Australian Government

Commonwealth Grants Commission

2020 REVIEW

SIGNIFICANT CHANGES SINCE THE DRAFT REPORT

COMMISSION POSITION PAPER
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BACKGROUND

1 The terms of reference for the 2020 Review ask the Commission to consult further with States if it expects to make substantive changes to the methods described in the draft report.[1] This position paper sets out the expected changes, both substantive and less so. If States wish to comment, any views are sought by 3 January 2020. The paper aims to provide sufficient information for States to understand the change and the reason for it. It does not attempt to respond to all State arguments concerning the issue. This will be done in the final report.

2 Methods not addressed in this paper can be taken as remaining as described in the draft report, but States should also be aware the Commission intends, at a late stage in the review, to re-examine all assessments, including all discounts, to ensure they pass a reality test and are internally consistent.

3 In addition, changes to data since the draft report, and a comprehensive rebuild of all draft report calculations, are likely to lead to minor changes to some illustrative assessment results presented in the draft report, for example for some cost weights and regional cost gradients. These are not covered in this paper.

4 The paper also presents information on the proposed adjustments to improve comparability of State stamp duty and Land tax State revenue bases. States may wish to comment. Also listed is other information intended to be provided to States prior to the release of the final report.

5 To assist States to navigate the final report, the indicative outline of the report structure is included at Attachment A. In brief, the report will be in two volumes. Volume 1 will present the Commission's findings, including its recommended relativities for distributing GST revenue among the States in 2020-21, along with illustrative distributions and major influences for each State. Volume 2 will address the methods used by the Commission in determining its findings.

SUBSTANTIVE METHOD CHANGE

Disaster recovery expenses

6 In the draft report, the Commission said it intended to assess States' net expenses for natural disaster relief on an APC basis, excluding local government net expenses, because at that time it was unclear whether States were the ultimate funder of these expenses.

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1 Terms of reference for the 2020 methodology review, clause 3(b).

7 Most States did not comment on this proposal in the draft report. However, Queensland strongly objected to the exclusion of local government expenses. It stated that local government were fiscally unable to fund natural disaster relief expenses, and that the State government contributed most of the funds for local government out of pocket expenses. The Northern Territory also stated that local government lacked the financial capacity to self-fund expenses, especially councils in remote areas.

8 Expenses for the natural disaster assessment include State out of pocket expenses under the Disaster Recovery Funding Arrangements 2018 (DRFA), net of Commonwealth assistance. Eligible expenses under the DRFA also include local government expenses.

9 Information provided since the draft report showed that all States support local governments to pay for natural disaster recovery, although the amounts may vary due to differences in State policy, the number and severity of disasters, and the financial capacity of local governments. In most States, local government are required to make a small contribution towards natural disaster relief expenses.

10 The Commission generally excludes local government activities from its assessments, because local government is subject to separate equalisation processes and the Commission does not consider it has a mandate to equalise local government activities. However, transactions between States and their local governments, for example, payments for services and grants, are included in the adjusted budget.

11 The Commission has decided that local government expenses should remain in the assessment, as States fund most of these expenses and they represent an unavoidable cost for States. However, an assessed contribution from local government towards natural disaster recovery will be deducted from the expenses, so that the assessment only recognises State out of pocket costs. The assessed contribution will be calculated each year by multiplying the national average rate of contributions by each State's gross local government expenses.

12 In the event of a disaster in the ACT, the Commission would estimate the proportion of the ACT's expenses that are local government-type expenses. The assessed local government contribution would be deducted from these expenses.

13 During the 2019 Update, the Commission did not include local government net expenses in the assessment. In addition, an adjustment was made to correct for the previous inclusion of local government expenses in the 2015-16 and 2016-17 assessment years, consistent with the Commission's policy on revisions for this assessment.[2]

[2] CGC, *Report on GST Revenue Sharing Relativities, 2017 Update*, 2017, p.38.

14 Consistent with its decision to include local government net expenses going forward, the Commission has also decided to unwind fully in the 2020 Review the adjustment to the assessment in the 2019 Update to remove local government net expenses. The adjustment will ensure that all eligible local government expense are included in the assessment for three inquiries. Table 1 shows the effect on the GST distribution in the 2019 Update of including local government expenses and unwinding the adjustment.

Table 1 Effect on the GST distribution of decision to change natural disasters assessment and unwind the adjustment included in the 2019 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
$ million	-170	-207	350	101	-74	-2	-22	24	475
$ per capita	-21	-31	68	38	-42	-4	-50	95	19

Source: Commission calculation based on the 2019 Update.

