



**Australian Government**  

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**Commonwealth Grants Commission**

**REPORT ON**  
**STATE REVENUE SHARING RELATIVITIES**  
**2015 REVIEW**

**DRAFT ONLY**

**Canberra**

## ACKNOWLEDGMENTS

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We are grateful for the ready co-operation extended to the Commission and its staff during the review by Australian, State and Territory Treasury officers and by staff of the Australian Bureau of Statistics, the Australian Institute of Health and Welfare and other agencies which supplied data.

# TERMS OF REFERENCE

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Chairperson  
Commonwealth Grants Commission  
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15 JUN 2013

Dear Mr Henderson

I am writing to you to convey the enclosed terms of reference for the Commission's *2015 Methodology Review of GST Revenue Sharing Relativities*.

As you know, on 30 March 2011, the Government appointed the Hon John Brumby, Mr Bruce Carter and the Hon Nick Greiner AC to review Australia's system of distributing the GST amongst the States and Territories. The final report of the *GST Distribution Review* (Review) was released publicly on 30 November 2012. I discussed the recommendations of the Review with my State colleagues at the Standing Council on Federal Financial Relations meeting of 3 April 2013. The Standing Council agreed to initiate an expedited methodology review, including asking the Commission to take into account certain recommendations from Chapters 3, 6 and 7 from the Review.

The terms of reference also ask the Commission to consider the appropriate treatment of disability services during the transition to DisabilityCare Australia and once the full scheme is operating nationally and school education funding under the National Education Reform Agreement funding arrangements.

This review will require close and regular engagement with the Commonwealth and States. The terms of reference require the Commission to provide a draft report within 12 months of receipt of the terms of reference. The final report is due by 28 February 2015, in order to inform consideration of the 2015-16 GST revenue sharing relativities.

I appreciate that this will be a challenging task for the Commission, however I have every confidence that you can deliver within these timeframes.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Wayne Swan'.

WAYNE SWAN  
enc

## **Terms of Reference**

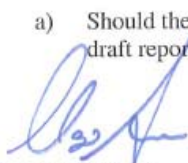
### **Commonwealth Grants Commission 2015 Methodology Review**

I, Wayne Maxwell Swan, Deputy Prime Minister and Treasurer, pursuant to sections 16, 16A and 16AA of the *Commonwealth Grants Commission Act 1973*, refer to the Commission for inquiry into the methodological approach to determining the per capita relativities to be used to distribute Goods and Services Tax (GST) revenue among the States, the Northern Territory and the Australian Capital Territory (collectively referred to as the States) from 2015-16. The Commission should provide its final report to the Commonwealth and States by 28 February 2015.

1. In preparing its assessments the Commission should:
  - a) take into account the Intergovernmental Agreement on Federal Financial Relations (as amended), which provides that the GST revenue will be distributed among the States in accordance with the principle of horizontal fiscal equalisation;
  - b) aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data;
  - c) ensure robust quality assurance processes; and
  - d) develop methods to appropriately capture the changing characteristics of the Indigenous population.
  
2. In undertaking its assessments, the Commission should also have regard to the recommendations of the final report of the *GST Distribution Review* (October 2012) to:
  - a) consider the appropriateness of the current materiality thresholds (Recommendation 3.1);
  - b) consider the appropriateness of continuing to round relativities to five decimal places (Recommendation 3.2);
  - c) develop a new transport infrastructure assessment. This should include, if appropriate, a framework to identify payments for nationally significant transport infrastructure projects which should affect the relativities only in part and options for providing that treatment (Recommendation 6.1);
  - d) consider the use of data which is updated or released annually with a lag, or updated or released less frequently than annually (Recommendation 6.2);
  - e) examine the merits of adopting a simplified and integrated assessment framework (Recommendation 6.3);
  - f) investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis (Recommendation 6.4);
  - g) develop a new mining revenue assessment (Recommendations 7.1 and 7.2); and
  - h) consider the appropriate treatment of mining related expenditure (Recommendation 7.3).

3. The Commission should prepare its assessments on the basis that:
  - a) National Specific Purpose Payments (NSPPs), National Health Reform (NHR) funding and National Partnership (NP) project payments should affect the relativities, recognising that these payments provide the States with budget support for providing standard state and territory services;
    - i. NHR funding and corresponding expenditure relating to the provision of cross-border services to the residents of other States should be allocated to States on the basis of residence.
  - b) NP facilitation and reward payments should not affect the relativities, so that any benefit to a State from achieving specified outputs sought by the Commonwealth, or through implementing reforms, will not be redistributed to other States through the horizontal fiscal equalisation process;
  - c) general revenue assistance, excluding GST payments, will affect the relativities, recognising that these payments are available to provide untied general budget support to a State or Territory;
  - d) those payments which the Commission has previously been directed to treat as having no direct influence on the relativities continue to be treated in that way. Where those payments are replaced, the treatment of the new payment should be guided by subparagraphs 3(a) – (c) and paragraph 4, unless otherwise directed; and
  - e) where responsibilities for funding and delivering aged care and disability services has not been transferred to the Commonwealth by a State under the NHR Agreement, these responsibilities will continue to be assessed as State services for that State.
4. Notwithstanding subparagraphs 3(a) – (c), with the exception of reward payments under NPs, the Commission may determine that it is appropriate for particular payments to be treated differently, reflecting the nature of the particular payment and the role of the State governments in providing particular services.
5. The Commission should consider the most appropriate treatment of disability services during the transition to DisabilityCare Australia (the National Disability Insurance Scheme) and once the full scheme is operating nationally.
6. The Commission will ensure that the GST distribution process will not have the effect of unwinding the recognition of educational disadvantage embedded in the National Education Reform Agreement (NERA) funding arrangements. The Commission will also ensure that no State or Territory receives a windfall gain through the GST distribution from non-participation in NERA funding arrangements.

7. The Commission will consult regularly with the Commonwealth and States as it considers these terms of reference.
8. The Commission will develop a work program, in consultation with the Commonwealth and States, which sees the matters outlined in paragraphs 1(d), 2(c), 2(g), 2 (h), 5 and 6 being progressed as a priority and subject to early consultation (including multilateral discussions) with the Commonwealth and States.
9. The Commission should provide a draft report for consideration by the Standing Council on Federal Financial Relations within 12 months from receipt of these terms of reference.
  - a) Should the Commission expect to make significant changes following consultation on the draft report, further consultation with the States on those changes will be required.



WAYNE SWAN

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# CHAPTER 1

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## INTRODUCTION

On 21 June 2013, the Commission received terms of reference for a review of fiscal equalisation methodologies to apply to the GST distribution from 2015-16. This report responds to the requirement that the Commission provide a draft report on its review within twelve months of receipt of the terms of reference, in advance of the final report to be provided on 28 February 2015.

Much of the data that will be used in the assessment of recommended relativities for 2015-16 are not yet available. Moreover, the Commission is continuing to develop its assessments in a range of areas. Accordingly, this draft report presents the state of play of the Commission's work on its assessments to date but does not include draft relativities or final decisions on all assessment issues.

The draft findings or options are provided as the basis for further consultation with the States and the Commonwealth. However, we consider that some assessments are more settled than others and have flagged these and the relevant considerations in the text.

In forming its final views, the Commission will consider any further evidence that may be presented by States and take into account any changes to policy affecting State fiscal capacities, or new or changed data, that may emerge.

This review has taken the 2010 Review methodologies as its starting point. To assist States, we have summarised the main possible changes compared to the 2010 methodology at the beginning of draft report attachments dealing with individual assessments.

The development of this draft report, although undertaken in a considerably shorter time frame than previous reviews, has already benefited from substantial consultation with all States and detailed submissions from them. In the time now remaining, we ask that States focus their responses to this draft on their key areas of concern, supported by substantiating data and analysis.

We understand that the conduct of such reviews imposes a burden on States, and that the annual updates have a smaller, though not negligible impact as well. We are also aware that the environment in which equalisation operates is subject to ongoing change and many areas are under further review; for example, through the White Paper on Federation and Taxation processes. Methods might need to change more quickly than the five yearly review process that characterises the past. We would welcome State views on what is the best process for developing and modifying methodology; for example, the proposal put forward by one State to have a rolling program of reviews of specific assessments.

## APPROACH TO REVIEW

- 1 The Commission was asked to develop a work program for the review, in consultation with the Commonwealth and States. This is set out in Table 1. So far, it has involved consultations with State Treasurers on the principles and methods which should be reviewed and on the priority issues. These were followed by a Commission position paper on the equalisation objective and supporting principles and staff papers on the priority issues the Commission was asked to address in the terms of reference, other implementation issues and proposed assessments. Further discussions have also taken place between State Treasury and Commission staff.

**Table 1 2015 Review program**

Date	Event
<b>2013</b>	
End July	State submissions due on: <ul style="list-style-type: none"> <li>• principles and architecture</li> <li>• priority issues as outlined in the terms of reference</li> <li>• other issues of priority for States, including specific assessments and identifying assessments which should not change.</li> </ul>
12-14 August	Bilateral meetings with Treasurers/Heads of Treasury to discuss State submissions.
End October	Commission (CGC) sends to States: <ul style="list-style-type: none"> <li>• Commission views on principles and architecture</li> <li>• staff views on priority issues and changes to assessments.</li> </ul>
End November	CGC staff meetings with State officials to discuss issues.
<b>2014</b>	
End January	State submissions due on October papers: <ul style="list-style-type: none"> <li>• principles and architecture</li> <li>• priority issues and changes to assessments.</li> </ul>
March	Multilateral meeting between CGC and Heads of Treasury (not held)
21 June	CGC releases draft report
June/July	Consideration of draft report by the Council on Federal Financial Relations
June/July	CGC staff meetings with State officials to discuss draft report
August	State submissions due on draft report
August	Potential meeting with Heads of Treasury to discuss draft report
August	New issues paper issued by CGC staff
End November	CGC to consult with States, as required by the terms of reference, if significant changes are made to the draft report
End December	Final State comments due on proposed changes to draft report
<b>2015</b>	
28 February	Release of final report

- 2 The 2010 Review started with a clean slate and entailed a rigorous justification of each assessment. While that resulted in significant changes in certain areas, it also showed that much existing methodology was robust.
- 3 In this review, while changes to all methods were within the terms of reference, given the shorter timeframe, we adopted an approach of focusing attention on areas where, in consultation with the States, we considered change was most warranted. Changes have been proposed where the terms of reference require it, State circumstances have changed, better data have become available or where other evidence, including in State submissions, has convinced us to do so.

