

# **Fiscal equalisation, supporting principles and assessments guidelines – 2025 Methodology Review**

## **Queensland submission**

19 May 2023



**Queensland  
Government**

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## Summary

Queensland Treasury appreciates the opportunity to provide input to the Commonwealth Grants Commission's 'Fiscal equalisation, supporting principles and assessments guidelines consultation paper'.

A summary of Queensland's positions is provided in the table below. Details are provided in sections 1 to 9.

### SUMMARY OF QUEENSLAND POSITIONS

Commission question	Queensland response
<b>Approach to HFE</b> – Does the approach to horizontal fiscal equalisation articulated in the 2020 Review remain the appropriate first step in determining GST distribution in accordance with the GST distribution legislation?	<b>Yes</b> , although the new arrangements no longer allow HFE to be met, assessed relativities remain important to the GST distribution calculation.
<b>Supporting principles – 'what states do'</b> – Does the 'what states do' principle, with assessments based on the weighted average policy of all states, remain appropriate?	<b>Yes</b> , the weighted average measure remains appropriate to most assessments with some exceptions.
<b>Supporting principles – policy neutrality</b> – 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?	<b>Yes</b> , this principle remains appropriate, however for assessments affected by policy neutrality concerns such as mining, greater consideration should be given to alternative assessment approaches to achieve policy neutrality.
<b>Supporting principles – practicality</b> – Does the practicality principle remain appropriate for ensuring assessment methods are simple, reliable and fit for purpose?	<b>Yes</b> , with further clarity needed on how this principle is applied across assessments. Queensland recommends a continued focus on quality assurance as part of the 2025 Review.
<b>Supporting principles – Contemporaneity</b> – Does the 3-year lagged average approach continue to provide the best balance between contemporaneity, predictability and stability in measuring states' fiscal capacities?	<b>Yes</b> , the current approach reduces data volatility and allows final audited data to be used ensuring the robustness of assessments.
<b>Supporting principles</b> – Do states agree there is no need to introduce any new principles?	<b>Yes</b> , no new principles are required.
<b>Assessment guidelines</b> – Do the assessment guidelines, and the Commission's application of those guidelines, remain appropriate?	<b>Yes</b> , Queensland supports the continued use of assessment guidelines as developed during the 2020 Review.
<b>Materiality thresholds</b> – Should the materiality thresholds be increased broadly in line with state spending per capita (to \$45 per capita for assessment of a driver and \$15 per capita for a data adjustment)?	<b>No</b> , while Queensland supports increasing the materiality thresholds, we consider that this should be done in line with the state price index, consistent with the 2020 Review.
<b>Discounting</b> – Does the 2020 Review approach to discounting remain appropriate?	<b>Yes</b> , the level of discounts and the circumstance of their use remains appropriate. <b>However</b> , Queensland recommends that the Commission regularly reviews its use and level of discount applied to assessments to ensure the discount reflects the degree of uncertainty with data and methods which may change over time.

## 1. Approach to HFE

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

Under legislated changes to GST distribution arrangements, the concept of HFE remains relevant to the first step in determining states' GST distributions – calculating states' relative fiscal capacities, or 'assessed relativities'. This first step is necessary to identify the fiscally stronger of New South Wales or Victoria, the benchmark set by the legislation.

In line with the conclusion in the 2020 Review, it is proposed that the assessment of state relative fiscal capacities continue to be determined such that after allowing for material factors affecting revenues and expenditures, each state 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.

### Queensland position:

- Queensland supports the objective of HFE, which is to provide a consistent level of services and infrastructure, by minimising differences in fiscal capacities across States. The new GST arrangements no longer allow this definition to be met, with states relativities now adjusted according to a new equalisation benchmark. This problem is particularly acute given the cessation of the no worse off guarantee payment.
- Despite this, Queensland notes that the calculation of assessed relativities (based on relative fiscal capacities) continues to play an important role under the new arrangements, as it is used for the identification of the stronger state between New South Wales and Victoria.
- Queensland also notes that the objective of HFE was changed under the previous review to reflect *similar* levels of service rather than the *same* level of service, recognising the challenges of data limitations and policy choices. Queensland continues to support this change.

## 2. Supporting principles – 'what states do'

Does the 'what states do' principle, with assessments based on the weighted average policy of all states, remain appropriate?

