwealth payments is the amount of payments for specific purposes (PSPs) it receives from the Commonwealth.[4]

2.8 The assessed equalisation requirement is the Commission's estimate of the funding each State requires to have the financial capacity to provide the average (or same) standard of services. This level of funding also ensures that each State has the financial capacity to finish the year with the average (or same) net financial worth (NFW) per capita. In other words, NFW is equalised.

2.9 Under the current arrangements, the Commission is required to produce per capita relativities for distributing GST revenue in accordance with the principle of HFE. These relativities reflect each State's assessed fiscal equalisation requirement. Under the new arrangements that take effect from 2021-22, the Commission's measures of relative fiscal capacity will no longer be the sole basis for determining the recommended GST distribution. The Commonwealth Government has adopted a new equalisation standard that will ensure that State governments receive funding from the GST pool such that each has the capacity to provide services at the standard of New South Wales or Victoria, whichever is higher.[5] In addition, the new arrangements specify minimum relativities for Western Australia and the Northern Territory.

2.10 In future, the new arrangements will require the Commission to measure the relative fiscal capacity of all States as a step towards recommending GST revenue sharing relativities consistent with the legislated transition to reasonable equalisation in 2026-27. Throughout this transition, the Commission will continue to base its measures of relative fiscal capacity on the same HFE definition that has applied previously, but the definition will be expressed in a way that acknowledges the changes to the arrangements for determining GST payments to the States. For the 2020 Review, the principle of HFE will be articulated as follows:

[4] The calculations include most, but not all, PSPs. The ToR quarantine (or exclude) some payments and the Commission excludes others because they do not affect fiscal capacities.

[5] The GST pool refers to the total GST entitlement of the States plus any permanent top-up payments.

> The assessment of State relative fiscal capacities, for informing the GST distribution, will be determined for each State 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.

2.11 The definition continues to focus on the main task of the Commission: to identify factors, or 'disabilities', affecting State finances.

2.12 Disabilities are influences that are beyond the direct control of States that cause their fiscal capacities to diverge. By assessing these factors, the Commission is able to determine the level of funding each State would need to provide the average level of services. The reference to material factors in the definition makes it clear that the Commission only measures those disabilities that have a relatively significant effect on State expenditure needs or revenue raising capacity.

2.13 Specifically, 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
- cause their assessed expenditure or revenue to differ from an equal per capita (EPC) assessment by more than the materiality thresholds.[6,7]

2.14 In 2020-21, the Commission's assessment of State relative fiscal capacities will provide the GST revenue sharing relativities as in previous years. From 2021-22, the Commission's assessments will allow it to assist the Government to implement the legislated changes by:

- identifying the stronger of New South Wales and Victoria for the purpose of producing reasonable equalisation relativities
- facilitating the legislated calculation of a set of blended relativities for distributing GST revenue during the transition years
- providing information to allow the Treasurer to determine if any State is worse off under the new arrangements during the transition years.

2.15 Chapter 4 discusses these issues in detail.

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6 Under an EPC assessment, each State is assessed as needing to spend the average per capita amount on delivering services or being able to raise the average per capita revenue from its revenue bases.

7 Materiality thresholds represent a minimum change from an equal per capita distribution of expenditure or revenue that must be met before the Commission will recognise a disability. The section on Implementation issues discusses material thresholds in more detail. See paragraph 2.131.

2.16 In commenting on the 2015 Review definition of the HFE principle used to distribute the GST revenue prior to the reforms being finalised, Victoria, Western Australia, South Australia, Tasmania, the ACT and the Northern Territory said they supported, or were comfortable with, the 2015 Review definition. Queensland said it strongly supported HFE but the definition should change to reflect better that in practice the outcomes deliver similar rather than the same fiscal capacities. New South Wales said it supported HFE, which in their view, an EPC distribution would achieve.

2.17 The legislated changes make clear the intentions of the Australian Government, subject to transitional arrangements. It endorses a form of HFE that ensures that State governments receive funding from the GST pool such that each would have the capacity to provide services at the standard of New South Wales or Victoria, whichever is higher.

2.18 Having regard to the terms of reference and the amendments to the *Commonwealth Grants Commission Act 1973* and *Federal Financial Relations Act 2009*, it will be necessary for the Commission to continue to assess State relative fiscal capacities in accordance with the principle of HFE applying before the HFE reforms were legislated. Consistent with this, the Commission considers that it must continue to estimate the amount required by each State under the current 'full equalisation' standard.

2.19 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. Box 2-1 discusses these arrangements in the Australian federation.

Box 2-1 Horizontal Fiscal Equalisation in the Australian Federation

The principle of HFE underlies the fiscal equalisation arrangements of all federations. Broadly, fiscal equalisation seeks to reduce fiscal disparities between sub-central governments. Each federation decides how to give effect to the principle and no two federations have the same arrangements. In Australia, the Commonwealth Government, in consultation with the States, is responsible for deciding the form of equalisation. The Commonwealth Grants Commission (CGC) is the body responsible for measuring the relative fiscal capacity of the States and recommending the distribution of GST revenue in accordance with the Government's fiscal equalisation policy.

Under HFE arrangements in Australia since the 1980s, equalisation has sought to ensure that each State 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.

The Commonwealth and State governments have responsibility for delivering major public services to Australians. The Commonwealth collects most of the tax revenue for both levels of government. In addition to defence and other national functions, 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, childcare and aged care.

Commonwealth funding policies generally apply on a common basis in all States, so that in these areas there is effective equalisation operating throughout the Commonwealth. The Commonwealth collects more revenue 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, 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 have the financial resources to provide the same standards of services in these and other areas.

Thus, HFE seeks to achieve the benefits of equalisation that would otherwise require transfers of functions 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.

SUPPORTING PRINCIPLES

2.20 In making and explaining decisions on the development of its methodology in accordance with HFE, the Commission has adopted certain supporting principles. They capture the main influences that experience suggests the Commission has to consider in evaluating the different aspects of the methodology for assessing State fiscal capacities. These principles also provide guidance to the States in preparing their submissions through the consultation process.

2.21 The four supporting principles developed over time are:

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

2.22 The supporting principles inform decisions on the structural elements of the Commission's methodology:

- scope — identifying which revenues and expenditures to assess and how to categorise them
- disabilities — identifying the conceptual case supporting the existence of a disability[8]
- assessment methods — how to give effect to, and measure, the disability.

2.23 Clause 6 of the terms of reference asked the Commission to consider whether the supporting principles it uses remain appropriate, including whether different weights should apply to different supporting principles.

2.24 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.

2.25 The interaction and subsequent constraints between the supporting principles requires a balancing of competing considerations when determining the choice of methods. The need to balance competing considerations reflects the complex issues the Commission must consider when undertaking its task, which in turn reflects the complexity and variety of State government activities. As required, the Commission uses its judgment to devise the best overall result consistent with the principle of HFE.

8 Paragraph 2.12 defines disabilities.

2.26 For the 2020 Review, the four existing supporting principles have been maintained, but with some further clarification of their purpose and scope. The Commission does not propose to establish any prior ranking or weighting of them. The balance of considerations may differ with the varying structural elements of the Commission's methodology and with varying underlying circumstances in each area of assessment. The Commission considers that wherever possible, methods should have regard to all of the supporting principles.

2.27 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 did not support a hierarchy of principles and argued the Commission should retain flexibility to use its judgment to determine the relative priority of the principles on a case-by-case basis. These States considered the supporting principles assist the Commission to implement HFE in a consistent and coherent way, and ensure HFE remains the priority. In addition, they did not suggest any new principles, noting that the four current principles are appropriate and sufficient.

2.28 The ACT considered 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 said that any trade-offs should ensure HFE remains the priority. The ACT said that one of the positive aspects of the HFE arrangements is the fact the Commission can exercise judgment if its best endeavours to build a reliable assessment do not lead to an outcome consistent with its observations of State circumstances.

2.29 Queensland also viewed HFE as the priority, with the supporting principles assisting the Commission to achieve HFE. Queensland emphasised the importance of:

- practicality, particularly simplicity, which helps to build the credibility and robustness of the HFE 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.

2.30 Queensland suggested the Commission specify a hierarchy for the supporting principles but did not suggest how a hierarchy might be developed or used.

2.31 Western Australia argued for a new set of principles and raised the following concerns about the current principles:

- HFE cannot be achieved without policy neutrality, because it is integral to ensuring that the outcomes reflect States applying the same effort and HFE does not distort their policy decisions

- the Commission's use of the 'what States do' principle leads to a micro approach which fails to uncover the essence of what States do and ignores intertemporal aspects of what States do
- the practicality principle is really an operational consideration, not a core principle, and it is inherently ambiguous
- contemporaneity is also an operational consideration rather than a defining principle, which the Commission acknowledges is not achieved due to the use of average historical assessments; this causes significant budget management difficulties and volatility for an outlier State.

2.32 Western Australia distinguished between fundamental principles and operational principles. It proposed the following fundamental principles to support HFE.

- Policy neutrality — proposing that broader indicators should be used so that GST grants are unaffected by revenue or spending mixes or differences in policies that affect revenue bases and spending needs. Western Australia's arguments focused on revenue assessments.
- Equity — so that underlying disabilities are recognised (rather than their detailed manifestations), consistent with policy neutrality, broadly reflecting State policies.

