QUEENSLAND TREASURY

Commonwealth Grants Commission 2020 Methodology Review

Response to Staff Discussion Paper CGC 2017-02-S: The Principle of HFE and its Implementation

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Queensland Government

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Executive summary

Queensland values the Commonwealth Grants Commission's (CGC) process and acknowledges the challenging and complex task at hand for the CGC in making recommendations about the implementation of Horizontal Fiscal Equalisation (HFE) in Australia. The process of HFE has considerable impacts on State finances and is arguably the most important aspect of financial relations between the Commonwealth and the States.

Queensland welcomes the opportunity to respond to the CGC's Staff Discussion Paper on the principle of HFE and its implementation. This submission focuses on the priority issues of concern and the questions the discussion paper raises. The following boxes summarise Queensland stated positions on the issues raised:

Objective and definition of HFE - Queensland's position

- While Queensland strongly supports HFE, the objective of HFE should be to provide each State and Territory with the fiscal capacity to deliver similar, rather than precisely the same levels of services and infrastructure.
- A change to the HFE definition to incorporate this would better reflect the challenges faced by the CGC including data limitations, the difficulty of separating policy choice from underlying capacity, and the need to consider simplicity, contemporaneity and transparency.

Supporting principles - Queensland's position

- Queensland supports retaining the current supporting principles but referring to them as guiding considerations.
- To improve transparency and understanding, Queensland also supports further exploration of establishing mechanisms around how the guiding considerations are used.

Internal or external standards - Queensland's position

- Queensland supports continuing to use an internal standard as the base for revenue and expense assessments.

Weighted averaging and average policy - Queensland's position

- While Queensland does not have any immediate concerns with the retention of the current approach to determining average policy, that is, it will consider any tax imposed or service provided by any State, the CGC must remain cognisant of practical issues and provide clear explanations for judgements formed to determine what average policy is.

Scope of equalisation - Queensland's position

- Queensland is broadly supportive of the current scope of equalisation. However, a change in the definition of HFE to equalise to a similar fiscal capacity could present an opportunity to review the current scope to move towards a simpler and more transparent model.

Disability measurement - Queensland's position

- In general, Queensland considers the CGC to reasonably reflect what States do and the disabilities they face. However, Queensland emphasises the importance of incorporating the most relevant and update to date data to accurately reflect what is happening.

Policy neutrality - Queensland's position

- Queensland does not consider the current system creates a disincentive for States to pursue economic reforms or grow their economies. While such disincentives may exist at a theoretical level, Queensland is not aware of hard evidence that these disincentives exist in practice.
- Queensland does not support the use of a State rotating average as it would add further complexity to the system, require further judgements by the CGC and would not reflect what States do.

Appropriate treatment of mining revenue - Queensland's position

- Queensland supports an aggregated mining revenue assessment rather than assessing each mineral separately to achieve policy neutrality.

Practicality - Queensland's position

- Queensland supports maintaining the uniform set of discounts, and reviewing where discounting has been used to ensure that the level used is appropriate.
- Queensland supports extending the application of discounts to cases where they could be used to more effectively respond to methodological issues which the existing framework is unable to adequately deal with.
- Further consideration and examination should be undertaken of an increase to the current materiality thresholds to $50 per capita. However, other factors should also be considered when deciding the inclusion or otherwise of an assessment.

Contemporaneity - Queensland's position

- Queensland supports achieving contemporaneity as far as reliable data will allow. However, it should not come at the cost of simple, reliable and robust assessments with broadly stable outcomes.
- There are substantial practical limitations and complexities in implementing greater contemporaneity that mean a contemporaneous approach is unlikely to better achieve HFE than the current lagged average approach.

Treatment of Commonwealth payments to States - Queensland's position

- Queensland supports the overarching framework the CGC uses to determine if a Commonwealth payment should either impact or not impact HFE. However, any change to the treatment of Commonwealth payments is challenging given the significant variation in the basis and reason for Commonwealth payments.

Assessment guidelines - Queensland's position

- Queensland supports retaining the assessment guidelines for the 2020 Review to ensure the CGC takes a consistent approach in developing assessments and that the assessments are conceptually sound, reliable and as transparent and simple as possible.

