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Commonwealth Grants Commission

2015 REVIEW

IMPLEMENTATION AND METHODOLOGICAL ISSUES

**STAFF DISCUSSION PAPER
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INTRODUCTION

- 1 This staff paper addresses a range of generic implementation and methodological issues flowing from the commission paper setting out what it considers it is asked to do through the terms of reference, and the principles it proposes to use in developing appropriate methodology. The commission has not adopted a clean slate approach as in the 2010 Review. Instead, it has started with the 2010 Review methodology and is reviewing that.
- 2 The paper contains the following sections:
 - Measure of fiscal capacity and the ‘simplified and integrated framework’
 - Implementation issues for what States collectively do
 - Implementation issues for policy neutrality
 - Implementation issues for practicality
 - Implementation issues for contemporaneity
 - A global revenue assessment
 - Broad indicator assessments
 - Treatment of Commonwealth payments
 - Assessment guidelines.
- 3 Within the above sections, the GST Distribution Review recommendations included in the terms of reference are covered. These are:
 - the appropriateness of the current materiality thresholds (Recommendation 3.1)
 - the appropriateness of continuing to round relativities to five decimal places (Recommendation 3.2)
 - the use of data which is updated or released annually with a lag, or updated or released less frequently than annually (Recommendation 6.2)
 - the merits of adopting a simplified and integrated assessment framework (Recommendation 6.3)
 - to investigate whether it is appropriate and feasible to equalise interstate costs on a ‘spend gradient’ basis (Recommendation 6.4).

MEASURE OF FISCAL CAPACITY AND THE ‘SIMPLIFIED AND INTEGRATED’ FRAMEWORK

- 4 The terms of reference direct the commission to examine the merits of adopting a ‘simplified and integrated assessment framework’, as per recommendation 6.3 of the GST Distribution Review Final Report.

- 5 The GST Review said ‘the changes to the capital assessment in the 2010 Review — including the population growth needs assessment — were a positive step forward’. Nevertheless, it recommended the commission consider adopting a ‘simplified and integrated assessment framework’ because it ‘could improve simplicity, transparency and stability while addressing concerns about the treatment of subsidised public non-financial corporations (PNFCs)¹, for example, public transport and social housing PNFCs, in the current framework’.
- 6 The GST Review approach involves moving from the existing direct assessments of capital requirements, the investment necessary to achieve them and the net lending (borrowing) needed to equalise State net financial worth to one which:
 - is based on a modified operating statement framework which includes the deficits of State housing and public transport agencies
 - includes ‘population growth needs, based on population growth dilution of net worth’, which is general government infrastructure plus net financial worth
 - ‘scales up’ the depreciation assessment by a user financial cost of capital element (that is, by the holding costs of capital).
- 7 Those changes would replace the current investment and net lending assessments.
- 8 The GST Review said its approach is consistent with the upfront inclusion of Commonwealth capital payments and should leave GST outcomes ‘largely unchanged in the long term’ because the largest component of the current assessment (the population growth needs) is retained.

State views

- 9 In submissions for this review, States said the following.
 - Queensland, Western Australia and the Northern Territory supported the 2010 Review approach, although Western Australia said the simplified and integrated approach would be acceptable if an appropriate holding cost could be derived.
 - South Australia supported the simplified and integrated framework.
 - New South Wales, Tasmania and the ACT said the simplified and integrated approach should be examined. However, New South Wales and Tasmania also said a simple holding cost approach which excludes population growth allowances should be used. The ACT said the case for population growth allowances was overstated.
 - Victoria said removing the capital assessments would be a more significant improvement than the simplified and integrated approach.

¹ Also referred to as public trading enterprises, or PTEs.

- 10 States supporting the simplified and integrated approach or a simple holding cost approach said they did so because those approaches would be simpler, better reflect what States do and reduce the volatility in GST shares.

Issues and analysis

- 11 The recognition of State infrastructure and net financial worth needs directly and immediately, rather than over time through debt charges, interest earnings/dividend or holding cost assessments, was a controversial and thoroughly debated aspect of the 2010 Review. The commission adopted its 2010 Review approach because:
 - it recognises most effects on State fiscal capacities of economic growth (especially population growth) in a complete and contemporary way
 - it explicitly recognises factors affecting balance sheets and operating results which is consistent with recent accounting and economic trends — it provides States with an equal capacity to hold net financial assets (and earn income from them) after recognising their differential need to provide the average level of services each year and hold the infrastructure necessary to provide those services
 - it was consistent with State practices of using recurrent revenue to fund much of their infrastructure acquisition.
- 12 The 2010 Review approach can be seen as one where the GST distribution provides a capital grant to allow each State to acquire the infrastructure and financial assets it needs in a year. In effect, spending by States on new infrastructure is treated the same way as other expenditures — as needs change the GST distribution responds. This reflects the fact that GST revenue is fungible and States can use it to provide services and/or acquire new infrastructure.
- 13 The GST Review said its approach represents a return to an operating statement framework. However, as we understand the proposal, it is equivalent to an approach which equalises State net worth per capita and which also includes the full annual costs of holding and using capital.
 - The inclusion of an upfront assessment of population growth effects on the total stock of State assets (infrastructure and net financial assets) gives States the capacity to finish each year with the same per capita net worth.
 - ‘Scaling up’ the depreciation assessment is equivalent to including holding costs. This action allows the proposed approach to recognise effects of State circumstances on the composition of their net worth (especially the infrastructure/financial asset split of net worth) and their fiscal capacities.
- 14 Thus, while the GST Review simplified and integrated approach may be portrayed as being based on an operating framework; in reality it continues the net lending statement framework, like the current approach of equalising net financial worth.

Staff view

- 15 We are not convinced there are advantages warranting a change from the current approach, especially as the commission has decided to include the infrastructure and investment of housing and urban transport agencies within its calculations. Compared with the 2010 Review approach, the alternate approach is:
- less transparent and simple, because it assesses differences among States in infrastructure requirements through the holding costs of capital, an artificial construct rather than an explicit assessment of spending required to acquire extra infrastructure as recorded in State budgets
 - less reliable, in that judgment is required to set the holding cost of capital and that judgment affects the GST distribution
 - less contemporary, in that changes in State circumstances within a year only partly affect the per capita requirements for infrastructure (although we acknowledge this reflects a deliberate attempt to reduce volatility).
- 16 In addition, recent experience suggests the effect of the proposed approach on the GST distribution could be noticeable, but largely immaterial. Reductions in volatility, a major claimed advantage of this approach, would not be uniform across States. Indeed, volatility in assessed infrastructure investment may rise for some States. Further, while assessed investment volatility might fall a new source of volatility would be introduced as changes in infrastructure intensities from year to year cause changes in assessed holding costs. The net effect for any one State in any year is unclear.

Staff propose to recommend the commission:

- retain the 2010 Review approach of equalising State net financial assets per capita and recognising needs for infrastructure and net financial assets directly and immediately, rather than changing to the simplified and integrated approach or other holding cost approaches.

- 17 None of the above is to say that the capital assessments will remain unchanged in this review. We expect details of the capital assessments to change following consultation with the States. The capital assessments are discussed in more detail in Staff Discussion Paper 2013-07 S.