2.33 Western Australia proposed the following operational 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, avoiding the influence of cyclical factors.
- 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 there is no consensus). The Commission should be responsible for implementation, not policy.
  - The Commission's methods should undergo regular peer review by independent experts commissioned to conduct reviews.
  - There needs to be full documentation of data and evidence used by the Commission in reaching decisions.
  - Methods should be clearly described and simple.

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

2.35 New South Wales argued that a well-designed and carefully targeted system of HFE, achieved 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, and easy to replicate.
- Accountability — this 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.

2.36 New South Wales acknowledged these principles are similar to the current principles the Commission uses. It argued that they are essential to HFE and not subsidiary to the overarching equity principle.

2.37 The Commission notes there is significant overlap between the supporting principles proposed by New South Wales and Western Australia and the Commission's current principles. The Commission considers that the proposals put forward by New South Wales and Western Australia stem from concerns with the Commission's emphasis on HFE and relate to how it applies the supporting principles to its work. For example, both States support a policy neutrality principle. However, their judgments on how to apply the principles in deciding questions of scope, disabilities and methods would be different to the Commission's judgments.

2.38 The main area of difference between the Commission's principles and those proposed by New South Wales and Western Australia relates to their views on HFE. Western Australia supports an equity principle that takes a broad view of what States do and a broader approach to measuring fiscal capacity (especially on the revenue side of the budget). New South Wales prefers a fairness principle that provides capacity for a minimum standard of core services. It also supports broader assessments, achieved by increasing the materiality threshold for a disability.

2.39 New South Wales and Western Australia also emphasised accountability and transparency as supporting principles. The Commission agrees these are important matters but considers them governance issues that do not change, in themselves, the task of measuring fiscal capacities. The Commission notes that simplicity, which is an aspect of the practicality principle, supports transparency.

2.40 Having considered the proposals of New South Wales and Western Australia, the Commission takes the view that the current supporting principles remain relevant and appropriate for supporting its work in assessing State fiscal capacities. The Commission considers that there would be no advantage in weighting the supporting principles or distinguishing between fundamental and operational principles as suggested by Western Australia. The task of the Commission, articulated in the terms of reference, is to measure the fiscal capacities of the States in accordance with the principle of HFE. The Commission considers that proposals presented by New South Wales and Western Australia would have the effect of limiting the Commission's ability to achieve its task.

'What States do'

2.41 This supporting principle ensures that the Commission's assessments reflect the full range of State expenditure and revenue. It applies mainly to deciding the scope of assessments and to identifying disabilities. 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 (or average) policy. Importantly, this principle reflects the long-standing empirical nature of the Commission's way of working to equalise State budgets, as opposed to a normative approach whereby the Commission would substitute its own view of 'what States should do' or 'what States could do'.

2.42 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 average expenditure and revenue,[9] rather than requiring 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.

2.43 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 revenues 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

9 Sometimes this is referred to as the revenue or expenditure 'standard'.

- the range of disabilities assessed reflects the material factors beyond a State's control actually affecting the cost of delivering State services and the capacity to raise State taxes.[10]

2.44 Victoria, Queensland, South Australia, Tasmania, ACT and the Northern Territory supported the 'what States do' principle and its implications for the scope of equalisation, choice of standards and disability measurement. New South Wales did not comment.

2.45 Western Australia was critical of the 'what States do' principle. It said the principle leads to the recognition of disabilities generated by policy instead of underlying disabilities. Western Australia suggested the Commission should 'try to uncover the essence of what States do', rather than focusing on the detailed manifestations of what States do. As well as having a concern that such an approach would compromise the achievement of HFE, the Commission also notes that adopting Western Australia's suggestion would involve a fundamental departure from the Commission's practices since its establishment in 1933, with a risk of creating a 'castle in the air' of what States might, in a theoretical sense, be able to do if freed from real world constraints.

Scope of equalisation

2.46 The Commission intends to retain the existing scope of equalisation, which includes the State general government sector, plus urban transport and social housing public non-financial corporations (PNFCs) and excluding local government (except for the interactions between it and the State sector).

2.47 The Commission considers that neither the intergovernmental agreement (IGA), nor successive terms of reference from the Treasurer, provide a basis for discriminating between services or revenues. Therefore, it considers there to be no logical basis for excluding particular activities as proposed by New South Wales and Queensland. A comprehensive coverage is consistent with an aim of measuring (to the extent possible) the capacities of States to provide services at the average standard. Omitting major revenues, expenditure or disabilities would not be consistent with equalising fiscal capacities. A comprehensive scope does not mean that all functions can or need to be differentially assessed or that spending and revenue needs to be examined in detail. Most States supported a comprehensive coverage of State activities, although Western Australia said it preferred to take a broader view of State activities. It suggested options for broader revenue assessments but not for expenditure.

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[10] Materiality thresholds represent a minimum change to the redistribution from an equal per capita assessment for a revenue or expense before the Commission will recognise a disability. The section on Implementation issues discusses them in more detail in.

2.48 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 when some services, in some States, are delivered through PNFCs. A comprehensive scope limits the risk of inadvertently favouring or prejudicing certain ways of delivery services through the creation of artificial distinctions. It leaves States with flexibility on how they manage the business of government.

2.49 The Commission intends to continue to equalise the fiscal capacity of States so that they have the same average per capita NFW. That is, as in the 2015 Review, the Commission will implement the HFE principle 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.

2.50 This approach explicitly states that equalising net financial worth means that income from general government holdings of NFW is equalised. There is a simplifying assumption underlying the equalisation of NFW, that States hold the average mix of financial assets and have the same capacity to earn income from those assets.

2.51 Victoria, South Australia, the ACT and the Northern Territory said they supported, or were comfortable with, the current approach to implementing HFE, which culminates in the equalisation of NFW. South Australia noted it continues to see merit in the 2012 GST Distribution Review's recommendation of a simplified and integrated assessment framework.[11] Tasmania said it continued to have concerns with the assumptions underlying the net borrowing assessment that ensures NFW is equalised. It acknowledged the effects of population growth on NFW but considered there are other offsetting effects that the assessment should recognise. Tasmania has not presented any new analysis of the issue, which the Commission considered in some detail in the 2010 and 2015 Reviews. In addition, the expanded scope of the adjusted budget from the 2015 Review, to include certain PNFCs, has seen a reduction in materiality of the net borrowing assessment. As a result, an assessment to recognise the influences Tasmania described would be immaterial. New South Wales, Queensland and Western Australia did not comment. In the absence of any new analysis to support a change to the assessment, the Commission intends to

[11] The simple and integrated approach uses a modified operating statement to recognise State capital needs. The modified operating statement would include the holding cost of capital and the activities of housing and urban transport PNFCs. Under this approach, net financial worth would be equalised.

continue to implement the HFE principle so that States have the capacity to hold the same average per capita NFW.

2.52 Regarding local government, all States that commented on this issue supported the exclusion of local government. New South Wales and Western Australia did not comment.

2.53 No State objected to including urban transport and social housing PNFCs; however, Tasmania noted the implications for the Investment assessment. Tasmania's concerns related to the Commission's approach to assessing capital rather than including PNFCs.

Internal standards

2.54 The Commission continues to have a strong preference for internal standards (that is, basing equalisation on what States do) because it avoids the need for normative judgments about appropriate external standards. However, in circumstances of extreme policy non-neutrality, where it is difficult to determine what average policy would be, the Commission could consider the use of external standards, if another suitable resolution is not available. In this review, the Commission has not identified any situations necessitating an external standard.

2.55 Average State expenses, investment and revenues are derived generally by dividing the total collective State expenses, investment and revenues by total State population. Average revenue raising efforts generally are derived by dividing the total collective State revenue by the total collective State tax bases. Therefore, these averages are influenced by what States do, to the extent each State undertakes the activity.

2.56 In relation to service delivery, the Commission intends to continue to observe what the data reveal about the different spending patterns States collectively 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.

2.57 The Commission notes that it does not intend to discount or otherwise adjust standards as a means of more actively encouraging efficiency. This would distort the observed relationships. The Commission will equalise States to the average cost of service delivery that 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.

2.58 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. In the same way, settlement patterns (including urban form) reflect a range of geographic, historical and economic conditions. The Commission's view is that measuring State fiscal capacities must take account of these differences.

2.59 The Commission acknowledges that data quality and policy neutrality challenges associated with more detailed approaches 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 a more reliable indicator of State capacity to raise revenue or service delivery costs than any alternative approach. As already noted, Western Australia said the Commission should not focus on what States do in detail but try to uncover the essence of what States do. This appears to be a reference to adopting broader assessment approaches. Western Australia has described what this entails for revenue assessments but not how the Commission would uncover the essence of what States do for service delivery, or how it would implement an assessment or assessments recognising the essence of what States do.

2.60 Victoria, Queensland, South Australia, Tasmania, the ACT and the Northern Territory supported the use of internal standards and considered any departure from an internal standard to overcome policy neutrality concerns should be in extraordinary cases only. South Australia doubted there are any current circumstances that would warrant the use of external standards. Queensland, Tasmania and the Northern Territory commented that an external standard would impinge on State autonomy. The Northern Territory noted that the most populous States dominate an internal standard, which embeds a level of efficiency into the national average cost, based on the largest States being able to achieve economies of scale. New South Wales and Western Australia did not comment specifically on the issue.

