Australian Government
Commonwealth Grants Commission

The framework for the treatment of Commonwealth payments in GST distribution

Research paper 5

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Summary

In 2020-21, the Commonwealth Government provided states and territories (states) with more than $140 billion in financial assistance. Around half was the distribution of GST revenue. The other half of Commonwealth payments to the states represents a significant source of revenue to help fund state services.

The Commonwealth Grants Commission (the Commission) assesses these 'other' Commonwealth payments when calculating the recommended GST distribution. Not to do so would disadvantage states who have less access to this revenue, and the objective of providing states with a similar fiscal capacity to provide services would not be achieved.

Not all Commonwealth payments are included as part of the calculations.

The Commission applies a principles-based framework to determine the treatment of Commonwealth payments in the GST calculations. This ensures consistent and transparent outcomes.

This principles-based framework includes considering whether the payment is for a service normally provided by states, and whether the Commission assesses different state expenditure needs in providing that service.

The Commission's treatment of Commonwealth payments affects a state's final share of the GST distribution.

The GST effect of including a payment depends on the comparative state share of the payment received and the Commission's assessment of state needs related to that payment.

Estimating the GST effect of a particular payment in isolation can be misleading. Instead, that payment's GST effect should be considered in the context of the GST effects of all Commonwealth payments.

Introduction

The Commonwealth Grants Commission (the Commission) provides independent advice to the Commonwealth Government on how Goods and Services Tax (GST) revenue should be distributed to ensure each state and territory (state) has a similar fiscal capacity to provide services.

The Commission's Occasional paper #6 - Why are some Commonwealth payments to states included in calculations of GST needs provides an overview of why the Commission includes some Commonwealth payments to states when determining states' fiscal capacities and GST distributions.

This research paper provides additional detail on the Commission's framework for determining which Commonwealth payments are included in the assessment of states' GST needs. It also provides an insight into how these payments affect the GST distribution.

Overview of Commonwealth payments

In 2020-21, the Commonwealth Government provided states with more than $140 billion in financial assistance. Around half of this was the distribution of GST revenue. The distribution of GST revenue seeks to give states a similar fiscal capacity to provide services. In recommending a GST distribution, the Commission takes account of states' different abilities to raise revenue and their different costs in providing services. States are free to choose how they spend their GST revenue.

The remaining financial assistance consisted of Commonwealth payments which must be used by states for the purpose agreed with the Commonwealth.[1] Figure 1 shows that these payments are

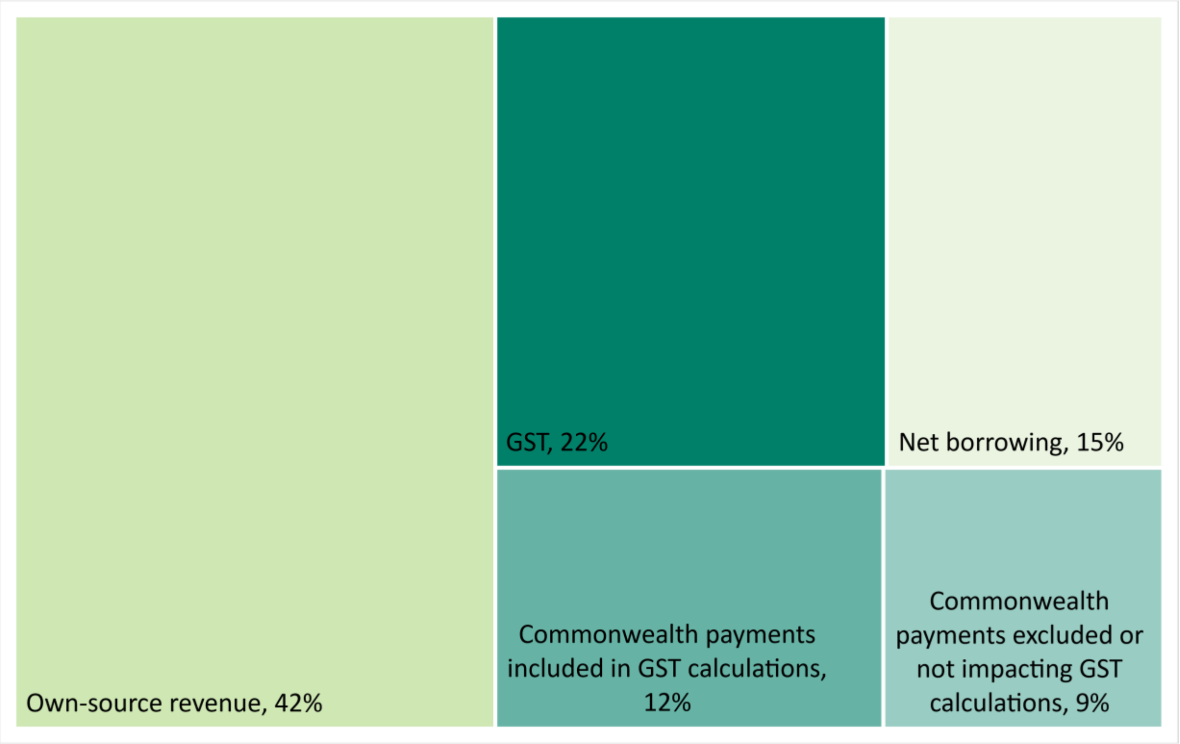
1 This is mainly in the form of payments for specific purposes. However, this also includes some Commonwealth own-purpose expenses.