## REQUIREMENTS OF THE TERMS OF REFERENCE

- 4 The terms of reference contain instructions and guidance on how we should approach the task of developing methodology to distribute GST revenue. They direct us:
  - to take into account the Intergovernmental Agreement on Federal Financial Relations (as amended) which provides that the GST should be distributed among the States in accordance with the principle of horizontal fiscal equalisation (HFE)
  - to aim for assessments that are simple and consistent with the quality and fitness for purpose of the available data
  - to ensure robust quality assurance procedures and
  - develop methods to appropriately capture the changing characteristics of the Indigenous population.
- 5 They also ask the Commission to have regard to nominated recommendations of the GST Distribution Review (October 2012) in undertaking the review. In some cases we are asked to consider a specific recommendation while in others we are directed to develop new assessments. We have followed these directions in our work. However, we have not responded to the more general findings of the GST Distribution Review, or to other recommendations of that review, considering that to be beyond our terms of reference.
- 6 Specific guidance is provided in relation to the treatment of Commonwealth Specific purpose (SPPs) and National partnership payments (NPPs). The terms of reference require the Commission:
  - to ensure some specified payments (usually referred to as quarantined payments), including all reward payments, have no impact on the GST distribution
  - to treat national SPPs, national health reform funding, National partnership project payments and general revenue assistance (GRA), other than the GST, so

that they would affect GST shares, but treat facilitation NPPs so that they would not.

However, the Commission is given discretion to vary the treatment of the second group of payments where it is appropriate, 'reflecting the nature of the payment and the role of State government in providing services'.

- 7 Table 2 identifies the matters the terms of reference require us to address and indicates how we have responded to them in this report.

**Table 2 Requirements of the terms of reference and our response**

<b>2015 Review reference clause</b>	<b>Response</b>
Per capita relativities from 2015-16	Not yet available
1(a) take into account the Intergovernmental Agreement on Federal Financial Relations ... the principle of horizontal fiscal equalisation	Chapters 2 and 3
1(b) aim for assessments that are simple and consistent with the quality and fitness for purpose of the available data	Chapter 3
1(c) ensure robust quality assurance procedures	The Quality Assurance Strategic Plan is available on our website.
2(a) consider the appropriateness of the current materiality thresholds (recommendation 3.1)	The Commission has increased the thresholds for disabilities to \$30 per capita and for data adjustments to \$10 per capita.
2(b) consider the appropriateness of continuing to round the relativities to five decimal places (recommendation 3.2)	The Commission does not consider there is significant benefit in terms of simplification or reduced false precision from rounding the relativities to less than five decimal places. Doing so may have a material impact on State GST shares.
2(c) develop a new transport infrastructure assessment. This should include, if appropriate, a framework to identify payments for nationally significant infrastructure projects which should affect the relativities in part and options for providing that treatment (recommendation 6.1)	The Commission has developed a new urban transport infrastructure assessment but does not consider it appropriate or possible to develop a framework to identify payments for nationally significant infrastructure projects.
2(d) consider the use of data which are updated or released annually with a lag, or updated or released less frequently than annually (recommendation 6.2)	The Commission will continue to use data which best reflect States' likely circumstances in the year of application.
2(e) examine the merits of adopting a simplified and integrated assessment framework (recommendation 6.3)	The Commission will continue equalising State net financial worth per capita and recognising needs for infrastructure and net financial worth directly and immediately, rather than adopting the simplified and integrated or other holding cost approaches.
2(f) investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis (recommendation 6.4)	The Commission will not adopt a spend gradient approach to interstate costs, because doing so is inconsistent with HFE.
2(g) develop a new mining revenue assessment (recommendation 7.1 and 7.2)	The Commission has developed a new mining revenue assessment.

**Table 2 Requirements of the terms of reference and our response (cont)**

2015 Review reference clause	Response
3 and 4 Treatment of Commonwealth payments	Chapter 4
8 Priority issues 1(d) capture the changing characteristics of the Indigenous population 2(c) develop a new transport infrastructure assessment 2(g) develop a new mining revenue assessment 2(h) consider the treatment of mining related expenditure 5 Treatment of disability services following the introduction of DisabilityCare Australia 6 Treatment of National Education Reform Agreement funding arrangements	Chapter 5

## THE DRAFT REPORT

- 8 This draft report contains the Commission’s preliminary response to the terms of reference. It contains our position on the principles we have used and assessments we propose to make in preparing our recommended relativities for February next year. It has been prepared on the basis of State circumstances as we understood them prior to the 2014-15 Commonwealth budget. We may need to reconsider our position in a number of areas when changes stemming from the budget become clearer.
- 9 The data and evidence available to us vary across assessments. In some cases, we consider that the evidence is such that an assessment is unlikely to change between the draft and final report. However, in some areas, the balance of evidence and analysis is much closer and State responses to this draft could see new data, evidence or analysis emerge which could lead us to reconsider our position. In some of these areas we have included what we consider to be placeholders. State assistance to resolve the issues surrounding these placeholders would be highly valued. We see that as a positive outcome of preparing a draft report and an intrinsic part of our approach to responding to the terms of reference.
- 10 We have not documented State arguments in detail throughout the draft report. Instead, we have responded to the issues States have raised. We have allowed States submissions to speak for themselves. They can be found on our website, classified by the issue or discussion paper to which they are responding:  
[https://cgc.gov.au/index.php?option=com\\_content&view=category&id=50&Itemid=142](https://cgc.gov.au/index.php?option=com_content&view=category&id=50&Itemid=142).
- 11 We have not shown the full financial impact of our proposals, nor comparisons with assessments in the 2014 Update. We do not have the data to do so reliably. We do not have most data for 2013-14 and our adjusted budget, population and other data

for earlier years are often preliminary. We have attempted to illustrate the financial impact of assessments, including the impact of each disability we have assessed, for at least one year. We have shown assessed expenses for one year and the GST impact for the same year, usually 2012-13. These numbers are likely to change in the final report. We consider this sufficient information to allow States to provide meaningful feedback on whether we are appropriately capturing the disabilities impacting on State fiscal capacities.

- 12 The draft report addresses all aspects of our principles and assessments. It comprises the following.
  - The main report explains the requirements of the terms of reference, discusses the equalisation objective and how this has been implemented, explains our approach to the treatment of Commonwealth payments and discusses our decisions on the priority issues.
  - Attachments contain the assessments for each category and each disability which affects a number of category assessments.
  - Two technical appendices set out how we have used population data and how we have treated each Commonwealth payment.
- 13 We envisage the final report will also provide information on:
  - the final relativities, why they have changed and why they differ
  - other contextual information, such as how equalisation works and
  - additional technical and supporting attachments which include explanations of how the adjusted budget has been compiled and the relativities calculated.

## CHANGES IN METHODS

- 14 As in the 2010 Review, we have been guided by the HFE objective and the supporting principles – what States do, policy neutrality, practicality and contemporaneity. We have changed how we define average policy of States which has some impact on assessments, including some revenue assessments, but at the margin. We have reviewed how and why we discount assessments and this has also meant some changes. Chapter 2 explains the HFE objective and supporting principles and Chapter 3, how we have implemented them.
- 15 We have rigorously evaluated potential method changes and data using the assessment guidelines which set out strong reliability and materiality criteria. These and how we have used them are also set out in Chapter 3.
- 16 Substantial changes in assessment methods have been proposed in the Mining revenue, Schools, Health and Welfare assessments. The changes in the Mining revenue assessment follow from a request in the terms of reference; the changes to

the Schools assessment are due in part to the introduction of the National Education Reforms and in part to a new and better data source; the changes in the Health assessment are due to the availability of a new and better data source; and the changes to the Welfare assessment<sup>1</sup> reflect changes in responsibility in the areas of aged care and disability services for older people.

- 17 New urban transport infrastructure, housing and housing infrastructure assessments have been developed. We have also made changes to our approach to measuring the differential costs associated with Indigenous people.
- 18 Table 3 and Table 4 summarise these changes – in each category and to each disability. Changes which are presentational in nature or are due to changes made by data suppliers have not necessarily been included.

**Table 3 Summary of proposed method changes (a), categories, 2010 to 2015 Reviews**

Category	Method changes
Land tax	<ul style="list-style-type: none"> <li>Metropolitan improvement levies are combined with the property part of fire and emergency services levies and assessed using the value of properties.</li> <li>The assessment method for land taxes levied on a landholder basis is unchanged.</li> </ul>
Stamp duty on conveyances	<ul style="list-style-type: none"> <li>The stamp duty on the transfer of motor vehicles assessment has been included in this category.</li> <li>Expenses and duty concessions relating to first home owners (such as First Home Owners Bonus Payments) have been moved from this category to Housing.</li> <li>The land rich adjustment for Tasmania has been discontinued because it is not material.</li> </ul>
Insurance tax	<ul style="list-style-type: none"> <li>The assessment method is unchanged, but fire and emergency services levies imposed on insurance premiums have been moved to this category and assessed using the insurance tax base instead of equal per capita (EPC).</li> </ul>
Motor taxes	<ul style="list-style-type: none"> <li>The assessment method is unchanged, but the stamp duties on the transfer of motor vehicles assessment has been moved to the conveyances category. Revenue from fire and emergency levies on motor vehicles has been included in this category.</li> </ul>
Mining revenue	<ul style="list-style-type: none"> <li>This category is assessed on a mineral by mineral basis with separate assessments of iron ore, coal, gold, onshore oil and gas, copper, bauxite and nickel.</li> <li>As a placeholder, the inclusion of iron fines with the rest of iron ore is being phased in.</li> </ul>
Other revenue	<ul style="list-style-type: none"> <li>The assessment method is unchanged. Revenue from Fire and emergency services levies have been moved from this category to the Land tax, Insurance tax and Motor taxes categories.</li> </ul>

<sup>1</sup> Further changes will also occur when the National Disability Insurance Scheme enters its transition phase, probably in the 2016 Update, as discussed in the Priority issues chapter.