Weighted averages and average policy

2.61 Where States follow different policies, the Commission needs to determine the average policy to be used as a benchmark for its assessments. If the Commission observes that a tax or service is part of what States do, it considers whether there are material differences in underlying capacities to raise the tax or deliver the service.

2.62 In adopting internal standards, States with a larger share of a revenue base or service population 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.

2.63 In the 2015 Review, the Commission extended its approach to determining average standards to also determining average policy. It said the aim was to use what the data told it about what States do to decide the scope of the assessments. The Commission intends to continue to adopt this ‘weighted average’ method as its general approach, where average policy reflects the average of what all States do, recognising that some States may make a zero effort.

2.64 Under this approach to average policy, if even one State raises a revenue or provides a service, the revenue raised or spent becomes part of what States do collectively. However, the Commission would only have a differential (non-EPC) assessment if the conceptual case for a disability is established and it is material. 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[12]
- 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.

2.65 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 the average per capita spending on the service will be. 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.

2.66 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. Thus, the materiality threshold guards against a proliferation of assessments under its average policy approach. 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.

2.67 The Commission notes that applying this approach to determining average policy, at times, may 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 practical. In these cases, the Commission intends to use its discretion in deciding the methods to adopt.

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[12] 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.

2.68 Victoria, Queensland, Western Australia and the Northern Territory commented on the Commission's approach to average policy. Victoria said it could not determine if the 2015 Review approach would produce different outcomes and therefore it was indifferent to which approach the Commission uses. Queensland and the Northern Territory said there are policy neutrality concerns with the 2015 Review approach. They were concerned that one or two States could potentially set average policy and directly influence outcomes. Queensland cited the commodity based Mining assessment as an example. Western Australia raised concerns about the lack of policy neutrality arising from a detailed view of what States do. It considered that the Commission's approach to average policy promotes a view that disabilities are generated by policy. The other States supported the Commission's approach to average policy or did not comment.

2.69 The Commission notes that the change in its approach to average policy has not increased the number of disability assessments in the 2015 or 2020 Review. This is largely due to the materiality threshold applying to a disability or absence of data to support a reliable assessment of a tax or service that is not common to most States. The advantage of the 2015 Review approach is that it reduces the need for judgment about when a tax or service is part of average policy. In addition, the Commission notes that, although all State spending and revenue contribute to average policy, not all spending and revenue is subject to a differential assessment. By applying its assessment guidelines, the Commission avoids the potential for policy-generated disabilities, a concern raised by Western Australia. The Commission intends to retain the current approach to average policy.

Disability measurement

2.70 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. For revenue assessments, it can often do this in a straightforward manner. 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.

2.71 For expense assessments, the Commission observes State service delivery policies and collects administrative data that reveal what States do. The data reveal the populations to whom States 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 each population group and divides that by the national number of people in each of those groups. The resulting expense per person for 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).

2.72 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. Therefore, 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.

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

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

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

- bulk-billed 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
- annual growth in service populations are proxies for the pressures States face in their capital requirements.

2.75 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.

2.76 Victoria, South Australia, Tasmania, the ACT and the Northern Territory supported the Commission's approach to disability measurement. Victoria noted that disability measures must minimise double counting. A number of States identified additional disabilities they would like the Commission to include. However, for reasons set out in paragraph 2.73, this has not always been possible.[13]

2.77 Western Australia considered that the Commission's 'national-centric approach' to identifying and measuring disabilities is one of the factors undermining confidence in HFE. The difficulty with moving away from measuring disabilities based on what States do on average is that it runs the risk of including assessments that are not policy neutral. Western Australia has consistently argued that the Commission's assessments are not sufficiently policy neutral. The Commission considers that its current approach to measuring disabilities leads to assessments that are policy neutral while giving appropriate recognition to material disabilities affecting State revenue raising capacity and expenditure needs. The Commission intends to maintain its current approach, which is to balance what States do and policy neutrality considerations to ensure the main sources of fiscal capacity difference are recognised.

2.78 Western Australia also argued that the Commission's approach to implementing what States do leads to detailed data-driven assessments that are too reliant on standard national classifications (for example, the Accessibility and Remoteness Index of Australia (ARIA) and indexes of socio-economic disadvantage). It argued that this fails to capture underlying drivers of need. The Commission prefers methods that are evidence-based and use standard classifications. This reduces the need for judgment. Many administrative datasets used in the expense assessments utilise standard classifications that are familiar to data providers and analysts. Adopting bespoke classifications would reduce transparency and unwind some of the simplification achieved in the 2010 and 2015 Reviews. It also appears inconsistent with other proposals put forward by Western Australia including on policy neutrality, conservatism and simplicity.

2.79 The Commission does not agree with Western Australia that the disability assessments are data-driven, or that the Commission engages in 'data mining'. The Commission's process for including a disability is set out in the assessment guidelines. The first step is to establish the conceptual case for a disability. In establishing the conceptual case, the Commission observes what States do. State visits and submissions are an important part of developing an understanding of the factors that affect service delivery costs and revenue raising capacity. Then the Commission looks for national datasets, or comparable State data, that show what States spend on different population groups or the size of each State's tax base. Without data, it is difficult for the Commission to confirm the presence of a disability

13 Chapter 1 provides a summary of the disabilities States asked the Commission to include and its response.

or measure its effect on State finances. This is how the Commission prefers to approach its task.

Policy neutrality

2.80 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.

2.81 Equalisation has the potential to interact with policy choices, at least indirectly. However, through assessing fiscal capacity using the weighted average of the revenue and expenditure policies of the States, it is possible to minimise direct effects of policy in most cases. Arguably, adopting a rotating standard approach might improve policy neutrality. However, the Commission does not consider these improvements would offset the increase in complexity that would flow from operationalising such an approach. No State supported a rotating standard, although Western Australia viewed it as a second best option to its broader revenue approach.[14]

2.82 The Commission's assessments continue to be based on average policies, so that a State's incentive to change its own policies in the expectation of increasing its grant share (that is, engage in grant seeking behaviour) is limited to the effect of its policies on the average. Under the Commission's approach, there are no allowances for differences between the average policy and a State's own policy. To the extent that those differences lead to increased costs, States are responsible for funding those additional costs. If those differences lead to reduced costs, States retain the benefit of the cost savings.

2.83 Western Australia said it accepted that complete policy neutrality is not feasible, but considered that policy neutrality needed greater emphasis. It highlighted policy neutrality concerns with the Mining assessment. Western Australia said the Commission's over reliance on a narrow interpretation of the 'what States do' principle undermines policy neutrality, which could be improved by adopting global revenue indicators.[15] Queensland suggested addressing policy neutrality concerns with the mining assessment through an aggregated Mining assessment or discounting. Nevertheless, Queensland stated that it is not aware of hard evidence that the current system creates disincentives for States to pursue economic reforms or engage in economic development.

14 Under a rotating standard approach each State in turn is chosen as the standard State and its policies are applied to every other State. The results for each standard State are then population weighted to obtain a State's assessed expense or assessed revenue.

15 See Attachment 8 — Mining, for further details on the policy neutrality of the Mining assessment.

2.84 Most States considered the Commission's current approach to achieving policy neutrality is effective. South Australia considered that the motive behind proposals to address policy neutrality concerns through broader assessments appears to be a desire to increase grant shares for States with strong fiscal capacities. South Australia is opposed to broad indicators to measure revenue capacity because this would result in arbitrary winners and losers, is unlikely to achieve significant simplification and would result in a less equitable and efficient HFE outcome. Tasmania said that legislated changes to the HFE system obviate the need to adjust the Mining assessment to address policy neutrality. It also said the Commission's proposal to limit the extent that tax and royalty changes constrained the operation of HFE, is impractical and may be unnecessary under new HFE arrangements.[16]

2.85 Victoria said that the current HFE system results in some minor incentives that could, conceptually, affect State policymaking. However, it said that in practice there appears to be no significant impact on policy. Victoria cited a number of examples of States undertaking reform in the presence of HFE. It also noted the view of the 2012 GST Distribution Review Panel, which doubted 'that GST share effects are a very powerful factor when States are considering tax reform'. The Northern Territory agreed that grant distribution effects are not a determinant of whether States pursue reforms.

2.86 The ACT supported the Commission's efforts to further strengthen policy neutrality through the proposal to limit the extent to which any discretionary change in mineral royalty rates flows through to assessed revenue capacities, ensuring States placing bans on minerals and energy development are not unduly rewarded and accounting for the influence of tax elasticities. Queensland and the Northern Territory also supported the Commission undertaking additional work to consider the influence of tax elasticities.