about equal in size to the GST pool and make up, on average, a fifth of state revenues. These payments are used by states to fund services and invest in infrastructure.

Given their importance to state budgets, these payments are taken into account by the Commission when determining each state's fiscal capacity and recommended GST share. If they were excluded, state fiscal capacities would not be similar and states that receive less revenue from Commonwealth payments would be disadvantaged.

Not all Commonwealth payments to states are included in the calculations of the GST distribution. Some payments are excluded as they are for Commonwealth or third-party purposes, or because the Commission does not include certain services in its assessments. About 40% of Commonwealth payments, equivalent to 9% of all state revenue in 2020-21, were excluded from the GST calculations.

Figure 1 Composition of state revenue sources, 2020-21



Source: Commission calculation

How ‘no impact’ payments affect GST calculations

The Commission uses the terminology ‘no impact’ when referring to Commonwealth payments that are excluded from the GST distribution calculations.

Where a payment is treated as no impact, its value is removed from the revenue being assessed for that state. The same value is also removed from the associated expenses incurred by the state. In this way, the payment and associated expenses do not influence the recommended GST distribution.

Some Commonwealth payments are described as being ‘out of scope’. Examples are payments made through states to local governments or third-party entities. In these cases, there is no associated state expense to remove. The revenue is included in the GST calculations and assessed as if each state had access to an equal per person amount of this revenue. This treatment ensures the revenue has no effect on the final recommended GST distribution. This treatment is also used if the Commission is unable to identify the expense associated with a particular payment.