**Table 3 Summary of proposed method changes (a), categories, 2010 to 2015 Reviews (cont)**

Category	Method changes
Schools education	<ul style="list-style-type: none"> <li>• The assessment uses actual enrolments as a broad measure of use for all age groups but with an adjustment to the distribution of students in pre-Year 1.</li> <li>• Regression analysis based on ACARA data is used to directly estimate cost weights for Indigeneity, SES, SDS, non-government students and remoteness. We are now using the socio-demographic characteristics of non-government students rather than assuming they have the same socio-demographic characteristics as government students.</li> <li>• The assessment of expenditure of Commonwealth NERA funding for government schools is based on the average SRS amount for government students in each State to avoid unwinding the recognition of educational disadvantage embedded in the NERA funding arrangements.</li> </ul>
Post-secondary education	<ul style="list-style-type: none"> <li>• Vocational education and training expenses have been moved from Services to industry to this category.</li> <li>• The assessment recognises non-remote Indigenous and non-Indigenous people from low socio-economic backgrounds use post-secondary education services more.</li> <li>• The differential use and cost of people who do not speak English at home is no longer assessed.</li> </ul>
Health	<ul style="list-style-type: none"> <li>• There is a single Health category and a direct method of assessment is used for all components instead of the previous subtraction method. The impact of the private sector is assessed using economic environment factors.</li> <li>• Category expenses are assessed net of user charges because we have data on net expenses incurred on different socio-demographic groups.</li> <li>• Data on the use and cost of health services are sourced from IHPA instead of the AIHW.</li> </ul>
Welfare	<ul style="list-style-type: none"> <li>• New child protection unit record data are used which improves the reliability of the family and child welfare services assessment.</li> <li>• As the Commonwealth has taken over State responsibilities in the areas of aged care services and disability services for older people, needs relating to welfare-related aged care services, including for Western Australia, are assessed EPC.</li> <li>• During the NDIS transition period, we are adopting dual disability services assessments — one for NDIS services and one for existing disability services delivered under the National Disability Agreement. Both NDIS and existing disability services will be assessed using the population eligible for NDIS.</li> <li>• All concessions other than transport concessions are included in the general welfare component and assessed using the number of concession card holders. The remainder of general welfare services are assessed using the relative State proportions of people in the bottom quintile of the ABS's SEIFI.</li> <li>• The changes in Commonwealth-State arrangements affecting this category and associated Commonwealth payments are, or will be, backcast as required.</li> </ul>



**Table 3 Summary of proposed method changes (a), categories, 2010 to 2015 Reviews (cont)**

Category	Method changes
Housing	<ul style="list-style-type: none"> <li>• The category covers PNFC and general government expenses and revenue.</li> <li>• Gross expenses are assessed using Census data on households in social housing cross-classified by income, Indigeneity and location instead of Commonwealth pensioner numbers classified by Indigenous status.</li> <li>• Assessed rents are calculated by applying average rents paid by the different household groups to assessed households.</li> <li>• First home buyer grants, bonuses and stamp duty concessions are consolidated in the Housing category and are assessed EPC.</li> <li>• As a placeholder, the Remote Indigenous Housing NPP will impact on the relativities from 2013-14.</li> </ul>
Services to communities	<ul style="list-style-type: none"> <li>• A utilities subsidies assessment has been introduced, distinguishing between water and electricity subsidies for uneconomic services in remote small communities and for uniform tariffs and special projects. The former is assessed using the proportion of population living in small remote and very remote communities. The latter is assessed EPC.</li> <li>• Small communities cover those with population between 50 and 1 000 instead of 200 to 1 000.</li> <li>• The impact on expenses of water availability and quality is no longer assessed.</li> <li>• A new definition of discrete Indigenous communities has been adopted.</li> </ul>
Roads	<ul style="list-style-type: none"> <li>• The assessment method is unchanged but ABS Urban Centres and Localities are used instead of Significant Urban Areas to distinguish between areas served by urban and rural roads.</li> </ul>
Transport	<ul style="list-style-type: none"> <li>• The category covers urban transport PNFC expenses and revenue as well as general government expenses and revenues, resulting in an increase in total expenses.</li> <li>• New data have been used to update the assessment and the regression model used to estimate net assessed expenses has been refined.</li> <li>• A regional cost assessment has been added to the non-urban expenses assessment, which is otherwise unchanged.</li> </ul>
Services to industry	<ul style="list-style-type: none"> <li>• The assessment includes a separate assessment of regulatory expenses for the mining industry.</li> <li>• Mining user changes have been netted off the relevant expenses.</li> <li>• Vocational education and training expenses are no longer included in this category but in Post-secondary education.</li> <li>• The 12.5% discount to the expense weights for this assessment has been removed.</li> </ul>
Other expenses	<ul style="list-style-type: none"> <li>• The impact of cultural and linguistic diversity on State expenses is no longer assessed.</li> <li>• Administrative scale, native title and land rights and some national capital assessments have been relocated from other categories.</li> </ul>

**Table 3 Summary of proposed method changes (a), categories, 2010 to 2015 Reviews (cont)**

Category	Method changes
Infrastructure	<ul style="list-style-type: none"> <li>• An assessment is made of PNFC and general government infrastructure used in providing urban transport and housing.</li> <li>• The quantity of infrastructure stock disabilities are calculated by combining the factors affecting the use of each service using the average proportion of infrastructure devoted to the service.</li> <li>• Factors affecting recurrent service use but which do not affect infrastructure requirements are explicitly excluded from the infrastructure calculations and the 12.5% discount has been deleted.</li> <li>• Capital cost disabilities are measured by reference to construction cost indices, discounted by 50% for roads and urban transport and by 25% for other services.</li> </ul>
Net borrowing	<ul style="list-style-type: none"> <li>• Infrastructure assets of urban transport and housing PNFCs are excluded from State net financial asset bases.</li> <li>• The 25% discount on this assessment has been removed because the new treatment of housing and urban transport assets has reduced the possibility that not all non-policy influences on net borrowing requirements are assessed.</li> </ul>

(a) Acronyms used in this table are spelt out in the relevant attachments.

Source: Commission decisions.

**Table 4 Summary of proposed method changes (a), disabilities, 2010 to 2015 Reviews**

Category	Method changes
Regional costs	<ul style="list-style-type: none"> <li>• Remoteness is assessed on the basis of ARIA rather than SARIA.</li> <li>• For categories, other than Justice services, where a regional cost disability is assessed, the gradient has been based on the output from the regression analysis of ACARA data.</li> </ul>
Interstate non wages	<ul style="list-style-type: none"> <li>• A separate assessment is not undertaken but the regional costs assessment, through the move to ARIA from SARIA, allows needs for Tasmania and the Northern Territory to be recognised.</li> </ul>
Service delivery scale	<ul style="list-style-type: none"> <li>• Output from the regression analysis of the ACARA data has been used to assess service delivery scale disabilities in Schools education.</li> <li>• The assessment of service delivery scale for housing and community health expenses, as well as for all Welfare services with the exception of family and child services, has ceased.</li> </ul>
Indigeneity	<ul style="list-style-type: none"> <li>• Where we use a geographic measure of socio-economic status, we propose to use the Indigenous specific IRSEO, and non-Indigenous specific NISEIFA measures where appropriate. In the 2010 Review we used a generic SEIFA to measure relative disadvantage for both Indigenous and non-Indigenous people. This change has been applied in Health, Post-secondary education and Welfare and will be in police.</li> </ul>
Cultural and linguistic diversity	<ul style="list-style-type: none"> <li>• Cultural and linguistic diversity is no longer assessed.</li> </ul>

(a) Acronyms used in this table are spelt out in the relevant attachments.

Source: Commission decisions.

## STATE VIEWS ARE SOUGHT

- 19 We particularly seek State views in relation to assessments responding to priority issues, where we are contemplating major changes or where we have included placeholders.
- 20 In addition, we ask States to identify any areas where they have concerns about the strength of the conceptual cases for the proposed assessments, the logic of the proposed methods, their reliability and the quality of the supporting data. We seek State assistance to ensure:
  - we have correctly interpreted State submissions and the supporting data and evidence
  - we have developed reliable methods; for example, whether we have included all material disabilities which are valid and measurable.
- 21 In any of these cases, alternative proposals and supporting data would be appreciated.
- 22 After we have an opportunity to discuss this report with the States, including any feedback from the Council on Federal Financial Relations, and have received a further round of State submissions in August 2014, we will finalise our recommendations. As part of this process, a new issues discussion paper will be issued by Commission staff and data for the final assessment year will be collected. At the end of November, we will advise States of any significant changes that have been made to methods set out in the draft report. Any final comments on these changes can then be provided in December.

## CHAPTER 2

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# THE EQUALISATION OBJECTIVE AND SUPPORTING PRINCIPLES

## INTRODUCTION

- 1 This chapter sets out what the Commission considers it is asked to do by the terms of reference for this review and the principles it has used in developing appropriate methods to respond to those terms of reference.

