

# Flexibility to consider method changes between reviews

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NSW Response to Commission Consultation Paper

1 March 2024

## Acknowledgement of Country

We acknowledge that Aboriginal and Torres Strait Islander peoples are the First Peoples and Traditional Custodians of Australia, and the oldest continuing culture in human history.

We pay respect to Elders past and present and commit to respecting the lands we walk on, and the communities we walk with.

We celebrate the deep and enduring connection of Aboriginal and Torres Strait Islander peoples to Country and acknowledge their continuing custodianship of the land, seas and sky.

We acknowledge the ongoing stewardship of Aboriginal and Torres Strait Islander peoples, and the important contribution they make to our communities and economies.

We reflect on the continuing impact of government policies and practices, and recognise our responsibility to work together with and for Aboriginal and Torres Strait Islander peoples, families and communities, towards improved economic, social and cultural outcomes.

Artwork:

*Regeneration* by Josie Rose



# 1 Method changes between reviews

This separate consultation paper considers the objective, advantages and challenges arising from changes to assessment methods between reviews.

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## Overview of category

- The Commission has been requested under the 2025 Review terms of reference to ‘consider if there is a case for the Commission to be given the flexibility to consider alternative methods in cases where there is a significant unanticipated shock (such as a pandemic) or where major policy reforms are enacted in between reviews.’
  - The Commission is seeking the views of states on relevant issues, including the objectives, advantages and challenges arising from changes to assessment methods between reviews.
  - The Commission has historically been asked to review assessment methods every five years. In between five-yearly reviews, the Commission is asked to update its recommendations annually using latest available data to capture changes in state fiscal circumstances over time and to ensure recommended relativities are appropriate for the year in which they are used.
  - Presently, the Commission will only have the latitude to make method changes in inter-review years if the Commonwealth Treasurer allows for this in the annual terms of reference for updates.
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## NSW Treasury position

- NSW Treasury can see clear benefit in providing the Commission increased flexibility to change its methods between reviews to achieve fiscal equalisation. While we appreciate the stability provided by a five-yearly review timeframe, there can be circumstances where existing methods actively undermine fiscal equalisation. This has been the case since the 2020 Review.
- The Commission’s inability to adjust its Health and Services to Industry assessments to reflect the realities of the COVID-19 pandemic has exacerbated the fiscal impact of COVID-19 for those states most affected. This has provided an unjust GST windfall to other states. While the Commission has acknowledged that this impact has not aligned with equalisation, the existing process has blocked the Commission from adjusting its methods.
- The existing process of review and annual update is supposed to provide flexibility. The Commonwealth Treasurer issues terms of reference for the Commission’s annual updates. Those terms theoretically provide an avenue for allowing the Commission to update methods in pursuit of the national equalisation objective, if required. Unfortunately, there is no mechanism to ensure this process genuinely prioritises fiscal equalisation above political or other considerations.
- As such, a new approach is required. States should not settle for a process that has not worked as intended, even if some have benefited throughout the COVID-affected years. There needs to be a renewed commitment to fiscal equalisation, between the Commission, the States, and the Commonwealth Treasurer.
- The Commission has proposed a new approach that would operationalise greater flexibility to change methods via standing terms of reference. This would shift greater responsibility and judgement onto the Commission.
- It is virtually impossible, however, to neatly define the circumstances in which the Commission should be authorised to flexibly adapt its methods between reviews. The flexibility would be

required only in response to unforeseen and unforeseeable events and such events cannot be identified ahead of time. To achieve flexibility, this proposed process would require wide latitude.

- NSW Treasury is concerned that any powers given to the Commission to exercise its own judgement in applying flexibility are likely to be too broad and will introduce an undesirable element of uncertainty into the process of update and review.
- We propose an alternative process which empowers the Commission to publicly recommend required method changes to the Commonwealth Treasurer as part of the annual review cycle. The Commonwealth Treasurer, or the Commonwealth Treasury as a proxy, would then provide a formal response to the Commission's recommendation as part of the Treasurer's issue of the terms of reference for the annual update. The Treasurer should address the implications of their decisions for fiscal equalisation. The Treasurer's response would be publicly released.

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## 1.1 Commission consultation questions

### The Commission asks:

- Do states agree that there may be situations, such as a significant unanticipated shock or major policy reform, such that there is a case to extend the circumstances when the Commission may need to consider alternative methods between reviews?

