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**File Ref:** TRM No.

Dear Mr Michael Willcock

**RE: NORTHERN TERRITORY FIRST SUBMISSION TO THE 2020 METHODOLOGY  
REVIEW ON THE PRINCIPLE OF HFE AND ITS IMPLEMENTATION**

I am pleased to provide you with the Northern Territory's first submission to the Commission's 2020 Methodology Review. The submission addresses the Northern Territory's views on the objective and implementation of horizontal fiscal equalisation (HFE).

The Northern Territory continues to strongly support HFE, as currently defined, as the underlying principle for distributing GST revenue among the states. Further, the Northern Territory supports the Commission's continued use of supporting principles to assist in the development of assessments that achieve HFE as the sole objective.

The Northern Territory's submission responds to each question outlined in the Commission's staff discussion paper: The principle of HFE and its Implementation. This submission also reiterates the Northern Territory's view that the National Partnership on Remote Housing should be excluded from equalisation to reflect its purpose of addressing unmet need.

I trust that you will give due consideration to the Northern Territory's submission and I look forward to discussing this with you at the bi-lateral meeting in August.

Yours sincerely



DAVID BRAINES-MEAD  
A/Under Treasurer

27 July 2017

# **Northern Territory Submission to the Commonwealth Grants Commission 2020 Review: The Principle of Horizontal Fiscal Equalisation and its Implementation**

July 2017



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# | Preface

The Northern Territory's views on many issues canvassed in this submission have also been discussed in its submission to the Productivity Commission's 2017 Inquiry into Horizontal Fiscal Equalisation (PC Inquiry), which should be read in conjunction with this submission.

Accordingly, the Northern Territory has provided references to relevant pages of its submission to the PC Inquiry throughout this submission.

## Executive Summary

The Northern Territory continues to strongly support Horizontal Fiscal Equalisation (HFE) as the underlying principle for distributing GST revenue among the states. The current HFE methodology aims to equalise the fiscal capacities of the states in order for each to have the capacity to provide the same standard of services.

The Intergovernmental Agreement on Federal Financial Relations (IGA) and the Terms of Reference (ToR) for the Commonwealth Grants Commission's (Commission) 2020 Methodology Review (2020 Review) clearly direct the Commission to develop GST revenue sharing relativities with the singular objective of achieving HFE.

The Northern Territory continues to support the current definition of HFE developed by the Commission in its 2010 Review of State Revenue Sharing Relativities (2010 Review), and maintained in the current methodology set out in the Commission's 2015 Review of State Revenue Sharing Relativities (2015 Review).

The Commission should continue to utilise the current supporting principles to assist it in developing assessments that support the achievement of HFE as its sole objective.

The Commission's discretion in producing a robust and adaptable methodology that adheres as closely as possible to the supporting principles, but has the main priority of achieving HFE, is preferable to weighting the importance of one principle against another.

The Commission should continue to determine average expenditure and tax rates based on internal standards. The approach is sound and does not require further consideration.

The adoption of the weighted average policy approach in the 2015 Review methodology has introduced a further level of conceptual complexity and ambiguity into the assessment methodology, as well as reduced the policy neutrality of the Commission's approach to HFE. The Northern Territory requests additional in-depth examination of this issue in a subsequent issues paper in order to enable due consideration of these issues.

Determining the 'ideal' state policy, through adopting external standards, is beyond the role of the Commission. It is the role of governments to determine what policies and level of services best suit their constituents.

The state rotating average approach would undermine HFE, as assessments would not be based on national averages. This approach would move away from the principle of what states do collectively and would add an unnecessary level of complexity to the assessments.

Discounting represents an arbitrary departure from full HFE and should not be adopted as a means of watering-down material assessments where data exists to support a clear conceptual case for an assessment.

The Northern Territory is opposed in-principle to materiality thresholds, and does not support increasing current materiality thresholds.

The current three-year averaging approach provides a level of predictability and stability of states' GST shares, and achieves a balance between accuracy and contemporaneity.

None of the proposed alternatives to applying the contemporaneity principle are supported by the Northern Territory, as they increase volatility and reduce reliability, hindering states fiscal management.

Materiality thresholds should not be applied to determine the treatment of Commonwealth payments.

The National Partnership Agreement on Northern Territory Remote Aboriginal Investment (NTRAI)<sup>1</sup> should continue to be excluded from equalisation, as directed by the Commonwealth through the ToR.

The National Partnership on Remote Housing (NPRH)<sup>2</sup> should be excluded from HFE to reflect its purpose to address unmet need, which is beyond the scope of the Commission's assessment of states' public housing expenditure and revenue.

The Commission should maintain the current assessment guidelines, which add transparency and clarity to its decision-making process, but also take steps to better communicate the rationale for its application of judgement and the need for discounting disabilities, as well as its rationale for choosing to achieve one principle over another in individual assessments.

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<sup>1</sup> Discussions also relate to the preceding Stronger Futures is the Northern Territory agreement.

<sup>2</sup> Discussions also relate to the preceding National Partnership Agreement on Remote Indigenous Housing.

# 1 The Objective and Definition of Horizontal Fiscal Equalisation

The Northern Territory's views:

- The IGA and the ToR for the Commission's 2020 Review clearly direct the Commission to develop GST revenue sharing relativities with the sole objective of achieving HFE.
- The Commission is not directed to achieve other policy objectives.
- The objective of fiscal equalisation and the Commission's current definition of HFE remains appropriate for the 2020 Review.
- HFE is not an impediment nor a disincentive for states to participate in productivity-enhancing reforms, and HFE does not interfere with decisions to pursue reform.

**Do the IGA and the ToR require the Commission to distribute the GST in such a way as to achieve HFE as the sole objective?**

- 1.1 The current form of equalisation has been in place since 1976 and has served the nation well. As stated in the Northern Territory's submissions to the 2015 Review, the Productivity Commission's 2017 Inquiry into HFE and previous inquiries into the role of HFE in Australia, including the 2012 GST Distribution Review, the only stated and agreed objective of HFE is the equalisation of fiscal capacities between states. The Northern Territory considers the IGA and the ToR to be clear, that GST should be distributed in accordance with the sole principle of HFE:

*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 (the average), if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency. (Commission's 2015 Review Final Report, Volume 1, page 27)*

- 1.2 The Northern Territory believes the current definition of HFE still remains appropriate for the 2020 Review and is supportive of the requirement of the Commission to continue to develop GST revenue sharing relativities with the sole objective of equalising states' fiscal capacities, as set out in the IGA and ToR.
- 1.3 The Northern Territory also supports the Commission's interpretation of the ToR, and its approach to achieving HFE as its sole objective, which is set out in Staff Discussion Paper 2017-02-S, 2020 Review The Principle of HFE and Its Implementation (the discussion paper). Specifically, the Commission identifies disabilities affecting states' fiscal capacities that are beyond their control, and is guided by the supporting principles of what states do, policy neutrality, practicality and contemporaneity.

*Impact of HFE on states' pursuit of economic growth and productivity-enhancing reforms*

- 1.4 Some states and other stakeholders have questioned the effectiveness of HFE in achieving other broad policy objectives, such as economic efficiency and incentives for states to pursue tax reform.



