ACT Government

COMMONWEALTH GRANTS COMMISSION 2025 METHODOLOGY REVIEW OF GST REVENUE SHARING RELATIVITIES

FISCAL EQUALISATION, SUPPORTING PRINCIPLES, AND ASSESSMENT GUIDELINES

ACT Government Submission

ACT GOVERNMENT SUBMISSION

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CONTENT

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BACKGROUND

On 21 April 2023, the Commonwealth Grants Commission (CGC) released their consultation paper on fiscal equalisation, supporting principles, and assessment guidelines for the 2025 Methodology Review of Goods and Services Tax (GST) Revenue Sharing Relativities (Review). The consultation paper sets out the CGC's initial views on horizontal fiscal equalisation (HFE), as well as the principles and guidelines that the CGC will use to guide its determination of the GST distribution methodology.

The CGC has invited states and territories to provide comments on its initial positions and nine consultation questions. The CGC is expected to release its next paper on 9 June 2023, which will present their finalised views on HFE, the supporting principles, and the assessment guidelines.

However, the CGC note the application of the principles of HFE will also be considered on an assessment-by-assessment basis through the consultation on assessment methods for the 2025 Review. This may result in the principles being revisited throughout the Review process. The draft report for the 2025 Review, due in June 2024, will set out any changes to the CGC's views on HFE, the supporting principles, or the assessment guidelines.

The ACT welcomes the opportunity to comment on the principles that will underly the CGC's approach to assessment methods in the 2025 Review. The ACT's responses to the nine consultation questions, as well as any additional comments on HFE, the supporting principles, and the assessment guidelines are presented below.

HORIZONTAL FISCAL EQUALISATION

Consultation Question

Does the approach to HFE articulated in the 2020 Review remain the appropriate first step in determining the GST distribution in accordance with the GST distribution legislation?

ACT Position

The ACT supports continuing the approach to HFE used in the 2020 Review for the 2025 Review.

Under the Terms of Reference for the 2025 Review, the CGC is required to recommend GST distributions in accordance with the principle of HFE. Moreover, following the assent of the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (2018 legislation), the *Commonwealth Grants Commission Act 1973* requires the Treasurer to ensure that the states and territories each have the fiscal capacity to provide services and infrastructure at a standard that is at least as high as the higher of New South Wales (NSW) or Victoria.

While the ACT does not support the outcomes of the 2018 legislation, the ACT agrees with the CGC's evaluation that given the two conditions above, it will be required, in the first instance, to make assessments of the relative fiscal capacities of the states and territories.

The ACT notes that the CGC would also be required to make these assessments even if the 2018 legislation had never been enacted.

The ACT considers that these assessments are an essential component of the CGC's role in Australia's HFE system, and without this step it will not be possible to achieve HFE or enact the 2018 legislation. The ACT also considers for thoroughness and accuracy that for such assessments the CGC must determine fiscal capacities for each jurisdiction to the extent that it would have the same capacity to provide goods and services if they made the same effort to raise revenue and operated at the same level of efficiency.

SUPPORTING PRINCIPLES

WHAT STATES DO

Consultation Question

Does the What States Do principle, with assessments based on the weighted average policy of all states, remain appropriate?

ACT Position

The ACT considers that the principle of What States Do remains critical for the functioning of Australia's HFE system. Further, the ACT considers that weighted average policy is generally the best available method for assessments to comply with this principle.

The ACT notes that there has been consideration given in the past, inside and outside of Reviews, to the use of alternatives to weighted average state and territory policy. Such alternatives have included other internal standards, such as the highest or lowest revenue raising effort or level of service, or external standards, such as international comparisons, or a deemed "desirable" or "efficient" policy.

In relation to the use of the highest or lowest revenue raising effort or level of service, the ACT considers that these two options would be incompatible with the principle of Policy Neutrality. The ACT notes that the use of these alternative approaches would grant the state or territory that happens to be the standard setter for a given assessment direct control over the CGC's assessment standard. This would result in both the strategic interaction and perverse incentive problems described in the Policy Neutrality section below. As such, the ACT considers that these alternative internal standards are inappropriate for the CGC to use in its assessments.