## OBJECTIVES OF THE GST DISTRIBUTION

- 2 For the 2015 Review, the terms of reference direct the Commission to take into account the Intergovernmental Agreement on Federal Financial Relations (IGA). This provides that the GST revenue will be distributed among the States and Territories (the States) in accordance with ‘the principle of horizontal fiscal equalisation (HFE)’.
- 3 The Commission considers it is appropriate to articulate the ‘principle of HFE’ using the definition it developed in 2010:

State governments should receive funding from the pool of goods and services tax such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.
- 4 That definition has, with only minor variations, formed the basis for distributing the GST since that tax’s introduction and Financial Assistance Grants before that.
- 5 The definition focuses on the main task of the Commission: to identify innate differences (disabilities) among the States which would cause their fiscal capacities to diverge and to recommend a distribution of GST revenue which would remove the impact of that divergence on State finances. As a result, States will have the same capacity to deliver services, provided they deliver them at the average level of technical efficiency and make the same effort to raise revenue.
- 6 If we can reliably measure a disability which has a material impact on the GST distribution, we include it in our methodology. The Commission does not aim to achieve precise equalisation because not all disabilities are included, either because

they cannot be reliably measured or have an immaterial impact. We aim for proximate (or comparable) equalisation.

- 7 Material disabilities affecting revenue and expenditures mean innate differences in State circumstances that:
  - give rise to differences in the capacities of States to raise revenue or differences in the cost of providing services or infrastructure, over and above any impact of the policies of individual States
  - have an impact on the recommended GST distribution which exceeds materiality thresholds
  - can be measured reliably.
- 8 The disabilities assessed cover a range of influences on the finances of a State. For example:
  - different demographic profiles can generate differences in what States need to spend to deliver the average service to their residents
  - in some areas the provision of services by the private sector, Commonwealth or local government reduces what States need to spend to deliver the average level of services:
    - for example, a State with an above average level of non-government schooling has a reduced need to provide public education, so above or below average provision of services in this way can constitute a material factor.
- 9 Based on our experience and the data available to us, these disabilities have a material impact on States' fiscal capacities. We conclude an equal per capita GST distribution would not be consistent with HFE.
- 10 The terms of reference make it clear financial support from the Commonwealth to States is to be considered by the Commission in developing its recommended methodology. They provide guidance on how the Commission is to approach this task. In general the Commission considers the receipt of Commonwealth payments impacting on States' fiscal capacities should be treated as another material factor and have an impact on the GST distribution, but there are exceptions. Further details are contained in the chapter on the treatment of Commonwealth payments.
- 11 Some States considered GST revenue should not be distributed according to the HFE principle, or the operation of HFE should be limited by other policy objectives, for example raising national productivity. Another State said the Commission should be more proactive in the area of tax reform, effectively holding governments to account in relation to reform agreements.
- 12 Some States have asked the Commission to take into account the intent of other Commonwealth-State financial agreements when developing methods and making decisions which impact on the GST distribution.

- 13 However, we consider our terms of reference are clear: we are to recommend how the GST should be distributed in accordance with the ‘principle of HFE’. We are not asked, nor given the discretion, to decide when other policy objectives or agreements between the Commonwealth and the States should moderate the achievement of HFE, unless explicitly directed in our terms of reference. Nonetheless, in adopting the definition, and in developing its methodology, the Commission is conscious of the desirability of minimising any adverse impacts of HFE on the operations of government and the economy generally.

## SUPPORTING PRINCIPLES

- 14 In making and explaining decisions on the development of methodology to achieve HFE, the Commission has adopted certain supporting principles. They capture the main influences which experience suggests the Commission has to consider through the course of a review in evaluating alternative assessment methods. These principles also provide guidance to the States in preparing their submissions through the consultation process.
- 15 Based on our experience and the views expressed to us in consultations to date, we intend to maintain the supporting principles from the 2010 Review, to guide us in the development of post-2015 methodology. As such, equalisation will be implemented by methods that:
- reflect what States collectively do
  - are policy neutral
  - are practical
  - deliver relativities that are appropriate to the application year.
- 16 These principles are deliberately expressed in aspirational terms and ideally all methods would embody these attributes. In practice, the Commission often has to evaluate alternative methods which embody mixtures of these principles and has to decide trade-offs among them — for example, between methods that capture what States do in detail and methods that are policy neutral. The Commission has not set rules for how it would decide the appropriate approach in any such cases, nor has it established a hierarchy among the principles. As required, judgment will be used to devise the best overall result.
- 17 However, the principles remain subsidiary to the Commission’s primary objective of achieving HFE and should not override that objective. We accept that achieving HFE using methods which reflect what States do will involve some policy non-neutrality. We do not think this is an argument, as some States have suggested, for diverging from HFE. Our approach is to develop methods which achieve HFE first, balancing the principles we have established to guide us among alternative methods.

- 18 Like past Commissions, we are not convinced other objectives, such as predictability or stability, should be added to the list of supporting principles. Our view is the important principles are included in our approach and such other principles would move the GST distribution away from what the ‘principle of HFE’ implies. The 2010 Review report provides a detailed explanation of our position.

## What States collectively do

- 19 The GST distribution provides significant financial support to the activities of State governments and its relevance is enhanced if it accurately reflects the services they provide, the infrastructure they are acquiring and the revenues they raise.
- 20 To give effect to this:
- our assessments reflect the range of services provided by State general government sectors and the range of revenues collected by them
  - the level of services and associated infrastructure States are funded to provide, and the revenue raising efforts they are assessed to make, are an average of those actually provided or made.
- 21 In this review we are changing our coverage of State activities to include the operation of Public Non-Financial Corporations (PNFCs) providing public housing and urban transport. In the 2010 Review, we treated these PNFCs as outside the scope of the general government sector and only dealt with subsidies and grants paid to them. We note a number of States have brought the functions previously provided by such PNFCs within the scope of their general government sectors. After giving careful consideration to the nature of these functions, we have concluded that, for our purposes, they are best considered as general government sector activities. The States are responsible for delivering urban transport and public housing services, whether they are provided by government departments or through PNFCs. States decide the level of services to be delivered, set the revenues to be collected (often collecting them and reimbursing service providers) and meet deficits.
- 22 The prime difference resulting from the inclusion of these PNFCs is that their infrastructure acquisitions and depreciation will now be included in our investment and depreciation assessments. They will no longer be included as part of State net financial worth. As a result, the impact of differences between the States in the capital required for these functions will be directly recognised in our assessments.
- 23 We consider including these activities will not add undue complexity to our assessments. We can adopt standard assessment approaches. Providing reliable data are available, this will allow us to better and more transparently recognise the different impact on State fiscal capacities of these activities, particularly their capital requirements.

- 24 The principle of ‘what States collectively do’ leads us to use the average of what we observe States to do — an internal standard — as distinct from what they could or should do — an external standard. One State said the standard could be based upon minimum standards and minimum efforts, as a way of providing incentives for efficiency in service delivery while still allowing jurisdictions to fund service provision at ‘acceptable’ levels.
- 25 External standards based on some ‘ideal’ level of services, a desired level of service delivery efficiency or an economically efficient tax policy, are not affected by the policies of any State. However, they require the Commission to make decisions about what constitutes an acceptable or ‘ideal’ level of services, desired level of service delivery, efficiency or economically efficient tax policies.
- 26 We do not consider it is our role to base our recommendations on any normative view of service delivery or revenue policy. We consider the most relevant and neutral approach is to base our recommendation on the actual average policy of the States as revealed in the data. Only in circumstances where other supporting principles come into play would we consider an alternative approach. (In the case of our Roads assessment, practical issues mandate making an assessment based on a stylised view of average policy, rather than the measured average policy of States.)
- 27 Nor are we attracted, as a general approach, to seek to look through what we observe States to do, to undertake some deeper analysis of the intent of State policy, as appears to be suggested by Western Australia. The evidence and analysis required by such an approach would appear beyond the data capacities of the States and we consider would lead us to rely even more on judgment.
- 28 Giving effect to the ‘what States do’ 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. In this review, the Commission has adopted a new approach to deciding what States do and how assessments will be made. It will consider any tax imposed or service provided by any State to be part of what States do collectively. These will be differentially assessed if doing so has a material impact on at least one State’s fiscal capacity. In this way, the impact of a large tax imposed by only one State, or an important service provided by one State, will no longer be ignored. HFE is more likely to be achieved.
- 29 Some States have said the approach will be difficult to implement and inappropriate in some areas. However, we believe it is a better way to capture what the average State does. We will need to be practical in the way the new approach is applied. If data unavailability makes it impractical, then the Commission will use its judgment to decide how a revenue or expense should be assessed.



## Policy neutrality

- 30 This principle aims 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. It also aims to ensure the GST distribution methodology creates no incentives or disincentives for States to choose one policy over another.
- 31 Because HFE aims to equalise the fiscal capacities of States, based on the average of what States do, it can never be completely policy neutral. What the Commission seeks to do, in conjunction with the other principles, is to achieve HFE in such a way that the policies of individual States have the minimum impact on their own GST share and the Commission's methodology creates the smallest incentives or disincentives impacting on State policy choice.
- 32 Currently, the Commission implements policy neutrality by undertaking assessments on the assumption that each State follows the average observed policy of all States in delivering services and raising revenue. If a State chooses to adopt a policy that varies from the average, say through a lower tax rate for a specific tax, the direct impact of its choice (probable lower revenue collections by that State for that tax) is not reflected in its GST distribution. It bears the financial consequences of its actions. Similarly if a State can deliver a service more efficiently, at below average cost, it retains the financial savings.
- 33 However, the approach we have adopted may mean differential policy choices can have second round consequences for the GST distribution, particularly through revenue assessments. Despite this, we have found no compelling case for elasticity adjustments to tax bases because of differences in tax rates. Nor do we consider discounts to tax bases for differences in long term industry policy should be made. The next chapter explains why. Nonetheless, we intend to monitor State policy differences to ensure our assessments are as policy neutral as possible.