- 1.5 The Northern Territory's view is that the amount of GST redistributed through HFE compared with an equal per capita (EPC) distribution is relatively modest in terms of the national economy, however it provides the smaller states with the capacity to deliver vital services and social and economic infrastructure, which supports greater overall economic growth, productivity and prosperity.
- 1.6 In 2015-16, only \$6.9 billion (12 per cent) of the \$57.4 billion GST pool was redistributed away from an EPC distribution. This equates to just 0.41 per cent of Australia's \$1.7 trillion gross domestic product (GDP)<sup>3</sup>. Further, the amount of GST redistributed away from the donor states ranges from 1.2 per cent of New South Wales' gross state product (GSP) to 1.9 per cent of Western Australia's, but the redistribution to the Northern Territory is significant, comprising 11.9 per cent of the Northern Territory's GSP. (Northern Territory submission to PC Inquiry, page 10)
- 1.7 There is no evidence that HFE has affected states' pursuits of microeconomic reforms. States pursue national productivity-enhancing reforms at the national and state levels in order to support economic growth and ultimately the prosperity of their constituents. In some instances the Commonwealth has provided financial incentives or support to facilitate reforms.
- 1.8 While there may be GST revenue implications of unilateral tax reforms, these will be minor, due to the marginal impact on the standard, and are not the determinant of whether states pursue reforms.
- 1.9 The Northern Territory Government's policy and reform agendas are determined in the interests of constituents and the state economy. There is no evidence to suggest that states are inhibited from pursuing economic or productivity-enhancing reforms as a result of HFE.
- 1.10 In support of this view, the Northern Territory presents the following details of its current program of productivity-enhancing reforms:
- in the construction and building sector, including being the first jurisdiction in Australia to have online transacted building, development and survey approvals;
  - to make it simpler to do business, including licensing and compliance online transactions, reducing the cost to government, businesses and individuals;
  - online transactions for many government services and fees, including vehicle registration, environmental licences and approvals, and extending licence terms to streamline and create efficiencies for licensees and government;
  - to the way government transacts with the non-government organisation (NGO) sector, including extending the terms of funding agreements and moving to an outcomes-based approach to minimise the administrative burden on NGOs and government, and generate efficiencies by having greater coordination and reduced duplication across government agencies;
  - deregulating retail trading hours, the Northern Territory is the national leader in this regard;

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<sup>3</sup> GDP data for 2016-17 is not yet available. Comparison uses most recent final financial year data for both GST redistribution and GDP.

- streamlining environmental approvals to support economic development and reduce costs of investment and development;
- moving towards a single point of information on land tenure, soil and water;
- implementing a water licence and data portal; and
- establishing an open data and data analytics work program (Northern Territory Submission to PC Inquiry, page 15).

#### *Moving to an outcomes-based GST distribution*

1.11 As stated in the Northern Territory's submission to the PC Inquiry, expanding the role of equalisation to provide incentives for states to achieve specified outcomes is beyond the scope of HFE, and these additional objectives are better pursued outside the equalisation process.

1.12 A common misconception is equalisation provides fiscal capacity to states to improve outcomes over time. Rather, the equalisation process provides states with the capacity to deliver the average level of services, which maintains existing differences in outcomes between sub-populations and regions.

1.13 This is due to the application of the supporting principle of what states do, which was affirmed in the Commission's 2008 submission to the Senate Inquiry on Government expenditure on Indigenous Affairs and Social Services in the Northern Territory, which noted that:

*...the Commission makes no independent assessment of what would need to be spent to address disadvantage. At an extreme, if the average policy of the states was to cease assisting a particular disadvantage group then the problems of that group would have no impact on the distribution of the pool. (page 3)*

#### *Is the aim of HFE to achieve equal fiscal capacities?*

1.14 The term 'equal fiscal capacities' is ambiguous. Some parties would consider equal fiscal capacities would be to distribute GST revenue such that each state's per capita revenues are equal, without taking into account any factors affecting the cost of delivering services or capacity to raise revenue in each state.

1.15 The Northern Territory's view is that the aim of HFE is consistent with the current implementation of the principle by the Commission: to provide each state with the capacity to provide the national average standard and scope of services, if each made average efforts to raise revenues from their own sources, given their revenue bases.

1.16 The Northern Territory acknowledges that, in practice, the aim of HFE is not fully realisable, due to data quality issues, time lags in data availability and application of relativities, difficulty in ascertaining national average policy and a range of other issues. Further, the current methodology does not fully achieve HFE, which is diluted by the use of materiality thresholds, discounting and the Commission's use of judgement in applying these principles.

1.17 Notwithstanding that full equalisation, while ideal in theory, is unachievable in practice, the Northern Territory firmly supports the pursuit of full equalisation in order to provide the most equitable distribution of GST revenue among the states, by taking into account as many factors affecting states' fiscal capacities as possible.

### *Alternative approaches to distributing the GST*

- 1.18 Fiscally stronger and more populous states have argued for moving the GST distribution towards an EPC distribution or adopting partial HFE. The Northern Territory strongly opposes these approaches, which are inconsistent with the directions to the Commission provided in the IGA and ToR, and would: lead to non-equalising outcomes; lead to greater disparity in the quality and level of services between states; and adversely affect fiscally weaker states' sovereignty and autonomy to determine the most appropriate expenditure and revenue policies for their constituents.
- 1.19 This was demonstrated in the Commission Staff Research Paper CGC 2017-03-S Achieving HFE – Other Approaches to Distributing the GST (Staff Research Paper 03), which examined the implications of EPC and partial EPC distributions, stating:
- Only a distribution that equalises state fiscal capacities satisfies the equalisation. It showed that a movement away from HFE would provide more populous states with a fiscal advantage because they are awarded GST based on their population shares and not based on their capacity to service their principle. If a state receives less than its recommended amount, it is under-equalised and it would have insufficient revenue to finance the average level of service.*  
(page 8)
- 1.20 The Northern Territory's strong view is that an EPC distribution of GST revenue would remove the smaller states' abilities to provide the current range and quality of government services, and would create significant inequities across state borders, an outcome that would neither aid national prosperity or efficiency. (Northern Territory Submission to PC Inquiry, page 9)
- 1.21 In its Staff Research Paper 03, the Commission also explored the option of an actual per capita (APC) distribution where GST is used as a balancing item to fill the gap between actual expenses and infrastructure spending and actual revenue raised and received by states.
- 1.22 An APC assessment is typically adopted for assessments where there is no variation in states expenditure or revenue policies, that is, there is no policy contamination. For example, in the 2015 Review the Commission assessed natural disaster relief expenditure on an APC basis because state expenses are not policy influenced and are sufficiently comparable to make a reliable assessment.
- 1.23 The Northern Territory does not support changing the form of HFE to an APC approach as it would not be based on average state policy. This is a key concern of the Northern Territory, as the adoption of average state policy and internal standards is key to the integrity of the HFE system.
- 1.24 Although an APC distribution would be simpler, it would introduce an unacceptable level of policy influence into the assessment methodology, enabling states to directly influence their share of GST revenue and would not achieve equalisation. For example, there is a strong disincentive for states to raise taxes under an APC approach, as their assessed revenue capacity is purely based on tax revenue they actual raised, as such, reducing actual revenue will increase their assessed GST needs. It would also remove the inbuilt efficiency measures in the current system arising from the use of internal standards, whereby the per capita costs of the largest, presumably most efficient states have the greatest influence on the national average.

- 1.25 Other alternate approaches to distributing the GST have included the exclusion of mining revenues from equalisation and revenue-only equalisation. As examined in the 2012 GST Distribution Review, while mining revenue accounts for a large share of the distribution and is concentrated on a few states, it is not warranted that mining revenue should be treated differently under the assessment to other states revenues.

