Australian Government
Commonwealth Grants Commission

2015 REVIEW

EQUALISATION OBJECTIVES AND SUPPORTING PRINCIPLES

COMMISSION POSITION PAPER
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Submissions sought by	31 January 2014. Submissions should be emailed in Word format to secretary@cgc.gov.au . Submissions of more than 10 pages in length should include a summary section.
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CONTENTS

EXECUTIVE SUMMARY

Following receipt of State submissions and consultations with them, the commission has concluded that it intends to retain the current interpretation of 'the principle of HFE' and the supporting principles used in the 2010 Review to guide the development of suitable methodology.

However, it considers that within this framework some change is required to adapt the methodology to changing circumstances and to the requirements of the terms of reference. For example, it proposes to expand the scope of equalisation to include housing and urban transport public non-financial corporations (PNFCs[1]), because they are close in nature to the operation of government departments and such an expansion allows their infrastructure investments to be assessed in the same way as other general government infrastructure investments.

To facilitate discussion of a range of detailed assessment issues, 3 papers containing staff proposals are being released. The commission will consider its position on these issues once consultations with States have concluded in the run up to the preparation of the draft report due in June 2014.

INTRODUCTION

1 This paper sets out what the commission considers it is asked to do in the terms of reference for this methodology review and the principles it proposes to use in developing appropriate methodology to respond to those terms of reference.

2 The paper covers:

- objectives of the GST distribution and
- supporting principles.

OBJECTIVES OF THE GST DISTRIBUTION

3 For the 2015 Review, the terms of reference (Attachment A) direct the commission to take into account the Intergovernmental Agreement on Federal Financial Relations (IGA). This provides that the GST revenue will be distributed among the States and Territories (the States) in accordance with 'the principle of horizontal fiscal equalisation (HFE)'.

4 The commission considers that it is appropriate to articulate the 'principle of HFE' using the definition it developed in 2010:

[1] Also referred to as public trading enterprises (PTEs).

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

5 That definition has, with only minor variations, formed the basis for distributing the GST since that tax's introduction and Financial Assistance Grants before that.

6 The definition focuses on the main task of the commission: to identify innate differences (factors) among the States which would cause their fiscal capacities to diverge and to recommend a distribution of GST revenue which would remove the impact of that divergence on State finances. As a result, States will have the same capacity to deliver services, provided they deliver them at the average level of technical efficiency and make the same effort to raise revenue.

7 If we can reliably measure the impact of a factor which has a material impact on the GST distribution, we include it in our methodology. Because not all factors are included, either because they cannot be reliably measured or have an immaterial impact, the commission does not aim to achieve precise equalisation, but rather proximate (or comparable) equalisation.

8 Material factors affecting revenue and expenditures means innate differences in State circumstances that:

- give rise to differences in the capacities of States to raise revenue or differences in the cost of providing services or infrastructure, over and above any impact of the policies of individual States
- have an impact on the recommended GST distribution which exceeds materiality thresholds
- can be measured reliably.

9 The factors cover a range of influences on the finances of a State. For example:

- different demographic profiles can generate differences in what States need to spend to deliver the average service to their residents
- in some areas the provision of services by the private sector, Commonwealth or local government reduces what States need to spend to deliver the average level of services:
  - a State with an above average level of non-government schooling has a reduced need to provide public education, so that above or below average provision of services in this way can constitute a material factor.

10 The terms of reference make it clear that financial support from the Commonwealth to States is to be considered by the commission in developing its recommended

methodology. They provide guidance on how the commission is to approach this task. In general the commission considers that the receipt of Commonwealth payments impacting on States' fiscal capacities should be treated as another material factor and have an impact on the GST distribution, but there are exceptions. Further details on the proposed treatment of Commonwealth payments are included in the staff paper on generic assessment issues.

11 Some States considered that GST revenue should not be distributed according to the HFE principle, or that the operation of HFE should be limited by other policy objectives, for example raising national productivity. Another State said that the commission should be more pro-active in the area of tax reform, effectively holding governments to account in relation to reform agreements.

12 Some States have asked that the commission take into account the intent of other Commonwealth-State financial agreements when developing methods and making decisions which impact on the GST distribution.

13 However, we consider that our terms of reference are clear: we are to recommend how the GST should be distributed in accordance with the 'principle of HFE'. We are not asked, nor given the discretion, to decide when other policy objectives or agreements between the Commonwealth and the States should moderate the achievement of HFE, unless explicitly directed in our terms of reference. Nonetheless, in adopting the definition, and in developing its methodology, the commission is conscious of the desirability of minimising any adverse impacts of HFE on the operations of government and the economy generally. For example, we seek to adopt methodology which has the minimum possible impact on government decision-making.