This supporting principle implies that Commission methods should, as far as practicable, reflect what states collectively do. The Commission does not make judgements about what states could or should do. Instead, the Commission bases its assessments on the average policies of all states.

### Queensland position:

- Queensland considers that the use of weighted average policy remains an appropriate measure for assessments, noting however that in certain circumstances it may not be the most reliable, for example where the policies or revenue base are significantly different between states. In these circumstances it is recommended that the Commission consider measures other than average policy.

## 3. Supporting principles – policy neutrality

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

The policy neutrality supporting principle has 2 related aspects. First, a state's policy choices (in relation to the revenue it raises or services it provides) should not directly influence its GST share. Second, the Commission's assessments should not create incentives or disincentives for states to choose one policy over another.

In most cases, the Commission is able to broadly achieve policy neutral assessments using its weighted average policy approach. Policy neutrality concerns arise where a revenue base is concentrated e.g iron ore production in Western Australia or where states ban mining activity e.g bans on coal seam gas and uranium.

### Queensland position:

- Policy neutrality remains an important supporting principle across assessments with increased significance where there are noted policy neutrality concerns, such as in the mining revenue assessment.

- Queensland considers that for the mining revenue assessment, and other assessments where policy neutrality is a concern, greater consideration should be given to alternative approaches to achieve policy neutrality. We look forward to exploring these issues further through the 2025 methodology review process.

## 4. Supporting principles - practicality

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

The practicality supporting principle means that assessments should be based on sound and reliable data and methods, and should be as simple as possible, while also capturing the major influences on state expenses and revenues.

Another aspect of the practicality supporting principle relates to the need for relativities to be formulated and delivered in a way that is 'fit for purpose' for state budget processes.

### Queensland position:

- Practicality should continue to remain an overarching principle across all assessments with a focus on data and methods that are simple, reliable, and fit for purpose.
- To ensure that assessments remain fit for purpose and that the practicality principle is being met, Queensland recommends that the Commission provide training to States on how each assessment operates.
- The practicality principle does not mention quality assurance as a component. This was included under the practicality principle in the 2020 Review and should be included within the 2025 Review principles. For states to properly quality assure assessments it is recommended that the Commission share the results, outputs, and diagnostic testing during the review and in each subsequent update, for all econometric models used within assessments along with the data used (both updated data and the data on which the estimation is based noting that some regression estimates significantly lag updated information) and when the model was last estimated.
- While recognising that there are some confidentiality concerns to be managed in doing this, increasing the transparency of the CGC's assessments will ensure that the significant information asymmetry between the CGC and states is rebalanced while assisting the CGC to ensure its assessments are robust.

## 5. Supporting principles - contemporaneity

Does the 3-year lagged average approach continue to provide the best balance between contemporaneity, predictability and stability in measuring states' fiscal capacities?

The contemporaneity supporting principle aims to ensure that, to the extent reliable data will allow, the distribution of GST provided to states in a year should reflect state circumstances in that year. As robust data is not available until the application year has passed, the assessment period has been the most recent 3 years for which reliable data are available.

Although the Commission recognises that, in circumstances of significant volatility in commodity prices or an economic shock this approach can result in a sizeable gap between a state's assessed and its actual needs in an application year, fiscal equalisation is still broadly achieved over time.

### Queensland position:

- Queensland supports the continuation of the 3-year lagged approach to assessment data. It is considered that this provides an appropriate balance between ensuring that recent trends and data movements are reflected while reducing the volatility that would result from using single year data.
- While it is recognised that under rapidly changing circumstances a lagged approach will not reflect current circumstances, Queensland does not support the use of forecast data to address this issue. The use of forecast data would introduce error into assessments, leading to inaccurate GST distributions as a result.
- A lagged approach to the data, while imperfect, is more robust as it allows final audited data to be incorporated which is inclusive of any data revisions. For this reason, Queensland also does not support any changes to reduce the 3-year assessment period.

## 6. Supporting principles

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

The Commission notes that significant experience, expertise and effort have gone into developing, refining and improving the supporting principles since they were introduced in the 2010 Review. In particular, the 2020 Review involved extensive consultation on, and consideration of, the supporting principles.

Overall, while aspects of the existing supporting principles could benefit from some elaboration, the Commission's preliminary view is that there are no developments that bring into question the appropriateness of the 4 existing supporting principles, nor a need to introduce any new principles.

