



Australian Government

Commonwealth Grants Commission

Occasional Paper

No 1: Impact of the COVID-19
pandemic on GST distribution

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Summary

The economic downturn resulting from the COVID-19 pandemic, with significant variation in the economic performance of the states and territories, along with a substantial reduction in the GST pool, may raise issues for the distribution of GST receipts among the States. The issues may include:

- Gaps between assessed and actual fiscal circumstances of the States and, in turn, gaps between a State's GST needs and the GST it receives in a given year. However, any change in the timing of assessments to reduce such gaps may introduce additional volatility in GST distributions.
- Whether a reduction in a State's fiscal capacity as a consequence of the pandemic is in part a consequence of its own policy decisions rather than an event beyond its control. It may, however, be very difficult for the Commonwealth Grants Commission to assess and decide the extent to which this is the case.

Introduction

The COVID-19 pandemic has caused many deaths, stretched health facilities, resulted in volatility in financial markets and led to a significant reduction in economic activity.

The pandemic has had an unprecedented impact on the global economy, with Australia not immune, notwithstanding that it performed relatively better than many economies.

The Australian economy fell by 7% in the June quarter 2020, the largest fall in Gross Domestic Product since quarterly measurement began in 1959. The previous largest quarterly fall was 2% in the June quarter 1974. The economy subsequently grew by 3.3% in the September quarter 2020.

The economic fallout from the pandemic has affected all states and territories (States), though the magnitude of the impact varies.

The decline in State Final Demand in the June quarter 2020 was around 8.5% in New South Wales and Victoria, 8% in Tasmania, just over 6% in Queensland, South Australia and Western Australia, a 5% decline in the Northern Territory and just under 2% in the Australian Capital Territory.

In the September quarter, State Final Demand grew strongly in most States. With a longer lockdown in Victoria from July 2020, while other States progressively opened, its economic activity continued to decline in the September quarter, although at a much slower rate than in the June quarter.

The combination of an unprecedented and sudden negative economic shock and the prospect of significant variation in the economic performance of States may raise issues regarding the distribution of the GST pool which is undertaken in Australia consistent with horizontal fiscal equalisation.

This paper provides an overview of some of the possible implications of the pandemic for State GST distributions. It starts by providing context on the objectives of equalisation and how the system works, then discusses, in general terms, the channels through which an economic shock can affect equalisation. The paper then explores lessons from past events, including the global financial crisis (GFC), natural disasters and mining booms before canvassing the COVID-19 pandemic. The final section outlines the process for considering changes to the GST distribution.

Objectives of fiscal equalisation and how it works.

The Commonwealth Grants Commission (Commission) provides recommendations to the Commonwealth Treasurer for the distribution of the national pool of GST revenue among the States in a way that achieves horizontal fiscal equalisation.¹

Underlying fiscal equalisation is the notion that Australians should have the potential to access a similar level of State services while facing a comparable State tax burden regardless of where they live. This is achieved by distributing the GST pool to equalise the fiscal capacities of States. The objective of horizontal fiscal equalisation in Australia is comparable to the aim of equalisation in other federations.

The Commission expresses recommendations for the distribution of the GST pool in terms of State relativities.

A State's relativity expresses the per capita GST grant it should receive to equalise fiscal capacities, as a proportion of the per capita grant it would receive if the pool were distributed on an equal per capita basis. It is not the proportion of each dollar contributed by a State that is returned to the State through equalisation, as sometimes claimed.²

Box 1 below provides a summary of how the Commission assesses the fiscal capacity of the States in order to calculate their GST needs consistent with fiscal equalisation.

In particular, the Commission assesses the extent there are circumstances outside the control of a State that affect its capacity to raise revenue with the same effort of all States and/or the amount a State has to spend to deliver the average level of services provided by all States.

The Commonwealth Treasurer determines the scope and timing of reviews by the Commission, in consultation with the States, of the methods it applies to assess the fiscal capacities of the States and their GST needs.

The Commission assesses States' GST needs based on the average spending and revenue policies of all States. It makes no judgements about what State spending and revenue policies should be but bases its assessments on 'what States do'. The averages vary over time due to underlying changes in State policies.³

The Commission also aims to ensure that its assessment of the GST needs of the States is policy neutral and is not affected by or influences individual State policy choices. With assessments of fiscal capacity based on the weighted average policy of all States, in theory an individual State's policy choices can have an impact on the average policy of all States and hence relativities.