SUPPORTING PRINCIPLES

14 In making and explaining decisions on the development of methodology to achieve HFE, the commission has adopted certain supporting principles. They capture the main influences which experience suggests the commission has to consider through the course of a review in evaluating alternative assessment methods. These principles also provide guidance to the States in preparing their submissions through the consultation process.

15 Based on our experience and the views expressed to us in consultations to date, we intend to maintain the supporting principles from the 2010 Review, to guide us in the development of post-2015 methodology. As such equalisation will be implemented by methods that:

- reflect what States collectively do
- are policy neutral

- are practical
- deliver relativities that are appropriate to the application year.

16 These principles are deliberately expressed in aspirational terms and ideally all methods would embody these attributes. In practice, the commission often has to evaluate methods which embody mixtures of these principles and has to decide trade-offs among them — for example, between methods that capture what States do in detail and methods that are policy neutral. The commission has not set rules for how it would decide the appropriate approach in any such cases, nor has it established a hierarchy among the principles. As required, judgement will be used to devise the best overall result consistent with the aim of achieving fiscal equalisation.

17 As for past commissions, we are not convinced that other objectives, such as predictability or stability should be added to the list of supporting principles. Our view is that the important principles are included in our approach and other proposed principles would move the GST distribution away from what the 'principle of HFE' implies.

WHAT STATES DO

18 The GST distribution provides significant financial support to the activities of State governments and its relevance is enhanced if it accurately reflects the services they provide, the infrastructure they are acquiring and the revenues they raise.

19 To give effect to this:

- our assessments reflect the range of services provided by State general government sectors and the range of revenues collected by them
- the level of services and associated infrastructure States are funded to provide, and the revenue raising efforts they are assessed to make, are an average of those actually provided or made.

20 In this review we are changing our coverage of State activities to include the operation of PNFCs providing public housing and urban transport. In 2010, we treated these PNFCs as outside the scope of the general government sector and only dealt with subsidies and grants paid to them. We consider that in effect they are akin to Government departments, are not commercial enterprises and, for HFE purposes, their operation should be integrated into our assessments. The prime difference is that their infrastructure acquisitions will now be included in our investment assessment and their depreciation in that assessment. They will no longer be included as part of State net financial worth.

21 We do not consider that including these activities will add complexity to our assessments. We can adopt standard assessment approaches. Providing reliable data

are available, this will allow us to better and more transparently recognise the different impact on State fiscal capacities of these activities, particularly their capital requirements.

22 The principle of ‘what States do’ leads us to use the average of what we observe States to do — an internal standard — as distinct from what they could or should do — an external standard. One State said that the standard could be based upon minimum standards and minimum efforts, as a way of providing incentives for efficiency in service delivery while still allowing jurisdictions to fund service provision at ‘acceptable’ levels.

23 External standards based on some ‘ideal’ level of services, a desired level of service delivery efficiency or an economically efficient tax policy, have the advantage that they are not affected by the policies of any State. However, they require the commission to make decisions about what constitutes an acceptable or ‘ideal’ level of services, desired level of service delivery, efficiency or economically efficient tax policies.

24 We do not consider it is our role to base our recommendations on any normative view of service delivery or revenue policy. We consider the most relevant and neutral approach is to base our recommendation on the actual average policy of the States as revealed in the data. Only in circumstances where other supporting principles come into play would we consider an alternative approach. (In the case of our roads assessment practical issues mandate making an assessment based on a stylised view of average policy, rather than the measured average policy of States).

25 Giving effect to this principle requires the commission to bring together the experiences and policies of States into a view of ‘the average State’ and then apply those policies to the circumstances of individual States. Doing this raises significant assessment issues, including at what level of detail such an average should be constructed and how the experiences of different States should be weighted in an average.

26 While we consider that much of this is settled methodology which we do not consider warrants reopening, some issues are addressed in the accompanying staff paper, including a proposal to remove some of the judgment currently implicit in how average policies are determined.

POLICY NEUTRALITY

27 This principle aims to ensure that a State’s own policies or choices, in relation to the services it provides, or the revenues it raises, do not directly influence the level of grants it receives. It also aims to ensure that the GST distribution methodology creates no incentives or disincentives for States to choose one policy over another.

28 Because HFE aims to equalise the fiscal capacities of States, it can never be completely policy neutral. What the commission seeks to do, in conjunction with the other principles, is achieve HFE in such a way that the policies of individual States have the minimum impact on their own GST share and that the commission's methodology creates the smallest incentives or disincentives impacting on State policy choice.