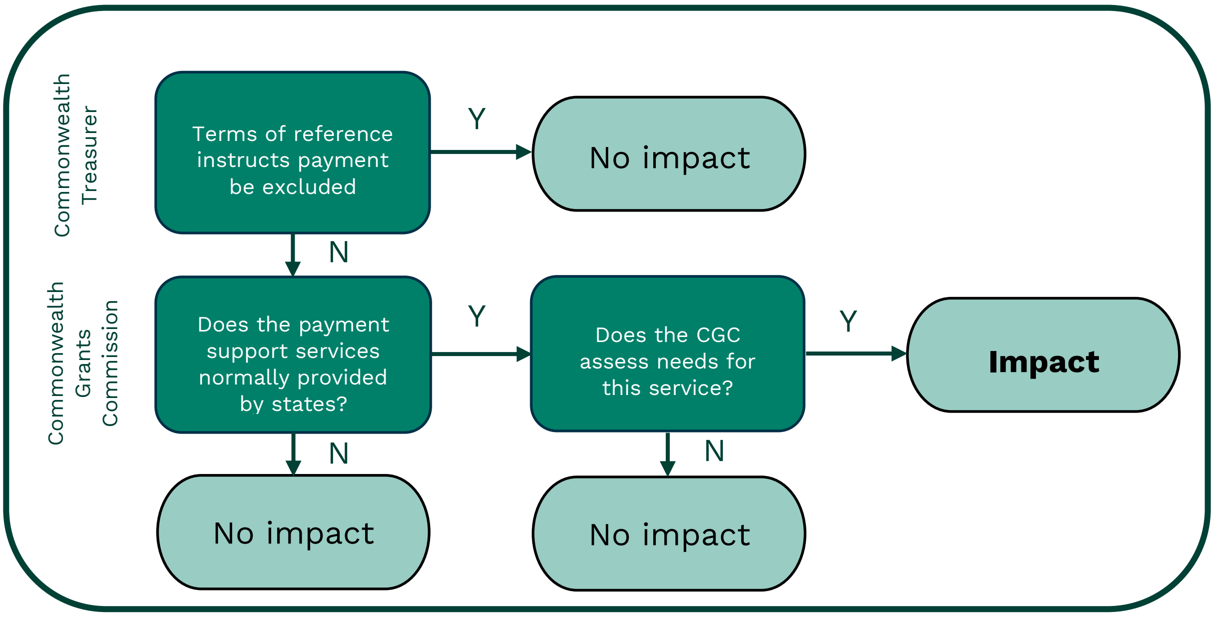
The framework for Commonwealth payments

Commission decisions on Commonwealth payments are guided by instructions from the Commonwealth Treasurer and the Commission’s principles-based framework for assessing such payments. This is to ensure a consistent and transparent decision-making process.

The Commonwealth Treasurer provides terms of reference to the Commission each year for its ‘update’ of recommended GST relativities for the next fiscal year. The terms of reference ask the Commission to consider Commonwealth payments when calculating GST relativities, recognising payments often support state services. In addition, terms of reference sometimes instruct the Commission to exclude certain payments.

The Commission has developed a framework to guide its judgment in deciding how to treat payments. Under the Commission’s framework, payments that support state-type services and that are assessed in determining a state’s GST needs are included in the calculation of the distribution of the GST pool.

Figure 2 Decision framework for the treatment of Commonwealth payments



A final decision on the treatment of each Commonwealth payment is made by the Commission after consulting with the states. The Commission considers the treatment of a new payment once it enters the three-year assessment period used in GST calculations.[2] The Commission does not normally make decisions about payments that have been announced by the Commonwealth Government but have yet to enter the Commission's three-year assessment period.

Payments excluded by terms of reference

The process of excluding payments due to a terms of reference instruction is known as 'quarantining'. The Commission has no role in the decision to quarantine a payment.

The terms of reference also instruct the Commission to continue to treat any previously directed treatments the same way. In this way instructions for quarantining payments last for the life of the payment.

In 2020-21, 14% of no impact payments were the result of quarantining instructions. The bulk of these quarantined payments were: *DisabilityCare Australia Fund* (43%); road investment payments (23%); payments to Victoria for the *Regional Rail Revival* program (14%); and the *Western Sydney Infrastructure Plan* (9%).

Payments supporting state services where the expenditure needed to provide the service is assessed

Payments that support a state service where the expenditure needed to provide the service is assessed are included in the GST calculations and impact recommended GST distribution. Examples of such payments include *National Health Reform funding: Hospital services*, *Quality Schools funding* for government schools and the *National water infrastructure development fund*.

Payments not supporting state services

Payments that do not support state services are excluded and do not impact the recommended GST distribution. Examples include *Quality Schools funding* for non-government schools, payments to local governments or for local government services, payments related to quarantining of international arrivals, and payments related to aged care.

Payments supporting state services where the expenditure needed to provide the service is not assessed

Some payments support state-type services, but the payment is excluded because the Commission does not assess the expenditure needed to provide the service.