Conversely, the use of external standards by the CGC would, in the ACT's view, also be inappropriate, as the use of external standards would not be reflective of actual state and territory policy decisions, and therefore would not be compatible with the principle of What States Do. Further, the use of external standards would require greater levels of judgement on the part of the CGC. The ACT considers that this would unnecessarily invite criticism of the HFE system based on the selection of standards.

This would likely be more heavily pronounced in the instance of using normative external standards such as “desirable” or “efficient” policy, where there is ubiquitous disagreement in political, academic, and public discourse on what policies are, in fact, “desirable” or “efficient”.

The ACT notes in some circumstances there are compromises with the use of a weighted average state and territory policy. Situations where there is a highly unequal distribution of a tax base or population demographic can result in a weighted average policy approach that closely resembles an actual per capita approach.[1] This can raise Policy Neutrality concerns with that assessment. However, there are very few assessments where this is a significant issue, with the mining revenue assessment being the primary focus of this concern.

As such, the ACT considers that the weighted average policy approach to still be sound across the full range of the CGC’s assessments. Instances of highly unequal distributions of tax bases and population demographics should be considered on an assessment-by-assessment basis, rather than changing the existing and broadly effective approach entirely.

Overall, the ACT regards the use of average state and territory policy to broadly be the best available option for ensuring that the CGC’s assessments are compliant with the principle of What States Do. The ACT considers that the use of weighted average state and territory policy ensures that the CGC’s standards are set based on actual state and territory policy. It also enhances Policy Neutrality by generally guaranteeing that no individual state or territory can exert deterministic influence over the standards that the CGC uses to assess fiscal capacities.

POLICY NEUTRALITY

Consultation Question

Does the Policy Neutrality principle remain appropriate, recognising there are particular circumstances where further consideration should be given to policy neutrality, such as dominant state issues and some instances of state tax reform?

ACT Position

The ACT considers that the principle of Policy Neutrality remains relevant for the 2025 Review. The ACT also recommends the CGC to reverse its decision to not proceed with the consultancy paper on tax reform and elasticity.

The ACT notes that maintaining a policy neutral mode of assessing state and territory fiscal capacities is essential in ensuring that the integrity and accuracy of the HFE system are maximised.

In the absence of Policy Neutrality, jurisdictions could strategically manipulate their policy settings to obtain a higher GST share, putting the HFE system at risk. This could also create

[1] An actual per capita assessment is where a state or territory’s revenue capacity, or expenditure need is assessed as being the same as what it actually raises or spends.

perverse policy incentives for the states and territories, and result in jurisdictions changing their policy settings for the purpose of maximising their GST revenue, rather than maximising social wellbeing. Further, the use of policy neutral assessments means that, as far as possible, the CGC assesses state and territory fiscal capacities on a like-for-like basis.

The ACT notes that the 2012 GST Distribution Review found that while there are theoretical incentives generated by the CGC's assessments, there is no definitive evidence of HFE exerting material influence on state and territory policy decisions. Further, the Productivity Commission's Inquiry into HFE notes that GST effects are likely to be small for most state and territory policy decisions, and thus are unlikely to distort policy outcomes.

The ACT does however consider that the CGC's current assessment approach has some difficulties in dealing with Policy Neutrality. In addition to concerns raised in the What States Do section, the CGC's current approach to revenue assessments does not capture second-order effects from state and territory tax reforms. As the CGC uses a weighted average state and territory effective tax rate in its revenue assessments, variation in actual state and territory policy from this average may imply variations in the size of the underlying tax bases. These effects will likely vary between different tax bases depending on their relative responsiveness to tax rate changes, or tax elasticity.