### Lack of flexibility in recent years

- NSW Treasury agrees that there are situations where methods finalised under a five-yearly review process are not fit for purpose in the update years to which those methods are applied.
- There have been two highly relevant examples of the need for greater flexibility in methods over recent years:
  - **COVID-19** – A global pandemic that required significant uplift in state spending on health and business support outside of traditional drivers of activity, with some states more materially impacted due to circumstances outside of their control. Despite this, no method changes were made to reflect the actual nature of COVID-19 spend.
  - **NSW stamp duty reform** - A proposed reform to replace stamp duty with a broad-based property tax that would have been expected to materially increase the value of property transferred, thereby resulting in the Commission's method materially overstating NSW's revenue raising capacity. The GST implications were a barrier to NSW enacting reform. Absent method changes, this would undermine the policy neutrality principle.
- Inflexibility in addressing these examples either undermined fiscal equalisation or failed to meet the Commission's commitment to policy neutrality. In both cases, the Commission was sympathetic to the need to change methods, but powerless to pursue changes.
- While these specific examples may not arise again in the foreseeable future, they represent types of events that would require a flexible approach to assessing fiscal capacities. Broadly, any event that necessitates significant government expenditure across one or more service categories and which has cost drivers that differ to traditional drivers in those categories will potentially create a need for flexibility. Such examples might include:
  - Major policy reform – A state undertaking a major revenue or expenditure reform that does not flow through to the Commission's methodology, which instead assumes that the state has the original revenue capacity or service need (e.g. NSW stamp duty).
  - Legal decision – A court decision that significantly alters the existing legal framework of state revenues or services and may require states to undertake sudden policy shifts to account for a new legal environment (e.g. Vanderstock).

- Health or biosecurity events – An unexpected event that requires a state to undertake extraordinary expenditure measures in response (e.g. COVID-19, fire ants).
- Localised economic or financial shocks – An event that requires states to provide business support beyond the ordinary drivers or policy levers (e.g. external tariffs on specific Australian goods).
- In practice, any such examples would require there to be a differential impact across states, which may not necessarily be the case in all instances of the above.
- Existing arrangements technically allow for flexibility in inter-review years through the annual terms of reference issued by the Commonwealth Treasurer. Any decision to utilise this flexibility sits with the Commonwealth Treasurer, rather than the Commission. As the Commission has identified<sup>1</sup>, its ability to change methods outside of a five-year review process is entirely dependent on the annual terms of reference.
- Despite the technical flexibility embedded within existing arrangements, the actual equalisation outcome of recent years has revealed that this process has not functioned effectively. The Commonwealth Treasurer has consistently excluded reference to COVID-19 in their recent terms of reference and, consequently, equalisation has not been achieved.
- Maintaining existing arrangements risks undermining equalisation or neutrality into the future. There are, however, various costs and benefits associated with alternative arrangements which need to be considered. Flexibility can be provided on a spectrum and the Commission must carefully balance any additional authority to adjust its methods with stability and predictability, and with public confidence in the robustness of its methods.

#### Foundations for a new process

- We believe there are core principles that should be considered in any process for implementing method changes between reviews. Any process should:
  1. Prioritise the core objective of horizontal fiscal equalisation, while continuing to align with the Commission's four supporting principles.
  2. Minimise the level of judgement required by the Commission in implementing a method change.
  3. Heavily limit the instances in which method changes should occur (i.e. only major unexpected developments or major policy reforms), with specific consideration of the materiality and complexity of a method change.
  4. Provide certainty by ensuring that a specific and active decision is made about whether to pursue a method change, even if it is to reject a method change being made.
- The existing arrangements clearly have not met these principles in recent years.

#### Retention of a five-year review term

- In principle, the use of a five-year review process provides states with a high degree of confidence in forecasting GST distributions for the period. More frequent review and amendment of methods may create an environment of permanent contest and consultation. It is important to retain the stability provided from fixing the method for five years.
- Any power given to the Commission to flexibly adjust its methods between reviews should be used sparingly. Any new process must not unintentionally create an annual review of the

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<sup>1</sup> See the Commission's 2022 and 2023 New Issues consultation papers



assessment methods. Changes to methods should only be implemented in limited and material circumstances.

#### The Commission asks:

- Do states agree that any consideration of whether method changes are warranted between reviews be undertaken in consultation with the states and the expectation should be that this flexibility would only be exercised in very limited circumstances?
- Any change in method, whether actioned through a formal five-yearly review or through a newly flexible approach to annual updates, should be subject to the same high standard of public state consultation as is currently undertaken for reviews.
- It should be noted that states' capacities to fully engage in comprehensive consultation would ordinarily be limited in the years between reviews. However, given the significance that any method change would have on GST distributions (noting they would only be pursued if highly material), states should commit to fulsome consultation.
- Any flexibility to make method changes should only be used in very limited circumstances.