Expense needs for a service may not be assessed because of lack of data or the inability to find a policy-neutral assessment measure. As the Commission is unable to determine a state's expense needs for a service, it is also unable to determine a state's need for a related Commonwealth payment. Therefore, the Commission excludes the payment from its GST calculations.

Expense assessments that cannot be assessed are known as non-deliberative equal per capita (EPC) assessments. Examples include environmental protection, first home-owner expenses and non-urban transport. On occasion, the Commission may decide states do not experience differences in costs of providing a service. These are known as deliberative EPC assessments and payments related to these services will be included in the calculation of GST shares.

2 The Commission uses lagged data for 3 assessment years to calculate the recommended GST distribution in a given application year (the year in which the recommended relativities are used to distribute the GST pool). For the 2022 Update, the assessment years were 2018–19, 2019–20 and 2020–21 and the application year was 2022-23.

Sometimes a payment is excluded because specific drivers of the expenses related to the payment are not appropriately reflected in the Commission's method. Examples include drought assistance, payments relating to bushfires, and payments related to COVID-19 (see Box below).

Applying the framework of Commonwealth payments: National Partnership on COVID-19 Response

The National Partnership on COVID-19 Response was established as part of the national response to the pandemic. The agreement included a Commonwealth-state cost-sharing arrangement for specific COVID-19 related public hospital and public health expenditure incurred after 21 January 2020.

The issue for the Commission was how to treat these Commonwealth payments — specifically, whether they should be included in the calculation of states' GST needs.

In applying the framework for treating Commonwealth payments, the Commission determined that these payments supported state services. This left the question of whether the expenditure needed to provide the services were assessed.

The Commission noted that the pattern of spending covered by the agreement likely differed from the pattern of assessed health needs based on the 2020 Review methods. For example, the 2020 Review health assessment recognised higher service use rates and cost for Indigenous people and people living in remote areas. As the pandemic was unfolding, the Commission considered it was unlikely this spending pattern applied to COVID-19 related health expenditure.

Therefore, the Commission determined the needs for the COVID-19 related health expenditure supported by this payment had not been assessed. Accordingly, the Commission decided that Commonwealth payments under the National Partnership on COVID-19 Response should not affect the assessment of state fiscal capacities.

Complexities in applying the framework of Commonwealth payments

Deciding the appropriate treatment to apply to a payment is not always straightforward. In some cases, a close examination of the contextual details of the payment is required to decide whether it funds a state-type service and whether the expenditure needed to provide the service is assessed. Some of the issues the Commission may need to consider are:

- whether a payment funds services normally provided by states, but also meets a broader national objective not assessed by the Commission
- whether the payment falls into a broader category of payments for which the Commission has an established treatment
- whether payments for the same service are made in different ways to different states
- whether the payment has several sub-payments, which fund different services.

Two examples of the complexities in applying the framework are road investment and payments for major sporting events.

Applying the framework of Commonwealth payments: Road investment

In 2020-21 the Commonwealth provided $5.2 billion of funds under the *Infrastructure Investment Program – Road Investment*. However, terms of reference instructed the Commission to exclude some of this payment. Parts of the payment that were quarantined related to the reallocation of the Perth Freight Link (2018 Update), the payment relating to the Kakadu Road upgrade (2021 Update) and road safety projects falling under the Government's JobMaker plan (2022 Update).

The remaining funds broadly fall into the categories of funds for road maintenance, investment in the construction of roads on the national network and investment in the construction of roads off the network.

The Commission regards maintenance and off-network construction as a state service where expenditure needs are assessed. Therefore, it includes payments for maintenance and off-network funding in the calculation of the recommended GST distribution.