29 Currently, the commission implements policy neutrality by undertaking assessments on the assumption that each State follows the average observed policy of all States in delivering services and raising revenue. If a State chooses to adopt a policy that varies from the average, say through a lower tax rate for a specific tax, the direct impact of that choice (lower revenue collections by that State for that tax) is not reflected in its GST distribution. It bears the financial consequences of its actions. Similarly if a State can deliver a service more efficiently, at below average cost, it retains the financial savings.

30 However, the second round consequences of differential policy choice can be reflected in the GST distribution.

31 For example, because the methodology uses observed tax bases to measure the capacity of a State to raise revenue, the indirect impact of State decisions can affect their GST shares. In the case where a State adopts a lower tax rate than other States, it would be expected that its tax base would be correspondingly increased. However, to date, the evidence available suggests that this indirect impact is small and in practice there appears to be no significant indirect impact on policy neutrality. In this review, the commission considers it prudent to evaluate assessments to see if such second round impacts are material and, if they are, how they should be recognised, consistent with achieving HFE.

32 State policy on long term industry support or economic development may also have an impact on State tax bases. The attached staff paper provides further discussion of this issue.

PRACTICALITY

33 In developing methodology to achieve HFE the commission seeks to be practical.

34 Assessments should be based on sound and reliable data and methods, be as simple as possible while also reflecting the major influences on State expenses and revenues. It recognises that, while State fiscal capacities are affected by a wide variety of factors, the equalisation outcome may not be improved by including factors when sufficient data are not available to measure their effects or where effects are small.

35 This principle is consistent with the requirement in the terms of reference that direct assessments be simple and consistent with the quality and fitness for purpose of the available data.

36 In this review, we are asked to consider specific practicality issues, such as the appropriate materiality thresholds to adopt and States have raised issues, for example, relating to the use of discounting. Proposals for each are covered in the staff paper on generic assessment issues.

CONTEMPORANEITY

37 This principle means that, as far as possible, the distribution of GST provided to States in a year should reflect State circumstances in that year. Without that, the capacity to provide services and the associated infrastructure at the same standard, if each State made the same effort to raise revenue from its own sources and operated at the same level of efficiency to deliver services, would be compromised.

38 We accept that in developing methodology to give effect to this principle our recommended distribution of GST can change significantly from year to year. But it only does so because revealed State circumstances have changed. We consider that methodology which is responsive to changing circumstances is appropriate.

39 Some approaches to equalisation aim to achieve it over much longer periods of time and are intrinsically more stable. A change in the relative circumstances of a State, say a significant natural disaster or decline in its share of a tax base, would have a more muted impact on its GST distribution. The State would have to cope with the fiscal circumstances of such an event from its own resources, with its GST share only increasing gradually over time. We consider that, in general, the quickest response to such a change in circumstance is most in accord with the ‘principle of HFE’.

40 We consider the current approach of basing assessments on the average observed data for the last three years provides a balance between reflecting conditions likely in the year a recommended GST distribution could be implemented, and practicality concerns such as data reliability and stability. Reflecting the situation of the year in which the recommended GST distribution will apply only in the case of major changes in Commonwealth-State financial relations is consistent with this balanced approach.

CONCLUDING REMARKS

41 This paper forms part of a set of papers being provided early in the 2015 Review to facilitate further engagement with the States and the Commonwealth.

42 This paper has been prepared after the commission has considered State submissions and consulted with Treasurers or Premiers of States. The commission considers the

main consultation task between now and the preparation of the draft report relates to more detailed implementation issues.

43 To facilitate that discussion, the commission is releasing 3 staff papers containing staff proposals on more detailed implementation issues. The first deals with a range of generic implementation issues; for example, how average policy might be determined; and responses to GST Distribution Review recommendations referred to the commission. The second covers proposed assessment approaches for individual areas of State activity and provides responses to the priority issues identified in the terms of reference, such as the appropriate recognition of Indigenous populations. The third paper provides a draft quality assurance plan in response to the requirement in the terms of reference that the commission ensure it has robust quality assurance processes in place in preparing its assessments.