Objective and definition of HFE

Queensland's position

- While Queensland strongly supports HFE, the objective of HFE should be to provide each State and Territory with the fiscal capacity to deliver similar, rather than precisely the same levels of services and infrastructure.
- A change to the HFE definition to incorporate this would better reflect the challenges faced by the CGC including data limitations, the difficulty of separating policy choice from underlying capacity, and the need to consider simplicity, contemporaneity and transparency.

1. Queensland places great value on HFE and strongly supports it. HFE has, and has had for many years, a significant nation-wide impact and plays a key role in helping States and Territories (States) deliver similar levels of services and infrastructure to the community. Given the broad service delivery responsibilities of the States, limited access to revenue sources, and the pressures that some of those service delivery areas will face into the future, HFE is essential.
2. Given the significance of HFE, it is important that Australia's system of HFE is robust, is seen as credible, and receives broad support. To ensure this requires a clear understanding of the objective of equalisation – what is HFE seeking to achieve?
3. While noting that the answer to this will continue to generate considerable debate, Queensland suggests equalisation is most helpfully viewed as a system designed to provide each State and Territory with the fiscal capacity to deliver similar levels of services and infrastructure. It does not, however, prevent States from making policy choices about the revenue and expenditure mix and effort.
4. In the 2015 Methodology Review, the Commonwealth Grants Commission (CGC) articulated the objective of HFE using the definition:

   > *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. As the CGC acknowledges in the Staff Discussion Paper, *SDP 2017-02-S The Principle of HFE and its Implementation*, this definition has as its aspirational goal, precise (or complete) equalisation. However, despite the dedication of the CGC, this aspirational goal has proved elusive and impediments such as data limitations, the difficulty of separating policy choice from underlying capacity, and the need to consider simplicity, contemporaneity and transparency, have all meant that HFE has probably never provided States with precisely the same fiscal capacity. It has also led to criticisms of false precision. As a result, the CGC have incorporated concepts such as materiality and practicality into its consideration of achieving HFE. Viewing the aim of the system as seeking to achieve similar capacities recognises the challenges faced by the CGC.
6. To reflect these challenges, Queensland suggests the definition of HFE should be recast to better reflect what is possible and what actually happens.
7. Queensland's objective for HFE allows for the consideration of a wider range of approaches to deliver equalisation. An objective that seeks to equalise to similar levels has the potential to create a simpler and more transparent system which does not attempt to adjust for every possible factor and is likely to be less subject to the criticisms of false precision that are sometimes directed at the current system.
8. The CGC's 2020 Methodology Review (2020 Review) and Productivity Commission Inquiry into HFE offer the opportunity to comprehensively review how HFE is conceptualised, how it is implemented, and ultimately whether there are alternative options that will more effectively achieve the desired objective.

9. The CGC has the capacity to ask these questions and re-examine the definition of HFE within is current terms of reference and the *Intergovernmental Agreement of Federal Financial Relations* (as amended). The current objective of HFE is a construct of the CGC and previous legislative wording in the *States (Personal Income Tax Sharing) Amendment Act 1976* has only ever required equalisation to be ‘not appreciably different’. Accordingly, a revised definition can be considered and implemented within the 2020 Review’s terms of reference.
10. While some may argue that a change to the definition to incorporate ‘similar’ rather than ‘same’ is unnecessary and potentially confusing, Queensland does not consider it would result in any more judgement or interpretation than the current system and in many circumstances would allow the CGC to utilise simpler, more robust and transparent processes.
11. Clearly stating HFE seeks to deliver similar levels of service and infrastructure would create a more readily understood, credible and robust system that would increase confidence in it and lead to greater support of the system and the CGC’s work.

Supporting principles

Queensland’s position

- Queensland supports retaining the current supporting principles but referring to them as guiding considerations.
- To improve transparency and understanding, Queensland also supports further exploration of establishing mechanisms around how the guiding considerations are used.