**Are changes to the definition necessary, or are state concerns more about the way HFE and its current definition is implemented?**

- 1.26 As stated throughout this section, the Northern Territory strongly supports the current definition of HFE and, in general, the 2015 Review methodology. There are certain issues with individual assessments that the Northern Territory will seek to address during the course of the 2020 Review, such as the principles underpinning the treatment of certain Commonwealth payments and more accurately capturing the level of Aboriginal disadvantage in remote communities compared with urban areas. However, on the whole, the Northern Territory is satisfied with the Commission's current interpretation and execution of HFE.

## 2 Supporting Principles

The Northern Territory's views:

- The Commission should continue to utilise the current supporting principles to assist in developing assessments that support the achievement of HFE as its sole objective.
- The Commission's discretion in producing a robust and adaptable methodology that adheres as closely as possible to the supporting principles, but has the main priority of achieving HFE, is preferable to weighting the importance of one principle against another.
- The current four supporting principles: what states do; policy neutrality; practicality; and contemporaneity, are sufficient and no additional supporting principles are required. There is a risk that additional principles could complicate the task of achieving HFE, particularly if there is a conflict between the principles when undertaking assessments.
- The Commission's suggestion to change the reference of 'supporting principles' to 'guiding considerations' is unlikely to remove public confusion surrounding the primary objective and definition of HFE. More emphasis from the Commission is required to explain HFE and its objectives and provide widespread engagement and understanding by the Australian public of this fundamental element of our federation.
- While changes in state fiscal and economic circumstances are not immediately reflected under the current approach to HFE, they are reflected two years later. This provides a level of predictability and stability to states' GST shares, and achieves a balance between accuracy and contemporaneity.

**Should the Commission continue to adopt supporting principles (or guiding considerations) to assist it in developing methods to give effect to the principle of HFE?**

- 2.1 The Northern Territory believes the current four supporting principles: what states do; policy neutrality; practicality; and contemporaneity are sufficient and work appropriately to guide judgement applied by the Commission to devise the best overall HFE result and does not propose any additional supporting principles.
- 2.2 The application of these supporting principles reduces complexity, maintains states' sovereignty and provides a balance between responsiveness and stability under the current HFE methodology. As discussed in section 1, the supporting principles of what states do and policy neutrality reduce the potential of incentives for states to vary policies in order to directly influence the GST distribution. In addition, the supporting principles of practicality and contemporaneity provide a balance between reflecting state circumstances in the current assessment year as far as possible and data reliability, and accuracy and stability of GST shares.

**Should HFE continue to be the priority, or are there circumstances under which certain supporting principles should take precedence over HFE?**

- 2.3 The Northern Territory supports the Commission's approach to implementing the supporting principles adopted in the 2015 Review, where primary consideration was given to the best

HFE outcome and secondary consideration to achieving the supporting principles, in no set order of importance.

- 2.4 Accordingly, the Northern Territory supports the continued adoption of supporting principles to assist the Commission in developing methods to achieve HFE, and does not propose any changes to the principles or the way they are applied. As noted in the discussion paper, Victoria, South Australia and Tasmania have similar views to the Northern Territory in this regard.
- 2.5 The Northern Territory supports the Commission's view that optimal HFE outcomes cannot be achieved without it making determinations about the best approach to assessing a category or disability, particularly where states' views differ considerably.

**Should the supporting principles have a pre-determined hierarchy, or should the Commission seek to balance the supporting principles case by case in order to best achieve HFE?**

- 2.6 The Northern Territory supports the Commission's view that HFE cannot be achieved without making decisions, on a case-by-case basis, about the methods to be used and the degree to which one principle should be applied over another. This is because differences between the states are not always clear and data is not always sufficiently available, meaning a rules-based approach would not be appropriate.
- 2.7 The best approach to ensuring HFE is the primary outcome of the assessment methodology is to allow the Commission to exercise discretion in producing a robust and adaptable methodology that adheres as closely as possible to the supporting principles, but does not arbitrarily bind it to achieving one principle over another, which may lead to an inferior HFE outcome.
- 2.8 For example, a level of complexity in an assessment is sometimes required to accurately reflect what states do, and to interrogate the best available data for use in an assessment. The Northern Territory does not consider a more rigorous approach to achieving HFE should be arbitrarily disregarded on simplicity grounds.
- 2.9 An example of where applying all principles would have led to a diminished HFE outcome was in the 2015 Review, when the Commission decided to maintain the existing administrative scale assessment despite it being based on outdated data. Although this approach did not satisfy the contemporaneity principle, the Northern Territory considered this to be an appropriate outcome, as a clear conceptual case existed, and it was the best means to achieve HFE when the time constraints for the 2015 Review prevented the collection of updated data.
- 2.10 A further example, as noted by the Commission in the discussion paper is the potential for lack of policy neutrality in a minority of circumstances where a tax base or service user population is concentrated within a small number of states. The Commission's decision to retain such assessments, such as the mining revenue assessment, is supported, despite it not being fully policy neutral, in the interests of achieving HFE as the first priority of the assessment.

**Should any of the 2015 Review supporting principles be removed, or any new supporting principles introduced? For any new principles, what is it that the new principle would achieve, not otherwise achieved?**

- 2.11 The current four principles are considered clear and fit for purpose to help guide the Commission's approach to achieving HFE. Nevertheless, the Northern Territory proposes that the Commission should go beyond merely identifying the supporting principles adopted in developing its assessment methodology and provide clear, detailed explanations around how principles have been weighed against one another in the development of an assessment.
- 2.12 The Northern Territory supports Victoria's view, outlined in its response to the Commission's letter on the 2020 Review Work Program, that it is unclear what the nature of additional principles could be and whether additional principles are required. There is a risk that additional principles could complicate the task of achieving HFE, and would likely result in an increasing number of assessments that fail to meet all of the supporting principles, if the number of principles increases.
- 2.13 The suggestion to change the reference of the 'supporting principles' to 'guiding considerations' is unlikely to remove confusion surrounding the primary objective and definition of HFE. Alternatively, the Northern Territory supports the findings of the 2012 Review of GST Distribution, which suggested the Commission take a more public role in explaining and defending the importance of HFE to the general public. (Northern Territory Submission to PC Inquiry, page 46)

*...[the Commission] does not actively seek to promote the understanding of HFE within the states outside of various Treasuries. A more widespread program of engagement (with states and the public) may help to ensure that equalisation principles are better understood by politicians and throughout the bureaucracy, with the result that the GST distribution process is more widely supported. (GST Distribution Review Final Report, October 2012, page 82)*

- 2.14 The Northern Territory's view is the GST distribution methodology is poorly understood by the public, enabling a high degree of political gaming and misinformation which can distort the public's support for and views on HFE.



# 3 What States Do

The Northern Territory's views:

- The Commission should continue to determine average expenditure and tax rates based on internal standards. The approach is sound and does not require further consideration.
- The Northern Territory strongly opposes the adoption of external standards. It is not appropriate for the Commission to determine a prescribed level of efficiency that states should operate at or create incentives for states to adopt particular policies.
- The adoption of the weighted average policy approach has introduced a further level of conceptual complexity and ambiguity into the assessment methodology, as well as reduced the policy neutrality of the Commission's approach to HFE. The Northern Territory requests additional in-depth examination of this issue in a subsequent issues paper in order to enable due consideration of this issue.
- The Northern Territory supports the continuation of equalising states to the same average per capita net financial worth, which includes the equalisation of income from general government and included public non-financial corporations' holdings of financial worth.
- The Northern Territory considers the existing scope of HFE to be appropriate and does not propose any changes to the range of revenues or expenditures included.
- The Northern Territory supports the continuation of the Commission's approach to reflecting what states do on average, which is generally achieved by disaggregating expenditure by different sub-populations and developing use weights to redistribute GST in accordance with higher cost groups.