Overall, however, an individual State's policy choices will only have a small impact on the average policy of all States. The exception is if a State dominates a particular revenue base, as in mining. In such a situation, the taxes or royalties the State imposes will materially influence the average tax rate and hence relativities.⁴

Since 2010, assessments of State fiscal capacities in a given application year have been based on an unweighted average of relativities for the three years immediately preceding that year. In large part this is to ensure that the most reliable data is used. Consequently, there is a lag between the assessment of States' fiscal capacities and the distribution of GST revenue in an application year.

¹ The Commission is subject to the framework set up by the Commonwealth in consultation with the States.

² It is not possible to calculate this proportion as there is no official data on GST collections by State. As well, many companies reporting GST liabilities headquarter in one State but operate in many jurisdictions.

³ The use of weighted averages means that States with larger shares of the national population, such as Victoria and New South Wales, have a bigger influence on the averages (benchmarks) that States are compared against to determine fiscal capacities.

⁴ Commonwealth Grants Commission (2018), *Improving the Policy Neutrality of the Mining Revenue Assessment*, Staff Discussion Paper, 2020 Review https://www.cgc.gov.au/sites/default/files/improving_the_policy_neutrality_of_the_mining_revenue_assessment.pdf?acsf_files_redirect.

For example, the Commission's recommendation for the distribution of GST in 2019–20 is based on the assessment of States' fiscal capacities and relativities averaged over the years 2015–16, 2016–17 and 2017–18. By using the most robust and reliable data available, the Commission avoids subsequent

large-scale adjustments for data revisions. An additional advantage of using 3-year averaging for State budgeting is that volatility in the GST distributions is smoothed over time. States have consistently argued that this is helpful to them in terms of budgetary planning.

Box 1: How the Commission assesses State GST needs in line with horizontal fiscal equalisation

To appreciate how an event such as the pandemic might affect horizontal fiscal equalisation (that is, equalisation horizontally across all States), it is necessary to understand how equalisation works. It can be explained in terms of the 'steps' the Commission goes through to calculate a State's relativity. These steps are described sequentially below but in fact the Commission undertakes them all at the same time. They make up the moving parts of the fiscal equalisation system.

An important step is to estimate each State's assessed expenditure. This is the total amount a State needs to spend on recurrent programmes and infrastructure in order to achieve an all-State average level of service provision. A State's assessed expenditure can be above or below this average, in per capita terms, because of costs arising from economic, social, demographic and other characteristics of the State beyond its control. A State's assessed spending is to be distinguished from its actual spending.

The Commission also calculates each State's assessed own-source revenue. To derive this, it calculates, for each State tax base, a weighted average tax rate across all States. The Commission then applies this average rate to each base in a State to estimate the revenue it could raise from that base if it makes the average tax effort. Summed across bases this yields a State's total assessed own-source revenue. This is the total revenue it could raise from its own tax bases with an average tax effort. This too is to be distinguished from its actual revenue.

The final step is to estimate using an analogous approach a State's assessed net borrowing. This is the amount it can borrow at average effort taking account of factors beyond its control.

Once these elements are constructed the Commission adds together each State's assessed revenue, assessed net borrowing and other non-quarantined grants it receives from the Commonwealth. This sum is deducted from the State's assessed expenditure to derive its GST *requirement*. This is the funding a State requires from the GST pool to give it the fiscal capacity to provide the average level of service provision while making the average tax effort.

If each State receives its GST requirement fiscal capacities will be equalised. The equalisation process also raises the fiscal capacities of all States as the GST distribution process is a revenue sharing arrangement. For this reason, GST requirements are positive for all States.

A State's relativity is simply its GST requirement per capita as a proportion of the per capita amount it would receive if the GST pool were allocated on an equal per capita basis. If a State's relativity exceeds one this means that to fund its assessed expenditure it requires more than its equal per capita allocation from the GST pool. Similarly, a relativity of less than one implies that a State requires less than its per capita allocation from the GST pool to fund its assessed expenditure. A relativity of one implies that a State only requires its equal per capita share of the GST pool in order to achieve horizontal fiscal equalisation.

How economic shocks can affect fiscal equalisation

Generally, economic shocks can affect efforts to achieve fiscal equalisation by changing the size of the GST pool and altering average State revenue and expenditure policies (what States do). They can also have implications for policy neutrality, the timeliness of assessments of fiscal capacity and the volatility of GST distributions.