12. The CGC has a well-developed set of supporting principles that allow equalisation to be implemented by methods that it considers:
    - reflect what States collectively do;
    - are policy neutral;
    - are practical; and
    - deliver relativities that as far as possible, are appropriate to the application year (contemporaneous relativities).
13. However, the mechanisms for exercising judgements and weighing competing principles are comparatively less well understood.
14. As such Queensland is supportive of efforts to provide greater clarity and transparency around how the principles are utilised by the CGC. Recasting the supporting principles as ‘guiding considerations’ and establishing a hierarchy could help to achieve this and allow the CGC to better articulate how each consideration has been applied in the equalisation process and, more importantly, the judgements employed by the CGC.
15. However, Queensland views the guiding considerations as concepts used by the CGC to help it achieve HFE. They do not override HFE, and it is therefore unclear how the guiding considerations could sit alongside HFE as a first order principle (as outlined in Table 1 in the CGC’s Staff Discussion Paper). Rather, Queensland would suggest a hierarchy be provided around the guiding considerations below the objective of HFE.
16. In considering how such a hierarchy could be ordered, Queensland would emphasise the importance of practicality, particularly the element of simplicity, across all the structural elements of the system (i.e. scope, disabilities and assessment methods). Simplicity must be a key consideration in helping build the credibility and robustness of the system. The HFE process can be a black box for many outside those directly involved, yet, through the large redistributions of GST it generates, it can significantly impact on the services and infrastructure delivered to them by their State governments. As such ensuring confidence and support in the system must be a key focus.

17. Queensland also considers 'what States do' is critical when determining the scope of revenues and expenses to be assessed and when identifying the factors (disabilities) affecting State finances. This reflects the significant underlying differences that exist between States, including the significantly higher costs Queensland faces in delivering services to a more decentralised State.
18. Queensland emphasises the importance of 'policy neutrality' when considering the CGC's assessment methods. HFE should not undermine or compromise the returns of government policy, and the impact on the HFE process should not be allowed to be a significant consideration in the making of expenditure and revenue decisions by policy makers. While this is usually the case, the current treatment of mining revenue is resulting in a situation where equalisation is achieved at the expense of all other considerations and the Mining Revenue assessment does not reflect the true tax base capacity of certain States. In this regard, the current mining assessment approach is leading to an inferior HFE outcome and reinforces the need for reform of that assessment.
19. Under an objective of HFE of seeking to achieve similar fiscal capacities, greater importance would need to be placed on the guiding considerations in outlining how the CGC has achieved HFE. A hierarchy for the considerations would provide the CGC with the framework to explain its decision making and judgements and provide greater transparency to stakeholders.

What States do

Internal or external standards

Queensland's position

- Queensland supports continuing to use an internal standard as the base for revenue and expense assessments.

20. There appear to be some limitations with the current approach, however, it does have a strong basis in what States actually do, rather than trying to create a nominal approach which is likely to be subjective or directive (that is, potentially reducing State sovereignty).
21. The key challenge with the option of creating an external standard will be the subjectivity involved. For example, when setting an external standard, who should decide what services should be provided, at what standards they should be provided or how and where they should be provided. These are important questions, but also inherently subjective and arguably value-based questions, and they are best answered by democratically-elected State governments. The use of internal standards means that the CGC does not need to make such judgements.
22. Additionally, there are questions around the level of detail such standards should be – to be workable could they be broad based or would they need to be at a very fine detail so that all States understand to what standard they will be held account.
23. Any adjustment of standards to achieve certain policy objectives beyond HFE and the guiding considerations would be a significant change in the practice of the CGC and presumably outside the 2020 Review terms of reference. However, Queensland is sympathetic to arguments, in certain situations, that the use of external standards could help achieve policy neutrality or preserve incentives that would exist in the absence of HFE. But establishing the right standard is vital for such a system to deliver real benefits and there remain significant data limitations which prevent external standards from being implemented.
24. Further consideration and significant justification of such issues needs to be considered by the CGC before external standards could be implemented. Adopting an external standard would carry the risk of both adding complication to the current system and producing unintended consequences.

Weighted averaging and average policy

Queensland's position

- While Queensland does not have any immediate concerns with the retention of the current approach to determining average policy, that is, it will consider any tax imposed or service provided by any State, the CGC must remain cognisant of practical issues and provide clear explanations for judgements formed to determine what average policy is.