2.87 Most State comments focused on policy neutrality and the revenue assessments, which the following sections discuss.

Dealing with policy neutrality of State revenue raising capacity

2.88 The Commission accepts that adoption of broader indicators, particularly for revenue assessments, may improve policy neutrality, but it does not agree that this would necessarily result in an improved HFE outcome when having appropriate regard 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

16 The Commission's proposal was outlined in *CGC 2017-21 — The Principle of HFE and its Implementation*, which is available on the Commission website, (https://cgc.gov.au/).

neutrality can only be achieved with a 'long term view' of what States do, as argued by Western Australia.[17]

2.89 Western Australia has again raised the issue of differences in State development efforts. It said its above average development effort represented a policy influence on its mineral production that the Mining assessment should recognise.[18] However, the Commission has not been able to determine how much of Western Australia's royalty revenue can be attributed to its development effort or how much of its effort was above the average effort. Similarly, it is not possible to identify any additional revenue that may be attributable to various economic development projects (reflecting above average effort) in other States.

2.90 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. 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 attained their positions due to 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.

2.91 Western Australia also argued that the current approach could result in a high loss of equalisation 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 relative to the costs of collection. It is more likely that diminishing returns, from collection costs increasing at a faster rate than tax receipts increasing, would have a larger effect on compliance policy than equalisation.

2.92 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 State revenue raising capacities, the Commission adopts different approaches depending upon the circumstances.

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17 Western Australia said that the revenue assessments should recognise the effects of past policies on current revenue bases in some manner, including by applying a discount.

18 The particular example Western Australia provided was the North West Shelf project.

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

Dealing with policy neutrality concerns relating to revenue rates

2.94 In most cases, each State has only a limited influence on the average rate policy. However, exceptions can arise, and over the past decade, these have become potentially significant in the case of State mining revenues. When 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 can have a dominant role in determining average rate policy, particularly where minerals are assessed separately.

2.95 The Commission considers that its current assessment of mining revenues appropriately supports the measurement of State relative fiscal capacities, observing that the Commonwealth's recent changes to the form of equalisation insulate Western Australia from the distributional effects related to its dominant producer position. See Box 2-2 for a discussion of the unique aspects of the mining assessment and Attachment 8 for further detail on the policy neutrality aspects of the Mining assessment.

Dealing with States applying a nil rate to a revenue base

2.96 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, where the Northern Territory does not raise this tax. The Commission imputes a land tax base for the Northern Territory for assessing its capacity to raise land tax, if it followed average policy.

Dealing with uncertain distributions of State revenue bases

2.97 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, 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, since the 2010 Review the Commission has taken the view that, because it cannot identify comparable revenue bases across States, it cannot construct a reliable and material differential assessment. Therefore, it makes an EPC assessment of gambling revenue. The Commission intends to retain this approach, which means gambling revenues do not affect the measurement of State fiscal capacities.

Dealing with tax rate effects on a revenue base

2.98 The Commission engaged consultants to produce elasticity estimates that would inform its decision whether to adjust its assessed revenue bases for elasticity effects. The aim was to minimise, to the extent practicable, tax reform disincentives arising from the direct effects on tax bases (elasticity effects) of tax policy choices.

2.99 The consultants calculated elasticity estimates for four revenue assessments: insurance taxes, conveyance duties, motor taxes and land tax. After considering the consultants' work and State views, the Commission intends not to implement elasticity adjustments because it is not clear that equalisation is improved by applying single adjustments to often significantly divergent tax rates, in some parts of assessments but not others. This issue is discussed in Chapter 3 — Main assessment issues.

Practicality

2.100 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.

2.101 Practicality is an umbrella principle that covers the following.

- Simplicity — 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 — the Commission will make assessments only where they have a sufficiently large impact on assessed revenue and expenditure.
- Quality assurance — processes are in place to ensure data are accurate and fit for purpose, and methods are sound and delivering outcomes 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.

2.102 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 practicality principle assists the Commission in ensuring it is meeting this requirement of the terms of reference.

Box 2-2 HFE and mining revenue policy

The changing fiscal role of mining revenue

Over the past decade, the role of mining revenues in fiscal equalisation has significantly increased. State 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. It has also resulted in greater volatility in the fiscal capacities of the States.

The continuing emergence of China and other Asian countries as leading growth engines of the world economy has driven the expansion of Australia's mineral and energy industries. Australia's endowments are key inputs to the rapidly expanding Asian supply chain.

While there has been some cyclical element in the price of commodities, the mining expansion is largely long term and structural. It has transformed the fiscal capacity of Western Australia, the main mining State. Throughout most of the 20th century, Western Australia received greater than average per capita Commonwealth funding under fiscal equalisation arrangements. However, 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.

- The distribution of mineral resources is highly unequal across the States.
- Each mineral product has a different effective tax (royalty) rate.
- The conceptual driver of the tax base is unclear — royalties appear to be related 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 certain 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. 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. (*Attachment 8 — Mining* discusses these issues in detail).

2.103 This principle originated from the emphasis in the 2010 Review terms of reference on simplification, reliability, materiality and quality assurance. 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. (See page 57).

2.104 Practicality recognises that, while a wide variety of factors affect State fiscal capacities, 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.

2.105 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.

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

2.107 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 they prefer fixed relativities that are:

- available in February, prior to the presentation of State budgets (for the following financial year), and
- to the extent possible, predictable and reasonably stable over the period of the forward estimates.

2.108 These States seek to minimise forecasting errors across the forward years, which could be greater if relativities are based on a narrower assessment window,[19] 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, it recognises these considerations are of some practical relevance in its choice of methods, through their effect on State budget processes.

2.109 In contrast, as a State subject to considerable volatility in own-source revenue (which in turn affects its fiscal capacity), Western Australia would prefer GST

19 This refers to the historical assessment years (currently three years) on which the relativity calculations are based.

revenue 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.[20] Western Australia supported the use of forecasts followed by a correction in the following year to reflect outcomes. In setting out this view, Western Australia has advocated a radical change to current assessment methods more generally. The following section on contemporaneity addresses these issues. Alternatively, Western Australia proposed adopting capacity measures that are unaffected by cyclical or transient factors. This appears to be a reference to using broader indicators. As noted previously, the Commission would only consider adopting broader indicators if they were a more reliable indicator of State capacity to raise revenue or service delivery costs than any alternative approach.

2.110 The Commission provides detailed reports during a review that explain reasons for decisions, assessment approaches and outcomes. The update reports explain the main sources of change each year in State fiscal capacities and decisions on new issues following State consultation. All of this information is publicly available on the Commission website, (https://cgc.gov.au/). The Commission and its staff continue to work with stakeholders to increase accessibility and understanding.

2.111 Most States support the Commission's practicality principle.

Contemporaneity

2.112 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).[21] The Commission interprets this to mean recommending relativities appropriate to equalising State fiscal capacities in the application year.

2.113 Currently, the Commission expresses its recommendations in the form of relativities. The new legislation requires the Commission to continue to present the outcomes of its work in this way. The effect of applying relativities (based upon the assessment window) to the application year is that State GST requirements are inflated by the growth in GST revenue between the assessment window and the application year.

2.114 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

20 It is worth noting that Western Australia's budget papers for 2011-12 provided a reasonably realistic forecast of the impact on its GST share in future years of its surging own-source revenues. This suggests that the problem Western Australia then faced was something other than its ability to predict its future relativities.

21 For example, the application year for the relativities recommended by the Commission in its 2019 Update Report is 2019-20. These relativities were derived from the average of the relativities calculated for the 2015-16, 2016-17 and 2017-18 assessment years (the assessment window).

has passed.[22] In the absence of such data, past Commissions have based recommendations on historical data. This provides a result that is reasonably appropriate for the application year, notwithstanding that it entails a lagged recognition of changes in State circumstances.

2.115 Since the 2010 Review, the assessment window has been the most recent three years for which reliable data are available. 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 (by narrowing the assessment window from three years to one or two years), to treating volatile revenues by absorption, or by using forecasts of conditions in the application year.[23,24]

2.116 The Commission prefers not to use estimates or forecasts of revenues and expenditure in the application year because they are not sufficiently reliable. 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. The Commission notes an approach using forecasts with subsequent adjustments would add to the complexity of the new arrangements.

2.117 All States that commented on this issue, except Western Australia, said they supported the Commission's current approach to contemporaneity. Western Australia supported a distribution more reflective of current budget circumstances to improve public transparency, aid budget management and mitigate the risks from volatility for an outlier State. It said the Commission could achieve contemporaneity, without volatility, by adopting policy neutral indicators of long-term revenue capacity. As a second best option, for achieving contemporaneity and stability for an outlier State, Western Australia supported the use of forecasts with ex-post corrections.

2.118 The Commission's view is that for this review it will continue to maintain the established approach, which uses the most recent three years for which reliable data are available, with each year receiving an equal weighting. The Commission acknowledges that it is possible to achieve HFE with a narrower assessment window;

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

23 Under an absorption approach, State GST shares in the application year depend on the distribution of PSPs in the application year, rather than their distribution in the assessment years.

24 Commission *Staff Research Paper CGC 2017-05 S* set out options for making the Commission's recommendations more contemporaneous.

however, the current approach provides an appropriate balance between contemporaneity, stability and predictability. The Commission understands that stability of the GST distribution was a key consideration in the design of the new HFE system.

Backcasting

2.119 If there are major changes in federal financial relations between the assessment years and the application year, the Commission 'backcasts' the new arrangements, unless the terms of reference direct the Commission not to or it cannot be done reliably. This makes the relativities more contemporary by ensuring they better reflect the range, level and interstate allocation of Commonwealth payments that will exist in the application year.