## Is the use of internal standards a sound approach to the achievement of HFE with no further consideration necessary?

- 3.1 The Commission currently uses internal standards to determine what states do, which are based on the level of government services actually provided to the Australian population and revenues actually raised. The internal standards approach provides an appropriate, measurable base for financial need to determine the amount of GST each state requires to be able to provide the national average level of services. This approach does not specify a level or standard of service required or that states should provide, nor should it. The Northern Territory strongly supports the current approach of applying internal standards, rather than what states 'could' or 'should' do.
- 3.2 The Northern Territory's view is that further consideration of the internal standards approach is unnecessary. The majority of states supported the approach in the 2015 Review and no significant changes since then warrant further deliberation. Any variation to the current approach would require the Commission to apply a significantly greater level of judgement to estimate an alternative standard or ideal level of service and taxation mix, which is beyond its remit. The current internal standards approach is driven by combining states' individual expenditure and revenue-raising policies to form a national average policy, it therefore reflects what states do in an acceptably policy-neutral way.



- 3.3 The internal standards approach aids the achievement of policy neutrality by limiting the scope for states to design policy aimed at gaming the HFE system. Further, the Northern Territory notes the policies and service delivery costs of the most populous states drive the standard, which embeds a level of efficiency into the national average cost based on the largest states being able to achieve economies of scale.
- 3.4 Under the current internal standards approach, if a state is more efficient than the average, it retains the benefit between its actual costs and its assessed costs, and if a state is less efficient than the average, it is not compensated through HFE.
- 3.5 In the 2015 Review the Commission examined states' arguments for global and broad measures of interpretation for revenue assessments and concluded that these measures of potential tax bases were not good indicators of what revenue states could raise. The Northern Territory supports the Commission's conclusion and does not see the benefit of re-examining this argument in the absence of new evidence.
- 3.6 The Northern Territory's preference is for the Commission to interpret internal standards narrowly where possible, with expenditure and revenue disaggregated within assessment categories in order to adequately capture the drivers of differences in factors affecting states' service delivery costs and tax bases. A broad interpretation of internal standards for service delivery in most cases does not offer a strong correlation with actual state expenditure on individual services. While the Northern Territory understands narrow interpretations may introduce complexity, as discussed in section 2, it considers that achieving full HFE should not be substituted for simplicity of assessments, particularly where there is a sound and compelling conceptual case for assessment.
- 3.7 As stated in the discussion paper, a narrow interpretation of internal standards focuses on the detail of state service provision and revenue-raising policies for each assessment category. In contrast a broad interpretation looks at the expenditure or revenue category as a whole, it does not examine the individual drivers within the category that affect expenditure and revenue.
- 3.8 For example, interpreting health services narrowly concludes that states provide hospital inpatient services, outpatient services, community health services, disease prevention services and other public health services. A broad interpretation of health services indicates health services are provided to the public based on clinical need. Different sections of health care services are utilised differently by subpopulations. Community health-type services are generally used more intensely by children and the elderly, however, the cost per unit of service delivery is much lower compared to hospital services, which are more intensely used by the Aboriginal population. To capture the unavoidable factors affecting states' health costs, it is essential a narrow focus be adopted to disaggregate the category, in order to apply the appropriate range of disabilities driving differences in health expenditure between states.

**Alternatively, are there any circumstances in which it would be appropriate for the Commission to apply an external standard?**

- 3.9 In contrast to internal standards, external standards are not based on state policy. They are conceptual standards based on some aspirational level of service that states should or could provide, or a desired level of efficiency.
- 3.10 The Northern Territory strongly opposes the adoption of external standards. It is not appropriate for the Commission to determine a prescribed level of efficiency that states

should operate at or create incentives for states to adopt particular policies. State expenditure decisions are the responsibility of state governments, which determine the appropriate range of services for their constituents.

- 3.11 The Northern Territory acknowledges a pure internal standards approach is not always adopted due to data limitations or policy contamination concerns. For example, the Commission currently implements a stylised average policy approach to determining rural road length to remove policy influence from the assessment. The Commission determined that data on states' actual rural roads length, classifications, and allocations of responsibility between state and local government differed greatly, and as such developed an algorithm to determine average policy. Although the Northern Territory accepts the Commission's decision in this regard, its firm preference is for an internal standards approach that reflects average state policy where possible.

### Should the Commission retain the 2015 Review approach – the 'weighted average' approach – to determine average policy or is there a better alternative?

- 3.12 The Northern Territory would appreciate further clarification from the Commission as to why it adopted a weighted average approach in the 2015 Review. The Northern Territory's view is that the new approach to determining average state policy has resulted in significant conceptual complexity and ambiguity and has not necessarily led to improved HFE outcomes.
- 3.13 The 2015 Review approach to determining average policy adopts the same methods as determining internal standards, reflecting the average of what all states do. It includes the effort of every state, including states that make zero effort. A differential assessment is only undertaken if the outcome is material, therefore the introduction of a new tax or service by one state only affects the GST distribution when its assessment materially redistributes GST revenue between the states (\$30 per capita under 2015 Review methodology).
- 3.14 The 2010 Review approach to determining average policy did not include unique taxes or service delivery, which were regarded as above-average policy. States retained all the revenue from unique taxes and funded all unique service expenses.
- 3.15 It is difficult for the Northern Territory to accept under the current approach, one or two states can potentially set the average policy, and would be interested to see a case study around the differences of implementation between the current approach and the proposal to return to an approach similar to that used in the 2010 Review.
- 3.16 Although the Northern Territory accepts the weighted average approach is closer to full HFE, it is not clear that it has substantially enhanced HFE outcomes, but it has reduced the policy neutrality of the approach to determining average policy, with states pursuing unilateral tax or service reforms now able to directly influence the GST distribution.
- 3.17 Further, the weighted average approach is skewed heavily towards reflecting the policies of the largest states. It is unlikely that a unique policy implemented by one of the small jurisdictions will be material. As a result, the policies of the largest states are overwhelmingly reflected in average state policy, with the adoption of internal standards and the current weighted average policy approach.
- 3.18 The Commission has proposed that if a return to the 2010 Review approach was preferred, a clearer definition of what to include in average policy would need to be adopted. It is proposed that the assessment is not made unless both the following conditions are met:

- at least half the states that could apply the policy do so; and
- states applying the policy represent at least half the relevant service base or tax base.

3.19 As stated above, the Northern Territory proposes that the issue of which determinant of average state policy should be adopted for the 2020 Review be considered in more detail in a subsequent Commission staff discussion paper, which provides comparative examples of affected assessments and its view on which approach best achieves HFE outcomes.

### How might the practical problems arising from the weighted average approach be handled to ensure HFE is achieved?

3.20 The Commission has recognised that in certain circumstances there may be a conflict between the weighted average approach and policy neutrality principle. The Northern Territory recognises that the Commission continually monitors assessments where there are policy neutrality concerns to ensure that HFE is being achieved to the fullest extent.