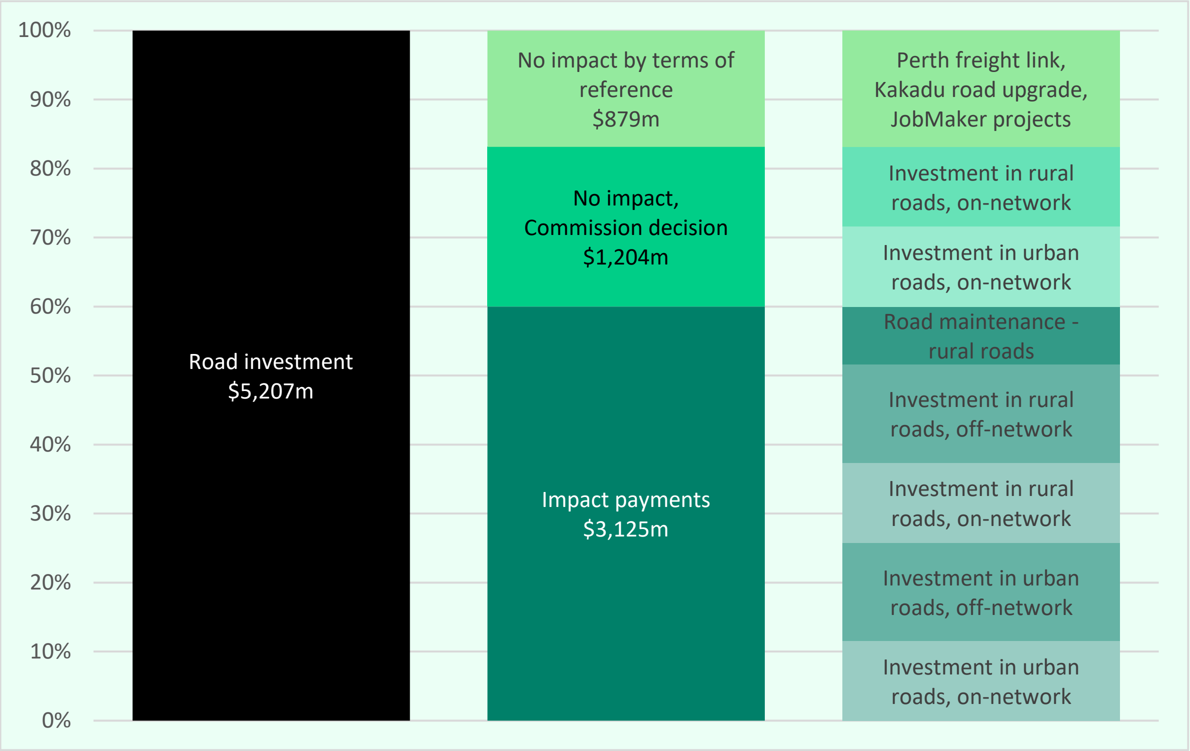
The case of investment for the national network is more complex as the network is both a service for the state but also fulfils broader national needs. Therefore, the Commission decided the payments should only partially impact the recommended GST distribution.

The process to deal with these multiple purposes is to split the payment. Data from the relevant Commonwealth department[3] enables the Commission to identify on-network and off-network projects and the specific projects mentioned in the terms of reference.

The Commission further splits the payments evenly between urban and rural roads.

Figure **3** shows the outcome of such splits for 2020-21.

Figure 3 Splitting and treatment of Road investment payment, 2020-21



Source: Commission calculation

3 In the 2022 Update this was the Commonwealth Department of Infrastructure, Transport, Regional Development and Communications.

In addition to the *Infrastructure Investment Program – Road Investment*, the Commonwealth provides other road investment funding including the *Western Sydney Infrastructure Plan*, *Bridges renewal program* and *Roads of Strategic Importance*. The same approach is used to determine the treatment of these payments.

Applying the framework of Commonwealth payments: International sporting events

A decision to host a large international event, such as the Olympics or Commonwealth Games, is usually made by the Commonwealth, the state and the city offering to host it. The Commonwealth and the relevant state usually enter into such agreements with the view of attracting tourist dollars and improving the profile of the city, with the knowledge that the investment in infrastructure is also likely to bring long-term benefits to the area. While such events may have some national benefits, other states rarely have input into these decisions and the benefit to them is less.