2.120 Most States supported backcasting major changes in federal financial relations, but only if the information and data used for backcasting are reliable. The ACT suggested the Commission backcast all Commonwealth payments to improve contemporaneity.

2.121 The Commission does not support backcasting all Commonwealth payments. The estimated amounts for forward years published in the Commonwealth's budget papers are not certain to eventuate and sometimes not available when a new agreement is under negotiation.

2.122 The Commission intends to backcast payments that are major changes in federal financial relations, only if the information and data available for backcasting are reliable. The Commission is currently backcasting State shares of spending on the National Disability Insurance Scheme (NDIS) and other disability services.

Applying the supporting principles

2.123 In general, wherever data are adequate, the Commission adopts methods that are readily understood and reproducible. 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 continue to be necessary. The Commission seeks to make its judgments as consistent and understandable as possible, and rejects suggestions that its judgments are arbitrary or inexplicable. Such complaints often reflect that the critic would prefer a different outcome to that reached by the Commission.

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

2.125 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 measure State fiscal capacities based upon the principle of 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.

2.126 The Commission's approach is to develop methods that 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 average revenue or expenses
- 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, and data for measuring disabilities, are those upon which assessments are based, and are updated each year.

2.127 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 a principle of conservatism appears likely to be interpreted as leading to partial equalisation. In both cases the Commission's Assessment guidelines (page 62) 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.

2.128 In the case of an EPC distribution, as proposed by New South Wales, the supporting principles are largely superfluous (perhaps other than contemporaneity). However, such a distribution does not meet HFE and so is not consistent with the Commission's terms of reference, or the IGA.[25]

2.129 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. The work of improving communication and accessibility is ongoing.

2.130 The following section addresses specific implementation issues.

IMPLEMENTATION ISSUES

Discounting assessments

2.131 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 assessments in proportion to their quality or ignoring the data and the particular influence completely.

2.132 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 recognise the disability or not. The quality of the available data is a key consideration guiding the Commission's judgment.

2.133 Discounting allows the Commission to partially recognise a disability when the presumptive case for the disability is established but there are concerns with its measurement. In other words, discounting allows the Commission to achieve the HFE objective while taking into account practical issues that affect the measurement of State fiscal capacities. Western Australia said that while not acknowledged by the Commission, the main justification for discounting is conservatism in the GST

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[25] Under an EPC approach, there would be no assessments and so no issues regarding what State do, policy neutrality and practicality would arise. The only issue would be the choice of a year, with contemporaneity suggesting application year populations.

distribution. It suggested using a global discount as an alternative to a profusion of individual discounts. The Commission rejects Western Australia's assertion. Discounting is a practical way of addressing specific concerns about particular data or methods while achieving HFE. The Commission considers a better HFE outcome is achieved if discounting targets the particular data or methods, rather than applying a global discount, which would guarantee partial equalisation at best.

2.134 The Commission intends to retain the discounting framework. This framework consists of four levels of discounting — low (12.5%), medium (25%), high (50%) and no assessment (100%) — depending on the Commission's judgment about the reliability of the data. The Commission has simplified the discussion of discounting in the assessment guidelines (Box 2-3). This change seeks to clarify when discounting should apply.

2.135 The Commission notes that some States raised concerns about the appropriateness of having discounts and with the consistency of their application. The 2020 Review draft report assessments include fewer discounts than the 2015 Review and each discount has been considered carefully, having regard to the need to recognise all material disabilities affecting State fiscal capacities and the data and methods available for measuring these influences. Where discounts are applied, the Commission has explained its concerns with the data or methods, or both.

2.136 In some instances, the Commission intends to remove or reduce discounts in this review. This reflects improvements in the available data (for example, regional costs, land tax), further consideration of the suitability of proxies (for example, community health) or decisions to adopt blended assessments (for example, transport). Blended assessments generally combine two assessments where more than one disability measure appears conceptually relevant. Queensland argued for caution in removing discounts from existing assessments if the concerns about the data or methods are unresolved. Where discounts have been removed, or blended assessments have been adopted, the Commission has explained its reasons.

2.137 While the Commission considers discounting as a tool to better achieve HFE, there are instances when the Commission does not consider discounting 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. In addition, the Commission considers 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.

2.138 In addition, the Commission has not used discounts to address concerns about 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.

2.139 Victoria, Queensland, South Australia, Tasmania and the ACT agreed with the Commission's approach to discounting. These States considered the current levels of discounting acceptable.

2.140 The Northern Territory considered that use of discounting should be more limited and the Commission should work with data providers to improve national datasets. Where a national dataset is designated the best available, the Northern Territory argued it should be used unadjusted. Victoria said that if the Commission is only able to deliver proximate equalisation then the widespread use of discounting is not required. Western Australia argued that discounting the best available information usually entails a risk of moving one or more jurisdictions away from a better HFE outcome. For example, it said the wages assessment significantly understates Western Australia's wage pressures, so that discounting would move the assessment even further away from HFE. In the draft report assessments, the use of discounting is more limited than in previous reviews.

2.141 Overall, Western Australia said the application of discounting is selective and inconsistent, which biases HFE. However, its main concern appears to be the Commission's decision not to discount the Mining assessment. Queensland supported the use of discounting to address policy neutrality issues in that assessment. The section on policy neutrality explains the Commission's reasons for not discounting the Mining assessment (page 46).

Materiality thresholds

2.142 In the 2010 Review, the Commission introduced materiality thresholds to help achieve greater simplicity. They were retained with higher thresholds in the 2015 Review. Materiality thresholds were set with reference to the effect an assessment had on the GST distribution in the application year.

2.143 The Commission considers that maintaining materiality thresholds is an effective way of maintaining simplicity in its assessments. It ensures that attention focuses 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 limiting the number of disabilities assessed by the Commission to those that have a substantive effect on the States revenue and spending.

2.144 In this review, the Commission has decided 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 has used a disability threshold of $35 per capita (up from $30 per capita) for any State for this review. The threshold for data adjustments has remained at $10 per capita.

2.145 In summary, the Commission has materiality thresholds to handle two circumstances.

- ***Disability assessment.*** A disability is considered material if it redistributes more than $35 per capita for any State, across all categories. When the threshold is reached, the disability is 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.
- ***Data adjustments.*** Data are adjusted where necessary to improve interstate comparability, but only if the adjustment redistributes more than $10 per capita for any State.

2.146 Previously, materiality thresholds have been expressed in terms of the effect of a disability or data adjustment on the GST distribution. In this review, the threshold will be based on the average redistribution from an EPC assessment of revenue or expenditure, averaged over the three assessment years. This is to recognise that there is no longer complete congruence between the assessment of fiscal capacities and the final distribution of GST.

2.147 In the position paper, the Commission said it intended to apply a $35 per capita materiality threshold for disaggregating a disability in the socio-demographic composition (SDC) assessments. The Commission found that implementing this threshold was problematic. For example, the decision to disaggregate remote and very remote populations in the health assessment was just below a materiality threshold of $35 per capita. However, the Commission disaggregates remote and very remote populations in other assessments, for example schools. It seemed inconsistent with the disability assessment threshold not to split remote and very remote populations in health. In other cases, it was material to split SES groups, but the use patterns that emerged from further splitting did not align with the underlying conceptual case for the disability. In addition, it was unclear what the starting point should be for applying the threshold. Therefore, the Commission has decided to take a more pragmatic approach to decisions on the level of disaggregation to adopt in the SDC assessments, having regard to materiality and the conceptual case for different levels of disaggregation.

2.148 New South Wales and Queensland supported higher materiality thresholds ($60 and $50 per capita respectively) as this would lead to broader assessments and greater simplification while continuing to recognise the fiscal circumstances of recipient States. Western Australia did not suggest a threshold but said the Commission needs to be more consistent and transparent in applying materiality thresholds. It also said the current approach encourages marginal changes to assessments rather fundamental reviews that would consider broader assessments.

2.149 Victoria, South Australia and Tasmania supported the current thresholds but did not support further increases beyond adjustments to maintain their real value. Victoria also noted that a case could be mounted for reducing the threshold because the size of the redistribution task is currently declining. The ACT and Northern Territory opposed materiality thresholds because they undermine HFE.

2.150 On balance, the Commission considers that the proposed thresholds strike the right balance between achieving HFE and maintaining simplification gains from the previous two methodology reviews. Since this review started with 2015 Review methods and not a clean slate, the Commission applies materiality tests in many instances by considering the effects of a change to current methods. However, this has not prevented consideration of new assessment approaches, consistent with HFE, using a new data sources or methods, as suggested by Western Australia.

Confidential data

2.151 The Commission intends to continue to use confidential data but only in circumstances where a disability assessment is material and there is no alternative. Wherever possible, States are encouraged to share confidential data at the Treasury level to facilitate the review of assessments. States supported this approach, especially if it led to a better HFE outcome. The Commission's data sharing protocol, introduced in the 2017 Update, maximises the sharing of data among State treasuries.

Quality assurance

2.152 An important way of ensuring the Commission's assessments are as reliable and as accurate as possible is through a rigorous 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 the 2010 and 2015 Reviews) by undertaking a risk assessment and preparing quality assurance strategic plans and action plans.