3.21 As stated above, the Northern Territory's view is that this matter should be explored in further detail throughout the 2020 Review in order to adequately assess the implications of the weighted average approach. It appears the risk of one state influencing the overall average policy is partially dispersed due to the requirement of meeting the materiality threshold in order for a differential assessment to be made, however it is not inconceivable that this could occur. Further information on the application of the change in the definition of average policy between the 2010 and 2015 Reviews would allow due consideration of this issue.

### Should the fiscal outcome of states the Commission equalises continue to be the same average per capita net financial worth?

#### If not, what fiscal outcome should the Commission equalise?

3.22 The Northern Territory supports the continuation of equalising states to the same average per capita net financial worth, which includes the equalisation of income from general government and included public non-financial corporations' (PNFCs) holdings of financial worth.

### Given current state circumstances, does the existing scope of equalisation (general government, plus urban transport and public housing PNFCs but excluding local government except for the interactions between it and the state sector) remain appropriate?

#### If not, what activities should the Commission equalise?

3.23 The Northern Territory considers the existing scope of HFE to be appropriate and should continue to include all general governmental-type activities of states and be as comprehensive as practically possible, but should not equalise the expenses of local governments, which are subject to a separate equalisation processes.

3.24 The Northern Territory supports the view outlined in the discussion paper that there is no logical basis for limiting the scope of HFE to include certain state expenditures and not others, such as only equalising 'core' government services. The Northern Territory agrees that this would be inconsistent with the directive to the Commission set out in the IGA and ToR, which do not provide a basis for the Commission to discriminate between different expenses and revenues.

- 3.25 In the 2015 Review the Northern Territory supported the proposed changes to the scope to include services provided by state housing PNFCs on the basis that these services were consistent with the provision of social housing retained by some state government departments. The Northern Territory was hesitant about capturing transport PNFCs, due to the great variation in the ownership structures and service delivery arrangements of metropolitan rail and tram networks, however the Northern Territory accepts the Commission's current approach.

### Should assessments reflect what states do on average?

- 3.26 The Northern Territory supports the continuation of the Commission's approach to reflecting what states do on average, which is generally achieved by disaggregating expenditure on different sub-populations and regions and developing use weights to redistribute GST in accordance with higher cost groups. This is a policy-neutral approach and more in line with what states do than seeking to only reflect states' policies, which are usually not overtly expressed in terms of additional amounts of funding that should be spent on particular sub-populations.

### Should changes be made to the general approaches used by the Commission in the past?

- 3.27 The Northern Territory strongly supports assessments that, as far as practically possible, reflect what states do on average.
- 3.28 The Northern Territory supports the use of disabilities to recognise differences from the average in state revenue-raising capacity and expenditure needs influenced by economic, socio-demographic, environmental and geographical characteristics.
- 3.29 The methodology of applying disabilities is to adjust the average per capita spending and revenue efforts of states to compensate for the financial impact of differences in characteristics beyond the direct control of the individual state governments.
- 3.30 The Commission only assess disabilities that can be reliably measured and where they meet the materiality threshold. There are some cases where disabilities are not assessed, including the impact of the physical environment on roads and other infrastructure costs, differences in the level of socio-economic disadvantage across regions and between states (rather than measuring socio-economic advantage) and those outlined in the Commission's discussion paper. The Northern Territory encourages the Commission to continually monitor the materiality and reliability of disabilities for inclusion in assessments.
- 3.31 The Commission often applies discounts to disabilities when it lacks confidence in the underlying data. In doing so, the Commission uses a significant level of judgement, particularly when determining the size of the discount, and the Northern Territory notes the Commission always makes the assumption that the data overestimates the impact of the disability being assessed. The Northern Territory opposes the use of discounting in principle, and takes issue with the fact that there has yet to be an upward discount applied – an inflation, even when a conceptual case for underestimation of a disability can be presented.
- 3.32 This highlights the importance of states and the Commission constantly reviewing the methodology and the Commission's approach under the methodology, and the relevance and usefulness of data, to ensure assessments reflect an outcome as close to HFE as possible.
- 3.33 The Northern Territory proposes the Commission take steps to provide greater clarity around its application of judgement and the need for discounting disabilities, as well as its rationale

for choosing to achieve one principle over another in individual assessments. This would provide greater clarity and rigour to the assessments, and understanding of the Commission's intentions.

- 3.34 The Northern Territory would support a review of sub-populations currently not included in differential assessments, where new data may now be available, to ensure a contemporary reflection of what states do. In particular the Northern Territory encourages a review of students with disabilities as outlined below.

#### *Students with Disabilities*

- 3.35 The Commission has acknowledged that certain sub-populations may result in greater expenditure on services but this cannot be recognised as a disability as there is no reliable data on the interstate distribution of the sub-population. The population of students with disabilities currently falls under this category.
- 3.36 The Northern Territory strongly encourages the Commission to reassess the inclusion of the sub-population of students with disabilities. Since 2015 all schools across Australia have participated in annual data collection for the Nationally Consistent Collection of Data on School Students with Disability. The Northern Territory proposes the Commission analyse this data set to see if it provides the appropriate data for the sub-population to be considered in a differential assessment.
- 3.37 The dataset aims to provide nationally consistent, high quality data on:
- the number of school students with disability;
  - students enrolled in Australian schools who receive an adjustment to participate in education because of a disability;
  - where these students are located;
  - the level of reasonable adjustment provided to assist them to participate in schooling on the same basis as other students; and
  - each student's broad category of disability.
- 3.38 The Northern Territory encourages the Commission to review all linkages between proxies and what states do to ensure contemporary assessments but in general supports the assessment of expenditure disabilities when a conceptual case has been established and, in such cases, the adoption of proxy measurements for disabilities.

# 4 Policy Neutrality

The Northern Territory's views:

- Determining the 'ideal' state policy, through adopting external standards, is beyond the role of the Commission. It is the role of governments to determine what policies and level of services best suit their constituents.
- The Commission and states should engage in further consideration of the policy neutrality implications of the weighted average approach, in a subsequent Commission staff discussion paper, which clearly examines the potential HFE implications of future changes in states' policies.
- The state rotating average approach would undermine HFE, as assessments would not be based on true averages, would move away from the principle of what states do collectively and add an unnecessary level of complexity to the assessments.
- HFE incorporates in-built efficiencies through the use of internal standards, which are driven by the larger states, and are not disincentives to tax reform.

4.1 The Northern Territory strongly opposes a policy-free approach to determining the standard. An external standards approach based on some 'ideal' level of services, would lead to a complex decision-making exercise by the Commission, given the vast array of policy options open to state governments to provide services tailored to suit their constituents. Determining 'ideal' state policy is beyond the role of the Commission. It is the role of governments to determine what policies and level of services best suit their constituents.

4.2 This view was supported by the Commission in its Final Report to the 2015 Review:

*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 recommendations on the actual average policy of the state as revealed in the data.* (2015 Review Final Report, Volume 1, page 8)

4.3 The Northern Territory supports an internal standards approach that reflects average state policy. As discussed in section 3, the Northern Territory considers there are policy neutrality issues with the weighted average policy approach but acknowledges that it is also a more 'full' form of equalisation, and has requested additional analysis from the Commission on this issue.

**Do states consider that a rotating state average would improve policy neutrality? If so, how could such an approach be implemented in practice?**

4.4 The Northern Territory strongly opposes a rotating state average approach on the basis that it would measure each state's capacity to raise revenues and expenditure needs against a different benchmark. In particular, it would measure the costs of the smallest, arguably least efficient states against the largest, most efficient states. For example, the disabilities applied to New South Wales would be applied to a higher average than under the current approach, because the service delivery costs of New South Wales (assumed to be efficient) would

be removed from the average. Conversely, the opposite would occur for the small states, understating their expenditure needs.