## Practicality

- 34 In developing methodology to achieve HFE the Commission seeks to be practical.
- 35 Assessments should be based on sound and reliable data and methods, be as simple as possible while also reflecting the major influences on State expenses and revenues. We recognise State fiscal capacities are affected by a wide variety of factors, but the equalisation outcome may not be improved by including factors when sufficient data are not available to measure their effects or where effects are small.
- 36 This principle is consistent with the requirement in the terms of reference that assessments be simple and consistent with the quality and fitness for purpose of the available data.

- 37 In this review, we are asked to consider specific practicality issues, such as the appropriate materiality thresholds to adopt, and States have raised issues, for example, the use of discounting. These matters are covered in the next chapter.

## Contemporaneity

- 38 This principle means that, as far as possible, the distribution of GST provided to States in a year should reflect State circumstances in that year. Without that, the capacity to provide services and the associated infrastructure at the same standard, if each State made the same effort to raise revenue from its own sources and operated at the same level of efficiency, would be compromised.
- 39 We accept methodology which gives effect to this principle may change our recommended distribution of GST significantly from year to year. But it only does so because revealed State circumstances have changed. We consider methodology which is responsive to changing circumstances is appropriate.
- 40 Some approaches to equalisation aim to achieve it over much longer periods of time and are intrinsically more stable. A change in the relative circumstances of a State, say a significant natural disaster or decline in its share of a tax base, would have a more muted impact on its GST distribution. The State would have to cope with the fiscal circumstances of such an event from its own resources, with its GST share only increasing gradually over time. We consider, in general, that the quickest response to such a change in circumstance is most in accord with the 'principle of HFE'.
- 41 We consider the current approach of basing assessments on the average observed data for the last three years provides a balance between reflecting conditions likely in the year a recommended GST distribution could be implemented, and practicality concerns such as data reliability and stability.
- 42 Reflecting the situation of the year in which the recommended GST distribution will apply, mainly in the case of major changes in Commonwealth-State financial relations, is consistent with this balanced approach. We understand Western Australia's concern that such an approach will mean the circumstances of the three historical years of data are not fully recognised in the distribution of the GST. However, we consider in the very cases where a large change in Commonwealth-State financial relations has occurred, it is better to reflect this change contemporaneously to better align the GST paid in the year with the State fiscal capacities in that year. Otherwise, State service delivery and revenue raising capacity could be skewed and unequal.
- 43 Our capacity, however, to form a view of other events which might affect the application year and to take these into account in the assessment years, such as the risks inherent in future Commonwealth-State financial relations, must be limited. Such speculation goes beyond what is required of HFE.

## CONCLUSION

- 44 While the supporting principles are helpful in guiding the development of Commission methods, it is the equalisation objective that must be achieved through the distribution of the GST. What that means in practice is set out in the rest of this report.

## CHAPTER 3

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### IMPLEMENTING EQUALISATION

This chapter sets out the procedures we follow in developing assessments, such as the assessment guidelines we have adopted. Those procedures are designed to give structure to our deliberations and to our consideration of the argument, evidence and data provided to us. They also improve the transparency of our processes because we seek to document for each assessment the application of those procedures and our rationale for reaching the assessments we consider to be most appropriate.

However, we face substantial inadequacies of data and other key information gaps or complexities at all levels of our work. Accordingly, we do not consider that we can or should be mechanistic in applying guidelines. Equally, in the face of these issues, we need to ensure that there is an appropriate balance in our overall assessments. Accordingly, we consider that as a Commission we should where necessary exercise informed judgment in reaching our recommendations. We consider that such judgment, supported by sound reasoning and focused on achieving the horizontal equalisation (HFE) objective, is an essential part of our response to the terms of reference.

In exercising our judgment, we seek to take the fullest possible account of State views, notwithstanding they are often substantially in conflict with one another. In this report, we have flagged a range of issues which we consider would benefit from further discussion or data. State comment on these, and on the balance of assessments proposed, would strengthen our ability to exercise the most informed judgment when we finalise our recommendations next February.

- 1 In particular, this chapter addresses a range of generic implementation and methodological issues flowing from the equalisation objective and supporting principles. It also responds to a number of related requirements of the terms of reference which stem from GST Distribution Review recommendations. The terms of reference ask the Commission to consider:
  - 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 are 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)
- whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis (Recommendation 6.4).

## HOW DO WE EQUALISE FISCAL CAPACITY?

- 2 The HFE objective requires that States receive GST to equalise their fiscal capacities.
- 3 An equal per capita (EPC) distribution of the GST would equalise fiscal capacities only if State circumstances were the same. However, State circumstances are not the same and their fiscal capacities differ for the following reasons.
  - The per capita revenues raised from any given tax rate differ because State revenue bases differ. For example, there are differences across States in mining production and land values.
  - The per capita costs of providing any given level of service and acquiring the necessary infrastructure differ due to differences in service use and cost structures. For example, there may be relatively more school-aged children in one State than another necessitating more schools and teachers, and market-related factors may result in higher wage levels in some States than others.
  - States need to invest and save at different rates to cope with the implications of the changes in their populations.
  - States receive different amounts of national specific purpose and partnership payments from the Commonwealth Government.
- 4 Such non-policy influenced differences among the States are often referred to as disabilities which generate different State needs for GST. They mean States need more or less than the average per capita amounts of GST. For example, States receive relatively more GST per capita if their costs of providing the average level of services are relatively high or their ability to raise their own revenue is constrained by relatively small revenue bases. Conversely, States receive relatively less GST per capita if their costs of providing the average level of services are low or they are better able to raise their own revenue.
- 5 The GST distribution aims to equalise State fiscal capacities. It does not try to equalise their actual fiscal outcomes because States choose to provide different levels of service, impose different tax rates or acquire different levels of assets. Equalising actual fiscal outcomes would allow States to shift part of the costs of their higher standards of service, extra assets or lower taxes to other States.
- 6 In this review, as in the last, we consider State fiscal capacities are equal when, after receiving GST and other Commonwealth payments impacting on fiscal capacities, and operating at the average level of service provision and revenue raising, their per

capita net financial worth is equal to the average. In particular, this enables the Commission to directly recognise State infrastructure and non-financial asset requirements when their circumstances change. For example, States with faster population growth are assessed as needing the capacity to invest in more infrastructure than slower growing States, and their GST shares rise as a result as they experience that faster growth. In earlier methodologies, the faster growing States would have been assessed as needing to borrow more, and the GST distribution moved over the life of such borrowings, giving them the capacity to finance greater interest payments.

- 7 In both the 2004 Review and the 2010 Review, the Commission recognised differential depreciation requirements as infrastructure was used over time.
- 8 The GST Distribution 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), for example, public transport and social housing PNFCs, in the current framework’.
- 9 The terms of reference picked up this recommendation and asked 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.
- 10 The GST Distribution 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:
  - equalises net worth, so that a State which needs more infrastructure per capita holds less net financial worth per capita, reducing its capacity to earn interest
  - 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) to compensate for the reduced capacity to earn interest on net financial worth.
- 11 Those changes would replace the current investment and net lending assessments.
- 12 The GST Distribution Review said this 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.

13 Only one State fully supported this approach. However, another said the Commission should adopt an approach based on the holding cost of infrastructure and another said we should cease all capital assessments.

14 We have decided to continue to implement the equalisation objective in the manner adopted the 2010 Review.

Fiscal capacities are equal when each State has the capacity to hold the average per capita value of net financial worth (and earn income from it) after recognising their differential revenue raising capacities, different amounts received from Commonwealth payments and differential costs of providing the average level of services and holding the infrastructure necessary to provide them.

15 We consider this approach is appropriate for the following reasons.

- It is contemporary as it provides States with the financial capacity to acquire the infrastructure and financial worth they need to provide the average services as their economic and demographic circumstances change.
- It explicitly recognises the effects on State fiscal capacities of population growth in a complete, reliable and simple way.
- It explicitly recognises factors affecting balance sheets and operating results, which is consistent with recent accounting and economic trends.
- It is consistent with State practices of using recurrent revenue to help fund their infrastructure acquisition.

16 This approach can be seen as one where the GST distribution provides, as well as recurrent support for service provision, a capital grant to allow each State to acquire the infrastructure and financial worth 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.

17 We consider the simplified and integrated approach and other holding cost approaches are:

- less transparent and simple, because they assess 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 recorded in State budgets
- less reliable, as judgment is required to set the holding cost of capital and that judgment affects the GST distribution
- less contemporary, as the simplified approach suggested by the GST Distribution Review recognises the GST impact of changes in State circumstances in a year (other than population growth) over the life of the infrastructure. Other holding cost approaches spread the implications of both

population growth and other changes in circumstances over the life of the infrastructure.

- 18 As discussed in the previous chapter, we have decided to include the operations of State housing and public transport PNFCs in our assessments because we consider, for equalisation purposes, they are essentially general government activities.

## USING THE SUPPORTING PRINCIPLES

### What States collectively do

- 19 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.

### *State activities*

- 20 To reflect what States do, the range of activities considered must be comprehensive and include all State general government type activities. Even if only one State raises a revenue or provides a service, this is collectively part of what States do and should contribute to what the average State does.

### *Revenue and expense standards*

- 21 Revenue and expense standards are based on internal standards derived from what States do in aggregate. Although this means States that have a larger share of the population generally have a greater effect on the standards, in our view, this is appropriate because it gives States with a larger share of the task a larger role in setting the standard.
- 22 As changing these standards in any way would destroy this relationship, we will not discount or otherwise adjust standards as a means of more actively encouraging efficiency. This approach to equalisation equalises States to the average cost of service delivery which incorporates the average level of technical efficiency. 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.
- 23 Most States supported the approach, noting the importance of not making adjustments to standards to attempt to influence economic development or efficiency.