Consequently, tax elasticity effects could disincentivise state and territory tax reforms, particularly in the case of shifting taxation effort from a relatively elastic tax base to a relatively inelastic one, such as from stamp duty to land tax. This is because as the effective tax rate decreases compared to the national average on the elastic tax base, and the rate on the inelastic base increases, the size of the elastic tax base will increase faster than the inelastic base will decrease. This would result in an increase in that jurisdiction's overall assessed revenue capacity, reducing its GST share.

The ACT also notes that, in principle, these effects could also be experienced in state and territory expenditure policy, though to date, there has been no analysis of the potential for such expenditure effects on the GST distribution.

The ACT argued this point during the 2020 Review and supported the CGC's exploration of tax elasticity adjustments to address these second order effects. As part of the 2020 Review, the Australian National University's Tax and Transfer Policy Institute and CGC analysis found that elasticity effects would only result in statistically significant changes in tax bases and material changes in the GST distribution for some revenue assessments. The CGC at the time did not want to treat tax elasticity dissimilarly across the various revenue assessments and thus rejected the use of tax elasticity adjustments in the 2020 Review. The ACT did not support the CGC's reasoning for this decision.

The ACT welcomed the CGC's proposed consideration of tax elasticity during the 2025 Review as set out in the draft work program. The ACT notes that tax elasticity adjustments would be a practical method to address Policy Neutrality concerns from second order effects and seeks reconsideration of their inclusion in the revenue assessment methodologies during the consultation on the assessments. Therefore, the ACT expresses concern at the CGC's decision to remove, without notice or consultation, the specific consultancy paper on tax reform and elasticity in its finalised work program for the 2025 Review. The ACT notes that all jurisdictions other than South Australia did not express concerns with this paper being included as part of the CGC's consultation. On this basis, the ACT recommends that the CGC reverse its decision and place this paper back on the work program.

PRACTICALITY

Consultation Question

Does the Practicality principle remain appropriate for ensuring assessment methods are simple, reliable, and fit for purpose?

ACT Position

The ACT considers that the Practicality principle remains appropriate for the 2025 Review.

Given the zero-sum nature of the GST distribution, the ACT considers that ensuring the methods used by the CGC are fit for purpose, and are based on the highest quality data available, is essential for maintaining confidence in the HFE system. Similarly, the ACT recognises that simplicity in the CGC's assessments is broadly desirable for maintaining confidence in the HFE system by the public. However, the ACT considers that the principle and objective of HFE should be the CGC's primary consideration, and that the CGC's distribution methods should only be simplified as far as simplification does not detract from accurately measuring the fiscal capacities of the states and territories.

The ACT does not, for example, support the adoption of global measures of revenue capacity as a means of simplifying the revenue assessments. The ACT notes that a global measurement would fail to recognise differences in the accessibility of different tax bases. A key assumption of a global approach is that macroeconomic indicators, such as Gross State Product (GSP) or State Final Demand, are sound measurements of the ability of states and territories to raise own-source revenue. However, due to Vertical Fiscal Imbalance, states and territories do not have equivalent tax raising abilities as the Commonwealth for various broad tax bases such as income, consumption, or company profits.

Consequently, states and territories are reliant on revenue sources which are significantly more unevenly distributed than the relative size of their domestic economies would indicate. The most present example is mining revenue. According to the CGC's 2023 Update of GST Revenue Sharing Relativities (2023 Update) Adjusted Budget, between 2018-19 and 2021-22, Western Australia (WA) alone raised 55 per cent of all state and territory mining revenue, and NSW, WA, and Queensland combined for 95 per cent of all revenue raised over this period. Differences in mining revenue was the single largest driver of the GST distribution in the 2023 Update.

The ACT's revenue capacity is further restricted by its role as the national capital and seat of the Commonwealth Government. Chapter Five of the Australian Constitution forbids states and territories from raising taxes on the Commonwealth. This restriction disproportionately affects the ACT due to the higher concentration of Commonwealth institutions in the ACT compares to other jurisdictions, and the heightened presence of the Australian Public

Service in the ACT labour market. This is one of the primary reasons why the ACT has positive GST distribution effects from revenue assessments that are influenced by the Commonwealth Government, such as payroll tax and land tax, despite the ACT having the third highest GSP per capita of any state or territory as of June 2022.