### Queensland position:

- Queensland supports the continued use of the current set of principles with no additional principles required.
- While a consistent framework around the supporting principles is desirable as this would offer greater transparency and certainty to assessments, Queensland recognises that this is difficult to achieve practically and that trade-offs between principles are often necessary.
- Further elaboration of the supporting principles and their application that the Commission plans to provide would be welcomed.

## 7. Assessment guidelines

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

In undertaking an assessment, there should be a sound conceptual case that differences exist and there is sufficient empirical evidence that the differences are material in terms of level of use or unit costs. Assessments should be based on reliable methods that are conceptually rigorous (measures what is intended to be measured, is based on internal standards and is policy neutral) and measurable with data that is fit for purpose and of suitable quality.

The Commission's preliminary view is that the 2020 Review assessment guidelines remain appropriate with the exception that materiality thresholds could be increased.

### Queensland position:

- Queensland supports the continued use of the assessment guidelines developed as per the 2020 Review. The proposed increase in the materiality thresholds is discussed below.

## 8. Materiality thresholds

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

The materiality thresholds aim to ensure only the main influences on state fiscal capacities are recognised and the assessments remain as simple as possible. Increasing the thresholds broadly in line with growth in states spending per capita would ensure that increases in standards of state services (as opposed to only increases in the prices faced by states) do not erode the value of the thresholds.

The Commission has considered 2 options for increasing the thresholds.

- Increase materiality thresholds broadly in line with the increase in the State and Local Government Final Consumption Expenditure chain price index, as in the 2020 Review.
- Increase materiality thresholds broadly in line with the increase in the state expenditure per capita.

Increasing the driver assessment threshold for growth over the 5 years to 2020-21 suggests a new threshold of \$40 per capita (state price index) or \$45 per capita (state spending per capita). Increasing the data adjustment threshold for growth over the 10 years to 2021-22 suggests a new threshold of \$12.5 per capita (state price index) or \$14.4 per capita (state spending per capita), both rounded up to \$15 per capita.

## **Queensland position:**

- Queensland accepts that materiality thresholds should increase in line with changes in the costs of providing state services. It is however essential that the thresholds levels are appropriately set as thresholds that are set too high will reduce the ability to account for differences in fiscal capacities between states.
- To maintain consistency with the index methods used in the 2020 Review, Queensland recommends increasing the materiality threshold according to the final consumption expenditure chain price index. This would increase the threshold for driver assessments to \$40 per capita and increase the threshold for data adjustments to \$12.5 per capita (which we recommend should be rounded to \$12 per capita).

## **9. Discounting**

### **Does the 2020 Review approach to discounting remain appropriate?**

The Commission's preliminary position is to retain the 2020 Review discounting framework.

The Commission currently has 4 levels of discount — low (12.5%), medium (25%), high (50%) and no assessment (100%). The level of discount applied depends on the Commission's judgment about the reliability of the data or method.

There are instances where the Commission does not consider discounting to be appropriate:

- The Commission has not used discounts to address policy neutrality concerns or general uncertainty.
- The Commission does not discount as a means of more actively encouraging efficiency.
- The Commission does not discount judgment-based estimates.

The Commission will consider the consistency of its use of discounting towards the end of the review.

## **Queensland position:**

- Queensland supports the retention of current discount levels and their current use to address data or method concerns.
- Queensland welcomes the Commission's review into discounting as this would reduce subjectivity in their application. It would be useful to states to better understand how each level of discount is determined as it would seem in some cases that the level of discount applied does not match the concerns it is addressing.
- A clear example of this is in the wage assessment example mentioned in the paper. The Commission acknowledges data and methodology concerns pertaining to the use of a proxy measure, the underlying dataset and the econometric model used in the assessment. Given this long list of issues and the fact that the recent assessments have been particularly volatile it would appear at odds with applying the lowest level of discount (12.5%).
- Queensland considers that it would be good practice for the Commission to regularly review and adjust any discounts as needed. Where it has become apparent that the current methods are not fit for purpose, and this is unable to be corrected through changes to those methods, increases to existing discounts should be considered. This is particularly important where an assessment has become increasingly volatile and there are mounting concerns regarding the suitability of the underlying data on which an assessment is based.



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