15 The Commission notes that the decision made during the 2019 Update to remove local government net expenses was consistent with State information provided at the time and the 2015 Review intention to assess only State natural disaster recovery expenses. However, the Commission acknowledges that it may have made a different decision during the 2019 Update if States had provided complete information on State and local government funding policies at the time.

MINOR METHOD CHANGES

Mining revenue

16 Supplementary terms of reference for the 2020 Review direct the Commission not to change the Mining revenue assessment methodology. There is one change to the draft report. In the draft report, grants in lieu of royalties were assessed with other Commonwealth payments. The Commission has decided to return these payments to the Mining revenue category. This change is purely presentational and does not change States' GST entitlement. It arguably removes any criticism of the Commission not following its terms of reference, as alluded to by Western Australia.

Welfare assessment

17 The Commission intends to make the following non-substantive changes to the draft report assessment of welfare expenses.

- Other welfare expenses will be assessed equal per capita (EPC) instead of using a low SES measure because the available evidence does not support the conceptual case that most service users are from low SES backgrounds. Differences in wage and regional costs will continue to be recognised.

- The other welfare assessment will include a cross-border allowance to recognise the net use by New South Wales residents of ACT services; however, the allowance will be included with the Health category that already includes a cross-border allowance for community health services.
- Service delivery scale and regional costs will be recognised in the child protection and family services assessment.

Electricity and water subsidies assessment

18 The Commission intends to make the following non-substantive changes to the draft report method for assessing electricity and water subsidies.

- The definition of small communities for the water subsidies component has been broadened to include communities of less than 3 000 people (instead of communities of less than 1 000 people), to capture more of the communities that receive water subsidies.
- The discount for the regional cost weight for the small community water subsidies component has been removed, to be consistent with other categories where regional cost weights have been derived using category data, and because the regional cost weight has been calculated using conservative assumptions.
- Wage costs have been applied to the small community water subsidies component and the remote community electricity subsidies component, as States with higher wage costs would be expected to have higher subsidies.

Investment assessment

Negative assessed investment

19 Among broader issues with negative assessed investment, the Northern Territory raised concerns about the validity of applying the cost factor to negative assessed investment. Doing so implies that a State can receive higher returns on the sale of assets to reflect these costs. The Northern Territory argued that this is not the case, especially in Indigenous communities, where construction costs are high and there are no private markets for these assets. The Commission agrees with this argument. Because States will be assessed as needing to disinvest in areas and times when growth, and presumably demand for such assets is low, differences in construction costs between States, or between regions, are unlikely to have a strong relationship with the value that States could receive for assets if they were to sell them. In the 2020 Review, capital cost factors will no longer be applied to negative assessed investment.

Capital cost disabilities (factors)

20 In the draft report, the Commission noted that, due to the significant changes in the assessment of recurrent regional costs, the derivation of capital cost factors would need to be further considered.

21 In the 2015 Review, the Commission introduced a construction cost index to measure capital costs. Construction cost indices published by Rawlinsons were considered reliable and comprehensive indicators of underlying differences in construction costs. However, due to some concerns about how well the indices capture some cost differentials, such as those for road construction and equipment, the Commission decided to assess capital cost disabilities as a blend of undiscounted factors based on Rawlinsons' construction cost indices and the recurrent wage and regional cost factors.

22 In this review, the Commission considers that blending the interstate differences in construction costs with interstate differences in wage costs remains the best measure of interstate differences in the costs of investment. However, the increased usage of category specific recurrent regional costs gradients reduces the justification for using a general recurrent regional cost gradient. Accordingly, with the exception of a small number of categories described below, Rawlinsons' measure of differences in regional costs alone is applied to these interstate cost differences.

23 Table 2 shows the cost factor applied in each component. For most categories, the assessed construction costs are calculated using the share of total population in each region. For roads, the construction costs in each region are applied to the relevant indicator: population in UCLs over 40 000 for urban roads, and population outside such areas for rural roads. Only the interstate cost differences are considered relevant to urban transport. Because the recurrent regional cost influences cannot be excluded from the capital stock factors in Health and Justice, these influences are excluded from the cost factor to avoid double counting, and only interstate differences in construction are applied to investment in these components.

Table 2 Investment assessment, capital cost factors by component

Component	Cost factor
Schools	Regional and Interstate
Post-secondary education	Regional and Interstate
Health	Interstate
Housing	Regional and Interstate
Welfare	Regional and Interstate
Services to Communities	Regional and Interstate
Justice	Interstate
Roads	
Rural roads	Regional (a) and Interstate
Urban roads	Regional (a) and Interstate
Transport	
Urban transport	Interstate
Non-urban transport	Regional and Interstate
Services to Industry	Regional and Interstate
Other Expenses	Regional and Interstate

Note: Interstate refers to the blended Rawlinsons' interstate differences in construction costs with interstate differences in wage costs. Regional refers to the Rawlinsons' State regional indices, unless otherwise noted.