A global approach to revenue assessment would fail to capture these influences on states and territories which result in mismatches between state and territory revenue capacities and their broad economic strength. As such, the ACT considers that a global revenue approach would conflict with the principle of What States Do and would detract from the achievement of HFE.

CONTEMPORANEITY

Consultation Question

Does the three-year lagged average approach continue to provide the best balance between contemporaneity, predictability, and stability in measuring states and territories' fiscal capacities?

ACT Position

The ACT is broadly supportive of continuing the three-year lagged average approach in the 2025 Review but considers that the use of forecasted data in one of the assessment years could be examined.

The ACT acknowledges that the use of the three-year lagged average is a compromise between adherence to the principle of Contemporaneity and practical state and territory budgeting considerations. The ACT considers that, ideally, only the most recent year's data would be used by the CGC in its assessment of state and territory fiscal capacity. However, due to issues such as data revisions, the ACT does not consider that this would be a practical approach.

The CGC has provided states and territories with analysis of the impact of using a three-year average, two-year average, or one-year lagged approach on the state and territory relativities since 2001. Further analysis of the CGC's modelling by the ACT shows that the variance for the three-year lagged average approach is the lowest between all three examined options across all jurisdictions, with the two-year average approach having an average 16.75 per cent higher variance than the three-year average approach across all jurisdictions, and the one-year approach having an average 44.11 per cent higher variance.

Table 1 – One, Two, and Three-year Average Relativity Variances by State and Territory

State	Variance			Lowest Variance Year	Variance Difference	
	1 Year	2 Year	3 Year		3 Year vs 2 Year	3 Year vs 1 Year
NSW	0.00429	0.00348	0.00270	3 Year	29.2%	59.2%
VIC	0.00278	0.00177	0.00154	3 Year	15.1%	81.0%
QLD	0.01048	0.00791	0.00624	3 Year	26.7%	67.8%
WA	0.10025	0.09271	0.08343	3 Year	11.1%	20.2%
SA	0.01123	0.00876	0.00794	3 Year	10.3%	41.4%
TAS	0.02365	0.02083	0.01976	3 Year	5.4%	19.7%
ACT	0.00337	0.00292	0.00219	3 Year	33.3%	53.9%
NT	0.27137	0.25471	0.24746	3 Year	2.9%	9.7%

Source – CGC and Chief Minister, Treasury, and Economic Development calculations

The significant increases in relativity variance indicates that the GST relativities would become increasingly volatile if the CGC were to reduce the number of assessment years in its assessments. For this reason, the ACT supports the use of a three-year lagged average approach by the CGC.

However, the ACT notes that there are multiple approaches that the CGC can use for a three-year lagged average. During the 2020 Review, the ACT presented a case for the use of forecasts for the current financial year in place of the furthest assessment year. The CGC rejected this proposal because of the unreliability of forecasts, and the increased complexity arising from the use of forecasts, particularly for disabilities.

The ACT notes however a recent proposal by WA in an occasional paper on HFE, in which the current balancing adjustment mechanism to account for inaccuracies in estimated GST receipts and populations could be leveraged to account for inaccuracies in the relativities when using forecasted data. Under the WA proposal, this would mean there are two sets of relativities determined for the relevant year – an initial set of relativities and an updated set of relativities. The initial relativities would incorporate forecasted data and be used to distribute GST over the relevant financial year, and the updated relativities would use actual data when it is made available and be used for determining the end-of-year balancing adjustment. The ACT holds no strong view on this proposal currently but considers there is merit for CGC to further investigate this for its practicality and its implications for volatility in the balancing adjustment. The ACT suggests that if the CGC were inclined to investigate this further, any additional work should initially focus on the mining assessment where issues of contemporaneity are most challenging.

NEW PRINCIPLES

Consultation Question

Do states and territories agree there is no need to introduce any new principles?

ACT Position

The ACT supports the current principles and does not find a compelling case to include additional principles.