Size of the GST pool

An economic event that reduces economic activity can reduce the size of the GST pool. If the impact on the pool is sufficiently large it is conceivable that the funds available would be insufficient to raise and equalise fiscal capacities. It is not expected that this will happen as a result of the pandemic.

The 2020–21 Budget reported that since the 2019–20 Mid-Year Economic and Fiscal Outlook (MYEFO), GST receipts have been revised down \$7.8 billion in 2020–21 and by \$21.2 billion in the four years to 2023–24.

An overall decline in GST receipts will not of itself change the relative distribution of the pool between the States. However, State relativities will be applied to a smaller GST pool so the extent to which horizontal fiscal equalisation raises the fiscal capacity of all States will be diminished even if the achievement of equalisation is still possible.

What States do

The Commission's assessments of what States do may change if the impact of an economic shock varies across States and this leads to different policy responses. The concept of average or common policy may be stretched. There may also be changes in Commonwealth-State responsibilities.

Policy neutrality

Variations in the impact of a shock on the economic performance of the States may reflect the different circumstances of each State rather than policy differences.

Individual State policy choices should not have a significant impact on GST distributions. However, if the magnitude of the impact of a shock on the economic circumstances facing a State reflected the policy choices of that State, there may be a case for this to be taken into account in determining GST distributions, although this may be challenging.

Timeliness of assessments of fiscal capacity (contemporaneity)

The lag between the assessment of a State's fiscal capacity and the distribution of GST revenue can result in a gap between a State's actual fiscal circumstances in a year and the GST distribution it receives in that year.

The lag between the assessment of fiscal capacity and States' economic circumstances can amplify the volatility of a State's finances as a result of a sudden shock. For example, in the case of a State experiencing a more pronounced negative economic shock than other States, it would receive less GST than it is assessed to need as its fiscal capacity deteriorates, and more GST than it is assessed to require as its economy recovers. It is the reverse impact for States less affected by the shock. However, the 3-year average assessment of fiscal capacities reduces the volatility in GST revenue for the States that are unaffected or less affected by the economic event. The result could be termed a 'swings and roundabouts' approach to matching States' GST shares with their fiscal capacities.

How previous economic shocks have affected fiscal equalisation

Australia's fiscal equalisation arrangements have responded to three recent economic shocks.

Global financial crisis

While the GFC resulted in many major economies experiencing their deepest recessions since the Great Depression in the 1930s, the Australian economy did not experience a large economic downturn or a major financial crisis. Australia did not go into recession, although the pace of economic growth did slow significantly, the unemployment rate rose sharply and there was a period of heightened uncertainty.

The negative effect of the GFC did reduce consumer expenditure and resulted in a 4% decline in GST receipts in 2008–09, although receipts increased by 9.2% in 2009–10.

The impact of the GFC was broadly uniform across State economies. The most significant influence on States' GST relativities in the wake of the GFC was the mining boom which significantly increased the fiscal capacity of Western Australia (discussed below).

It is fair to say that though the GFC was a significant world economic event it did not have major implications for horizontal fiscal equalisation in Australia, largely because there was not a significantly differential impact on States' economies and hence their relative fiscal capacities.

Natural disasters

States can be significantly affected by natural disasters. Between 2009 and 2014, Queensland experienced a succession of tropical cyclones that adversely affected its revenue raising capacity (destruction of infrastructure and facilities) and increased its assessed expenditure (replacing and repairing infrastructure and spending on emergency services).

Some of the expenditure repairing infrastructure was funded by Commonwealth grants that were quarantined from assessments of GST relativities. Similarly, other States were adversely affected by bushfires in the summer of 2019–20.

The Commission assesses natural disaster expenses based on actual State net expenses under the Disaster Recovery Funding Arrangements (this is a joint Commonwealth-State cost sharing arrangement designed to alleviate the fiscal burden on States from a natural disaster).

While there are some policy differences in State natural disaster expenditure, spending under the Disaster Recovery Funding Arrangement is considered the best available proxy of a policy neutral indicator of need.

The result is that the GST requirement and relativity of a State experiencing a natural disaster are adjusted upwards primarily because its assessed expenditure increases while assessed own-source revenue may fall.

Part of the increase in spending and fall in tax receipts as a result of the disaster is effectively shared across other States through a reduction in their GST shares.

As natural disasters are usually focussed in specific States and are staggered through time, they have so far not had a major impact on relativities.

The mining boom

Successive mining booms have had more substantial impacts on fiscal equalisation. After 10 years of strong growth in mining construction, Western Australia's actual revenue from mining royalties peaked in 2013–14 and declined for a number of years

thereafter.⁵ The fiscal consequences of this boom flowed through the equalisation process.