ATTACHMENT A – 2015 TERMS OF REFERENCE

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Mr Alan Henderson AM
Chairperson
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15 JUN 2013

Dear Mr Henderson

I am writing to you to convey the enclosed terms of reference for the Commission's *2015 Methodology Review of GST Revenue Sharing Relativities.*

As you know, on 30 March 2011, the Government appointed the Hon John Brumby, Mr Bruce Carter and the Hon Nick Greiner AC to review Australia's system of distributing the GST amongst the States and Territories. The final report of the *GST Distribution Review* (Review) was released publicly on 30 November 2012. I discussed the recommendations of the Review with my State colleagues at the Standing Council on Federal Financial Relations meeting of 3 April 2013. The Standing Council agreed to initiate an expedited methodology review, including asking the Commission to take into account certain recommendations from Chapters 3, 6 and 7 from the Review.

The terms of reference also ask the Commission to consider the appropriate treatment of disability services during the transition to DisabilityCare Australia and once the full scheme is operating nationally and school education funding under the National Education Reform Agreement funding arrangements.

This review will require close and regular engagement with the Commonwealth and States. The terms of reference require the Commission to provide a draft report within 12 months of receipt of the terms of reference. The final report is due by 28 February 2015, in order to inform consideration of the 2015-16 GST revenue sharing relativities.

I appreciate that this will be a challenging task for the Commission, however I have every confidence that you can deliver within these timeframes.

Yours sincerely

WAYNE SWAN
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Terms of Reference
Commonwealth Grants Commission 2015 Methodology Review

I, Wayne Maxwell Swan, Deputy Prime Minister and Treasurer, pursuant to sections 16, 16A and 16AA of the *Commonwealth Grants Commission Act 1973,* refer to the Commission for inquiry into the methodological approach to determining the per capita relativities to be used 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 2015-16. The Commission should provide its final report to the Commonwealth and States by 28 February 2015.

1. In preparing its assessments the Commission should:

   a) take into account the Intergovernmental Agreement on Federal Financial Relations (as amended), which provides that the GST revenue will be distributed among the States in accordance with the principle of horizontal fiscal equalisation;

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

   c) ensure robust quality assurance processes; and

   d) develop methods to appropriately capture the changing characteristics of the Indigenous population.

2. In undertaking its assessments, the Commission should also have regard to the recommendations of the final report of the *GST Distribution Review* (October 2012) to:

   a) consider the appropriateness of the current materiality thresholds (Recommendation 3.1);

   b) consider the appropriateness of continuing to round relativities to five decimal places (Recommendation 3.2);

   c) develop a new transport infrastructure assessment. This should include, if appropriate, a framework to identify payments for nationally significant transport infrastructure projects which should affect the relativities only in part and options for providing that treatment (Recommendation 6.1);

   d) consider the use of data which is updated or released annually with a lag, or updated or released less frequently than annually (Recommendation 6.2);

   e) examine the merits of adopting a simplified and integrated assessment framework (Recommendation 6.3);

   f) investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis (Recommendation 6.4);

   g) develop a new mining revenue assessment (Recommendations 7.1 and 7.2); and

   h) consider the appropriate treatment of mining related expenditure (Recommendation 7.3).

3. The Commission should prepare its assessments on the basis that:

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

      i. NHR funding and corresponding expenditure relating to the provision of cross-border services to the residents of other States should be allocated to States on the basis of residence.

   b) NP 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 or Territory;

   d) those payments which the Commission has previously been directed to treat as having no direct influence on the relativities continue to be treated in that way. Where those payments are replaced, the treatment of the new payment should be guided by subparagraphs 3(a) – (c) and paragraph 4, unless otherwise directed; and

   e) where responsibilities for funding and delivering aged care and disability services has not been transferred to the Commonwealth by a State under the NHR Agreement, these responsibilities will continue to be assessed as State services for that State.

4. Notwithstanding subparagraphs 3(a) – (c), with the exception of reward payments under NPs, 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.

5. The Commission should consider the most appropriate treatment of disability services during the transition to DisabilityCare Australia (the National Disability Insurance Scheme) and once the full scheme is operating nationally.

6. The Commission will ensure that the GST distribution process will not have the effect of unwinding the recognition of educational disadvantage embedded in the National Education Reform Agreement (NERA) funding arrangements. The Commission will also ensure that no State or Territory receives a windfall gain through the GST distribution from non-participation in NERA funding arrangements.

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

8. The Commission will develop a work program, in consultation with the Commonwealth and States, which sees the matters outlined in paragraphs 1(d), 2(c), 2(g), 2 (h), 5 and 6 being progressed as a priority and subject to early consultation (including multilateral discussions) with the Commonwealth and States.

9. The Commission should provide a draft report for consideration by the Standing Council on Federal Financial Relations within 12 months from receipt of these terms of reference.

   a) Should the Commission expect to make significant changes following consultation on the draft report, further consultation with the States on those changes will be required.

WAYNE SWAN