2.153 The Commission released the 2020 Review Quality Assurance (QA) Strategic Plan to States in October 2018. It builds on the 2015 Review QA strategic plan, following consultation with the States. The aim of the QA strategic plan is to ensure there are strategies in place that will result in reliable and accurate assessments of State fiscal capacities and to strengthen confidence in the processes undertaken in their development.

2.154 The 2020 Review QA Strategic Plan documents the processes the Commission will put in place to quality assure its work and to demonstrate compliance with these processes. The strategic plan is translated into actions through annual operational work plans of the Commission.

2.155 There are three objectives:

- assure stakeholders of the conceptual validity, reliability and accuracy of the relativities that will be used to distribute GST revenue to the States
- ensure the reporting of methods, decisions and results are transparent and in appropriate detail for their purposes
- monitor and report on the effectiveness of implemented QA processes.

2.156 Performance targets for QA processes are:

- Commission decisions are evidence based and transparent
- Commission decisions on assessments are correctly implemented
- data are fit for purpose and of good quality
- calculations are error-free
- the work of the Commission and resulting relativities are reported in a transparent and verifiable manner.

2.157 The 2020 Review plan is on the Commission website, (https://cgc.gov.au/).

The Assessment guidelines

2.158 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. The Commission intends to retain the Assessment guidelines developed in the 2015 Review in this review with some amendments to explain more clearly the Commission's approach to discounting. The Assessment guidelines for the 2020 Review are included in Box 2-3.

2.159 The guidelines also form a key part of the QA process. They allow the Commission to be confident that all relevant steps in the decision-making process have been followed. They allow external parties to follow the Commission's decision processes and to form conclusions about whether due process has been observed. This is important for ensuring transparency.

2.160 The guidelines cover the following implementation processes:

- the steps for establishing and measuring disabilities
- when and how discounting decisions are made and applied
- the materiality threshold for recognising a disability.

2.161 The Commission uses the guidelines to inform its decision-making processes. However, it retains the right to exercise judgment if its best endeavours to build a reliable assessment do not lead to an outcome consistent with its observations and understanding of State circumstances. Where the Commission deviates from the guidelines, it will aim to explain clearly its reasoning. The Commission notes the views expressed by some States that it could improve the way it documents its deliberations and decisions by providing additional information on how it applies the supporting principles to reach conclusions for individual assessments including discounting decisions. The Commission consistently endeavours to provide clear documentation of its decision-making processes.

Box 2-3 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 or unit costs, or both, 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 State 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.

The Commission will adjust data where necessary to improve interstate comparability. However, the Commission will only make data adjustments if they redistribute more than $10 per capita for any State.

Where a case for assessing a disability in a category is established, but the Commission has concerns with the underlying data or assessment method, a uniform set of discounts will be used:

- low (12.5%)
- medium (25%)
- high (50%)
- no assessment (100%).

The Commission will use higher discounts when the Commission has greater concerns with the underlying data or assessment method.

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 effect 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 effect on the conceptual rigor and reliability of assessments.

CHAPTER 3

MAIN ASSESSMENT ISSUES

3.1 The main consultation on assessment issues for this review occurred during 2018. Commission staff released Draft Assessment Papers in April 2018 identifying particular issues for each assessment. Following this, the Commission conducted a series of State visits in mid-2018, which provided opportunities for States to present information to the Commission. The Commission received submissions from State treasuries on the Draft Assessment Papers in the second half of 2018, which it considered in formulating this report.

3.2 This chapter outlines the main issues considered by the Commission in this review. Table 1-4 summarises all State proposals for changes to the 2015 Review methodology. Additional details about each of the issues mentioned in this chapter are in the relevant assessment attachments.

ELASTICITY ADJUSTMENTS TO STATE TAX BASES

3.3 The Commission currently measures State revenue bases using data that closely reflect the actual revenue bases accessed by States. Economic theory suggests that differences in State tax rates (and other tax policies) can affect the level of activity and, therefore, the observed revenue base. A State imposing an above average tax rate would have a smaller revenue base than if it were to impose the average rate, and vice versa. If differences in tax rates had material impacts on observed revenue bases, incorporating elasticity adjustments would improve the policy neutrality of the Commission's revenue assessments.

3.4 The Commission engaged consultants to provide, where possible, estimates of the size of elasticity effects for each revenue base. This would inform its decision on whether to make elasticity adjustments in the 2020 Review. This report can be found on the Commission website, (https://cgc.gov.au/). The consultants developed models to estimate elasticities for five revenue categories: Payroll tax, Insurance tax, Motor taxes, Stamp duty and Land tax. Due to data limitations and methodological problems, the consultants concluded they could not estimate elasticities for mining royalties at this time.

3.5 Of the five elasticities they estimated, four were found to be statistically significant. The consultants found no measurable behavioural effect of changes in payroll tax on labour market outcomes.

3.6 The consultants were able to develop elasticity estimates for four revenue categories using both external and Commission datasets. The estimates are set out in Table 3-1.

Table 3-1 Summary of selected elasticities by State tax

Tax	Elasticity	Interpretation
Payroll	Statistically insignificant	Not applicable
Insurance	-0.057 (CGC)	A one percentage point increase in the tax rate (equivalent to about a 10% increase) reduces expenditure on total premiums by 0.6%.
Motor	-0.056 (CGC)	A 10% increase in licence fees reduces vehicle ownership by 0.6%.
	-0.035 (HILDA)	A 10% increase in licence fees reduces car ownership by 0.35%.
Stamp duty	-0.29 to -0.43 (CGC)	A 10% increase in the tax rate reduces the overall value of sold properties by 3 to 4%.
	-0.01 to -0.37 (Corelogic)	A 10% increase in the tax rate reduces the value of sold properties by 0.1 to 3.7%, depending on the specification chosen.
Land	-0.054 to -0.062 (CGC)	A 10% increase in the tax rate will reduce the overall unimproved value of taxable properties by about 0.6%.
Mining	Could not be estimated	Not applicable.

Note: The insurance tax elasticity was expressed as a percentage point change so that it could be more easily compared to the international literature.

Source: Tax and Transfer Policy Institute, *State Tax Elasticities of Revenue Bases*, page 4.

3.7 Four States commented on the report and their comments were provided to the consultants. The consultants responded and addressed most of the concerns regarding the model and the results, with the Commission considering questions on the scope of the project or issues it may face in implementing elasticity adjustments.

3.8 The Commission's intention is not to implement elasticity adjustments in the 2020 Review because it is not clear that equalisation is improved by applying single adjustments to often significantly divergent tax rates, in some parts of assessments but not others. The Commission also noted that, while an elasticity adjustment would progressively reduce the ACT's stamp duty revenue base as it phased out stamp duty, a counteracting adjustment could not be made to recognise the elasticity effects of its higher municipal rates, as the latter are not differentially assessed.

3.9 The Commission may review the issue of elasticity adjustments should States undertake major tax reforms in the future.

MINING REVENUE

3.10 The most contentious issue with the 2015 Review assessment was policy neutrality. Policy neutrality concerns arose because of the uneven distribution of mineral endowments across States. When one State dominates production of a mineral, its royalty rate determines the average royalty rate. This carries a risk to policy neutrality because changes to its rate could be influenced by expectations of resulting offsetting effects on grant shares. For this reason, the Commission initially considered two adjustments to improve the policy neutrality of the mining assessment.

- A dominant State adjustment. Any change in revenue from a discretionary royalty rate change by a dominant State would be assessed equal per capita (EPC).
- A banned minerals adjustment. Revenue from banned minerals, for example coal seam gas, would be assessed EPC.

3.11 Since then, new equalisation arrangements have been enacted in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* and the Treasurer has written to the Commission indicating that 'the Commission [is] not to consider changes to the mining royalties methodology as part of the 2020 Review'.

3.12 In practice, the policy neutrality risk is significant only for Western Australia. The new equalisation arrangements substantively mitigate that risk. Therefore, the Commission does not propose to make either of its policy neutrality adjustments. It intends to continue the 2015 Review approach of assessing revenue capacity using a mineral by mineral approach. This is consistent with the intent conveyed in the Treasurer's letter that the assessment method not be changed.

3.13 While making no change to the assessment method, the Commission has considered its application in the 2020 Review. The 2015 Review methodology allowed the composition of the category to respond to changes in the materiality of individual mineral assessments. In the context of the 2020 Review, this means nickel royalties would not be separately assessed. Similarly, should it become material to separately assess a different material (for example, lithium), and the Commission takes the view its materiality would likely continue for the foreseeable future, the Commission considers a separate assessment of that mineral would be consistent with the 2015 Review methodology. That methodology also allowed for the inclusion of non-royalty mining-related revenues, where it was material to do so. The Commission is seeking State information on the extent of these non-royalty revenues and views on how they should be treated.

GAMBLING

3.14 A criticism of the equalisation process made by some commentators relates to the Commission's assessment of gambling taxes (that is, taxes on lotteries, electronic gaming machines, casinos, racing and sports betting). This criticism implies that the equalisation process somehow disadvantages Western Australia, because of its policy to restrict the availability of gaming machines.