(a) The regional cost gradient weighted by a category specific distribution of user population, rather than the distribution of the total population.

REVENUE BASE ADJUSTMENTS

Stamp duty on conveyances

24 The draft report proposed two adjustments, to account for State policy differences, in the Stamp duty on conveyances assessment:

- an off-the-plan adjustment for Victoria because its off-the-plan transactions are reported by dutiable value rather than purchase price
- a unit trust adjustment for Queensland, Western Australia and South Australia because their legislation captures a wider range of transactions than for other States.

25 In addition, States proposed a third adjustment — a land rich adjustment.

Off-the-plan adjustment

26 Victoria's off-the-plan concession means its off-the-plan transactions may be reported in lower value ranges. In previous reviews, Victoria provided its off-the-plan transactions by dutiable value. An adjustment was required to estimate the difference between their dutiable values and their purchase price.

27 For this review, Victoria has provided its off-the-plan transactions by purchase price and so an off-the-plan adjustment is not required. Consequently, the Commission intends to discontinue this adjustment.

Unit trusts adjustment

28 The unit trusts adjustment was introduced in the 1990 Update to capture State legislative differences in the application of conveyance duty to the issue and redemption of units in private unit trusts. At that time, most States did not apply conveyance duty to these transactions, but Queensland, Western Australia and South Australia did.

29 The adjustment was initially set at 1%, based on data provided in the 1988 Review. The adjustment was increased to 3% in the 1999 Review, based on evidence about the increased prevalence of unit trusts and a number of court rulings (including the Industry Superannuation Property Trust). The adjustment remained at that level in subsequent reviews.

30 Three States commented on the adjustment.

31 Queensland supported a continuation of the adjustment in the absence of new data to support a different adjustment.

32 New South Wales said the adjustment should be discontinued because there had been significant legislative changes such that the differences had effectively ceased. While Queensland imposes conveyance duty on the transfer of units in a private trust, other States chose to impose landholder duty. New South Wales said a remaining difference was that Queensland allowed a principal place of residence exemption for land owned by a trust, but other States did not. New South Wales believed the policy choices of Queensland affected the form of land ownership (trusts rather than direct ownership), but did not have a material effect on the total value of property transferred and, as such, an adjustment was not warranted.

33 Western Australia also said that Queensland was the only State to have a unit trust scheme rather than land holder/land rich provisions. It believed the difference in State policies was predominately about the land acquisition threshold and the applicable rate of duty, with most States applying a rate of duty that was 10% of the general rate. It concluded the Commission should reconsider the need for a unit trust adjustment.

34 The Commission accepts there have been legislative changes that have reduced the State differences. It is not clear that Queensland's choice of a unit trust scheme rather than a land holder/land rich provision would lead to a materially different value of property transferred. Therefore, it has decided to remove the unit trusts adjustment. Table 3 shows the effect of removing the adjustment in 2017-18.

Table 3 **Change in redistribution since the draft report, unit trust adjustment, 2017-18**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
Dollars million	62	52	-77	-26	-16	3	3	1	120
Dollars per capita	8	8	-16	-10	-9	5	7	2	5

Source: Commission simulation.

Land rich adjustment

35 In the draft report, the Commission proposed differentially assessing land rich transactions by listed companies. New South Wales and Western Australia noted a majority of States applied a rate of duty that was 10% of the general rate.
New South Wales suggested the Commission either:

- assess land rich transactions by listed entities as a separate part of the tax base, or
- include only 10% of their transaction value.

36 Five States apply duty at 10% of their general rate. Consequently, the Commission has decided to introduce a 10% adjustment, which would apply to all States. This adjustment would reduce the influence of land rich transactions. Table 4 shows the effect of introducing the land rich adjustment in 2017-18.

Table 4 **Change in redistribution since the draft report, land rich adjustment, 2017-18**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
Dollars million	-25	-11	8	25	2	1	1	0	37
Dollars per capita	-3	-2	2	10	1	1	1	0	1

Source: Commission simulation.

Land tax

37 The draft report proposed two adjustments, to account for State policy differences, in the Land tax assessment:

- an adjustment for the ACT because of its policy to impose land tax on an individual property basis rather than aggregating a land holder’s taxable land holdings
- an adjustment for the Northern Territory to estimate its taxable land holdings because it does not impose land tax.