IMPLEMENTATION ISSUES FOR WHAT STATES COLLECTIVELY DO

- 18 Giving effect to the ‘what States collectively do’ supporting principle requires the commission to bring together the experiences and policies of States into a view of ‘the average State’ and then apply those policies to the circumstances of individual

States. Doing this raises significant assessment issues, including at what level of detail such an average should be constructed and how the experiences of different States should be weighted in an average.

Revenue and expense standards

- 19 Staff propose that the commission continue to base revenue and expense standards on population, revenue or service base weighted averages of what States do, rather than simple averages. This approach means continuing to not discount or otherwise adjust standards as a means of more actively encouraging efficiency. A weighted average gives greater weight to States that have a larger share of the weighting variable (population, revenue, expense, service base or tax base).
- 20 The current approach to equalisation equalises States to the average cost of service delivery which incorporates the average level of technical efficiency.² If a State is more efficient than average, its own budget benefits. If a State is less efficient than average, it must finance its inefficient practices itself.

Determining average policy

- 21 Where States follow different policies, the commission exercises its judgment in determining the average policy. If the commission decides a tax is part of what States do, it allows differences in States' underlying capacities to affect GST shares. Under current practices, if the commission decides a tax is not average policy, it treats any revenue raised as above average effort and allows the State to retain the benefit of its additional effort. It does this by assessing the revenue equal per capita.
- 22 When determining whether a particular tax is average policy, the commission's first decision is whether to 'look through' the application of the tax and combine it with another tax. The commission will do this where a tax is sufficiently similar to another State tax. In this case the tax is considered to be average policy and is differentially assessed.
- 23 While it is rarer for one State to provide a service not provided by others, similar considerations apply to determining average policy. The commission attempts to distil the average policy of the States in such a way as to not distort States' decision making. The staged implementation of DisabilityCare Australia and the introduction of the National Education Reform Agreement (NERA) represent examples of service provision where the commission will need to determine average policy. The treatment of these new disability and education reforms are identified in the terms of

² We distinguish between technical efficiency, the production of a given range of services that minimises cost, and allocative efficiency, what particular mix of services would maximise welfare or output. Being based on what States do, our assessments do not incorporate allocative efficiency considerations.

reference as priority issues for the review. They are considered in more detail in Staff Discussion Paper 2013-07 S.

- 24 In the 2010 Review, the commission applied a further test. It considered that the average policy was to impose a tax (or provide a service), where a majority of States does so and it affects a majority of the aggregate tax base (or relevant population). If that threshold was met, the average policy was based on the average observed effective tax rate (or level of spending). Otherwise, any revenues (or expenses) were treated in a way that did not affect State GST requirements.
- 25 Some States have said that a State may be able to influence the determination of whether a particular policy is average policy in cases where the average depends on the number of States applying the policy.
- 26 In this review, staff propose the commission apply a simpler test. Under this approach for revenues, the commission would presume that every tax raised by one or more States — not necessarily a majority and not sufficiently similar to another tax to be included with that tax — is part of the average policy. All States will be considered to have the relevant tax base, with one or more States taxing it at a non-zero rate and the rest at a zero rate. Any revenue raised will be subject to differential assessment. If the subsequent assessment passes the proposed disability materiality test, the revenue raised will impact GST shares. If the revenue raised by even one State is sufficiently large, this is a possible outcome. Otherwise, the revenue will be included in the budget but assessed equal per capita.
- 27 This approach means that to affect GST shares, a tax will need to have large revenues and/or a diverse tax base. We consider that this approach is simpler, more inclusive and less likely to suffer from policy neutrality problems than the test used in the previous review.
- 28 While, as noted above, common State practices in service delivery mean there are few instances where similar considerations apply, staff propose that for expenses, the commission consider whether State spending on a service is materially impacted by State disabilities, regardless of the proportion of service users receiving the service. For example, while the implementation of DisabilityCare Australia will become the dominant policy for delivering disability services, it may not be the only one. Recipients of DisabilityCare services may receive additional State funded services, as might non-recipients. Staff propose that, where an assessment of services would have a material effect on the GST distribution, even if only provided by some States, an assessment should be made.

Staff propose to recommend the commission:

- simplify its approach to determining average policy for revenues, by presuming that every tax imposed by one or more States is part of

average policy and affects State fiscal capacities

- any revenue raised will be subject to differential assessment and impact GST shares where it passes the revised disability materiality test.
- where the assessment of a service, even if only provided by some States, would have a material effect on the GST distribution, the service would be treated as average policy and assessed.

29 The effects of this change are addressed in Staff Discussion Paper 2013-07 S in the chapters on Land tax, Stamp duty on conveyances, Insurance tax and Other revenue (Fire and emergency services levies).

Equalisation of interstate costs on a 'spend gradient' basis

30 The terms of reference ask the commission to investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis, per recommendation 6.4 of the GST Distribution Review report.

31 The spend gradient approach has no support from States, although Victoria considers that a spend gradient should be applied to regional costs, because providing high standards of service in high cost areas undermines national efficiency.

32 Staff propose that the commission not adopt a spend-gradient approach to interstate costs because doing so is inconsistent with HFE.

33 In relation to regional costs, the purpose of the regional costs assessment is to attempt to equalise comparable communities. This means that our assessments assume that all remote communities are funded to the same standard of service. If States do provide lower quality services in higher cost areas (or respond in any other way), we would capture that with our current and proposed approach. Therefore, we reflect a spend gradient to the extent to which it is what States do. The commission does not try to reflect a level of service that should be provided in higher cost remote areas, as it has no basis upon which to make such a judgment.

Staff propose to recommend the commission:

- not adopt a spend-gradient approach to interstate costs, because doing so is inconsistent with HFE.

IMPLEMENTATION ISSUES FOR POLICY NEUTRALITY

34 The intention of this supporting principle is to ensure a State's own policies or choices (in relation to the services it provides or the revenues it raises) do not directly

influence the level of grants it receives. Alternatively, the commission could adopt a policy free approach. This means assessments would be completely free of State influence, for example by adopting an external standard. So, a State's policy would have no influence on determining the average policy.

- 35 If the difference between the average policy and a State's policy leads to increased costs, the State is responsible for funding those additional costs. If the difference leads to reduced costs, the State retains the benefit of those cost savings.
- 36 In the 2010 Review, some States argued the current approach was not policy neutral.
- This was because collectively, the policies of States set the standards. To be policy neutral the standards should be based on what States could do (a concept of policy-free).
 - Also, some States can affect the average policies more than others. The more populous States have a greater effect on setting the average per capita revenues and expenses, States with high mineral production have a greater effect on average royalty rates, States with a large number of Indigenous people have a greater effect on the costs of providing services to Indigenous people, and so on.
 - Lastly, equalisation can create incentives or disincentives for States to make particular decisions or act in particular ways.³ There is some evidence that is consistent with this view, but it could also be explained by other things.
- 37 It is true that some States have a greater influence on setting the average policy. That is because the average policy is a weighted policy and, the more people they have, the more influence they have on the average.
- 38 In practice, State decisions are based on more immediate considerations than the potential effect of equalisation and there is no evidence that State decisions are affected by equalisation considerations. While the commission accepts the potential for assessments to provide incentives for States to make certain decisions, it is not clear that the effects are material or potential solutions are reliable or simple.
- 39 While policy neutrality tends to be spoken about in terms of State policies not influencing their grant shares, it has a second aspect — commission practices should not provide an incentive for States to act in particular ways.