25. Queensland appreciates the conceptual basis for the approach the CGC adopted in the 2015 Methodology Review to determine average policy – that is it will consider any tax imposed or service provided by any State to be part of what States do collectively, as better reflection of 'what States do'.
26. The previous approach which required a majority of States and a majority of the tax or service base to be affected, for an activity to be accepted as average policy, had the potential for a unique tax or service to have no impact on the GST distribution.
27. However, the weighted average approach can create practical challenges and has the potential to compromise the guiding consideration of policy neutrality in certain instances. In particular, where a States dominates a tax base or service provision or when a State prohibits a tax base being accessed, Queensland has concerns around whether the weighted average approach is delivering a policy neutral outcome. This is currently the case for the Mining Revenue assessment and its treatment of individual commodity revenue streams and for onshore gas development.
28. Additionally, it is often problematic for States to provide the data required to assess revenue capacity or service delivery needs reliably in areas they do not raise revenues or provide services.
29. One possible approach the CGC could consider in such circumstances is applying the weighted average approach to higher level categories. For example, rather than averaging revenue from individual minerals such iron ore or coal, the mining assessment could be performed on total mining revenue. Along with many other assessment methods, there is a question of whether the level of detail currently used in the system is leading to a better HFE outcome or overcomplicates the assessment reducing confidence in the system.
30. Queensland appreciates this proposal will not resolve all the practical issues faced by the CGC. In other situations, it is essential for the CGC to disclose in greater detail its decision making process with emphasise on what judgements have been used. This information should be clearly relayed and explain how it is consistent with the guiding considerations.

Scope of equalisation

Queensland's position

- Queensland is broadly supportive of the current scope of equalisation. However, a change in the definition of HFE to equalise to a similar fiscal capacity could present an opportunity to review the current scope to move towards a simpler and more transparent model.

31. The current scope of equalisation reflects the services State governments provide, the infrastructure States build and the revenue States raise. This comprehensive scope includes all State general government type activities.
32. Within the confines of the current objective of HFE, Queensland is broadly comfortable with this scope. However, a change to the definition of HFE to reflect providing States with similar fiscal capacities would allow the CGC to review the current scope to move towards a simpler model. This could include further consideration of only capturing core services or disabilities or broader revenue measures.
33. The scope of equalisation should not be expanded to include local government activities. There are significant differences in roles and responsibilities between States for the local government sector and attempting to reflect this would add further complexity to the system.

Disability measurement

Queensland's position

- In general, Queensland considers the CGC to reasonably reflect what States do and the disabilities they face. However, Queensland emphasises the importance of incorporating the most relevant and update to date data to accurately reflect what is happening.

34. Queensland strongly supports identifying factors (disabilities) affecting State finances that are beyond their direct control and which cause fiscal capacities to diverge. Such factors represent the underlying cost factors that States face when delivering services to their citizens and are critical for explaining the differences between States. However, Queensland maintains that the CGC's use of some disabilities, such as wage cost, still need further work to ensure the conceptual case has been met.
35. Queensland broadly supports the current application of disabilities in the expenditure assessments. These being:
    - Indigenous status
    - socioeconomic status
    - remoteness
    - age
    - urban/rural population
    - population growth
    - non-State sector
    - wage costs
    - regional costs
    - service delivery scale
    - national capital
    - cross-border
36. The system must continue to maintain the consideration given to States such as Queensland in relation to factors including:
    - decentralisation with a large geographical spread of regional population centres and the associated need for equitable access to services including education, health, transport and justice, and the costs associated with decentralisation; and
    - Queensland's high proportions of Indigenous people which have a greater effect on the costs of providing services.
37. The significant costs that come from decentralisation should not be underestimated and greater weight should be given to these costs. Queensland and its population is spread across many regional population centres – often thousands of kilometres from each other. The size and population distribution in Queensland has a significant impact on the funding required to provide access to critical services including education, health (such as regional hospitals of a standard to meet the regional population base) and transport.
38. It is important that the CGC continues to focus on identifying 'structural' disabilities rather than data adjustments when examining what disabilities should apply. There always needs to be a strong conceptual argument for incorporating a disability into the system to explain why fiscal capacities diverge between States. To the extent these factors can be kept at as high a level as possible, will keep the identification and measurement of disabilities as practical as possible and ensure simplicity and help build understanding of and confidence in the system.

39. To ensure these factors are accurately measured, Queensland would like to ensure the most relevant data continue to be utilised and maintained. Queensland encourages the Commission and the Commission's Staff to undertake State visits to gain a firsthand account of the costs and difficulties in delivering government services in regional and remote towns.

40. One assessment where Queensland continues to have conceptual concerns is the wages model. The current Wage Cost assessment model assumes that States' relative private sector wage levels can be regarded as a proxy for States' relative public sector wage requirements. Queensland and other States have long argued the wages assessment has severe conceptual and data limitations. For instance, the assessment assumes private sector wages are the sole driver of public sector wages, which is not reasonable or supported by evidence. While there may be a case that there are differences in the wages States pay that are beyond their control (potentially cost of living), there is little reason to believe the current model reliably captures these pressures. Additionally, the relationship between public and private sector wages had deteriorated in recent years, with Queensland demonstrating during the 2015 Methodology Review it was no longer statistically significant. As the conceptual case underpinning the model has not changed, Queensland considers it worth further examination by the CGC.