- 4.5 This is a perverse outcome and, while it could be considered an incentive for states to reduce service delivery costs, the Northern Territory notes this is not the role of HFE. The Commission assesses states' costs based on unavoidable differences in states' service delivery costs and revenue-raising capacities. Therefore, any difference in assessed costs between states is not a reflection of efficiency but rather population and geographic differences, and different tax base endowments.
- 4.6 In addition, the state rotating average approach would move away from the principle of what states do, would add complexity to the assessments and could introduce technical complications, moving away from the practicality principle.

**Does HFE act as a disincentive to tax reform? If so, how does it do so – in reality as opposed to theory – and could such effects be mitigated in practice?**

- 4.7 The Northern Territory does not consider HFE and the current GST distribution methodology an impediment to tax reform. Although there may be GST revenue implications of unilateral tax reforms, these will generally be minor, due to the marginal impact on the average, and are not the determinant of whether states pursue reforms in practice. (Northern Territory Submission to PC Inquiry, page 19)
- 4.8 The Northern Territory contends that HFE incorporates inbuilt efficiencies through the use of an internal standards approach that is driven by the larger states. The Northern Territory notes that HFE incentivises states to make above-average tax effort (by broadening the tax base beyond the average or levying a higher than average tax rate), with states retaining any revenue raised above their assessed capacity. Conversely, if states make below-average effort to raise taxes, they are 'penalised' through HFE. In this way, unilateral tax reform, or tax policy that differs from the national average is unimpeded by HFE, however states that make below-average revenue effort are assessed as if they levy the national average tax rate.
- 4.9 The Northern Territory notes as part of the 2020 Review the Commission intends to undertake a consultancy to examine whether reliable estimates can be made of elasticity effects on state revenue bases. The Northern Territory is supportive of this work and has no further comment until findings are presented.



# 5 Practicality

Northern Territory's views:

- The Commission should continue to adopt the overall principle of practicality.
- Discounting represents an arbitrary departure from full equalisation and should not be adopted as a means of watering down material assessments where data exists to support a clear conceptual case for an assessment.
- The Northern Territory is opposed in-principle to materiality thresholds and does not support increases to materiality thresholds.

5.1 The Northern Territory supports the overall principle of practicality, which maintains the aim of achieving HFE while encouraging simplicity and ensuring the use of sound and reliable data that is robust, fit for purpose and as up to date as possible. The principle of practicality is inclusive of simplicity, reliability, materiality and quality assurance ideals.

## *Discounting and Materiality*

**A further aspect of practicality is the transparent use of data. In the 2015 Review the Commission made use of data that were in some cases confidential. Should assessments be made using confidential data?**

- 5.2 The Northern Territory considers the use of confidential data as appropriate in the Commission's assessments, provided confidentiality is adequately maintained in the Commission's representations of the data.
- 5.3 The most appropriate and accurate data that assists in the aim of achieving full HFE should be used in assessments. Ideally the data would be from national datasets collated by independent sources. However this is not always possible and where a conceptual case is made, the Northern Territory's view is that all efforts to develop an assessment should be made, including using state-provided data.
- 5.4 Some state data required by the Commission is confidential. Data provided by the Northern Territory for the mining revenue assessment is commercial-in-confidence due to the small number of operations in the Northern Territory. Nevertheless the data is provided confidentially, while being fit for the Commission's purposes.
- 5.5 During the Commission's 2017 Update, Western Australia raised concerns about the sharing of confidential data among states. It stated the data sharing protocol was proving inconvenient. As a result the Commission updated the protocol with the support of most states to 'sharing non-confidential data among states which have not designated their data as confidential, providing any data designated as confidential by states cannot be back-solved from the assessment outcome.' The Northern Territory supported this change.

**Are the three levels of discounting appropriate? If not how could discounts be changed?**

- 5.6 The Northern Territory has strongly held the argument for a number of years that discounting does not necessarily move an assessment in the appropriate direction to achieve HFE, whether it be revenue or expenditure. Discounting is biased, it is one directional. The



Commission discounts data to lessen the impact of a disability on the GST distribution, which assumes the disability is overestimated, however, this is not always the case.

- 5.7 For example, in a submission to the 2015 Review, the Northern Territory noted the Commission applies a discount of 12.5 per cent to interstate wage costs on the basis the data supporting the assessment may not be fully fit for purpose. The data is obtained from the Australian Bureau of Statistics (ABS) Survey of Education and Training and there is no evidence this data overestimates the difference in wage costs between states.
- 5.8 Although the Northern Territory acknowledges that in other circumstances, data underpinning assessments may be incomplete, dated, unreliable or not fully fit for purpose, discounting requires a significant amount of Commission judgement that is not desirable and does not necessarily overcome these issues.
- 5.9 The Northern Territory believes the priority should be to address the data quality issues within the methodology rather than ignoring or discounting unavoidable disabilities because of data limitations. In terms of concerns with national data sets, the Commission should work with the relevant national body to address those issues. In terms of state administrative data, the Northern Territory acknowledges that data limitations exist but is committed to assisting the Commission where possible to improve existing data.
- 5.10 In the discussion paper, the Commission identified that discounting is not always appropriate, such as in relation to best available estimates of national expenditure or judgement-based estimates. Similar to the Commission's opinion, the Northern Territory believes that if a dataset is classified as the best available to be used as an indicator for a particular assessment, then it should be used, unadjusted.

### Should the materiality thresholds remain at the 2015 Review levels or should they be increased? If increased, to what levels?

- 5.11 The Northern Territory is opposed in-principle to the use of materiality thresholds, and as such does not support an increase to the current thresholds. Materiality thresholds dilute the achievement of full HFE, as they exclude assessment of smaller disabilities on the basis that they are insignificant. While this leads to fewer assessments and therefore enhances simplicity, the Northern Territory notes that it still requires analysis to establish whether or not a disability is material, which adds a layer of complexity to the Commission's methodology.

#### *Quality Assurance*

### Is this an acceptable way to ensure 'robust quality assurance processes'?

- 5.12 The Northern Territory endorses the preparation of a quality assurance strategic plan to ensure a robust process of achieving reliable, accurate and conceptually sound assessment methods.
- 5.13 It appears reasonable to base the 2020 Review quality assurance plan on the 2015 Review Quality Assurance Strategic Plan (2015 Review Plan), and to incorporate adjustments to address any new risks identified by states. The Northern Territory supports the overall objectives outlined in the 2015 Review Plan.

**Are there any new risks that the Commission should take into account from a state perspective? How might the 2015 Strategic Plan be changed to deal with those risks?**

5.14 The Northern Territory would encourage the Commission to take greater steps to facilitate better public understanding of its role and the role of HFE in the federation. The Northern Territory considers that the value of HFE to the national interest is misunderstood and consistently criticised by various stakeholders, which is a major risk to the Commission and to states. One option for consideration is the preparation of fact sheets for media and public use in interpreting annual updates, and the Commission could take a more public role in defending HFE in order to mitigate these risks.

**Should any other changes be made?**

5.15 Further changes to the 2015 Review Plan are not apparent at this time. The Northern Territory welcomes the draft 2020 Review Quality Assurance Plan for further consideration.