³ For example, they reduce the incentive for a State to promote growth where it has a below average revenue raising capacity, reduce the incentive to improve efficiency of service delivery where it has an above average costs of service delivery, provide incentives for States to over provide services where they have above average costs of service delivery and vice versa, provide incentives for States to over tax revenue bases where they have a revenue raising disadvantage and vice versa, and provide incentives for States to invest resources in identifying disabilities and developing more sophisticated ways of measuring them.

- 40 One State said that policy neutrality is focussed on reducing any immediate effects of State policies, rather than on longer term incentives to vary (or not) behaviours. It said that current circumstances should be recognised as the aggregate outcome of underlying disabilities and past State policies, not just taken at face value. It said that one way to address this issue is to apply a general discount across assessments, particularly the revenue assessments. To operationalise an approach to recognising past policy effects on current revenue bases, the commission would have to develop ways to identify the effect of each State's policies over time on its respective revenue bases. It is not clear that the commission could do this in a reliable and comparable way across States, nor that a general discount would lead to an improved HFE outcome. This is discussed further in the chapter on Mining expenditure in Staff Discussion Paper 2013-07.
- 41 Some States have said that the current treatment of national network roads payments creates a bias for States to seek Commonwealth assistance for road projects over rail projects. Another State said that if infrastructure payments are discounted for HFE purposes, then this would create incentives for States to seek funding from the Commonwealth in capital, rather than recurrent, form. While the majority of States support some form of equivalent treatment for infrastructure projects deemed to be 'nationally significant', there is no general agreement on how such projects should be identified. Further details on the treatment of Commonwealth payments are included later in this paper.

Elasticity adjustments

- 42 The commission assesses revenue capacity by assuming each State applies average revenue policy, including average taxation rates. Economic theory suggests that if State tax rates differ from the average, that difference can affect the level of observed activity and therefore the size of States' tax bases. States imposing above average rates of tax would shrink their tax bases and vice versa.
- 43 Past commissions made elasticity adjustments sparingly. These adjustments were discontinued in the 1999 Review. Table 1 shows the history of elasticity adjustments.

Table 1 History of elasticity adjustments

Review	Petroleum	Tobacco	Mining
1985	-	Adjustment assessed for Queensland only	-
1988	-	Price elasticity of demand of -0.15 for all States	-
1993	Price elasticity of demand of -0.5 for all States	Price elasticity of demand of -0.4 for all States	Tax elasticity of supply of -3 for all States
1999	-	-	Tax elasticity of supply of -3 for all States

Source: Commonwealth Grants Commission, Reports on Research in Progress, 1996, Volume 2, page 283.

- 44 The GST Distribution Review discussed elasticity adjustments. It concluded there may be merit in further investigation by the commission in relation to the impact of tax rates on the size of State tax bases⁴.
- 45 Adjustments for elasticity effects were not made in the 2010 Review. The commission concluded the lack of reliable data and evidence meant an assessment could not be made reliably.
- 46 One State suggested the commission investigate incorporating tax elasticity effects into revenue assessments, to avoid penalising States that undertake tax reform. It believed elasticity effects could have significant impacts. It said tax reform which shifted effort from less efficient to more efficient taxes meant shifting from taxes with high elasticity to those with low elasticity, with a net effect being to increase the overall size of a State's tax base, and thus its revenue raising capacity. Another State said the size of insurance premiums was influenced by States' rates of insurance duty. It said that the disincentive effects of equalisation could only be removed by a new approach that did not rely on category by category assessments. Alternatively, the commission could incorporate tax elasticity effects for insurance using data from the Henry Review (*Australia's Future Tax System*), possibly combined with discounting.
- 47 Staff have examined whether adjustments for elasticity effects can be reliably made and whether they are likely to produce materially different GST distributions.
- 48 Data to reliably quantify elasticity effects on revenue bases continue to be elusive and so we have adopted a more pragmatic approach to estimating whether elasticity effects are likely to be material. We have made simple adjustments to State revenue bases to see how big the adjustments would need to be before a materially different GST distribution would result. It is arguable whether elasticity adjustments are disabilities or data adjustments. We have used the revised data adjustment materiality threshold for this analysis (see the section on Materiality thresholds under Implementation issues for practicality).

⁴ Finding 9.1, *GST Distribution Review Final Report*, October 2012.

- 49 An elasticity factor of -3 implies that a 1% difference in tax rate reduces the assessed revenue base by 3%.
- 50 For payroll tax, a relatively high elasticity factor of -2.5 would be required to produce a material assessment. The economic incidence of payroll tax is thought to fall on employees via reduced wages. There is little data available to indicate how sensitive remuneration levels are to payroll tax rates. While there are many influences on wage levels, the commission's Interstate wages assessment attempts to model the wage levels of comparable employees in different States. If above average payroll tax rates result in lower wages this may be captured in the commission's interstate wage assessment. A comparison of wage levels and legislated payroll tax rates over the past decade does not show a consistent correlation. While New South Wales, the ACT and the Northern Territory have had above average wage levels over the past decade, they have also had above average payroll tax rates. New South Wales has reduced its legislated payroll tax rates (and increased its tax free threshold) since 2007-08, but its relative wage levels have fallen in that time. This may indicate the payroll tax base is either not highly elastic or is subject to complex influences of which tax rates are a minor part.
- 51 Conveyance duty would require an elasticity factor of about -2 to produce a material assessment. As this is around 4 times the size of the effect found by Leigh (2009), staff consider it unlikely that conveyance activity would be this sensitive to duty rates.⁵ Furthermore, there was not a consistent relationship between property transaction levels and another cost factor (interest rates) over time. We conclude an elasticity adjustment is not appropriate.
- 52 We conducted our analysis of motor taxes separately for each of the 3 components — transfer duty, light vehicle registrations and heavy vehicle registrations. For motor transfer duty, an elasticity factor of more than -30 would be required to produce a material assessment. We consider this improbable.
- 53 A different analytical approach was used for the 2 registration components. Registration fees are an annual charge for each vehicle registered and so the current assessment uses the number of registered vehicles in each State. However, this is not a price or cost measure. To estimate elasticity effects, we used the annual running cost of a vehicle (excluding fuel)⁶ as the cost to the consumer that would be affected by the annual registration charge. An elasticity factor of -1.5 for light vehicle registrations and -7 for heavy vehicle registrations would be required to produce a material assessment. We considered sensitivity to registration charges at these levels unlikely given that vehicle ownership is often driven by need, not cost, and owners

⁵ Australia's Future Tax System, Part 2, Volume 1, page 255.

⁶ A figure of \$4 558 was used for a typical light vehicles. This was based on motoring association running cost data. A figure of \$20 000 was used for a heavy vehicle. This was a staff estimate.

have considerable control over other cost factors (vehicle type, purchase price etc), which are likely to have far greater impacts on cost to owners. Concessions offered by States or by retailers of new cars would work to dilute any impact.