The ACT notes that there have been proposals for the inclusion of additional principles in the past, such as Conservatism. The ACT notes that the CGC's role is to determine the relative fiscal capacities of the states and territories for the purposes of distributing the GST in accordance with the principle of HFE. As such, all supporting principles for the CGC's methods should be set with the goal of HFE in mind. While the ACT acknowledges that there is inherent uncertainty in how closely the CGC's recommended GST relativities reflect "true HFE", the ACT considers that the CGC's current methods and recommendations reflect best estimates of "true HFE" given methodological and data constraints.

Given the above, the ACT considers that there is no concrete reason why the CGC should inherently favour a GST distribution closer to equal-per-capita than one which is further from equal-per-capita, as there is no conceptual justification for why a distribution closer to equal-per-capita would improve the CGC's ability to achieve HFE. The ACT considers that a Conservatism principle would only serve to reduce the scope of the CGC's assessments and would bias the GST relativities away from the best available estimate of "true HFE".

Similarly, the ACT does not see a compelling case for the adoption of a Policy Consistency principle. The ACT notes that the existing principle of Policy Neutrality already guides the CGC to make assessments of state and territory fiscal capacities that, as far as possible, eliminate policy differences between the states and territories. As explained in the Policy Neutrality section, the ACT remains a strong supporter of this principle. However, the ACT also notes that the CGC's assessments are often required to make compromises between Policy Neutrality and the other supporting principles. As such, the ACT welcomes proposals by the CGC and other jurisdictions that seek to improve the compliance of assessments with Policy Neutrality but considers that this needs to be balanced with the other principles.

The ACT acknowledges that this can result in assessment methods that are not fully unaffected by state and territory policy. However, the ACT considers generally results in a sound middle-ground between the principles in a manner that is individually suitable for each assessment. The ACT does not support the adoption of a hierarchy between the principles and considers that an absolute approach of Policy Neutrality, or Policy Consistency, is not possible without disregard for at least some of the other principles. The ACT considers that, in practice, the adoption of a Policy Consistency principle would serve only as a justification for the adoption of broad measurements of state and territory fiscal capacities. The ACT does not support the adoption of broad measurements for the reasons described in the Practicality section.

ASSESSMENT GUIDELINES

APPLICATION OF THE GUIDELINES

Consultation Question

Do the assessment guidelines, and the CGC's application of those guidelines, remain appropriate?

ACT Position

The ACT broadly considers that the assessment guidelines remain appropriate and is comfortable with the CGC's application of the guidelines. However, the ACT recommends some amendments to the guidelines on data.

In relation to data, the ACT notes that the CGC's assessment guidelines identify appropriate collection and sampling techniques, consistency across the states and territories and across time, and a lack of large revisions as the indicators of data quality. Further, the guidelines define fitness for purpose as providing a valid measure of state and territory circumstances. While the ACT does not disagree with any of these indicators or definitions, the ACT considers that the supporting principle of Contemporaneity is not reflected in any of them.

As such, the ACT suggests including reference to the timeliness of data in the definition of fitness for purpose, to reflect that the data used by the CGC in its assessments should, as much as possible, reflect the contemporary circumstances of the states and territories in the assessment years.

The ACT suggests the following wording:

- Data are available that are:
    - Fit for purpose – they capture the influence the Commission is trying to measure and provide a valid measure of State circumstances that is relevant to the Commission's assessment period.

The ACT also considers that the current assessment guidelines do not explicitly provide the CGC with flexibility in relation to the use of best-available data in assessments, when that data does not strictly meet the guidelines' definition of data quality. As such, they do not fully reflect how the CGC approaches the use of data which is conceptually valid, but is not of ideal quality.