In the past, several states have received Commonwealth assistance for such national events. This assistance has taken different forms including payments for specific purposes, Commonwealth own-purpose expenses and the provision of 'in-kind' services by the Commonwealth in support of the event.

This assistance has supported construction of venue infrastructure, event coordination, volunteer programs, other coordination activities, drug testing and security.

To date, the Commission has only considered Commonwealth assistance provided in the form of a payment for specific purposes. In the past, these mainly related to venue infrastructure and some event and coordination support. The Commission has treated these payments as not impacting GST calculations. This treatment recognised that:

- while sporting infrastructure facilities are a state service, the expenditure needed for the construction of sporting infrastructure specifically required for international competition is not assessed
- in the past, states have received payments for similar events, for example in the form of 'in-kind' payments, and these past payments did not impact relativities
- the Commission seeks to be consistent in its treatment, regardless of whether the funding was in the form of a payment for specific purpose or via other means.

These treatment decisions have been made on the basis that the funding was for 'competition-specific' venue infrastructure, events, and organisational costs. Should the scope of Commonwealth assistance widen beyond this, or the decision-making environment change, these cases may no longer offer appropriate guidance given the changed circumstances.

In making its decision the Commission will consider whether the new payment relates to a service normally provided by states and if so, whether the existing assessment captures expenditure needs relating to the service funded by the payment.

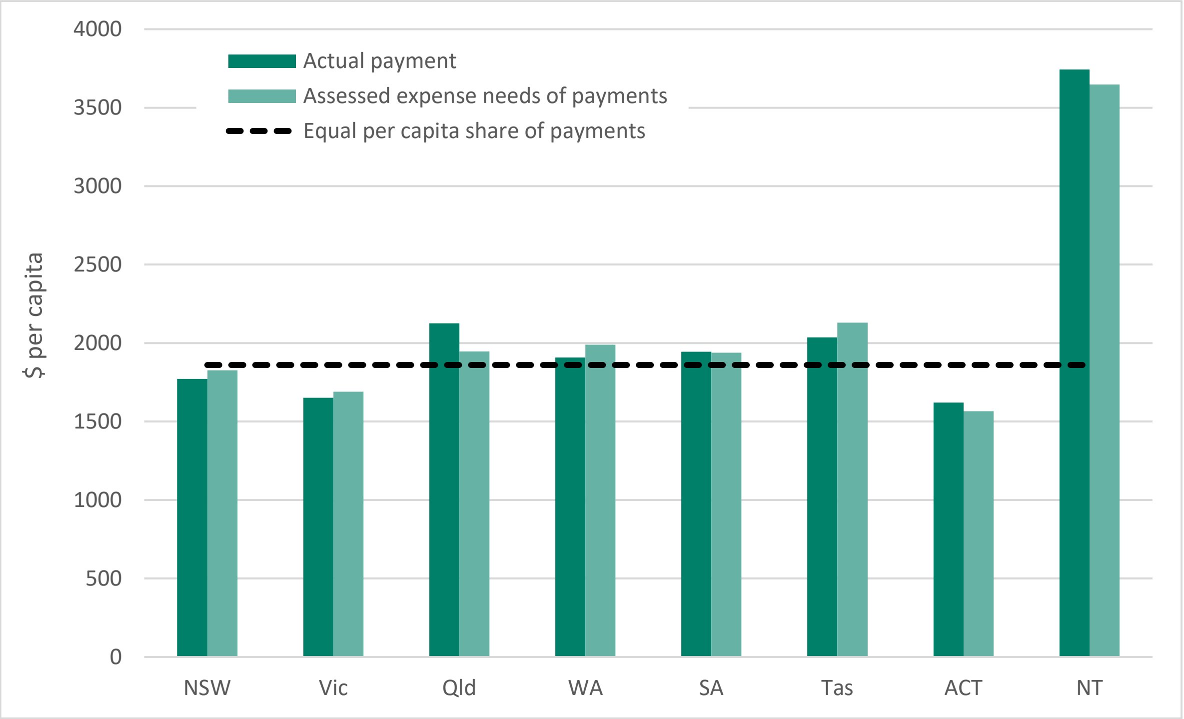
How payments affect the GST distribution