Policy neutrality

Queensland's position

- Queensland does not consider the current system creates a disincentive for States to pursue economic reforms or grow their economies in practice. While such disincentives may exist at a theoretical level, Queensland is not aware of hard evidence that these disincentives exist in practice.
- Queensland does not support the use of a State rotating average as it would add further complexity to the system, require further judgements by the CGC and would not reflect what States do.

41. The policy neutrality guiding consideration is an important cornerstone of HFE and failure to achieve policy neutrality risks both undermining the ability of the system to equalise States' capacities, and distorting incentives for States to change their tax or spending policies. However, while an important consideration, Queensland acknowledges policy neutrality is challenging to implement.

42. The current system's approach of using an average of policies of all States, on the assumption all States apply the same service delivery and revenue raising policies, is conceptually simple and transparent and likely to be reasonable in most circumstances, given the similarity between 'what States do'.

43. However, collectively, the policies of States set the 'standard' (that is, the average) so each State policy does ultimately affect the average to some degree, with some States' policies affecting it more than others. For instance, more populous States have a greater effect on average per capita revenues and expenses. Similarly States with high mineral production have a greater effect on average royalty rates, and States with high proportions of Indigenous people have a greater effect on the costs of providing services to Indigenous people. An approach based on internal standards of 'what States do' therefore cannot be completely free from State policy choices. That is, it can never be completely policy neutral.

44. Reflecting on this, the current system has been criticised for a lack of neutrality, and for consequently creating a range of perverse incentives which influence policy decision making and undermine efficiency. Frequently identified disincentives include:
    - reducing the incentive for a State to promote growth;
    - reducing the incentive to improve efficiency of service delivery;
    - providing incentives for States to over provide services where they have above average costs of service delivery and vice versa; and
    - providing incentives for States to over tax revenue bases where they have a revenue raising disadvantage and vice versa.

45. As an example, consider the claim that HFE reduces the incentive to promote economic growth: it is theoretically possible that the incentive to pursue economic growth enhancing reform (through levers such as micro-economic reform, developing industries or investing in infrastructure to facilitate new industry) could be diminished because a State would only retain its population share of any increase in its revenue.
46. However, a distinction must be made between incentives or problems that exist in theory and those where there is evidence of the problem in practice. While it may be technically possible for States to influence their GST shares at the margin by changing their expenditure or tax mix, Queensland is not aware of any evidence that this is a factor for governments in the setting of expenditure and revenue policies.
47. The policy focus for States is on economic development, service provision and sound fiscal management. Governments focus on the benefits and risks that come from any particular policy change, rather than on possible outcomes of the CGC's processes.
48. Even where CGC distribution is considered, the impact on the distribution is often uncertain, as CGC processes can change and changes in other State policies need to be taken into account. Neither of these factors can always be clearly predicted.
49. Furthermore, to the extent the claim that the current system creates a disincentive to reform is true, the impact of the distribution would need to be large enough to have a material impact on the decisions of State governments. Queensland suggests that this is often not the case. Any reduction in GST would be outweighed by the benefits of reform.
50. Where potential HFE impacts are considered in the policy decision making process, they are at best lower order considerations. This means that many of the incentives or disincentives that are identified in the literature, and mentioned above, exist in theory but not to any meaningful degree in practice. A similar conclusion was reached by the 2012 GST Distribution Review, which suggested that while the current system creates perverse theoretical incentives in some instances, there is little practical evidence of efficiency losses.
51. While one option to absolutely ensure policy neutrality would be to equalise to an external standard, there are significant challenges with such an option.
52. Additionally, Queensland does not consider the use of a State rotating average is likely to address policy neutrality concerns. Such a proposal is likely to add additional complexity to the system and require further judgements by the CGC.
53. Queensland looks forward to reviewing work the CGC is currently undertaking in relation to elasticity adjustments, but there are a number of important questions the CGC must ask around whether incorporating such an adjustment will lead to an improved HFE outcome. There is a conceptual justification for elasticity adjustments being made in assessments. For example, high conveyance duty rates are likely to suppress property market activity and prices and therefore affect the assessment of the revenue base and the State's revenue raising capacity for conveyance duty. Policy neutrality considerations would require that this policy effect, if material, should be allowed for in the assessment.
54. However, there are likely to be significant practical issues with measuring such affects, including size and direction. There would need to be significant justification on simplicity, practicality and materiality grounds to add elasticity adjustments without risking questioning of the robustness of the system.
55. Another area Queensland suggests warrants further attention for policy neutrality concerns is the current Mining Revenue assessment.