# 6 Contemporaneity

The Northern Territory's views:

- The Commission should maintain the current aim of achieving GST distribution relevant to the application year.
- The current three-year lagged average approach provides a level of predictability and stability of states' GST shares, and achieves a balance between accuracy and contemporaneity.
- None of the proposed alternatives to applying the contemporaneity principle are supported by the Northern Territory. The alternatives increase volatility and reduce reliability, hindering states' fiscal management.
- Backcasting major changes in Commonwealth-state financial arrangements should continue in its current limited form, taking place only where changes are material and achieved reliably.

**Should the Commission maintain the aim of achieving a GST distribution relevant to the application year, or should the aim be varied to achieve equalisation over time using historical assessments?**

- 6.1 The Northern Territory does not support calls for HFE to be realised in the application year to better achieve the contemporaneity principle. The Northern Territory is not convinced that implementing HFE without lags could substantially improve states' budgetary certainty or revenue volatility, as claimed by some states.
- 6.2 The Northern Territory believes trading precision for timeliness would hinder states' fiscal management, as this approach would likely lead to increased volatility through either the use of forecast data or only one year's worth of data in the assessments for the distribution of the GST pool. (Northern Territory Submission to PC Inquiry, page 27)
- 6.3 The Northern Territory acknowledges the inherent trade-off between contemporaneity and data reliability arising from calculating states' fiscal capacities using previous years' data. However, considers the Commission's current approach appropriately captures changes in states' fiscal and economic circumstances over time. Further, the three-year averaging process and the two-year data lag provides a level of predictability and stability to states' annual GST revenue receipts, and achieves a balance between accuracy and contemporaneity.
- 6.4 The Northern Territory is of the opinion that the principle of contemporaneity has been thoroughly scrutinised in both the 2010 and 2015 Reviews. The Northern Territory supports the Commission's aim to achieve, as far as practically possible, equalisation relevant to the application year.
- 6.5 A range of data sources are used in the Commission's assessment methodology including national datasets and state administrative data. Historical data, whether it is updated annually with a lag or updated or released less frequently, should not be dismissed because of concerns it is not contemporary. This would significantly restrict the data available to the Commission for use in the assessment process.

Does the current three year lagged average approach present undue difficulties to managing your state's cyclical cash flows?

- If so, which of the approaches discussed would result in an improvement to cyclical cash flow management and why, noting the concerns about using reliable and consistent data, the unreliability of forward estimates and the risk of policy contamination through the different budgeting practices of the states (with the consequent likelihood of increasing complexity through a completions type process)?
- If none of the proposed approaches appeals, what approach would your state propose and why?

6.6 The Northern Territory staunchly believes the current form of HFE is dynamic and responsive to changes in both structural and cyclical factors affecting state economies over time.

6.7 The Northern Territory acknowledges that cyclical factors may run ahead of GST relativity adjustments on the downside due to the lagged effect of GST relativities, however, the reverse also applies on the upside with GST relativity adjustments running ahead of cyclical factors.

6.8 The current three-year averaging process achieves an appropriate balance between precision and contemporaneity in the calculation of GST relativities which facilitates the smoothing of the volatility of revenue streams arising from cyclical changes in states' economic circumstances. (Northern Territory Submission to PC Inquiry, page 32)

6.9 This was supported by Michael Willcock's testimony to the Senate Economic Legislative Committee, Estimates Hearing, on 31 May 2017:

*the Commission has used this approach—the three years of data rather than just one year's data—to smooth any sorts of lumps and bumps and volatility and outlier bits of data, and it uses three-year data because that is more authoritative, it is ABS-verified, GFS data, rather than, say, forecasts from individual states which may or may not turn out to be less than robust.*

6.10 Any change to the current three-year averaging process would increase volatility and impact the reliability of the HFE system. The current method provides some stability and ability for states to plan for changes in its GST share, particularly where the distribution is driven by cyclical changes impacting states revenue capacity.

6.11 As discussed below, the proposed options to improve contemporaneity, including: assessing states' fiscal capacities on only one year's data rather than a three-year average; adopting later reporting dates; adopting forecast data; or developing different assessments for volatile revenues. Each would create greater fiscal management challenges by introducing less predictability of relativities and not enhance the HFE assessment. The Northern Territory does not support any of these approaches, which seek to alter the impact of HFE on a particular state by changing the way in which the contemporaneity principle is applied.

6.12 It is noted that the 2011-12 case studies presented by the Commission's Staff Research Paper CGC 201705S Options for Improving Contemporaneity (Staff Research Paper 05), demonstrated that the total gap between GST paid and GST required can be reduced under the proposed alternatives, but an individual state's gap can be exacerbated in each proposal. No one method resulted in every state decreasing their gap.

### *One-Year Model*

- 6.13 The Northern Territory acknowledges that a one-year model improves contemporaneity by reducing the length of the lag in the GST assessment model and moving the assessment year closer to the application year. However, there is no guarantee the closest assessment year correlates more highly to the circumstances in the application year compared to the current three-year approach.
- 6.14 An issue with reducing the number of years in the assessment period is that the approach significantly increases the volatility of GST distribution from year to year, hindering a state's ability to predict their GST payments and manage cyclical cash flows.
- 6.15 A further issue with this proposed alternative is the ability of the Commission to collect reliable data. The Commission has identified that data reliability is a significant concern under the one-year model as final assessment year data is provided by the states rather than obtained as ABS Government Finance Statistics.

### *Later Reporting Date*

- 6.16 The Northern Territory is hesitant to support an approach that publishes GST relativities later in the year. The current publication of relativities in February each year falls in the middle of the Northern Territory budget development process, and is therefore timely.
- 6.17 The release of relativities, depending on the accuracy of forecasts, can require last minute adaptations to the budget development process before final approval to ensure responsible state fiscal management. The level of budget certainty afforded through the release of final GST relativities would not be possible with a midyear reporting date as the Northern Territory Budget is handed down in May each year.
- 6.18 While the Commission acknowledges this could be a problem with state budgets, the proposal to provide an early indicative GST relativity rather than a final relativity mid-year would still create uncertainty during state budget preparation.

### *Use of Projections and Forecasts*

- 6.19 The Northern Territory strongly believes the use of projected and forecast data is not optimal and would potentially require GST adjustments in subsequent years to reflect actual data outcomes. The use of forecast data and the consequent corrections required would add an increased level of complexity to the assessment methodology without improving HFE outcomes in the application year. Annual revisions to states' GST payments to correct for actual data, would create an unacceptable level of uncertainty, significantly increasing the difficulty of states' budget management.
- 6.20 The Commission has alluded to evidence that suggests the biggest difference between GST paid and GST required by states over time is changes in states' circumstances, which are reflected in changes to disabilities, rather than states' financial positions. The forecast approach would be increasingly complex in this regard, due to the need to forecast changes in states' disability factors in addition to changes in their relative fiscal capacities.
- 6.21 The Commission's case study on forecast data in Staff Research Paper 05 models the effect of using states' midyear budget documents. States' projected fiscal circumstances are subject to their own methodologies and hence carry the risks of reliability, volatility and policy contamination. The approach of using forecast and projected state data would open the assessment up to gaming by states, leaving the Commission with the additional responsibility of careful monitoring and potentially judgement based adjustments, moving away from an assessment based on what states do.