3.15 In this review, the Commission again investigated whether it could develop a differential assessment of gambling taxes. None of the approaches it investigated proved satisfactory. The problem was that the pervasiveness of State policies, which materially affect the level of gambling activity in each jurisdiction, proved insurmountable. The Commission also investigated weighted socio-demographic models using gender, age and education level, but none of these models produced an assessment that was material. In addition, none of the approaches addressed the advent of online gambling which is making gambling activity more mobile. Taxation in one State might relate to the activities of residents from other States or overseas.

3.16 In this review, the Commission intends to continue to assess gambling taxes on an EPC basis, meaning that these taxes do not affect any State's relative fiscal capacity. Most States supported this approach, including Western Australia.

SCHOOLS

3.17 In this review, the Commission intends to adopt a new model to estimate the drivers of differences in State expenses for government schools. The new model estimates the drivers to be the remoteness, socio-economic status (SES) and Indigenous status of school students. Most States supported the development of a new model.

3.18 The model directly measures the SES of students within each school, replacing the previous method that measured the SES of a whole school based on the school location.

3.19 The previous model measured Indigenous SES and non-Indigenous SES separately. The new model independently measures Indigenous status and SES status. This greatly simplifies the model and removes the need for assumptions about the internal distribution of school funding between Indigenous and non-Indigenous students, as well as being a better reflection of how States fund schools.

3.20 In addition, the new model estimates that there are no significant differences in expenses between some remoteness classifications. This has resulted in fewer remoteness classifications, with some remoteness areas being grouped together.

3.21 In this review, the Commission intends to assess student transport expenses in the Transport category. This reflects a view that the disabilities affecting the cost of transporting school children are likely to be more closely related to the disabilities affecting the cost of transporting other people, than to the disabilities affecting the cost of educating school children.

HEALTH

3.22 In this review, the Commission re-considered and confirmed its approach for recognising non-State sector influences on State health spending. Western Australia was critical of the Commission's decision in the 2015 Review to adopt a more direct approach for assessing State health expenses. Although officer level discussions initially focused on the choice of approach — subtraction or direct — it became apparent that the real issue under either approach was the extent to which non-State sector services are substitutable for State services.[1]

3.23 When Western Australia articulated the case for adopting a broad view of what constitutes substitutable services, it became clear that it was seeking an approach that would equalise all health spending, including services that are predominantly provided by the non-State sector (for example, primary care, dental and applied health services). It argued that in the long-run, as the main provider of hospital services, States bear the costs of inadequate non-State sector activity. Therefore, the health assessment should recognise below average levels of non-State sector activity on an annual basis if States are to be fully equalised in the long-run.

3.24 The Commission acknowledges that States fill service gaps, but in limited circumstances. Furthermore, their capacity to meet all needs is constrained by State budgets. For example, a lack of general practitioners (GPs) in more remote areas means that States are often the main providers of primary health care services in these regions. The Commission's direct assessment acknowledges that this is what States do by recognising the higher use and cost of community and public health services in remote areas. A non-State sector adjustment recognises that the availability of GPs in remote areas varies between States. Thus, if a State has below average use of GP services in remote areas, it would receive the capacity to fund more State services.

3.25 The Commission considers that Western Australia's proposition would effectively go beyond the scope of HFE by seeking to equalise the health outcomes of the community. The Commission prefers a more direct approach that focuses on what States collectively do while acknowledging the influence of the non-State sector where it is relevant. This avoids States being equalised to fund the provision of services that they do not provide. The Commission observes there are not wide

1 The subtraction approach refers to the method the Commission adopted in the 2010 Review but discontinued in the 2015 Review in favour of a more direct assessment.

variations in what States do in the area of health. Thus, an approach that focuses on average State policy, including spending, provides an appropriate equalisation outcome.

3.26 The other States supported the direct approach and were broadly supportive of the levels of substitutability adopted for each component. The Northern Territory raised some concerns about the implementation of the direct method in the community health assessment, which the Commission has sought to address. Attachment 12 — Health discusses these issues in more detail.

JUSTICE

3.27 The judgment-based split between community policing (assessed on an EPC basis) and specialised policing (which is differentially assessed) has been criticised by a number of States, although they had conflicting opinions on what this split should be.

3.28 In response, in this review, the Commission has developed a more empirical-based method, using State provided data on spending by police districts, which removes the need for a judgment-based split. The new approach also implicitly captures regional costs and the very high cost of providing policing services in very remote areas.

3.29 The Commission has also developed new methods for determining regional costs for courts and prisons, as the use of police regional costs as a proxy is no longer appropriate due to the changed nature of police data collected for this review.

TRANSPORT

3.30 A priority for the Commission for the 2020 Review was to review the urban transport recurrent and infrastructure assessments. The assessments developed during the 2010 and 2015 Reviews used urban population as the main driver of urban transport expenditure.

3.31 Queensland, Western Australia, South Australia, Tasmania and the ACT expressed concerns with use of urban population as the sole driver of needs and did not support retaining the assessment for the 2020 Review. They noted that the assessment should recognise the influence of factors such as the presence of rail, population density and urban form/geography. States were also concerned about the theoretical foundation of the 2015 Review model.

3.32 To address these concerns and improve the urban transport assessments, the Commission engaged consultants to develop a model for to assessing State urban transport recurrent and infrastructure expenditure requirements.[2]

3.33 After consideration of the consultants' recommended model and State feedback on the consultants' report, and having engaged further with the consultant on various aspects of their report, the Commission intends to adopt an econometric model for urban transport recurrent expenses that recognises the following influences:

- population density
- numbers of public transport passengers (separately assessed for bus/light rail and heavy rail)
- the presence of ferry services[3]
- distance to work
- topography.

3.34 The Commission intends to use the model developed for recurrent expenses to assess investment needs, as recommended by the consultants. The consultants concluded that the drivers of recurrent expenses were sufficiently similar to assess both using one model. They argued there were too few observations to estimate an investment-specific multi-variable model with confidence.

3.35 Further, to address concerns with the use of proxy data in the proposed econometric model, the Commission intends to:

- for the urban transport expenses assessment, blend the assessment based on the econometric model with a broad assessment based on the proportion of State populations living in urban centres
- for the transport infrastructure assessment, blend the assessment based on the econometric model with an assessment based on the square of urban centre population.

3.36 The econometric model assessment would be given a weight of 75% and the population-based assessments a weight of 25%.

3.37 States raised a number of issues with the outcomes of the transport consultancy including policy neutrality concerns, the definition of urban areas and the use of proxy data. Attachment 18 — Transport discusses these issues in more detail and addresses State views.

2 The stage 1 and stage 2 reports are available on the Commission website, (https://cgc.gov.au/).

3 The presence of other transport modes, including heavy rail, buses and light rail, is recognised through the inclusion of passenger numbers by mode.

INVESTMENT

3.38 The assessment of investment remains largely unchanged. However, in this review the Commission has refined its methods, to improve accuracy and to address concern that the investment assessment is too complex and difficult to interpret. Most States were generally supportive of the changes.

3.39 The Commission intends to assess investment separately in all service areas (not just roads and transport), to ensure actual investment levels are reflected and to make the assessment more transparent (by associating redistributive effects to each service area). Previously, the mechanism for combining investment resulted in the assumption that investment in each category is equal to its proportion of the capital stock, not actual investment, which could lead to revaluations having undue effects on the assessment.

3.40 Depreciation and net investment will now be assessed together in a gross assessment of investment. The Commission considers this a simpler approach, because the same disabilities apply to both investment and depreciation and it removes the likelihood of any State being assessed as requiring negative investment in any particular service area, which, while conceptually valid, was difficult to interpret.

3.41 In addition, single year stock disabilities will be applied to stocks, improving the accuracy and transparency of the assessment. This removes the averaging of stock disabilities (over three years), which created a mismatch between growth in population and growth in stock disabilities, without unduly affecting the volatility of the assessment.

GEOGRAPHY

3.42 The distribution patterns of State populations play a significant role in the cost of delivering services. These distribution patterns, measured by the geographic distribution of the population, vary considerably between States. In the 2015 Review, the Commission assessed the effect of geography in a variety of different ways. States have been critical of some of these approaches. In particular:

- the regional costs assessment relied on the experience of schools and police, and extrapolated the effect of remoteness on the services in those sectors to a wide range of other services
- the service delivery scale geographic classification was seen as complex and arbitrary
- the differences in non-wage costs between cities was assessed using Commission judgment.

3.43 The insight gained by the Commission over the course of the review, primarily through the State visits program, has assisted the development of its methods in this area. In this review, while there is still some extrapolation, the Commission has widened the range of services where regional cost influences are measured directly, thereby improving the evidence base for the assessment. The Commission intends to discontinue the previous approach to determining areas affected by service delivery scale, and use the more standard ABS remoteness areas to classify service delivery scale. Recognising that it was largely judgment based, the Commission intends to cease the adjustment for differences in non-wage costs between cities (in the 2015 Review, this was referred to as the location adjustment).

CHAPTER 4

IMPLEMENTING LEGISLATED CHANGES TO THE GST DISTRIBUTION

4.1 The purpose of this chapter is to outline the Commission's preliminary understanding of the requirements for its future work of the Commonwealth's new equalisation arrangements enacted in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018*.