- 54 Land tax also required a different approach since land values, not transactions, are used to measure the tax base. Economic theory suggests land tax is capitalised into land values, so land values in States can be influenced by tax rates. We explored the impact of differences in land tax rates based on the degree to which they impact land values through capitalisation of land tax⁷. The analysis also required an assumption about the rate of return expected from investment land. If a 4% rate of return is assumed, about 40% of land tax would have to be capitalised into land values for a material assessment. At 6% rate of return, about 50% of land tax would have to be capitalised into land values. The degree of capitalisation in residential land is likely to be low due to competition with owner-occupiers who do not pay land tax but high for commercial and industrial land. We assumed 20% capitalisation into values for land tax for residential land and 80% capitalisation for commercial land. As commercial land makes up 70% of the land tax base, this implies an overall capitalisation of around 60%. This is at the margins of materiality. We do not consider the case for an elasticity adjustment sufficiently compelling or reliable.
- 55 We were unable to conduct a satisfactory analysis for some revenues. In the case of mining revenue, differences in the grade, accessibility and processing cost of mineral deposits are likely to result in differences in effective royalty rates between States. Those with more profitable deposits are likely to sustain greater royalty levels and vice versa. Hence, a simple analysis of the type we undertook to compare royalty rates between States and adjust for differences from an all-State average was unlikely to give a reliable estimate of elasticity effects. Setting those difficulties to one side, we found a high elasticity was required to make a material assessment — 3 times the level that we assessed in the 1999 Review.⁸
- 56 We were also unable to conduct a satisfactory analysis on insurance taxes. While we observed relatively small differences in legislated tax rates on insurance products between States, effective tax rates calculated using our current revenue base measure and State insurance tax collections showed much larger differences. The simple elasticity analysis we performed relied on the effective tax rate differences. We suspect some or most of the discrepancy between legislated and effective tax rates arises because our tax base measure used in the assessment differs from the actual tax base accessed by some States. We were unable to satisfactorily resolve this

⁷ The adjustment for differences in land tax rates was made using a mathematical formulation from *Removing the effects of interstate tax policy differences from land values* Neil Warren, May 2002. Report commissioned by NSW Treasury. The report was a contribution to the CGC's 2004 Review.

⁸ In the 1999 Review, the elasticity adjustment was a tax elasticity of supply. The adjustment was calculated using the formula: Elasticity adjustment = $\tau(t_s - t_i)$. Where τ was the tax elasticity of supply (assumed to be -3) and t_s and t_i were the average and individual State tax rates.

problem. We consider a more complex approach unjustified given the small amount redistributed by the category in total.

- 57 An elasticity adjustment for the Other revenue category, which is assessed equal per capita, is not relevant since the commission only intends to use it for revenues that should have no GST impact.⁹
- 58 Staff propose that the commission not reintroduce elasticity adjustments in the 2015 Review. We did not find a compelling case for adjusting State revenue bases for the effect of differences in tax rates.¹⁰

Staff propose to recommend the commission:

- not reintroduce elasticity adjustments in the 2015 Review as based on the data available, no compelling evidence could be found for adjusting State revenue bases for the effect of differences in tax rates.

IMPLEMENTATION ISSUES FOR PRACTICALITY

- 59 In this review, the commission is asked to consider specific practicality issues, such as the appropriate materiality thresholds to adopt. In addition, States have raised related issues, for example relating to the use of discounting.
- 60 Most States have said that improving data reliability is the most appropriate way to improve assessments. The commission considers that data reliability and fitness for purpose are its primary considerations. It does not intend to impose materiality thresholds in a mechanical way.

Materiality thresholds

- 61 In its 2010 Review report the commission noted the introduction of materiality thresholds had aided simplification. It said in future reviews the thresholds should at least be indexed to ensure those simplification gains were not eroded over time.
- 62 The GST Distribution Review recommended a further round of simplification by substantially lifting the materiality thresholds, rather than merely indexing them. It

⁹ Either because State population shares are conceptually the best characterisation of capacity to raise revenue, a reliable assessment can't be made or it is not average policy to raise the particular revenue.

¹⁰ The broader issue of whether the size of a State's tax base has been affected by past policy is discussed in the chapter on Mining expenditure in Staff Discussion Paper 2013-07.

recommended thresholds be quadrupled (recommendation 3.1).¹¹ The panel said its recommendation would remove 6 expense disabilities and a revenue category.¹²

- 63 New South Wales said that further analysis is needed to determine the impact of any increase in thresholds and that, to be effective, an increase in materiality thresholds would need to be coupled with measures designed to reduce the number of assessment categories. Queensland said it was not opposed to raising materiality thresholds but considered that a more effective approach would be to focus on both the reliability and materiality of current assessments. Western Australia supported consideration of higher thresholds in the context of developing broader indicators, but not simply to eliminate 'moving parts' in existing assessments.
- 64 Victoria, South Australia, Tasmania, the ACT and the Northern Territory did not support an increase in materiality thresholds. These States generally considered any increase to be arbitrary and not consistent with achieving equalisation.
- 65 Materiality of disabilities was a deciding factor for assessing disabilities in very few cases in the 2010 Review. The incapacity to establish a case and the lack of reliable data were the most common deciding factors in not assessing a disability. In practical terms, even significant increases in the thresholds would have only a marginal impact on the current assessments. In part this is because the current threshold is lower than the impact of the smallest disability. The threshold could rise to \$15 with no impact.
- 66 Staff consider that the commission should set out to constrain complexity and so set thresholds above a business as usual level. Staff therefore propose the commission adopt a \$30 per capita threshold for disabilities. It would represent a significant increase from \$10 per capita and would preserve simplification. Staff propose a corresponding increase in the threshold for data adjustments to \$10 per capita.
- 67 It is disabilities that drive the GST distribution, not how they are grouped and presented in expense and revenue categories. Accordingly staff propose the commission drop the category threshold and redistribution thresholds. This would allow the commission to decide how to present its results to facilitate understanding.
- 68 Table 2 below provides a summary of staff proposals on how the commission should use the materiality guidelines in constructing assessments.

¹¹ The panel recognised the difficulties of assessing the materiality of volatile assessments. It suggested materiality be evaluated over a number of years rather than a single year.

¹² The expense disabilities were the first home owners scheme, cultural and linguistic diversity, natural disasters, urban roads disabilities, water concessions and concessions for water and electricity users on low incomes. The revenue category was Insurance taxes.

Table 2 Summary of use of materiality guidelines for the 2015 Review

Decision	Main criteria	Comment	Threshold
Assessment of Disabilities, including sub-divisions	Assessment guidelines (conceptual case, empirical evidence, suitable method and data, materiality)	Materiality test, GST impact aggregated across categories	\$30
Data set	Fit for purpose, suitable	If decision on data adjustment unclear, or difference likely to be small, use materiality test	\$10
Adjustment to remove a non-taxable part of base or non-users	Data fit for purpose, reliable measure – to better reflect what States can do, need to do	Materiality test required	\$10
Adjustments for policy differences	Policy neutrality, data reliable adjustment	Materiality test of impact of aggregate policy adjustments	\$10
Correction of errors, misclassifications	Should be done	Materiality not relevant, do if can be done reliably	na

Staff propose to recommend the commission:

- increase materiality thresholds for disabilities to \$30 per capita and for data adjustments to \$10 per capita, and to remove the category structure and redistribution thresholds.