### *Recognising differences in what States do*

- 24 In a similar way, we derive average State policies on revenue raising or service delivery by using a revenue or service base weight. For example, a State with more of the revenue base will have a larger impact on the average tax rate used to calculate revenue raising capacity. This average tax rate is applied to the bases States actually tax. Most often, this is the legislative base, with adjustments for average exemptions and thresholds because this is what States collectively tax. For this reason, we have not adopted global or broad indicators of State revenue raising capacity, although these may be simpler and more policy neutral. We consider the arguments for a global or broad revenue approach in Revenue assessments overview attachment.
- 25 On the service delivery side, an influence on State expenses, or disability, is only recognised if States fund it. If States did not spend more on delivering services to Indigenous people, this would not be recognised in the assessments. If however, States do spend more, whether due to differences in use or unit cost, then States with more Indigenous people will have a greater influence on the average spending applied to Indigenous people in the calculation of what States need to spend.
- 26 The only case when using a different standard may be appropriate could be to overcome policy neutrality concerns, such as in the Mining revenue assessment. Developing an assessment which achieves HFE and is also policy neutral is difficult because of the highly skewed distribution of the tax base. As noted by two States, an external standard might be used in such a case as a last resort. However, in our view, primacy should still be given to achieving HFE.

### *Determining average policy*

- 27 Where States follow different policies, the Commission needs to exercise its judgment to determine the average policy. If the Commission decides a tax or service is part of what States do, it allows differences in States' underlying capacities to affect GST shares.
- 28 We propose to adopt the new approach to deciding what States do and how assessments will be made in this review. If even one State does something (raises a revenue or provides a service), that is part of what States do collectively and the materiality of its impact on State fiscal capacities will be tested. If the impact is material, the tax or service will be regarded as average policy and it will have an impact on the GST distribution.
- 29 This test of what is average policy should lead to better HFE outcomes than the previous one which required a majority of States and a majority of the tax or service base to be affected for an activity to be accepted as average policy. The previous approach meant a unique tax or service had no impact on the GST distribution. It was regarded as above average policy and States retained all of the revenue or had to

fund the unique service. It was based on a view that if only one State did something, it was not average policy. We ran the risk of not making an assessment of a material tax, even if only one State could levy it, or of a service only one State needed to provide.

- 30 Now the impact on States' fiscal capacities of everything States do will be assessed if it makes a material difference. If a State collects a revenue or provides a service, its capacities and costs will be reflected in the assessments – no longer where a State does something different will we ignore this. More appropriate weights (revenue and expense) will be applied to the disabilities we consider need to be recognised. The approach will be more inclusive of different State policies. Most States recognised the conceptual merit of this.
- 31 The new test is also simpler to apply. The previous approach was difficult to use if more than one State was involved. For example, it did not help to decide what was average policy if, say, four States imposed a tax and four did not; or if six States imposed a tax but these States had only 20% of the tax base. A judgment was required and there were times in the past when decisions on average policy were made on the basis of the number of States involved, the proportion of the tax or service base covered or what was easiest. Consistency in decision making was not always achieved.
- 32 That is not to say the new approach will always be simple to implement. As some States noted, there is potential for the new approach:
  - to require data that are not available (in the case of taxes some States do not impose)
  - to increase the number of dual assessments where States provide services in very different ways
  - to increase the number of materiality tests staff need to undertake.
- 33 We consider it a better starting point for determining average policy, especially for revenue, than the previous approach. However, we acknowledge it only provides a guide and we need to be practical in deciding what characterisation of average policy best meets the HFE objective in a particular case.
- 34 Because now everything States do is part of what States do collectively and may affect their fiscal capacities, we will take the following approach to the assessments.
  - A tax will be differentially assessed if it is imposed by one or more State(s) and if its differential distribution has a material impact on GST shares:
    - in a broader category assessment if the distribution of the tax base is not materially different from the larger tax base
    - in a separate assessment if it is materially different.
  - A tax will be assessed EPC if a differential assessment is not material.

- A service will be similarly differentially assessed if it is provided by one or more States and has a material effect on the GST distribution
  - in a broader category assessment if the disabilities affecting State spending needs are not materially different from the disabilities affecting the other spending
  - in a separate assessment if they are materially different.
- A service should be assessed EPC if a differential assessment is not material.

35 In response to other State concerns, we provide the following comments.

- Similar tax bases would only be merged if the outcome were not materially different from a separate assessment.
- The new approach is policy neutral. It is true the smaller States are less likely to impose a material tax or spend enough on a unique service to have their advantages/disabilities recognised than the larger States. But this is appropriate under HFE and the same approach is taken to defining standards in general. The correct weights would be applied to those advantages or disabilities affecting State fiscal capacities, but they would be recognised only if they are material. Again, practicality considerations would apply.
- It could be argued the new approach could act as a disincentive to tax reform, particularly in the larger States or those with a large share of the tax base. Under the old average policy approach there were potential benefits from being an ‘early adopter’ of tax reform. As an ‘early adopter’, potential future GST disadvantage could be mitigated in the early years due to the new tax arrangements not being average policy (and hence the revenues not being assessed). Under the new approach, the large States potentially lose some ‘early adopter’ benefits, while this is not the case for the small States. However, whether the new approach provides a disincentive, or whether it is removing an incentive previously in place, depends on the start point. Whether this is a real problem or a theoretical one is hard to say.
- In any case, for all revenues, there is a theoretical incentive for States to raise more revenue from taxes where they are assessed to have a lower revenue raising capacity to increase their GST shares. This is true irrespective of whether tax reform is being undertaken or not. For example, in 2012-13, New South Wales was assessed to have a higher revenue capacity for stamp duties than for land tax. Therefore, there is a theoretical incentive in terms of GST distribution for New South Wales to raise less revenue from stamp duties and more from land tax. The GST Distribution Review found no evidence States currently act in such a manner, so there would not appear to be any additional potential under the new approach for tax reform to be adversely affected.

36 Although New South Wales, Victoria and the Northern Territory preferred retaining the previous approach and most other States were cautious about the use of the new approach in practice, we consider it should be adopted on the grounds that the

Commission is instructed to achieve HFE. We believe better HFE outcomes will be achieved by the change as all material influences on State fiscal capacities will now be recognised.

### ***Equalisation of interstate costs on a 'spend gradient' basis***

- 37 The terms of reference ask the Commission to investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis, as per recommendation 6.4 of the GST Distribution Review report. We do not intend to do so because it is inconsistent with the achievement of HFE. Using a spend gradient (providing less GST to States where wages and non-wage costs are high) would mean not all States had the same capacity to deliver services.
- 38 The spend gradient approach has no support from States, although Victoria considers a spend gradient should be applied to regional costs. It argued a maximum discount which increases with remoteness should be applied.
- 39 We take the same view on applying a differential discount on the basis of remoteness to regional costs as we do the concept of applying a spend gradient to interstate cost differences. The purpose of the regional costs assessment is to attempt to equalise comparable communities. This means our assessments assume all remote communities are funded to the same standard of service.
- 40 In any case, if States do provide lower quality services in higher cost areas (or respond in any other way), we would capture that with our 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.

### ***Policy neutrality***

- 41 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 or that the Commission's methods do not influence State decision making. We acknowledge it is not easily achieved and we implement policy neutrality by undertaking assessments on the assumption that each State follows the average observed policy of all States in delivering services and raising revenue.
- 42 All States consider policy neutrality a valid supporting principle but have expressed some concerns that, in developing assessments, the Commission does not always achieve an outcome consistent with the principle. That might occur where the Commission considers the particular assessment provides a better HFE outcome and its policy neutrality concerns are given their appropriate secondary consideration. For example, the use of a State weighted average means some States can affect the

average policy more than others. The more populous States have a greater effect on average revenues and expenses and States with higher mineral production have a greater effect on average royalty rates. In our view, this is consistent with ‘what States collectively do’ and represents the impact on the average Australian.

- 43 Theoretically, equalisation methods can be seen to create incentives or disincentives for States to make particular decisions or act in particular ways. There is some evidence consistent with this view, but it is unclear if what was observed can be attributed solely to the equalisation process. In practice, we consider State decisions are more likely based on more immediate considerations than the potential effect of equalisation. While the Commission accepts the potential for assessments to provide incentives for States to make certain decisions, it is not clear the effects are material or potential solutions are reliable or simple. The GST Distribution Review supported this view.
- 44 The alternative would be a policy free approach. This means assessments would be completely free of State influence. For example, an external standard could be adopted and States could be equalised to what they could or should do to be most efficient or to achieve best practice outcomes. So, a State’s policy would have no influence on determining the average policy. This would not be consistent with the ‘what States do’ principle. Adopting an average policy approach prevents each State’s own policies from having an undue effect on GST outcomes.

### **Second round effects**

- 45 With the approach we have adopted, however, there may be second round consequences of differential policy choice on the GST distribution.
- 46 **Elasticity.** Because the methodology uses observed tax bases to measure the capacity of a State to raise revenue, the indirect impact of State decisions can affect their GST shares. In the case where a State adopts a lower tax rate than other States, it would be expected that its tax base would be correspondingly increased. In this review, we have evaluated assessments to see if such second round impacts are material and, if they are, how they should be recognised, consistent with achieving HFE. We have concluded, however, that elasticity adjustments should not be used in the 2015 Review. We did not find a compelling case for adjusting State revenue bases for the effect of differences in tax rates.
- 47 **State policies on long term industry support.** Another second round effect may stem from State policy on long term industry support or economic development. This may also have an impact on State tax bases. Western Australia suggested applying a general discount across assessments, particularly the revenue assessments, to recognise the tax base measures we observe are not policy neutral

because they have been influenced by the aggregate outcome of underlying disabilities and past State policies.