The ACT adjustment

38 The ACT's lack of aggregation means more of its taxable land holdings are reported in lower value ranges. An adjustment is required to estimate the effect of aggregation on its taxable land holdings. In the 2015 Review a 2% adjustment was applied.

39 Western Australia said its aggregation policies increased its land tax and Metropolitan Regional Improvement Tax revenue by more than 50%. In its State Tax Review Discussion Paper[3], South Australia provided data suggesting its aggregation policies increased its land tax revenues by more than 30%. The progressivity of States' rates of land tax means aggregation has a greater effect on State revenues than States' land holdings. Thus, the ACT adjustment should be less than the revenue effects experienced by these two States.

40 The Commission proposes to base the ACT adjustment on a comparison of States' shares of land holdings data and their shares of ABS adjusted land values.[4] The Commission compared the ACT to New South Wales and Queensland. Like the ACT, they are the only States that had a share of adjusted land values bigger than their share of land holdings. Also, data from Western Australia's Overview of State Taxes and Royalties also suggest these two States have a tax rate progressivity closest to the ACT.

41 For the three years to 2018-19, the combined share of taxable land holdings for New South Wales and Queensland was 92% of their combined share of adjusted land values. An adjustment of 10% would be required to the ACT's share of land holdings to lift its ratio to 92%.

42 Based on this comparison, and taking into account the experience of Western Australia and South Australia, the Commission has decided to increase the ACT adjustment to 10%. Table 5 shows the effect of increasing the ACT adjustment in 2017-18.

Table 5 Change in redistribution since the draft report, ACT adjustment, 2017-18

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
Dollars million	1	1	0	0	0	0	-3	0	1
Dollars per capita	0	0	0	0	0	0	-7	0	0

Source: Commission simulation.

3 Review of Tax Reform Discussion Paper, February 2015, Section 8.3 Land tax, pages 40-41.

4 The ABS publishes land values as part of the National Accounts. An adjustment was made to remove principal places of residence from its residential land values. That adjustment was based on the proportion of private renters in each State.

The Northern Territory adjustment

43 An adjustment is required for the Northern Territory to estimate its taxable land holdings. In both the 2010 and 2015 Reviews, an adjustment of 0.6% was used. The adjustment was based on the Northern Territory's share of Valuers'-General land values for the three years of the 2010 Review.

44 The Northern Territory said the Commission should base this adjustment on its Valuer-General's data. However, the Commission no longer collects these data. Western Australia said the Commission should develop the adjustment by comparing States' taxable land holdings to ABS' land values. The Northern Territory's share of ABS adjusted land value data for the three years of the 2010 Review was also 0.6%. For the three years to 2018-19, its share increased to 0.8%. Its increased share was driven both by an increase in its residential and commercial land values and by an increase in its proportion of renters.

45 The Commission has decided to estimate the Northern Territory's taxable land holdings data as 0.8% of the other States' taxable land holdings. Table 6 shows the effect of increasing the Northern Territory adjustment in 2017-18.

Table 6 Change in redistribution since the draft report, NT adjustment, 2017-18

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
Dollars million	6	4	1	1	0	0	0	-13	13
Dollars per capita	1	1	0	1	0	0	0	-52	1

Source: Commission simulation.

Expanding the number of value ranges

46 In response to the draft report, the ACT suggested the Commission expand the number of value ranges in both Land tax and Stamp duty on conveyances. In particular, it said the highest value range in each assessment should be split to reflect that several States apply multiple thresholds within those ranges.

47 In setting its value ranges, the Commission's primary consideration has not been the materiality of those ranges, which can change for different States in different years. Rather, on practicality grounds, the Commission uses a fixed set of value ranges for the period of the review, that capture the practice of States to apply those taxes progressively and enable States to set up a process for extracting data in the knowledge that the Commission's data specifications will not change year to year.

48 The Commission sought data from State Revenue Offices to allow it to break the top value range into three value ranges. As data have not yet been received from all States, the Commission is not in a position to decide whether to use the same number of value ranges as in the previous review or to expand the number of ranges.

OTHER INFORMATION TO BE RELEASED PRIOR TO THE FINAL REPORT

49 The following data will be provided separately to States once finalised:

- the results of the wages regression using the latest data from the ABS Characteristics of Employees survey (CoES) that will be used in the wage costs assessment
- housing Indigenous cost weights and regional costs gradient.

SUBMISSIONS

50 State comments on the issues discussed in this paper are due by 3 January 2020.

ATTACHMENT A — STRUCTURE OF 2020 REVIEW REPORT

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- Movements in the GST distribution

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Chapter 3 State by State changes since 2019 Update

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Chapter 4 Why State relative fiscal capacities differ

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Part B - Assessments

SUPPORTING DATA