This experience offers lessons pertinent to the pandemic. During the upturn phase of the mining boom gaps opened between States' actual fiscal circumstances in an application year and what they were assessed to be.

For Western Australia, assessed own-source revenue in each application year during the upturn was substantially less than its actual own-source revenue. As a result, Western Australia's GST requirement exceeded by a considerable margin what it would have been if fiscal equalisation had been more contemporaneous.⁶

Conversely, the assessed revenues of the other States were larger than if fiscal equalisation had been more contemporaneous, implying smaller GST requirements than otherwise (though this effect was spread across seven States so it was not particularly noticeable for any one jurisdiction).

In the downward phase, the opposite happened. Again, this was most acute for the boom State. The Commission assessed Western Australia's own-source revenue in each application year to be greater than its actual revenue.⁷

As a result, GST requirements calculated during the downturn for Western Australia were less than under a more contemporaneous process. All the other States were assessed to have GST requirements exceeding what they would have been under a more contemporaneous approach.

The result was that horizontal fiscal equalisation over-equalised the boom State in the upturn (under-equalising the other States) and under-

equalised it on the downturn (over-equalising the other States).

This is a consequence of using a 3-year lagged moving average to smooth the fiscal effects of an economic shock on the relativities and GST payments.

Assessments closer to the application year would have reduced the lag between the assessment of fiscal capacity and GST payments at the cost of greater volatility in relativities.

The outcome here is that using a 3-year moving average to smooth volatility in GST relativities may result in gaps between assessed and actual circumstances before the smoothed series catches up with actual data but this can be viewed as a matter of swings and roundabouts. It can be argued that the appropriate degree of fiscal equalisation is achieved over time.

Of course, the presence of such gaps during the downturn and upturn of a cycle can lead to criticism of the equalisation process, as proved to be the case during the mining boom.

During this period, the Commission deemed that Western Australia followed the average economic development policies of all States. The implication is that all its actual mining revenues were equalised. While this was considered the appropriate approach, there was also the practical difficulty of sorting out policy influences in the successive mining booms relative to the fact that mineral deposits are located in particular States and this is beyond a State's control.

The position taken by the Commission was that the mining boom was an external shock and Western Australia followed average policy.

⁵ Western Australia's actual revenue from mining royalties peaked in 2013-14. Revenues subsequently came off this peak for a number of years, before surpassing it in 2018-19 and going higher again in 2019-20.

⁶ Contemporaneous refers to calculating assessed revenue and expenditures in an application year by using the data from the immediately preceding year. Strictly speaking this is not fully contemporaneous but is as close as can realistically be achieved without resorting to forecasts of the application year.

⁷ This occurred over a 3-year period, from 2015-16 to 2017-18 (the period for which the 2013-14 peak royalty year was included in the assessments).

The COVID-19 pandemic

The economic consequences of the pandemic have been sudden and of a much larger scale than previous economic shocks experienced this century.

It has had an immediate and significant impact across all States on both their expenditure needs and revenue sources. However, the negative economic impact on some States may be significantly larger than others.

In terms of expenses, States have announced new spending initiatives in response to the pandemic in all expense categories, particularly on health and assistance to industry.

On health expenditure, the National Cabinet developed the National Partnership on COVID-19 Response, where the Commonwealth funds 50% of COVID-19 related allowable hospital and public health expenditure by the States.

On the revenue side, the pandemic has resulted in a recession in all States, although the length and severity are likely to vary across States.

For example, the impact of the pandemic on Western Australia was mitigated with mining output largely unaffected and iron ore prices remaining strong. In contrast, the extended lock down in Victoria is likely to result in a significant and longer decline in its fiscal capacity compared to other States. Currently jobs growth is recovering strongly in all States but Victoria.

It is likely that horizontal fiscal equalisation will confront the same issues related to contemporaneity, volatility and policy neutrality as were faced in the mining boom.

The pandemic will cause volatility, and the continuation of the lag between the assessment of a State's fiscal capacity and the distribution of GST revenue will likely result in gaps between assessed and actual fiscal circumstances in the downturn as well as the upturn.

This time on the downturn of the cycle — and for States that experience a large and quick deterioration in their actual fiscal circumstances relative to other States — the gap between their GST requirement under a more contemporaneous approach and what the Commission assesses it to be with lagged averaging for any particular application year, may be significant.