OBJECTIVE OF HORIZONTAL FISCAL EQUALISATION IN AUSTRALIA

4.2 From 2021-22, legislated changes will see a change in the objective of HFE in Australia. The changes will result in a gradual move away from distributing GST revenue using the previous arrangements (based on State relative fiscal capacities as measured by the Commission), to new arrangements (equalising to a standard State, being the fiscally stronger of New South Wales and Victoria). The transition from the previous, to the new, arrangements will be completed in 2026-27.[1] The new policy was enacted in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018*, which amends the *Commonwealth Grants Commission Act 1973* and the *Federal Financial Relations Act 2009*.

4.3 The legislation states that the new arrangements will ensure that the States, the Australian Capital Territory and the Northern Territory (the States) each have the fiscal capacity to provide services (including associated infrastructure) at a standard that is at least as high as the standard for whichever of New South Wales and Victoria has the higher standard.[2]

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1 Item 4 of the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* also specifies that by the end of 2026 the Productivity Commission is to hold an inquiry into whether the changes are operating efficiently, effectively and as intended, as well as into the fiscal implications for the States.

2 Subsection 16AB(2) of the amended *Commonwealth Grants Commission Act 1973*.

IMPLEMENTING THE NEW LEGISLATION

4.4 The new HFE arrangements transition into effect from 2021-22, with the new arrangements fully applying in 2026-27.[3] Therefore, the legislation will not affect the Commission's work until the 2021-22 payment year.

4.5 Terms of reference received from the Australian Treasurer determine the work of the Commission. Until the Commission receives terms of reference, it is only able to provide indicative information about how it intends to give effect to the new legislation.

4.6 The *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018,* which amends the *Commonwealth Grants Commission Act 1973* and the *Federal Financial Relations Act 2009,* involves:

- introducing a minimum GST revenue sharing relativity (relativity floor), with an initial floor (of 0.7) introduced for 2022-23 which is then raised (to 0.75) from 2024-25[4]
- from 2021-22, permanently boosting the GST revenue pool with additional Commonwealth financial assistance, referred to as 'pool top-ups'[5]
- transitioning the HFE system from the previous arrangements to new arrangements, based upon the fiscal capacity of the stronger of New South Wales and Victoria[6]
- providing for additional financial assistance to any State to ensure that each receives total grants at least as much as they would have received had the new legislation not been enacted (the 'no worse off' provision).[7]

4.7 Separately, from 2019-20 to 2021-22, States may receive short-term transitional assistance payments sourced from other Commonwealth revenue. However, these payments do not relate directly to the work of the Commission.

4.8 The legislation does not affect the Commission's methodology for measuring State relative fiscal capacities, which is the focus of the 2020 methodology review. The

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3 The *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* and its explanatory memorandum variously refer to the current, old or previous HFE arrangements as 'applying a full equalisation standard' (which this paper refers to as the previous arrangements). The new or updated HFE system is referred to as 'applying a reasonable equalisation standard' (which this paper refers to as the new arrangements).

4 Subsections 8(2A) and 8(2B) of the amended *Federal Financial Relations Act 2009.*

5 Section 8A of the amended *Federal Financial Relations Act 2009* describes the pool top-ups for a payment year.

6 Years 2021-22 to 2025-26 are transition years where the move from the full equalisation standard to the reasonable equalisation standard is 'rolled out in broadly equivalent steps' (see paragraph 1.54 of the explanatory memorandum). Subsection 16AB(3)(b)(ii) of the amended *Commonwealth Grants Commission Act 1973* includes a table describing the proportions of the relativities to be derived from the previous and new arrangements over the transition years 2021-22 to 2025-26.

7 Subsections 5(2) and (3) of the amended *Federal Financial Relations Act 2009.*

measures of relative fiscal capacity derived by the Commission are the basic building blocks for deriving the GST revenue sharing relativities under the previous arrangements and will continue to be so under the new arrangements.

4.9 The remainder of this chapter describes the Commission's preliminary understanding of the requirements of the legislation. Stakeholders are invited to provide comments on how the Commission intends to give effect to the legislation.

Giving effect to the new legislation

4.10 Most existing legislative mechanisms will continue from 2021-22. The Commission's recommendations, in response to terms of reference, will continue to be the basis for the Treasurer determining the GST revenue sharing relativities used to distribute the GST revenue pool.[8] From 2021-22, in preparing its recommended GST revenue sharing relativities, and subject to terms of reference from the Treasurer, the Commission will do the following:

- measure State relative fiscal capacities (as per the previous arrangements)
- from these relative fiscal capacity measures, derive the corresponding standard State capacities (new arrangements)
- during the transition period, blend the previous and new fiscal capacity measures as prescribed in the legislation
- adjust as required if the relativity floor provision is activated.

Previous arrangements

4.11 Beyond 2020-21, the Commission will continue to calculate State relative fiscal capacities using the methodology adopted in the 2020 Review. The pool used to measure the relative fiscal capacities of the States will be the GST revenue, plus any top-up payments.

New arrangements

4.12 The Commission will use its relative fiscal capacity measures based on the 2020 Review methods to identify the fiscally stronger State as between New South Wales and Victoria (the standard State). Having identified the standard State in an assessment year, the Commission will then derive the corresponding standard State capacities for that assessment year by:

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8 In the *Federal Financial Relations Act 2009* relativities are also referred to as 'factors'. The relativities (or factors) determined by the Treasurer are used to adjust State populations and hence determine State shares of the GST revenue pool (with each State's share based upon its share of the total adjusted populations).

- bringing States fiscally weaker than the standard State to the capacity of the standard State[9]
- allocating the remainder of the GST revenue pool on an equal per capita (EPC) basis across all States
- dividing the resulting GST distributions by an EPC distribution.

4.13 The Commission would derive standard State capacities from the same pool and population estimates used to calculate the associated relative fiscal capacities.[10] In the same way that the relative fiscal capacities are the average of three assessment years, the standard State capacities would similarly be over the average of three assessment years.

Transition period

4.14 Subsection 16AB(3) of the amended *Commonwealth Grants Commission Act 1973* includes a schedule which specifies the proportions of the previous and new arrangements to be blended over the transition years 2021-22 to 2025-26 to derive the GST revenue sharing relativities for those years.

Relativity floor

4.15 From 2022-23, as a final step, the Commission may have to adjust the blended (or from 2026-27 the standard State) capacities, should the relativity floor be activated.

4.16 The simplest way for the Commission to adjust for activation of the floor is to:

- determine the additional amount required to meet the provision of the floor relativity (using the application year estimates of State populations and the GST pool available to it at the time the Commission is required to report)
- fund this amount by deducting it on a population basis from the other States
- divide the resulting GST distributions by an EPC distribution to derive the GST revenue sharing relativities.

4.17 This approach will maintain the same relative fiscal capacities for all States other than the State receiving the floor relativity. These adjusted relativities will then be the Commission's recommended GST revenue sharing relativities.[11]

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9 It is conceivable that the standard State will vary between New South Wales and Victoria from assessment year to assessment year.

10 This approach differs from that adopted by the Productivity Commission and the Australian Treasury. In their modelling, they derived standard State relativities using application year estimates of the GST pool and State populations. If standard State relativities are based on application year pools and populations, then the calculation of standard State relativities could differ, most likely only slightly, depending on the estimates used. The Commission's approach avoids the question of which application year pool and population estimates to use in the calculations.

11 From 2022-23, the Treasurer cannot make a determination of a relativity factor for a State less than the relevant relativity floor applying at the time.

Summary

4.18 Over the period the 2020 Review methods are applied, the process used by the Commission to derive its recommended relativities for use in distributing the GST pool (including any top-ups) will vary depending upon the inquiry year's place in the transition period.

4.19 Box 4-1 provides a summary of the derivation of the recommended GST revenue sharing relativities during the transition period.

Box 4-1 Summary of the process for deriving the Commission's recommended GST revenue sharing relativities

- For 2020-21, the State relative fiscal capacities will be the Commission's recommended GST revenue sharing relativities.
- For 2021-22 to 2025-26, the blended proportions of the previous and new arrangements (as prescribed in the legislation) will form the Commission's recommended GST revenue sharing relativities.
- From 2022-23, as a final step, the Commission may have to adjust the blended (or from 2026-27 the standard State) relativities, should the relativity floor be activated.
- For 2026-27, the transition will be complete and the relative fiscal capacities based upon the standard State (fiscally stronger of New South Wales and Victoria) will form the Commission's recommended GST revenue sharing relativities.
- The process beyond 2026 is subject to the outcome of the Productivity Commission review inquiry.

Determination of 'no worse off'

4.20 Section 5 of the amended *Federal Financial Relation Act 2009* specifies the criteria for determining whether the 'no worse off' provisions will be triggered. It states that the 'no worse off' comparison over the transitional years be made on the basis of a comparison between the grants received by a State under the legislated changes and those it would have received if the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* had not been enacted.

4.21 This implies that the Commission will have to continue to calculate relative fiscal capacities on a GST revenue only basis (that is, excluding pool top-ups). To determine the relative fiscal capacities on a GST revenue only pool in assessment years when the GST pool includes top-up payments, the Commission proposes to assess the top-up payments on an EPC basis, instead of including them in the pool of general revenue assistance.

4.22 The Commission also proposes not to make any corresponding adjustment to State expenditures. This is how the Commission usually treats expenditure related to no impact Commonwealth payments when it does not know where States have spent those payments.