The GST impact of Commonwealth payments depends on a state's share of payments relative to its share of assessed expenses funded by the payments. States will receive more GST if the state share of Commonwealth payments is below its share of assessed expense needs. It will receive less GST if the payment share is above its share of assessed expense needs. For example, if a state's assessed needs were 10% of expenses Australia-wide and it received a share of payments that was 7%, it would receive more GST. If it received a share of payments that was 14%, it would receive less GST.

These concepts are demonstrated in Figure 4. Tasmania and Queensland both receive a share of Commonwealth payments that is greater than their population share (equal per capita share). In addition, they are both assessed as having higher than average expenditure needs in providing the associated services. In Queensland's case, however, these payments exceed its assessed cost of providing the associated services. As a result, the Commission assesses Queensland as requiring relatively less GST due to its high share of payments. While Tasmania also received an above average amount of Commonwealth payments, its payments fell short of its assessed cost of providing the associated services. As a result, the Commission assesses Tasmania as requiring relatively more GST despite its high share of payments.

The Commission assesses Victoria and the ACT to have below average costs of providing the associated services. In Victoria's case, its share of Commonwealth payments falls short of its assessed cost of providing the associated services. Therefore, the Commission assesses Victoria as requiring relatively more GST because of its low share of these payments. However, the ACT's share of Commonwealth payments exceeds its assessed cost of providing the associated services. Therefore, the Commission assesses the ACT as requiring relatively less GST despite its low share of Commonwealth payments.

Figure 4 Commonwealth payments, actual and assessed need per capita, 2020-21



Source: Commission calculation

Table 1 shows the GST impact of Commonwealth payments in the 2022 Update. It is the sum of two effects. The revenue impact is the difference between a state's population share of payments and its actual share. A negative (positive) figure signifies a state that received more (less) than its population share of the payments. The expense impact is the difference between a state's assessed cost of providing the associated services and the average cost. A negative (positive) figure signifies a state that faces above (below) average costs of providing these services.

The GST impact is the net of these two effects. It is the difference between the actual payments received and the assessed need of the related service expenses.

The Northern Territory received an above average share of Commonwealth payments because the Commonwealth recognised the higher cost of providing services to Indigenous people and people in remote areas. The Northern Territory's higher share is signified by the high negative revenue impact. However, the Commission assesses the Northern Territory to have above average costs of providing the associated services (also reflecting the higher cost of providing services to Indigenous people and people in remote areas). This higher cost is signified by the high positive expense impact. Thus, the net GST impact of Commonwealth payments for the Northern Territory is less than $50 per capita.

Table 1 Net impact of Commonwealth payments, 2022 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc
Revenue impact	73	200	-238	-32	-80	-165	239	-1,834	79
Expenses impact	-33	-170	87	129	77	269	-296	1,788	59
GST impact	40	30	-151	96	-4	104	-57	-46	33

Source: Commission calculation

It is not possible to determine overall GST effects of Commonwealth payments without knowing the value of payments all states receive and their assessed costs of providing all the associated services. This is because states have different assessed expense needs for different services. Additionally, there may be multiple Commonwealth payments to states associated with that service and it is a state's final share of all such payments that affect their need for GST. If a state's share of payments is the same as its assessed cost of providing the associated services, then those payments will not affect its assessed GST relativity. Table 2 shows the GST impacts by category for payments received in the 2022 Update.