- 48 We do not accept that applying a general discount is an appropriate response to concerns about policy neutrality. The scale of mining in each State does not necessarily reflect the relative policy of each State. For example, the ACT's lack of mining is not due to its below average effort and it should not lose from an adjustment. Any adjustment for policy impacts would need to redistribute GST between mining States. A discount will not do this.
- 49 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. For example, future State policies on coal seam gas mining may have an impact on the revenue base observed in each State. To make an adjustment, the Commission would need to be convinced mines approved, or disapproved, in one State would not have been treated in that way by the average State when circumstances were similar. Doing so will not be easy.
- 50 It is not clear the Commission can adjust for such policy differences in an equitable, reliable and comparable way across States. States were unable to propose ways of doing so. However, we will continue to monitor State policy differences with respect to revenue raising to ensure the revenue bases we use are as policy neutral as possible.

## Practicality

- 51 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, the use of discounting.
- 52 Most States have said improving data reliability is the most appropriate way to improve assessments. We agree data reliability and fitness for purpose are primary considerations. As in the 2010 Review, when the incapacity to establish a case and the lack of reliable data were the most common deciding factors in not assessing a disability, rather than materiality, we intend to impose materiality thresholds and discounting in a considered way.

## Materiality thresholds

- 53 The introduction of materiality thresholds in the 2010 Review has aided simplification and made it clear that the Commission seeks not perfect, but approximate, equalisation. Such differences among States would not have a meaningful impact on the GST distribution. The then Commission said in future reviews the thresholds should at least be indexed to ensure those gains were not eroded over time.

- 54 The GST Distribution Review recommended a further round of simplification by substantially lifting the materiality thresholds, rather than merely indexing them. It recommended thresholds be quadrupled (recommendation 3.1). The panel said its recommendation would remove six expense disabilities and a revenue category.
- 55 Some States supported the increase in the materiality thresholds, although generally as part of a broader strategy for change, such as to develop broad indicators, or to improve reliability.
- 56 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. Tasmania, in particular, was concerned by a possible 'ongoing incremental simplification'. It said the Commission appeared to be establishing a precedent where we could increase the materiality threshold each review, and gradually unwind HFE.
- 57 We do not consider the increase in materiality reflects an implied recommendation for real growth in materiality thresholds in each review. Rather, we consider we introduced materiality at a conservative level in the 2010 Review, and, reflecting our conclusion that it was effective, have set it at a less conservative level. With a national average expenditure of over \$9 800 per capita in 2012-13<sup>2</sup>, a materiality threshold of \$30 per capita does not seem excessive.
- 58 In addition to using materiality to determine whether a disability should be assessed generally, in the 2015 Review, we are also applying the \$30 materiality threshold in making decisions on the appropriate level of disaggregation in a disability measure.
- If a disability is material at its broadest level of disaggregation, across all categories it would be included in all assessments where there is a conceptual case to include it.
  - If it is material, at \$30, to disaggregate that variable more finely within a specific category, we would do so.
- 59 For example, if we disaggregate appropriate expense assessments by age into our broadest age groups (0-14; 15-64; 65 and over) we get a materially different result from not using age at all. Therefore age should be included, in these age groups, in any assessment where there is a conceptual case.
- 60 In each individual category assessment, we would add any additional age groups that make a material difference to the assessment.
- 61 In addition, consistent with our view that any guidelines should be used in a considered way, we will not necessarily apply materiality thresholds mechanistically. For example, with volatile items which may have assessments above and below the

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<sup>2</sup> Commonwealth Grants Commission, 2014 Update report.

threshold in different years, the Commission may exercise its judgment on the most appropriate outcome.

- 62 Table 1 provides a summary of how we have decided whether to make an assessment, including the materiality guidelines we have adopted.

**Table 1 Summary of use of materiality guidelines for the 2015 Review**

Decision	Main criteria	Comment	Threshold
Assessment of disabilities, including number of groups	Assessment guidelines (conceptual case, empirical evidence, suitable method and data, materiality)	Materiality test, GST impact aggregated across categories	\$30
No. of groups within a disability	Materiality, suitable data	Materiality test, GST impact within a category	\$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

### *Rounding relativities*

- 63 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 five decimal places.
- 64 The Final Report said the current system of horizontal fiscal equalisation appeared to be overly precise, and one way to overcome this was to move from specifying relativities at five decimal places to specifying them at two decimal places (Recommendation 3.2).
- 65 No State supported a reduction in decimal places for relativities. New South Wales agreed there is false precision in the HFE system. However it said rounding relativities to two 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 five decimal place relativities should be retained, and rounding could encourage arguments over small changes if they impacted the rounding. Tasmania supported retaining five 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 five decimal place relativities were appropriate, and rounding would provide minimal gains, if any, in terms of simplicity and perceived views around accuracy.

- 66 An analysis of relativities since the 2000 Update indicates the cumulative effects of rounding to two decimal places would be small, but there could be material impacts on the GST distribution in any one year. As such, and because we consider the simplification benefit to be negligible, we will continue to report to five decimal places.

### *Discounting*

- 67 We consider discounting is an appropriate means of dealing with uncertainty in assessments. Assessments might have a level of uncertainty attached to them because the indicator we are using may not be a good proxy of what we are trying to measure or because data are of poor quality, either not fully comparable across States or not representative of the situation in all States.
- 68 We consider three levels of discounting (12.5%, 25% and 50%) are appropriate.
- 69 Some States oppose discounting on the grounds that it introduces bias, and leads to a 'conservatively biased estimate of HFE rather than the best available estimate' or because it enables the development of unreliable assessments. However, we consider that discounting is an important tool in achieving HFE. We do not use it to introduce conservative bias or to allow unreliable assessments, but to achieve our best estimate of HFE where we have uncertainty. We agree with the ACT view that 'the use of discounting is consistent with the CGC's starting assumption that, in the absence of reliable data, no disabilities should be assessed...'. The logical extension of this assumption is that, when data do exist but their quality is in question, a partial discount is a valid approach.
- 70 As discounting is a tool to enable us to better achieve HFE, there are certain times when discounting is not appropriate. For example, we should not discount the best available estimates of national spending, such as those derived from ABS Government Finance Statistics. Nor should we discount a judgment based estimate, say the proportion of expenses to which a disability should be applied, because it is the best available and already incorporates any necessary allowance for uncertainty.
- 71 Nor should we discount reliable assessments because of policy neutrality or other concerns, as proposed by Western Australia. We consider this would be explicitly moving away from HFE, and do not consider it appropriate.
- 72 Box 1 summarises where we have applied discounting in this review.

## **Box 1            Discounted assessments in the 2015 Review**

For each assessment where we have considered a discount, the basis for our decision is described in each relevant attachment. Here, we summarise the discounts that have been made. We consider we have discounted consistently and treated data of comparable quality in a comparable way.

### **Land tax**

We have found inconsistencies between the total value of land holdings and the distribution of those holdings across values. We are concerned these apparent inconsistencies reflect data quality problems. We are also concerned States deal with aggregations of land parcels very differently.

We consider a 25% discount appropriate.

### **Health — community health socio-demographic composition**

We have concerns about how closely the socio-demographic profile of people using emergency departments reflects the profile of people using community health services.

We consider a medium discount of 25% is warranted.

### **Police custody weights**

We are concerned our measure of police custody incidents does not allow for differences in the complexity of different police investigations and that some police activities do not involve taking people into custody. Data on police to population ratios support the judgment that a medium discount is warranted.

Police custody use weights have been discounted by 25%.

### **Location — regional costs**

We have concerns about the quality of data used in measuring regional costs for police, as these data are not available from all States, and there is some inconsistency in the data provided by States. We are also concerned about the need to extrapolate disabilities to categories other than schools and police.

The regional cost factors have been discounted by 12.5% for police and extrapolated categories. No discount is applied to regional costs for the Schools assessment.

### **Location — wages costs**

We are concerned the relationship between public and private wages in the 2009 SET was relatively weak. We are also concerned by the age of the data, but given our indexation by the ABS' wage price index, we do not consider an increase in the discount is warranted.

We consider a 12.5% discount remains appropriate.

### **Location — service delivery scale**

We consider the ACARA data used in the calculation of service delivery scale for schools are of higher quality than the data used in the 2010 assessment. As such, a discount is no longer required for schools. However, we are still concerned about the reliability of police data, as it is not fully comparable between States, and is not available for some States. We are also concerned about extrapolating to other services.

For categories other than schools, we apply a 12.5% discount.

### **Assessed urban transport asset stocks**

There are concerns about the measured relationship between per capita urban transport asset

values and city size and we are awaiting a consultant’s report on the analysis.

As a placeholder, we have discounted the relationship by 50% before applying it to urban centre populations.

### Capital cost disabilities

We have decided to measure capital cost disabilities by using a construction cost index derived from the Rawlinsons construction cost. However, we have concerns about whether the indices are sufficiently reliable and suitable for our purposes, including concerns about the extent to which they accurately capture differentials in the costs of road construction materials and plant and equipment.

We have applied a 50% discount when capital cost disabilities are applied to roads and urban transport and a 25% discount when they are applied to other services.

### Impact on the GST distribution

The table below shows the impact of discounting compared with making those assessments without any discount.

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Land tax	-2	42	-11	70	-55	-24	-14	-7	113
Health - community health SDC	51	64	-35	-15	1	-24	23	-65	139
Justice - police custody weights	12	61	-21	-6	5	-4	4	-52	82
Location - regional costs	25	27	-20	-12	-2	-7	4	-15	55
Location - wages costs	-41	73	56	-100	21	13	-12	-11	164
Location - service delivery scale	6	7	-3	-3	-4	-1	1	-3	13
Capital cost disabilities	7	11	-5	-2	0	-2	2	-11	20
Investment - transport infrastructure stocks	-178	-294	212	71	88	34	45	23	473
<b>Total</b>	<b>-122</b>	<b>-8</b>	<b>174</b>	<b>4</b>	<b>55</b>	<b>-14</b>	<b>52</b>	<b>-140</b>	<b>284</b>

## Contemporaneity

- 73 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.
- 74 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 the trade-off for greater stability is less contemporaneity. We consider 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 increasing the lag by a year would increase data accuracy, albeit at the cost of reduced contemporaneity.