Appropriate treatment of mining revenue

Queensland's position

- Queensland supports an aggregated mining revenue assessment rather than assessing each mineral separately to achieve policy neutrality.

56. The treatment of mining revenue poses a particular challenge when it comes to policy neutrality. The challenge stems from two key issues: mining revenue is concentrated in two States (Western Australia and Queensland) and is not spread evenly across the country like many other revenue bases; and mining revenue has been large, and volatile, in recent years.
57. These two issues together have meant that mining revenue has been responsible for a large amount of redistribution of funds over the last decade or so. Under the current HFE system, the assessment of mining revenue leads to the largest redistribution impact of all current assessments. In 2015-16 mining revenue comprised around 6.9 per cent of all State revenue in aggregate, yet represented 80.3 per cent of the GST redistributed as a result of revenue assessments. Compared to an equal per capita basis, the mining assessment redistributed $5,758 million at the CGC's 2017 update.
58. The Mining Revenue assessment is the primary reason Western Australia has experienced such a low relativity outcome recently, with the Mining Revenue assessment accounting for 82 per cent of Western Australia's revenue redistribution.
59. As mining revenue is concentrated in two States, so too does the impact of the redistribution fall disproportionately on two States. Specifically, Queensland with coal, and Western Australia with iron ore dominate the revenue base for different mining activity. Unlike other State own-source revenues such as conveyance duties or payroll taxes, which are broadly similar in each State, mineral reserves are disparate.
60. While the core of the challenge – the concentration of mining revenue in two States – cannot be altered, it is worth considering whether the method used by the CGC to assess mining revenue is appropriate, given the concentrated nature of the revenue stream.
61. Under the current system, mining revenue is assessed mineral by mineral. Given the dominance of Western Australia and Queensland in iron ore and coal respectively, the policy of one State effectively becomes the policy average for HFE purposes, which in turn creates policy neutrality concerns, whether acted on or not.
62. While acknowledging this issue, the CGC is yet to find an alternative approach that would allow equalisation to occur without risking creating a policy incentive for a particular State.
63. Queensland suggests an aggregated mining revenue assessment could be examined further and considered by the CGC. Under this approach, all mining revenue would be considered together – rather than assessing each mineral separately. This approach could greatly enhance the policy neutrality of the assessment while still assessing each State's relative capacity to raise revenue through mining royalties. It could also remove the potential for minerals to redistribute a substantial proportion of revenue when a single State opts to change a commodity's royalty rate. While no option is without its problems, an aggregated mining revenue assessment would strike a better balance between the need to equalise for differences in revenue raising capacity, and the benefits of the system remaining policy neutral.
64. Such an approach would also be consistent with simplifying the system and making it more transparent to stakeholders. This would again help improve the robustness of the system and enhance its credibility because no one particular revenue stream is driving HFE outcomes.
65. While alternative options also exist which the CGC should further examine and consult on, including discounting of mining revenue, a, the significant challenges posed by mining suggest further effort is warranted.

Practicality

Queensland's position

- Queensland supports maintaining the uniform set of discounts, and reviewing where discounting has been used to ensure that the level used is appropriate.
- Queensland supports extending the application of discounts to cases where they could be used to more effectively respond to methodological issues which the existing framework is unable to adequately deal with.
- Further consideration and examination should be undertaken of an increase to the current materiality thresholds to $50 per capita. However, other factors should also be considered when deciding the inclusion or otherwise of an assessment.