- 69 **Materiality threshold for Commonwealth payments.** In the 2010 Review the commission considered (but did not adopt) developing a materiality threshold to apply to Commonwealth payments. A threshold would have meant the commission would not have had to consider numerous small payments.
- 70 There have been an increasing number of National Partnership agreements for small payments since 2008-09. Based on the revenue impact of payments in the 2012 Update, only 28 NPPs (out of 140) would have redistributed more than \$5 per capita for any State; that number would rise to 35 if a threshold of \$2 per capita was used.
- 71 Some minor payments are paid for specific purposes. For example, the payment for Secure schools program to assist at-risk religious, ethnic and secular schools meet their particular security needs (\$6.9 million in 2010-11).
- 72 State views are sought on whether there is an asymmetry in the current approach, with a materiality threshold applied to disabilities, yet even small payments being subject to equalisation. Do States consider that a materiality threshold should apply to Commonwealth payments, and if so, at what level and how should that level be applied? For example, should there be a default treatment for payments below a

materiality threshold (either impacting or not impacting relativities) and should the commission only consider the equalisation implications of payments that exceed the materiality threshold?

State views are sought on:

- whether there is an asymmetry in applying materiality thresholds to disabilities but not to Commonwealth payments
- whether a materiality threshold should apply to Commonwealth payments
 - if so, at what level and how should that level be applied.

- 73 **Rounding relativities.** The terms of reference ask the commission, having regard to the recommendations of the Final Report of the *GST Distribution Review*, to consider the appropriateness of continuing to round relativities to 5 decimal places.
- 74 The Final Report said that the current system of horizontal fiscal equalisation appeared to be overly precise, and that one way to overcome this was to move from specifying relativities at 5 decimal places to specifying them at 2 decimal places (Recommendation 3.2).
- 75 No State supported a reduction in decimal places for relativities. New South Wales agreed that there is false precision in the HFE system. However it said rounding relativities to 2 decimal places would not remove false precision and could produce volatile outcomes in GST shares. Queensland said it would not oppose rounding if it had no material impact. Western Australia said 5 decimal place relativities should be retained, and that rounding could encourage arguments over small changes if they impacted the rounding. Tasmania supported retaining 5 decimal place relativities. It said rounding would have no impact on the underlying calculations but could result in material and arbitrary variations in year on year outcomes in GST shares. The Northern Territory said that 5 decimal place relativities were appropriate, and that rounding would provide minimal gains, if any, in terms of simplicity and perceived views around accuracy.
- 76 Victoria, South Australia and the ACT did not comment.
- 77 An analysis of relativities since the 2000 Update indicates that whereas the cumulative effects of rounding to 2 decimal places would be small, there could be material impacts on the GST distribution in any one year. In contrast, rounding to 3 decimal places made only small (less than \$3 per capita) differences to the GST distribution in any one year, compared with 5 decimal place relativities. As it appears that rounding to 3 decimal places is unlikely to be material (at a \$30 per capita level)

staff propose recommending the commission report its relativities to 3 decimal places.

Staff propose to recommend the commission:

- report relativities to 3 decimal places because this produces GST outcomes that are not materially different to those produced by relativities rounded to 5 decimal places.

Discounting

- 78 In the 2010 Review, the commission chose from a uniform set of discounts when deciding whether a discount was appropriate. Discounting was applied when the commission determined that the data on which an assessment was based was not sufficiently reliable. Through applying a discount to an assessment, the commission signalled that it was confident in the direction, but not the size, of the resulting redistributions arising from the assessment. The less confidence in the outcome of an assessment or the more uncertainty attaching to the information underlying the assessment, the higher the discount it applied.
- 79 Some States have said that the use of discounting is biased, because it acts to reduce the redistribution of GST. These States say the data being discounted may be as likely to underestimate the differences between States as to overestimate. Some States have also said that further bias occurs because discounts apply more frequently to expenses than revenues. As a result, some States call for discounting to be abolished, while others say that its use would be best applied across the board, to better achieve policy neutrality and address general uncertainty.
- 80 While staff accept that lower quality data are as likely to underestimate as overestimate a disability, it is difficult to know how we might determine the direction in which the data are biased. The more frequent discounting on expenses than revenues generally reflects the quality of the data available for respective assessments. We consider discounting in the face of known uncertainty is appropriate as this reduces the impact that the assessment has on the redistribution of the GST. It is used across the board to deal with different degrees of uncertainty – the higher the uncertainty the higher the discount; the lower the uncertainty, the lower the discount, even zero. It is not clear how discounting would increase policy neutrality. A discounted level of a policy influence would remain.
- 81 Staff propose recommending the commission maintain the uniform set of discounts, but review where discounting has been used to ensure that it is still appropriate.

Staff propose to recommend the commission:

- maintain the uniform set of discounts, but review where discounting has been used to ensure that it is still appropriate.

IMPLEMENTATION ISSUES FOR CONTEMPORANEITY

- 82 This principle means equalisation should reflect State circumstances in the year the funds are used, as far as possible. Fully contemporaneous relativities would be based on data for the year they are applied. Since that is in the future, the data would consist of projections of State finances and circumstances and may not be reliable. This principle, therefore, is constrained by the need for reliable data.
- 83 There is a balance between contemporaneity, data accuracy and stability. Most States support some level of stability, or at least not introducing greater volatility (less stability) to the assessments, but acknowledge that the trade-off for greater stability is less contemporaneity. In Commission paper 2013–05, the commission confirmed that it considers the current approach of basing assessments on the average observed data for the last three years provides a balance between approximating conditions likely in the year a recommended GST distribution could be implemented, and addressing practical concerns about data reliability and stability. There is general agreement with this approach among the States, although one State has said that increasing the lag by a year would increase data accuracy, albeit at the cost of reduced contemporaneity.
- 84 The contemporaneity supporting principle makes clear:
- the aim is to equalise States in the year of application, but
 - recognises the only practical approach is to use historical data.

Backcasting

- 85 The commission's methodology uses historical data and so is essentially backward looking. On occasions it will use a 'backcasting' approach to improve the contemporaneity of its methods. Under this approach, it adjusts the historical data for known changes in the application year. This approach is limited to major changes in Commonwealth-State financial arrangements. State policy changes are not backcast. Backcasting is only done when the application year changes are reliably known.
- 86 For example, the 2008 IGA introduced major changes in the distribution of national SPPs, commencing a stepped transition from historical distributions to EPC distributions. The 2010 Review methodology backcast this change into the historical years. We determined the proportion of the payments in the application year that

would be distributed EPC and backcast that proportion into the same payments in each of the assessment years.