### *Treating Volatile Revenues by Absorption*

- 6.22 The Commission explored the option of treating volatile revenues by absorption in the 2015 Review and concluded that singling out a particular revenue stream risks unbalancing the HFE system over time. The Northern Territory strongly supports this view and does not believe there have been any significant changes to warrant the Commission revisiting this option.
- 6.23 The absorption method has been proposed as a means of improving contemporaneity by reflecting changes in states' revenue capacity for a particular revenue in the application year, rather than at a two-year lag. As explained in Staff Research Paper 05, absorption could be extended to volatile revenue streams by:
- adding the revenue stream to the GST pool in the years of the assessment;
  - applying the ensuing relativities to a combined pool (of GST and the relevant revenue stream) in the application year; or
  - deriving states' GST revenue by deducting an application year assessment of the relevant revenue streams from the combined distribution.
- 6.24 The 2011-12 case study in the Staff Research Paper 05 showed that correcting the national overall gap between GST paid and GST required by states by absorbing one source of revenue (mining royalties) can exacerbate individual states' gaps. It appears this occurred due to other influences that may have been offsetting the gap arising from the absorbed revenue item.
- 6.25 The Northern Territory's view is that any contemporaneity gains would be offset by added complexity and would require significant judgement around which revenues are considered volatile, and when the absorption method should begin and cease to be applied.
- 6.26 Further, the Northern Territory is not convinced that any state revenues are significantly volatile, but rather reflect cyclical changes in states' economies.
- 6.27 Finally, the Northern Territory notes that states' experiencing significant revenue growth experience a GST windfall in the initial years of this change, before it is reflected in their relativity, due to the two year data lag. As such, the implementation of an absorption approach could result in some states receiving a fiscal gain that would otherwise be smoothed out under the current HFE methodology.

### **Under any contemporaneous approach, should backcasting in its current limited form continue? If so, can/should backcasting be expanded to cover a wider range of Commonwealth payments or other volatile revenues?**

- 6.28 The Northern Territory supports the use of backcasting to reflect major changes in Commonwealth-state financial arrangements, under the current limited application approach of backcasting to Commonwealth payments where changes to arrangements are material and can be assessed reliably.
- 6.29 The use of backcasting increases the contemporaneity of assessments by reflecting major changes in Commonwealth-state financial arrangements in the application year, rather than waiting until the changes flow through the data in assessment years.
- 6.30 The Northern Territory suggests that consideration be given to whether recent changes to Commonwealth-state financial relations, including the new school funding arrangements expected to be implemented by 2018 and updates to the health funding arrangements post 2019-20, should be backcast as part of the 2020 Review.

# 7 Treatment of other Commonwealth Payments to the States

The Northern Territory's views:

- Materiality thresholds should not be applied to determine the treatment of Commonwealth payments.
- The National Partnership Agreement on Northern Territory Remote Aboriginal Investment (NTRAI)<sup>4</sup> should continue to be excluded from equalisation, as directed by the Commonwealth through the ToR.
- The National Partnership on Remote Housing (NPRH)<sup>5</sup> should be excluded from equalisation to reflect its purpose to address unmet need, which is beyond the scope of the Commission's assessment of states' public housing expenditure and revenue.

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

- 7.1 The Northern Territory opposes the proposal to implement materiality thresholds to determine the treatment of tied Commonwealth payments. This approach would add unnecessary complexity to the equalisation process and could lead to the proliferation of many low-value bilateral Commonwealth funding agreements as a means of circumventing the equalisation process.
- 7.2 In general, the Northern Territory supports Commonwealth payments that relate to state services being included in the GST methodology and the Commission's discretion to vary the treatment of Commonwealth payments where appropriate to reflect the nature of particular payments and the role of state governments in providing services.
- 7.3 However, the Northern Territory considers that the framework used by the Commission for assessing whether a Commonwealth payment should affect states' GST revenue receipts should be made explicit. This ensures, prior to state agreements, that states can predict the likely treatment of a Commonwealth payment.
- 7.4 For the Northern Territory, a major Commonwealth payment excluded from equalisation is NTRAI. Funding provided under this agreement is designed to address Aboriginal disadvantage through the provision of additional programs, over and above general state service delivery, in order to address the gap in outcomes between Aboriginal and non-Aboriginal Territorians. The Northern Territory strongly supports the continuation of this arrangement, which ensures that the intent of NTRAI funding is upheld.
- 7.5 In the 2010 Review, the Commission excluded payments under NPRH from equalisation on the basis this funding related to improvements to assets not owned by the states. However in the 2015 Review, the Commission decided to change the treatment of NPRH on the basis that states have been acquiring greater responsibility for the delivery of remote Aboriginal housing, phasing NPRH from the 2013-14 assessment year. Subsequently, in the 2016 Update the Commission further altered the treatment of NPRH to exclude 25 per cent

<sup>4</sup> Discussions also relate to the preceding Stronger Futures is the Northern Territory agreement.

<sup>5</sup> Discussions also relate to the preceding National Partnership Agreement on Remote Indigenous Housing.



of the capital component from its assessments in recognition of the Commonwealth's underinvestment in remote Aboriginal housing prior to the transfer of this function to states in 2007.

- 7.6 This treatment ignores the intent of NPRH, which is to bring remote housing infrastructure and housing outcomes up to acceptable Australian standards. NPRH is intended to address the under-investment in remote housing in the decades preceding this agreement (and the previous iterations of it), and provide acceptable quality and quantity of remote housing infrastructure in remote Aboriginal communities. The Northern Territory strongly considers this payment to go above average state policy to explicitly target unmet need.
- 7.7 The Northern Territory does not accept the Commission's rationale that needs are assessed for this type of expenditure. The infrastructure and housing categories recognise that remote Aboriginal housing is more expensive to provide and more intensely used. However, these assessments do not take into account the need to significantly increase the number of houses in remote communities to equalise standards with those of public housing elsewhere in Australia.
- 7.8 The Northern Territory urges the Commission to recognise this in its approach to deciding the future treatment of NPRH, which is crucial to addressing Aboriginal disadvantage.



# 8 The Assessment Guidelines

Northern Territory's view is the Commission should maintain the current assessment guidelines, which add transparency and clarity to its decision-making process, but also take steps to better communicate the rationale for its application of judgement and the need for discounting of disabilities, as well as its rationale for choosing to achieve one principle over another in individual assessments.

## Are changes needed to the assessment guidelines?

- 8.1 The Northern Territory supports the continued use of assessment guidelines to provide transparency and clarity around the Commission's decision-making process.
- 8.2 The guidelines currently cover the implementation of:
  - the steps for establishing and measuring disabilities;
  - when and how discounting decisions are made and applied; and
  - the threshold change in the GST distribution for recognising a disability.
- 8.3 The Northern Territory does not believe changes are required to the guidelines for establishing and measuring disabilities and agrees a presumptive case for the disability must be established, a reliable method must be devised and the appropriate data must be readily available before a disability factor is able to influence an assessment.
- 8.4 As stated throughout this submission, the Northern Territory does not support materiality thresholds or discounting in principle as they dilute the achievement of HFE. The Northern Territory believes the introduction of discounting in assessments is biased as it is only applied in one direction.
- 8.5 The Northern Territory strongly supports the Commission's use, as much as practically possible, of nationally collected and independently sourced data to maintain the integrity in state comparability.
- 8.6 As discussed in section 3, the Northern Territory proposes the Commission take steps to better communicate the rationale for its application of judgement and the need for discounting of disabilities, as well as its rationale for choosing to achieve one principle over another in individual assessments. This would provide greater clarity and rigour to the assessments, and understanding of the Commission's intentions.