For instance, through the 2020 Review, the ACT recommended that the CGC explore alternatives to Compensation of Employees (CoE) data, due to persistent and significant data revisions by the Australian Bureau of Statistics. The ACT notes that these revisions can and have resulted in significant variations year-to-year in the assessed payroll tax capacity of the ACT. The CGC rejected the proposal and continues to use CoE data in the payroll tax assessment, noting in the 2020 Review final report that it "considers CoE data fit for purpose and the best available data at this time". The ACT considers that the CGC's position that CoE was the best data available at the time was fair, particularly given the unavailability of the Business Longitudinal Analysis Data Environment at the time. However, the strict application of the assessment guidelines should, in principle, have ruled out the use of CoE data due to the prevalence of large data revisions.

The ACT considers that this reveals an inconsistency in the assessment guidelines, and the CGC's application of them. Namely, that the CGC is willing to use data that is subject to significant revisions, or that is otherwise not fully compliant with the assessment guidelines, if the data is the best available and the assessment the data is used for is conceptually valid. To rectify this, the ACT suggests that the assessment guidelines be amended to reflect that the CGC will endeavour to use the best available data if a fully compliant source is not available, and the assessment is otherwise valid and material.

MATERIALITY THRESHOLDS

Consultation Question

Should the materiality thresholds be increased broadly in line with state and territory spending per capita (to $45 per capita for assessment of a driver and $15 per capita for a data adjustment)?

ACT Position

The ACT does not support the proposed increase in materiality thresholds. The ACT also proposes a new application of materiality thresholds to account for the significant fiscal implications of assessments which would otherwise be considered immaterial by the CGC.

The ACT notes that in the application of materiality thresholds, the CGC is required to complete a full assessment of a proposed methodology or data revision to ascertain whether it is material or not. That is, the CGC must complete the required work for an assessment method prior to deciding whether it should affect the GST distribution. As such, the ACT considers that materiality thresholds do not make the HFE system simpler.

Moreover, the decision on where to set materiality thresholds is, in the ACT's view, arbitrary, and their application clashes with the CGC's methodical approach in the development of assessments. While the ACT acknowledges that there are practical reasons for materiality thresholds to be applied, the ACT considers that materiality thresholds should be set deliberately, balancing their practicality benefits against their detrimental effects on the achievement of HFE. Therefore, the ACT considers that indexation is not an appropriate method for achieving this balance.

The ACT notes that the current assessment method threshold of $35 per capita can result in significant fiscal implications for the states and territories. For example, the application of the $35 per capita materiality threshold could result in around $16 million in GST not being distributed to the ACT. This amount would be sufficient to fund range of services such as the expansion of the allied health workforce at Canberra Hospital announced in the 2022-23 ACT Budget. These effects are even more pronounced for the large states and territories, where the threshold would amount to approximately $293 million in GST not being distributed to NSW. This amount would be sufficient to have funded more than 100 water infrastructure, water carting, and emergency water infrastructure works programs, as per the 2022-23 NSW Budget Infrastructure Statement.

Given these large potential fiscal impacts from materiality thresholds, the ACT recommends that the CGC take into consideration the aggregate distribution of GST when applying materiality thresholds. The ACT considers that this could be done through a two-part materiality threshold, where the CGC would accept a methodology as materially impacting the GST distribution if the method results in:

- at least one state or territory receiving or losing at least $35 per capita compared to an equal-per-capita distribution; or
- the total amount of GST being redistributed by the method being equal or greater than the equivalent of $35 per capita for the largest state or territory.

The second condition would mean that if an assessment method resulted in a redistribution from equal-per-capita of more than $35 multiplied by the population of the largest jurisdiction (currently NSW) on a national level, the CGC would consider the method to be material.

Based on 2023-24 Commonwealth Budget population estimates for 2023-24, this would mean that if a method redistributed more than approximately $293 million from an equal-per-capita distribution nationally, it would be considered material. The ACT considers that this approach would maintain the practical benefits of materiality thresholds, while addressing the substantial real fiscal implications of their application.

DISCOUNTING ASSESSMENTS

Consultation Question

Does the 2020 Review approach to discounting remain appropriate?

ACT Position

The ACT considers that the 2020 Review approach to discounting remains appropriate and proposes no changes.

ACT Government

Chief Minister, Treasury and Economic Development Directorate

May 2023