As noted previously, the Commission has a 'swings and roundabouts' approach to the impact of an economic shock on GST distributions. Alternatively, the assessments of fiscal capacities could be more contemporaneous to what is occurring in each application year, although this would introduce more volatility to the relativities for GST distribution. Based on prior feedback to the Commission, States dislike volatility in relativities as this makes their budget planning more difficult.

States facing difficult budget pressures resulting from an economic downturn from the pandemic are likely to emphasise the need for more contemporaneous assessments. Others are likely to continue to emphasise the importance of limiting volatility in the fiscal equalisation process and support the current 3-year lagged assessment method.

A further issue is whether, and to what extent, any decline in a State's relative fiscal position during the pandemic arises from divergences from average policy versus circumstances beyond its control.

To the extent that it is a result of differences from the average policy adopted by all States in response to the pandemic, such a decline is not compensable under the fiscal equalisation process on policy neutrality grounds. As noted above, for the successive mining booms, the Commission was of the view that Western Australia adopted average economic development policies and so all its mining royalties were equalised.

In theory, under equalisation arrangements, only external influences on fiscal capacities outside the control of the States should be compensable.

Fiscal equalisation can be viewed as a risk sharing or self-insurance mechanism between the States which insures any individual jurisdiction against the uncertainty from an adverse event beyond its control (e.g. cyclones in Queensland or fires in New South Wales and Victoria). As noted previously, this is how the system operates for exogenous natural disasters. The burden of the negative external event is shared across the national tax base through horizontal fiscal equalisation rather than being borne solely by the taxpayers of the affected jurisdiction.

Nevertheless, the costs of damage from a natural disaster are not entirely beyond a State's control as they can be reduced through mitigation initiatives. Yet the incentive to implement mitigation policies may be reduced because the costs from the natural disaster are shared through horizontal fiscal equalisation

In the case of the pandemic, if the adverse economic impact that a State experiences is in part due to its divergence from average State pandemic policies, there could be a moral hazard issue if that State is compensated for what might be viewed as policy choices.

The question that could be raised is: why should the other States insure one jurisdiction against its policy choices? But it may be very difficult for the Commission to assess and decide how much of one State's misfortune during the pandemic is due to its own policy decisions. Just as in the mining boom, it may prove technically impossible to disentangle differential policy from observed outcomes and the Commission may be compelled to treat all States as having pursued average policies during the pandemic.

The pandemic may also have implications for the new GST distribution arrangements enacted in 2018 (see Box 2). Under the new arrangements, the Commonwealth will now explicitly share with the States the risk and uncertainty in the horizontal fiscal equalisation system arising from external shocks.

Box 2 Legislated changes to the GST distribution

Changes to GST distribution were enacted in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018*. The new arrangements involve:

- Introducing a minimum GST relativity (relativity floor), with an initial floor of 0.7 introduced for 2022–23 and increasing to 0.75 from 2024–25. This is a floor through which a State's GST relativity cannot fall.
- From 2021–22, permanently boosting the GST revenue pool with additional Commonwealth financial assistance.
- Transitioning horizontal fiscal equalisation from a system based on the fiscal capacity of the strongest State to one based on the fiscal capacity of the stronger of New South Wales or Victoria.
- Providing additional financial assistance to any State to ensure that each receives total grants at least as much as it would have received had the new legislation not been enacted – a 'no worse off provision'.

How the Commission may consider changes to the GST distribution as a result of the COVID-19 pandemic

Under current arrangements, the Commission reviews, generally every five years, its methods to derive per capita relativities for distributing GST among the States. The scope of the review, along with its timing, is established by the Commonwealth Treasurer.

The Commission completed its last five-year review in February 2020, before the economic fallout from the pandemic was evident.

Between methodological reviews, the Commission provides an annual update of per capita relativities for GST distribution.

The terms of reference set by the Commonwealth Treasurer for such updates

normally provide that the Commission can only change methods from its latest review if 'data problems necessitate changes' or there is 'significant change in arrangements which govern Commonwealth-State relations'.⁸

Under current arrangements, the 2021 Update, which would normally be completed in February 2021, will only cover the COVID-19 related impacts in 2019–20.

The effects after 30 June 2020 would need to be considered in future updates. The scope for considering any changes to the equalisation process as a result of the economic fallout from the pandemic will depend on future terms of reference.

⁸ For example, see the terms of reference for the Commission's 2019 Update at https://www.cgc.gov.au/sites/default/files/u2019_final_terms_of_reference.pdf.