66. Queensland emphasises the importance of the practicality, particularly the element of simplicity, in implementing the current system. The current process remains highly complex and it is arguable the current level of detail on which the current system operates delivers overall outcomes that are better than could be achieved under a simpler model.
67. Additionally, the uncertainty in outcomes from the current system can create challenges for States seeking to plan for the sustainable provision of services. This has become more of a concern in recent times, as relativity outcomes under the HFE system have become increasingly volatile. Volatility appears to be the result of a combination of factors, including changes in different States' fiscal capacities relative to each other, and is magnified by issues in the methodology.
68. Queensland supports maintaining a uniform set of discounts. Establishing the levels of uncertainty generated by methodological or data quality issues is necessarily imprecise and based on judgement. Applying a uniform set of discounts where levels of uncertainty are judged to be "low", "medium" or "high" is preferable to setting levels of discount individually for each category.
69. Queensland supports continuing the current levels of discounting to allow the CGC to partially recognise the influence of a disability when the presumptive case for the disability has been established but there are concerns with the data. However, where a discount of 50 per cent is applied, the CGC may wish to consider other factors including the reliability and the strength of a conceptual case for the assessment.
70. The current discounts applied should be reviewed to ensure they are still appropriate. In general, Queensland considers that caution should be exercised in removing existing discounts, and discounting should only be removed from existing assessments where the concerns the discount was addressing have been resolved. In cases where uncertainty remains, Queensland supports retaining discounts.
71. The CGC may also wish to consider extending the application of discounts to cases where they can be used to more effectively respond to methodological issues which the existing framework is unable to adequately deal with. For example, a discount to the Mining Revenue assessment is another way of addressing the policy neutrality issues raised by this assessment.
72. Queensland supports the proposal to increase the materiality thresholds as these are likely to encourage the development of simpler assessments based on broad indicators. At the same time, it is important to ensure that the thresholds are not applied in a mechanical way. Materiality thresholds are a useful tool to prevent the assessments from becoming increasingly complex, but are one of a number of important considerations, such as reliability and the strength of a conceptual case.
73. Instances where materiality should not be applied as a mechanical rule include:
    - where a disability does not meet materiality thresholds, but its redistribution is close to $50 per capita, the CGC should consider retaining the assessment if the conceptual case is strong and underlying data is robust and stable; and
    - where the redistribution from a disability is likely to be highly variable between years, these disabilities should be retained as they may satisfy materiality thresholds in future updates. One example of this is the Natural Disaster Relief and Recovery Arrangements assessment.

Contemporaneity

Queensland's position

- Queensland supports achieving contemporaneity as far as reliable data will allow. However, it should not come at the cost of simple, reliable and robust assessments with broadly stable outcomes.
- There are substantial practical limitations and complexities in implementing greater contemporaneity that mean a contemporaneous approach is unlikely to better achieve HFE than the current lagged average approach.

74. Queensland supports achieving contemporaneity as far as reliable data will allow. Without that, the capacity to provide services and the associated infrastructure at similar standards can arguably be compromised (while noting that States should be able to manage some variation in their fiscal capacities from year to year).
75. However, Queensland recognises the challenges faced by the CGC in implementing contemporaneity given lags in the data used to calculate States' relative fiscal capacities.
76. In recent years there has been a rapid divergence in relative State fiscal circumstances. In this environment, assessed relativities, using three-year historical averages, have appeared increasing less appropriate as they do not provide States with grant shares which reflect their relative circumstances in the application year. Under the current system, the relativities recommended by the CGC reflect State polices and circumstances that existed between two and five years before the relativities are applied.
77. Equalising State fiscal capacities in the application year could theoretically be achieved by eliminating time lags. The CGC has proposed alternative models in their Staff Research Paper *CGC 2017-05-S: Options for Improving Contemporaneity*, which could potentially lead to better contemporaneity and equalisation in the application year. While a one-year model would be more contemporaneous, volatility would likely increase, creating further challenges for State governments seeking to manage their budgets.
78. Fully contemporaneous assessments could place greater reliance on projections of important data, with revisions (completion payments) made after actual data becomes available. However, any move away from using historical (real) data for assessment purposes would likely have to involve the CGC making projections about the relative fiscal capacities and expenditure requirements of States in the future.
79. While theoretically attractive, there is little evidence suggesting this method would be an improvement on the current approach, for several reasons.
80. Firstly, it may not be worthwhile to implement a fully contemporaneous assessment where significant revisions are required each year to offset inaccurate projections. The revisions may create as much volatility as the original movements, and may themselves result in a State not being equalised in a particular year (due to a need to compensate for an inappropriately large or small payment the year before).
81. Secondly, data required at the level of detail for forward estimates may not be readily available from States. This could lead to a process of applying trends from historical data in order to prepare forecasts, which could prove problematic where revenues are subject to fluctuating economic cycles such as housing and mining.
82. Finally, it would also be necessary to develop a methodology for creating forecasts for relativity purposes. State's own forecasts are likely to rely on different assumptions and methodologies which could make them unsuitable for use in the CGC's methodology. It is possible that forecasting the data required is not practical with the current level of complexity in the CGC's assessments.
83. In previous reviews, States have flagged that the ability to accurately predict the outcome is precisely what is lacking in the current system. Forecasting or estimating application year data may simply add a layer of complexity to the current process, and not necessarily guarantee improved results. Rather the completion payment, as a result of actual data becoming available, could come as a significant shock.
84. If full contemporaneity is to be attempted, the CGC may need to develop assessment methods that are simpler and broader, which may be better suited to the forecasting of key parameters.