Table 2 Net impact of Commonwealth payments by category, 2022 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc
Schools	3	-1	-13	45	1	-45	16	-213	6
Post-secondary education	-8	5	8	-4	-4	-3	-9	47	3
Health	33	18	-129	-2	129	223	-119	14	29
Social housing	-1	-9	2	8	9	3	-23	128	3
Welfare	2	1	0	-10	3	-1	3	-3	1
Services to communities	2	-6	5	3	-5	-5	-11	27	2
Justice	1	1	-1	-1	-2	-2	-2	-20	1
Roads	1	1	-3	0	4	3	-3	-24	1
Transport	0	0	0	0	0	0	0	0	0
Services to industry	2	0	-3	0	0	0	2	-4	1
Other expenses	0	0	0	0	0	0	0	0	0
Investment	6	21	-17	57	-140	-71	91	1	15
Net borrowing	0	0	0	0	0	0	0	0	0
Total	**40**	**30**	**-151**	**96**	**-4**	**104**	**-57**	**-46**	**33**

Source: Commission calculation

South Australia illustrates the need to consider all the Commonwealth payments it receives to assess the overall GST effect. South Australia's GST impact for health-related Commonwealth payments was $129 per capita. This implies it received a share of hospital and other health payments from the Commonwealth that was less than its assessed cost of providing the associated services. However, this was offset by Commonwealth payments it received for investment-related services. The negative GST impact implies it received a share of these payments that exceeded its assessed cost of providing investment-related services. The net GST effect of all the Commonwealth payments to South Australia was -$4 per capita. Overall, the Commonwealth payments South Australia received were very close to its assessed costs of providing total associated services.

Effect of payments on state budgets

States sometimes argue that accepting a particular Commonwealth payment will result in a lower GST share. If accepting a Commonwealth payment gives rise to a negative GST impact for a state, refusing the payment will avoid this negative impact. However, this would also mean less Commonwealth assistance to states overall and, therefore, reduced assistance to finance their service provision. The higher the total amount of payments from the Commonwealth, the more Commonwealth funding available to all states to fund services.

Generally, state concerns about Commonwealth payments go beyond the existence of a negative GST impact. States have complete discretion in how they use their GST revenues. This is not the case for Commonwealth payments for specific purposes, which must be spent on agreed purposes. States with a low proportion of GST revenues may be concerned with how this affects the discretionary funds they have available for their own priorities.

States can be concerned about the timing of GST impacts on their budgets. Any GST impacts of Commonwealth payments are delayed. They do not arise until a payment enters the Commission's three-year assessment period. The GST impacts will remain until the payment exits this period, meaning these GST impacts will influence the GST distribution over three successive years.

The Commission's treatment of Commonwealth payments is not influenced by the reasons states accept or decline particular payments. The Commission's approach reflects what states actually do. If states accept a payment, the Commission determines its treatment based on the application of its framework.

Conclusion

In 2020-21, the Commonwealth Government provided states with more than $140 billion in financial assistance. Around half was the distribution of GST revenue. The other Commonwealth payments to the states are considered in the calculation of recommended GST relativities. This ensures states are not disadvantaged if they receive less from Commonwealth payments than other states.

Since Commonwealth payments (other than the distribution of the GST pool) are a significant source of funding for state services, the Commission includes them as part of its assessment of state capacities and the calculation of GST relativities. This is consistent with the objective of distributing the GST pool so that states have a similar fiscal capacity to provide services.

Not all Commonwealth payments are included in the GST calculations. The Commission may exclude a payment if it finances a service that is not a state-type service or if the Commission does not assess state expenditure needs in providing the service financed by the payment.

The Commission uses a principles-based framework to assess if Commonwealth payments should impact recommended GST relativities. This approach ensures consistency, including in complex cases where a single payment may serve multiple purposes (such as national and state benefits) or where there is an unusual event (such as a pandemic or a one-off international sporting event).

The GST impact of Commonwealth payments depends on the state's share of Commonwealth payments received and how this share compares to the Commission's assessment of the state's expense needs. States will receive more GST if its share of the Commonwealth payment is below its share of expense needs. It will receive less GST if the share is above its assessed expense needs.

Receiving Commonwealth payments may have implications for a state's share of GST and, therefore, its untied funds. However, refusing a payment also reduces the overall amount of assistance to the states from the Commonwealth.