- 87 With the introduction of the national health reforms and the national education reform agreement in particular, the distribution of these national SPPs is now moving away from EPC. Following its contemporaneity principle, staff propose the commission continue its backcasting approach, but only if the change is reliably known and material.
- 88 In adjusting for a major change in Commonwealth-State arrangements in relation to the agreement the Commonwealth reached with States in 2006 to abolish certain taxes (following on from an original agreement in 1999 as part of the introduction of GST), the commission experienced some problems. A common abolition schedule was not agreed — each State set its own timetable. In the 2010 Review report the commission said it would adjust State tax bases to make them more comparable and it would base its adjustments on the policies applying in the application year of the relevant inquiry.
- 89 In the 2012 Update, budget announcements suggested a majority of States would no longer collect duty on the sale of some business assets such as intellectual property (non real property) in the 2012-13 year. The commission concluded the average policy was not to apply duty to these transactions and an adjustment was made to the revenue bases of those States collecting the duty in the assessment years. After the update report was published, New South Wales and the Northern Territory reversed their decision to abolish the duty, meaning the average policy was to continue to collect the duty in 2012-13.
- 90 Two States have raised issues with the commission's approach. One said the treatment appeared to run counter to the principle that the circumstances in the historical years would be used to determine the GST distribution in the application year, and to be inconsistent with its treatment of other state revenue measures. It said the commission should only use backcasting in relation to Commonwealth payments, and should ensure that clear and thorough justification is provided for any such backcasting.
- 91 The other said that concurrent equalisation is not achievable and that the commission should aim to achieve equalisation over time. It said that backcasting could lead to a deletion or modification of needs in the assessment years and so limits equalisation over time. Backcasting would not occur under an 'equalisation over time' approach.
- 92 Staff consider that reflecting major changes in Commonwealth-State arrangements in the application year is desirable if the relativities are to give meaningful and contemporary outcomes. States could be considerably over or under equalised in the application year, if such backcasting does not occur. However, on practicality grounds

only large and known changes should be backcast. Our experience suggests that large changes in Commonwealth payment arrangements are reasonably certain, but those involving the phasing out of State taxes, especially where the States can vary the phasing arrangements, less so. Staff consider that the only option for the commission is to base a decision on the best available information on what the circumstances are proposed to be in the application year, bearing in mind the reliability of that information.

Staff propose to recommend the commission:

- continue backcasting major changes in Commonwealth-State financial arrangements, but only if the changes can be made reliably and they are material.

Use of non-annual and lagged data

- 93 The terms of reference ask the commission to consider the use of data which is updated or released annually with a lag, or updated or released less frequently than annually.
- 94 The Final Report of the GST Distribution Review noted the commission often revised data it had used in a previous inquiry. It said there was a range of reasons why the commission might consider revising its data — more recent relevant data become available, to correct errors subsequently discovered, or to address changes in statistical collection methods.
- 95 However the GST Distribution Review expressed concern about the potential for revisions to cause undue volatility in States' GST shares, which could occur if the revision was introduced into more than one assessment year. It focussed its considerations on 2 types of data:
- annual data published with a lag, such as the AIHW morbidity data set that is published with a 2 year lag
 - non-annual data, such as the Census and the ABS Survey of Education and Training data.
- 96 The GST Distribution Review recommendation was:
- Where data are updated or released annually with a lag, or updated or released less frequently than annually, the CGC should allow the newly available data to only inform changes in States' circumstances in the most recent assessment year and not be used to revise previous estimates of earlier inter-survey years (recommendation 3.2).

- 97 New South Wales supported the recommendation. Victoria suggested inserting an extra year's lag into the assessment years¹³, while not being as contemporaneous as the current approach, may be likely to provide a more accurate representation of the financial situation of States. Most States supported the current approach, that assessments should reflect the most reliable and up-to-date data available. The Northern Territory said that there could be instances where use of the latest data highlights a deficiency in an assessment (for example where the latest population data are used but do not necessarily align with service user administrative data).
- 98 Implementing the GST Distribution Review recommendation would mean that lagged data and non-annual data would be introduced in the year they became available, but they would not be used to revise the corresponding data in earlier assessment years. Thus, under this approach, data are phased in and phased out. A new data set would be used until its replacement became available. For example, new 2011 Census data would be introduced into 2011-12 year and remain until 2016 Census data became available. The 2011 Census data would not be used to revise assessments prior to 2011-12. They would continue to be based on 2006 Census data.
- 99 The GST Distribution Review approach takes a longer term view, of equalisation being achieved if data are phased in and phased out, even if its impact is not synchronised with the period to which the data relate. This approach is consistent with the concept of equalisation over time.
- 100 However, the commission's view, and the purpose of the contemporaneity principle, is that it is trying to achieve equalisation in the year of application. Under this approach, the latest available data best reflects States' circumstances in the year of application, unless it were in some way compromised, reflecting temporary influences.
- 101 Staff consider there are 2 arguments against the GST Distribution Review approach. First, it would mean data are not aligned with other data from the same period and this could have grant implications. Second, it is hard to conclude that the commission should not revise data to correct errors. In the 2013 Update, the commission revised State populations in all years because of an intercensal error with the 2006 Census. It did this because it believed the previous (2006 Census based) State populations did not reflect the demands being experienced by States. The recommended approach would have led the commission to change one year and leave the error in the other two years.
- 102 The commission aims to achieve equalisation in the year of application and, thus, staff propose to recommend to the commission that it continue to use data which best reflect States' likely circumstances in that period.

¹³ So for example, the assessment years for the 2013 Update would be 2008-09 to 2010-11, not 2009-10 to 2011-12 as per the current approach.

Staff propose to recommend the commission:

- continue to use data which best reflect States' likely circumstances in the year of application.

A GLOBAL REVENUE ASSESSMENT

2010 Review approach

103 The commission did not adopt a global revenue approach in the 2010 Review, because it concluded a global assessment that went beyond the legal basis of State taxes would not be a reliable indicator of State fiscal capacities.

State views

104 Some States advocated a global revenue assessment because it would:

- be simple
- be less policy contaminated (because it would not be tied to how States raise taxes)
- remove disincentives (to either tax reform or tax compliance) and grant design inefficiencies
- capture the capacity of the community to pay taxes.

105 States proposed a range of global indicators, including Equal Per Capita, Household Disposable Income, and adjusted Gross State Product.

Issues and analysis

106 Staff accept the advantages of a global approach are that it is likely to be simpler and less policy contaminated than a tax by tax approach. However, our concerns with a global approach are:

- Equalisation is about the capacity of States to raise taxes rather than the capacity of communities to pay taxes.
- States cannot tax global revenue bases in reality. Tax by tax assessments reflected how States actually raise revenue; they are more consistent with the 'what States collectively do' supporting principle.
- Revenue raising disabilities differ for different taxes. Revenue bases that reflect legislative basis are better able to capture these differences than a global assessment.
- There are theoretical and data problems with global assessments; for instance, the aggregate measure of State production or income do not allow for

differences in industry structure, income distribution, wealth or ability to export tax bases.

- 107 We think the advantage of a tax by tax approach is it is focussed on the legislative bases available to States and it reflects how they actually raise revenue, whereas a global revenue assessment is focussed on the community's underlying capacity to pay. By capturing the activities States are legally empowered to tax and are actually taxing, we consider a tax by tax approach better reflects what States collectively do.
- 108 In addition, we have concerns about whether the global indicators proposed by States capture a community's underlying capacity to pay. Most of the proposed measures do not allow for differences in the ability to export tax bases to non-residents, differences in wealth, income distribution and structural differences in State economies. They would produce a very different measure of States' revenue capacities compared to a tax by tax approach.
- 109 Staff consider the supporting principle 'what States collectively do' requires the commission to reflect on how States raise taxes. States are not able to overcome the legal and other practical constraints on their taxing powers. Staff do not consider a global assessment that goes beyond the legal basis of State taxes to be a reliable indicator of State fiscal capacities.

Staff propose to recommend the commission:

- not adopt a global revenue assessment for the 2015 Review because a tax by tax approach better captures States' revenue capacities.