85. Contemporaneity should not come at the cost of simple, reliable and robust assessments with broadly stable outcomes. There are substantial practical limitations and complexities in implementing greater contemporaneity that mean a contemporaneous approach is unlikely to better achieve HFE than the current lagged average approach. In the past, New South Wales flagged that this concept does not represent a solution to the problem - it merely casts it in a different form. The current system of a two-year lag and three-year averaging period can be considered to represent a compromise between contemporaneity and other considerations (accuracy, predictability, data availability and stability).

86. The three-year lagged average approach also assists States with budget management, in that any State's GST revenue is not immediately subject to the volatile outcomes in other States or the unpredictability of State own-source revenue. For example, while the equalisation system will see a State compensated by the other States for expenses incurred in addressing natural disasters, other States do not bear this cost unexpectedly in the year in which the disasters occur. States can plan to absorb those costs through reductions in GST revenue as the relevant year moves through the equalisation system.

87. Further work must be undertaken before a more contemporaneous approach could be considered. Any benefits from greater contemporaneity need to be weighed against the uncertainties such a model would introduce into the system. There is potential for a more contemporaneous model to lead to greater revenue volatility which is unlikely to help build confidence in the system and poses significant risks to the credibility of HFE.

Treatment of Commonwealth payments to States

Queensland's position

- Queensland supports the overarching framework the CGC uses to determine if a Commonwealth payment should either impact or not impact HFE. However, any change to the treatment of Commonwealth payments is challenging given the significant variation in the basis and reason for Commonwealth payments.

88. The Commonwealth supports States in a range of ways, most notably through tied funding – Special Purpose Payments and National Partnership Payments.

89. The provision of tied funding gives the Commonwealth the opportunity to influence expenditure in areas of State responsibility. However, they are also a source of increasing contention within federal-State relations and a potential challenge to achieving HFE.

90. Specific Purpose Payments constitute around 20 per cent of total State Government revenues. Under the current system, the financial capacities of the States are equalised by examining most (significant) revenue sources and expenditure requirements, including Commonwealth payments.

91. However, this approach can, in certain circumstances, be perceived as overriding national objectives and agreements established between Commonwealth and State Governments to achieve a specific outcome.

92. While this is appropriately a consideration of governments, for the CGC the significant variation in how these funds are provided (e.g. needs, efficient price, special treatment) suggests there is a need to address complex impacts, rather than a simple 'all-in' or 'all out' approach.

93. Perhaps even more challenging in the area of tied funding is the ability for the Commonwealth to direct the CGC to not include certain payments entirely at its discretion. Such action has the potential to undermine the equalisation process, particularly where it is exercised in an arbitrary manner.

94. In addition to tied funding, the Commonwealth supports States in a range of other ways – including through industry assistance (where provided to industries focussed in one particular State) or regulation amendments to support particular projects or areas. To the extent that these types of support enhance the fiscal capacity of a particular State, the CGC may wish to further examine whether or how this assistance could be incorporated into the assessment of HFE.

Assessment guidelines

Queensland's position

- Queensland supports retaining the assessment guidelines for the 2020 Review to ensure the CGC takes a consistent approach in developing assessments and that the assessments are conceptually sound, reliable and as transparent and simple as possible.

95. While supportive of the assessment guidelines, Queensland suggests the CGC may wish to consider the development and publication of short structured notes outlining how each assessment is constructed and the judgment used against each of the guiding considerations. Such documentation would be invaluable to stakeholders, helping to build understanding of and confidence in the system.

Queensland
Government