#### The Commission asks:

- Do states agree that the circumstances supporting the case to extend the Commission's flexibility to change methods between reviews should include major unexpected developments:
  - that have a significant impact on state fiscal positions
  - that are not captured in existing assessment methods,
  - that require a change in methods for the Commission to achieve the objective of fiscal equalisation?
- NSW Treasury agrees that the flexibility to change methods should apply in cases of major unexpected developments that align with the above criteria. This should also include the introduction and implementation of major policy reforms.
- However, given that unexpected developments are unforeseeable in terms of their nature, timing, and magnitude, it is highly difficult to develop a suitable definition or threshold for determining when a method change would be appropriate.
- Too strict a definition risks limiting almost all method changes and continuing the currently ineffective process. Too broad a definition risks introducing too much uncertainty about when the Commission will seek to change methods. It is possible that there is not an appropriate definition for the terms of reference that balances these two tensions.
- We are open to any further language developed by the Commission to include in the terms of reference as a means of operationalising extra flexibility. We are uncertain about whether an appropriate definition is achievable.

### The Commission asks:

- Should the extended flexibility to change assessments between reviews in certain circumstances be operationalised in standing terms of reference for updates?
- NSW Treasury recognises that operationalising the extended flexibility in standing terms of reference for updates is a reasonable approach. However, based on the earlier identified criteria, we have some concerns.
- We consider the difficulty in specifically defining events that would necessitate a method change is a key weakness of the proposed approach. While we believe the Commission would act in concert with the first principle of prioritising fiscal equalisation, such an approach would necessarily require significant judgement from the Commission, would not put clear limitations on the instances in which method changes should occur, and would ultimately introduce an element of uncertainty into the process.
- If clear limitations or definitions cannot be set for the circumstances necessitating a method change, then ideally the required discretion should remain with the Commonwealth Treasurer. However, the Commonwealth Treasurer's unwillingness to allow for flexibility in recent years has had significant adverse implications for equalisation. Billions of dollars of GST revenue has been misallocated without any rationale having been provided to states. This has damaged the credibility of the HFE system.

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## 1.2 An alternative approach

### NSW Treasury proposes:

- That an alternative process is implemented, in line with our suggested principles, to best support effective equalisation when method changes are required.
- We suggest an alternative approach that retains the Commonwealth Treasurer's role in updating the terms of reference for annual reviews but creates a new obligation for the Treasurer to consider advice from the Commission on the need for any method changes and to make an active decision on whether to allow the Commission to adjust its methods.
- The proposed process would be as follows:
  1. The Commission evaluates whether there have been major shocks or policy changes that could warrant adjusted methods in an update year.
  2. If any such shocks or changes have occurred, the Commission releases a consultation paper to states on these items, including its preliminary views on changes to methods.
  3. Once state views are received and the Commission finalises its recommendations, the Commission's and states' views should be provided to the Commonwealth Treasurer **prior to the draft terms of reference** for an annual update being released.
  4. In releasing the terms of reference, the Commonwealth Treasurer publicly responds to the Commission's recommendation on proposed method changes, confirming whether method changes can be implemented for the relevant update and providing a rationale for the decision.
- In considering the alignment of this process with our identified core principles for any new process:
  1. **Prioritises equalisation** – The Commission and all states will have the opportunity to present views on potential method changes and their alignment with equalisation.

2. **Minimises the level of Commission judgement** – Judgement will remain with the Commonwealth Treasurer, rather than the Commission. The Commission and states will have the opportunity to put forward recommendations and any counterviews respectively but will not have the power to make a final decision.
  3. **Limits instances of method changes** – Given the difficulty in specifically defining instances where method changes should be implemented, this will retain the model of the Commonwealth Treasurer having discretion over which method changes should apply. While it does not set clear limitations, the final decision remains with the Treasurer, in line with the existing approach.
  4. **Specific and active decision** – The decision will remain with the Commonwealth Treasurer, rather than the Commission. The Treasurer will be required to take a specific position on the recommendations and views put forward by the Commission and States respectively.
- In our view, this represents a small but important change to the existing process. The key changes would be:
    - Inclusion of a formal process for making inter-review method changes, with recommendations to be put forward by the Commission, responded to by the States, and decided upon by the Commonwealth Treasurer.
    - Requiring the Commonwealth Treasurer (or Commonwealth Treasury) to provide public comment on whether a method change will be made and the rationale for any decision.
  - While the Commission would still define what constitutes an unexpected development or major reform in this approach, the States would be able to formally respond to the Commission’s position, and the final decision on whether to change methods would remain with the Commonwealth Treasurer.
  - A formal decision from the Commonwealth Treasurer on proposed method changes, even if a method change is disagreed with by States, provides certainty.
  - We expect that the need to consider inter-review method changes will be limited, and major unexpected shocks or policy reforms will remain relatively rare. However, despite such circumstances being rare, the overall materiality of these events is sufficient to have a process in place to manage them.
  - These changes would reduce the risk that equalisation is undermined in inter-review years, only place greater impost on states in rare circumstances, and not represent a significant departure from the existing process of making method changes between reviews.



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