BROAD INDICATOR ASSESSMENTS

2010 Review approach

- 110 The terms of reference for the 2010 Review asked the commission to consider the use of more general indicators of revenue capacity.
- 111 Unlike global indicators, broad indicators remain focussed on the activities States are legally empowered to tax. A broad indicator emphasises the potential revenue base, whereas a tax by tax approach is focussed on the taxable part of the potential revenue base. Broad indicators do not focus on how States access their tax bases; they would not have adjustments for exemptions, thresholds or progressive rates of tax.
- 112 In the 2010 Review, the commission decided not to use broad revenue indicators. It continued to assess revenue capacity by measuring the taxable part of potential

revenue bases, because it concluded that it provided a better measure of States' fiscal capacities.

- 113 Consequently, the commission continued to make adjustments for differences in progressive tax rates by applying an average of the exemptions, thresholds and rates in all States. It made such adjustments only when it considered an adjustment was warranted, it had a material impact on the GST distribution, reliable data were available, and it was not unduly complex.

State views

- 114 Some States expressed concerns about the policy contamination of existing revenue bases and suggested the commission could simplify revenue assessments and reduce policy contamination by exploring revenue bases based on the potential legal tax base.

Issues and analysis

- 115 Staff accept that broader indicators are likely to be simpler and less policy contaminated than a tax by tax approach.
- 116 While the commission's objective is equalisation, the terms of reference provide it with discretion on the methodologies it can use to implement equalisation. It allows the commission to explore broader measures of revenue capacity, particularly if they lead to simpler or less policy contaminated assessment methods.
- 117 At one level, a State decision to have a tax free threshold is a policy choice. Thus, the commission could include the payrolls of small firms in its revenue base, even though no State raises revenue from them. We consider the supporting principle 'what States collectively do' requires the commission to reflect on how States raise taxes. States cannot overcome the legal and other practical constraints on their taxing powers. For example, the ACT has higher than average incomes, but it cannot directly tax those higher incomes. It can only indirectly access those higher incomes to the limited extent its legal payroll tax base allows it to do so.
- 118 Staff propose the commission use the broadest possible indicator that is consistent with the legal tax base and what States collectively do. If exemptions, thresholds and progressive rates reflect what States collectively do and if they are material, then staff consider they should be taken into account in the commission's assessment of fiscal capacity. In such cases, staff think a potential tax base measure that did not take them into account would not be a reliable indicator of State fiscal capacities.

Staff propose to recommend the commission:

- use the broadest possible indicator that is consistent with the legal tax

base and what States collectively do

- continue making adjustments for differences arising from progressive tax rates, exemptions and thresholds if they reflect what States collectively do and the adjustments would be material.

TREATMENT OF COMMONWEALTH PAYMENTS

- 119 The terms of reference provide guidance to the commission on the treatment of Commonwealth payments. They require the commission to:
- ensure that some specified payments (usually referred to as quarantined payments), including all reward payments, have no impact on the GST distribution
 - treat national SPPs, national health reform funding, National Partnership (NP) project payments and general revenue assistance (GRA), other than the GST, so that they would affect GST shares, but treat facilitation NP payments so that they would not
 - the commission is given discretion to vary the treatment where it is appropriate, ‘reflecting the nature of the payment and the role of State government in providing services’.
- 120 From an HFE perspective, Commonwealth payments provide States with financial support to provide services either directly, or indirectly through the acquisition of infrastructure. As such the receipt of these payments should be taken into account when determining a distribution of GST revenue which would achieve HFE.
- 121 Conceptually all Commonwealth payments which impact on State finances should be included within the commission’s processes. However in practice the commission will only consider those transactions which are readily identified (in scope payments). This covers transactions classified as payments direct to State Treasuries, but other transactions of an indirect nature may not be identified. For example, transactions where the commonwealth delivers a service in a State, which relieves the State of the need to provide that service, are difficult to extract from the general run of Commonwealth purchases.
- 122 However not all these payments should affect the GST distribution. The GST distribution is designed to offset the measured financial consequences of differences among States in the provision of average services. If Commonwealth payments can be used to offset those consequences the payments should affect the GST distribution. They should not affect the GST distribution if the payments are used to address differences that the commission does not take into account in its calculations.
- 123 Therefore, staff propose the commission decide the treatment of all in scope payments on a case by case basis using the following guideline:

payments for usual State functions and for which expenditure needs have been assessed, including a deliberative equal per capita assessment, will impact the relativities.

- 124 Examples of payments which would not impact on the relativities include:
- payments specified in the terms of reference that they should not affect the relativities (for example, reward payments under national partnership agreements)
 - payments to fund a purchase by the Australian Government (for example, funding for essential vaccines for immunisation) which does not impact on fiscal capacities.
 - payments through the States to local government or other third parties where the payment does not influence State fiscal capacities (for example, payments to non-government schools)
 - payments for which expenditure needs have not been able to be assessed by the commission (for example, payments for the Secure schools program that assist at-risk religious, ethnic and secular schools meet their particular security needs).
- 125 Making judgments about payments which fall into these classes, except those specified by the terms of reference, can be difficult. It might be argued that any payment to a State, even if it is through the State, has an impact on State fiscal capacities, unless it is clearly for a Commonwealth function. The assistance the Commonwealth provides to local government or other third parties might be said to reduce assistance that the States need to provide. Making judgments about whether needs have been assessed is also fraught. Do relatively broad indicators, such as the population in remote areas, mean that all needs have been assessed for remote area service provision or that they have not been assessed for specific Indigenous service provision in remote areas? Staff consider that the commission can only examine all relevant information relating to each program, take advice from States, and make a judgment.
- 126 These examples of the types of payments that staff now consider should not impact on the relativities, excludes 'programs implemented at the behest of the Australian Government and which lead to above average or unique state outcomes'. In the 2010 Review, the commission decided that such payments, designed to deliver a unique outcome or to produce an above average outcome, should have no effect on the GST distribution. One State said this guideline is not functioning effectively.
- 127 It is difficult for the commission to distinguish these payments from others, particularly if they relate to normal State functions. Payments for programs implemented by the Australian Government which it wants to result in unique, or above average, outcomes after equalisation, should be identified in the commission's terms of reference. On that basis, we have excluded them as an example of the types of payments which should not impact on the relativities.

- 128 Beyond the general guidelines listed above, the treatment of Commonwealth payments associated with transport infrastructure (or ‘nationally significant’) projects is being considered as part of the development of a new transport infrastructure assessment, which is a priority issue under the terms of reference. This issue is addressed in Staff Discussion Paper 2013-07 S.
- 129 In addition to deciding how to treat an individual payment, the commission also needs to consider the distribution of the payment among the States. This should be considered from the perspective that the actions of individual States should not affect the payment that it receives.
- 130 For the majority of payments this is an easy exercise. Payments are determined mechanistically and individual States have no influence on what they receive. Historically, when national SPPs were moving to an equal per capita distribution, they fell into this class of payment.
- 131 However the commission has dealt with other types of payment. When Western Australia delayed receipt of Health reform payments the commission attributed the delay to its policy decision (the other States having agreed to the reform and additional funding) and treated Western Australia as if it had received the additional funding for the purpose of determining its GST share.¹⁴
- 132 The appropriate HFE treatment of payments resulting from major Commonwealth State reform agreements will be determined by the commission on a case by case basis. Intrinsic to this determination is that commission methods should not provide States with incentives to adopt particular policies, for example by receiving additional GST revenue for below average service provision. In the end, it might be impractical to decide how to make a reliable adjustment, with the result that no, or only a partial, adjustment would be made to the revenues States received.

Staff propose the commission:

- decide the treatment of all in scope payments on a case by case basis using the following guideline:
 - payments for usual State functions and for which expenditure needs have been assessed, including a deliberative equal per capita assessment, will impact on the relativities
- provide examples of the types of payments that would not impact on the relativities, such as:
 - payments specified in the terms of reference that they should not affect the relativities

¹⁴ CGC, *Report on GST Revenue Sharing Relativities — 2011 Update*, page 47.

- payments to fund a purchase by the Australian Government
- payments through the States to local government or other third parties where the payment does not influence State fiscal capacities
- payments for which expenditure needs have not been able to be assessed by the commission.

ASSESSMENT GUIDELINES

- 133 Staff propose the commission again adopt assessment guidelines for this review.
- 134 The purpose of the assessment guidelines used in the 2010 Review was to achieve consistent and appropriate standards in the development of categories and the assessment of disabilities. They also aimed to achieve greater transparency and simplicity.
- 135 The guidelines also formed a key part of the quality assurance process. They allowed the commission to be confident that all relevant steps in the decision making process were followed. They allowed external parties to follow the decision processes used by the commission and to form conclusions about whether due process was observed.
- 136 Compared with the 2010 Review guidelines, reflecting that this is not a clean slate review, staff propose that guidelines relating to scope and structure be removed, along with some other minor changes. While the guidelines will be used to inform the commission's decision making processes, the commission will retain the right to exercise judgment if it has good reasons for not following the guidelines. Such reasons will be provided to States. A copy of the proposed Assessment guidelines is included at Attachment A.

SUMMARY OF STAFF PROPOSALS IN RELATION TO GST DISTRIBUTION REVIEW RECOMMENDATIONS INCLUDED IN THE TERMS OF REFERENCE

In relation to the GST Distribution Review recommendations included in the terms of reference for its consideration, staff propose to recommend the commission:

- in response to recommendation 3.1, increase materiality thresholds for disabilities to \$30 per capita and for data adjustments to \$10 per capita, and to remove the category structure and redistribution thresholds.
- in response to recommendation 3.2, report relativities to 3 decimal places because this produces GST outcomes that are not materially different to those produced by relativities rounded to 5 decimal places.
- in response to recommendation 6.2, continue to use data which best reflects States' likely circumstances in the year of application.
- in response to recommendation 6.3, retain the 2010 Review approach of equalising State net financial assets per capita and recognising needs for infrastructure and net financial assets directly and immediately, rather than changing to the simplified and integrated approach or other holding cost approaches.
- in response to recommendation 6.4, not adopt a spend-gradient approach to interstate costs, because doing so is inconsistent with HFE.

SUMMARY OF OTHER STAFF PROPOSALS

Staff propose to recommend the commission:

- simplify its approach to determining average policy for revenues, by presuming that every tax imposed by one or more States and deemed not to be sufficiently similar to another tax, is part of average policy and affects State fiscal capacities
 - any revenue raised will be subject to differential assessment and impact GST shares where it passes the revised disability materiality test.
- where the assessment of a service, even if only provided by some States, would have a material effect on the GST distribution, the service would be treated as average policy and assessed.
- not reintroduce elasticity adjustments in the 2015 Review as based on the data available, no compelling evidence could be found for adjusting State revenue bases for the effect of differences in tax rates.
- maintain the uniform set of discounts, but review where discounting has been used to ensure that it is still appropriate.
- continue backcasting major changes in Commonwealth-State financial

arrangements, but only if the changes can be made reliably and they are material.

- not adopt a global revenue assessment for the 2015 Review because a tax by tax approach better captures States' revenue capacities.
- use the broadest possible indicator that is consistent with the legal tax base and what States collectively do.
- continue making adjustments for differences arising from progressive tax rates, exemptions and thresholds if they reflect what States collectively do and the adjustments would be material.
- decide the treatment of all in scope payments on a case by case basis using the following guideline:
 - payments for usual State functions and for which expenditure needs have been assessed, including a deliberative equal per capita assessment, will impact on the relativities.
- provide examples of the types of payments that would not impact on the relativities, such as:
 - payments specified in the terms of reference that they should not affect the relativities
 - payments to fund a purchase by the Australian Government
 - payments through the States to local government or other third parties where the payment does not influence State fiscal capacities
 - payments for which expenditure needs have not been able to be assessed by the commission.

SUMMARY OF STATE VIEWS SOUGHT

State views are sought on:

- whether there is an asymmetry in applying materiality thresholds to disabilities but not to Commonwealth payments.
- whether a materiality threshold should apply to Commonwealth payments
 - if so, at what level and how should that level be applied.

ATTACHMENT A

ASSESSMENT GUIDELINES

- 1 The commission organises its work by making assessments for individual categories.
- 2 The commission will include a disability in a category when:
 - A presumptive case for the disability is established, namely:
 - a sound conceptual basis for these differences exists and
 - there is sufficient empirical evidence that differences exist between States in the levels of use and/or unit costs in providing services or in their capacities to raise revenues.
 - A reliable method has been devised that is:
 - conceptually rigorous (for example, it measures what is intended to be measured, is based on internal standards and is policy neutral)
 - implementable (the disability can be measured satisfactorily)
 - where used, consistent with external review outcomes.
 - Data are available that are:
 - fit for purpose — they capture the influence the commission is trying to measure and provide a valid measure of States' circumstances
 - of suitable quality — the collection process and sampling techniques are appropriate, the data are consistent across the States and over time and are not subject to large revisions.
 - Data will be adjusted where necessary to improve interstate comparability. The commission will not make data adjustments unless they redistribute more than \$10 per capita for any State.
 - Where a case for including a disability in a category is established but the commission is unable to make a suitable assessment of its impact, the options are:
 - to discount the impact that has been determined
 - to make no assessment.
- 3 The option chosen will reflect the specific circumstances of the assessment. It will depend on:
 - the particular concerns about the assessment
 - the strength of the conceptual case for assessing the category or the disability
 - the reliability of the method and data

- the sensitivity of the assessment to the data used, measured in terms of the likely impact on State revenue shares of an error in the data
 - consistency with State circumstances.
 - When the assessment is to be discounted, a uniform set of discounts is used, with higher discounts being applied when there is less confidence in the outcome of the assessment or more uncertainty attached to the information. The discounts are:
 - 12.5 per cent, if there is not full confidence about the size of an effect because of a low level of uncertainty around the information on which it is based
 - 25 per cent, if there is a medium level of confidence about the size of an effect or a medium level of uncertainty about the information
 - 50 per cent, if an effect on States is known to be large and there is confidence about its direction but there is limited confidence in the measurement of its size due to a high level of uncertainty in the information
 - if there is little confidence in the direction of an effect or its size, no differential assessment would be made.
- 4 The commission will include the disability in its final assessments if:
- it redistributes more than \$30 per capita for any State in the assessment period (the materiality test will be applied to the total impact the disability has on the redistribution of funds across all revenue or expense categories in which it is assessed)
 - removing the disability has a significant impact on the conceptual rigor and reliability of assessments.
- 5 The disability may not be assessed in a category, if the amount redistributed in that category is small.