- 75 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.

### *Use of non-annual and lagged data*

- 76 The terms of reference ask us to consider the use of data which are updated or released annually with a lag, or updated or released less frequently than annually.
- 77 The GST Distribution Review noted the Commission often revised data it had used in a previous inquiry. It said there were a range of reasons why the Commission might consider revising its data — more recent relevant data become available, to correct errors, or to address changes in statistical collection methods.
- 78 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 on two types of data:
- annual data published with a lag, such as the AIHW morbidity data set that is published with a two year lag
  - non-annual data, such as the Census and the ABS Survey of Education and Training data.
- 79 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).
- 80 New South Wales supported the recommendation. Victoria suggested inserting an extra year's lag into the assessment years, 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 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).
- 81 Implementing the GST Distribution Review recommendation would mean 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.

- 82 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.
- 83 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.
- 84 There are two 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 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 approach recommended by the GST Distribution Review would have led the Commission to change one year and leave the error in the other two years.
- 85 The Commission aims to achieve equalisation in the year of application and, thus will continue to use data which best reflect States' likely circumstances in that period.

### **Backcasting**

- 86 The Commission uses historical data to calculate relativities. On occasions, we use a 'backcasting' approach to improve the contemporaneity of our methods. We adjust the historical data for known changes that will affect the year in which the relativities will be applied. This approach is largely limited to major changes in Commonwealth-State financial arrangements. This is discussed in Chapter 4.
- 87 However, sometimes State policy changes may be backcast. For example, if all States were to abolish or introduce a material tax which affected the year in which the relativities were to be applied, the Commission would need to consider whether backcasting would mean the relativities would better reflect State fiscal capacities in that year. Backcasting would, however, only be implemented if the application year changes are reliably known.
- 88 All States but Western Australia agreed the Commission should continue to backcast major changes in Commonwealth-State financial arrangements for contemporaneity

reasons. They agreed changes should only be made if they can be made reliably and are material.

- 89 Victoria said any proposed changes in State taxation policy should not be subject to backcasting because adjustments made for proposed taxation policy changes in past annual updates turned out to be based on false premises. However, Queensland and Tasmania accepted this could not be applied in a blanket manner, particularly if the change were associated with a major change in Commonwealth-State financial arrangements (as it was when States agreed in 2006 to abolish certain State taxes).
- 90 Western Australia continues to hold the view that only lagged equalisation is actually achievable. It argues that if backcasting is to continue, it should only be done where there is certainty. It notes that Commonwealth budget estimates are not often sufficiently reliable.
- 91 We consider reflecting major changes in State budgets, as well as 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 did not occur. However, on practicality grounds, only large and known changes should be backcast.

## DEVELOPING ASSESSMENTS

- 92 We begin our methodological work by making decisions on the range of State activities to be covered. These are grouped in a way which allows us to recognise in a practical and easily understood way the innate differences (disabilities) among States which affect their fiscal capacities. We identify and measure these differences in a number of revenue and expenditure assessments, making sure we keep the assessments as simple and reliable as possible. We then bring these individual assessments together. We do this for the last three financial years.

### State activities

- 93 The range of activities includes all State general government sector activities and urban transport and public housing public non-financial corporations included in the ABS Government Financial Statistics. Revenue and expenditure data are mainly derived from this source, although supplementary details and data for the last financial year are collected directly from States.

### Assessment guidelines

- 94 We have again adopted assessment guidelines to assist in the development of assessments. The guidelines are consistent with how we have decided to implement the HFE objective and supporting principles. They are also consistent with the

requirement in the terms of reference that the Commission should aim to have assessments that are simple and consistent with the fitness and quality of the data. They are set out in Box 2.

- 95 These guidelines aim to ensure the Commission takes a consistent approach in developing assessments and that the assessments are conceptually sound, reliable and as transparent and simple as possible. The guidelines cover how a conceptual case should be established, when a method can be judged reliable, what is meant by data that are fit for purpose and of suitable quality and how an assessment should be adjusted if there is uncertainty about the assessment. Materiality guidelines have again been set to ensure only the main influences on State fiscal capacities are recognised and the assessments remain as simple as possible.
- 96 To comply with the guidelines, we have attempted to use data from national collections or independent sources (such as the ABS) as much as possible. These are more likely to be comparable across States and reliable. The States are also important sources of data and, with the States, we have developed a protocol for the provision of data. That protocol includes the development of standard definitions in requests for data, the collection of information on the extent to which data provided by States complied with the requirements, State and staff checks on the internal integrity of the data and explanations for unexpected trends in the data.
- 97 We have also engaged external expertise to improve assessments and to provide States with a level of assurance that the guidelines have been followed by the Commission. A list of consultants engaged will be provided in the final report.
- 98 The guidelines form a key part of the quality assurance process. They allow the Commission to be confident all relevant steps in the decision making process were followed. They allow external parties to follow the decision processes used by the Commission and to form conclusions about whether due process was observed.
- 99 While the guidelines have been used to inform the Commission's decision making processes, we retain the right to exercise judgment if we have good reasons for not following the guidelines. Reasons are provided where we have deviated from the guidelines.

## **Box 2            Assessment guidelines**

- 1 The Commission organises its work by making assessments for individual categories. Separate assessments will be made when they are materially different from other assessments or if the assessment is easier to understand if undertaken in a separate category.
- 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.
- 3 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.
- 4 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.
- 5 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.
- 6 When the assessment is to be discounted to improve the equalisation outcome, 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%, 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%, if there is a medium level of confidence about the size of an effect or a medium level of uncertainty about the information
  - 50%, 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.
- 7 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.
- 8 The disability may not be assessed in a category, if the amount redistributed in that category is small.

## Categories

- 100 Our starting position for the 2015 Review is the category structure from the 2010 Review. Some changes have been made to better allow innate disabilities to be recognised and to make the assessments easier to understand.
- 101 Eight categories of State revenue and 13 categories of State expenditure have been assessed in this review. There have been a few minor changes to the structure of the revenue assessments, with revenue from vehicle transfers moving to the Stamp duty on conveyances category and revenue from fire and emergency levies moving to other categories. Assessments of States' revenue raising capacity are undertaken for payroll tax, land tax, stamp duty on conveyances, insurance taxes, motor taxes, mining revenue, other revenue, and revenue from Commonwealth payments.
- 102 For expenses, the categories of Admitted patients and Community and other health services have been combined into one Health category and the Welfare and housing category has been split into two. Assessments are undertaken for schools, post-secondary education, health, welfare, housing, services to communities, justice, roads, transport, services to industry, depreciation and investment. Reflecting the changes in State fiscal balances, net borrowing is now assessed instead of net lending.

## Assessing disabilities

- 103 Using the assessment guidelines and the category structure, we have recognised that State revenue raising capacity and spending differs from the average because of differences in the economic, socio-demographic, environmental and geographic characteristics of the States. We have quantified these disabilities as reliably as possible, choosing in some cases not to assess a disability if it cannot be measured reliably or it is not material.

104 In some cases an EPC assessment has been adopted where we do not consider disabilities exist or to reflect State shares of population alone.

## Bringing the assessments together

105 A State's GST allocation (its equalising requirement) is the difference between its assessed spending on service provision and asset acquisition and its assessed revenues. More specifically, it is calculated as:

- the expenses it would incur to provide the average services (its assessed expenses) plus
- the investment it would make to have the infrastructure required to provide the average services (its assessed investment) less
- the net borrowing it would make to finish the year with the average per capita net financial worth (its assessed net borrowing) less
- the revenue it would raise if it made the average revenue raising effort (its assessed revenue) less
- the revenue from Commonwealth payments which are available to fund its spending requirements.

106 A per capita relativity is derived for each State by expressing its per capita GST allocation as a ratio of the national average per capita GST distributed in the year.

107 This calculation is undertaken for each of the three assessment or reference years. The per capita relativities recommended for use in 2015-16 (the application year for this review report) are the average of the annual relativities for the three assessment years 2011-12 to 2013-14.

108 A relativity below one indicates a State requires less than an EPC share of GST revenue; a relativity above one indicates it requires more than an EPC share. No State can have its relativity increased without one or more of the other States having theirs reduced. Box 3 explains in greater detail what a relativity is.

### Box 3      What is a relativity?

If States had the same economic, social and demographic features and Commonwealth payments were distributed uniformly among them, the Commission would recommend that the GST be distributed equally per person. Each State would be allocated the same (average) amount per resident.

However some States are fiscally stronger than others — they have stronger tax bases, lower service delivery costs or receive above average Commonwealth payments. They need less GST revenue than other States if all States are to be fiscally equal.

That relative strength (or weakness) is measured by the State's need for GST revenue, compared to the average and is summarised in its relativity.

A stronger State might be assessed as needing only 90% of the average GST — its relativity would be 0.9. A weaker State might be assessed as needing 110% of the average, its relativity would be 1.1.

Some people have misinterpreted a relativity to be the proportion of the GST revenue raised in a State which is returned to that State. This would only be true if the GST collected per person were the same in every State, which given differences among the States is unlikely.

109 A State's relativity changes from year to year for several reasons, including:

- its inherent characteristics change — for example, if its tax base grows more than the average, the State will become relatively stronger and its relativity will decline
- the characteristics of the other States change, affecting the State's relative position — for example, if the tax bases of the other States grow, the average will increase, the State will become relatively weaker and its relativity will increase
- the structure of State budgets change — for example, if State spending grows relative to State revenue, revenue differences will become less important, while differences in the cost of delivering services will become more important.

## CHAPTER 4

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# TREATMENT OF COMMONWEALTH PAYMENTS

## INTRODUCTION

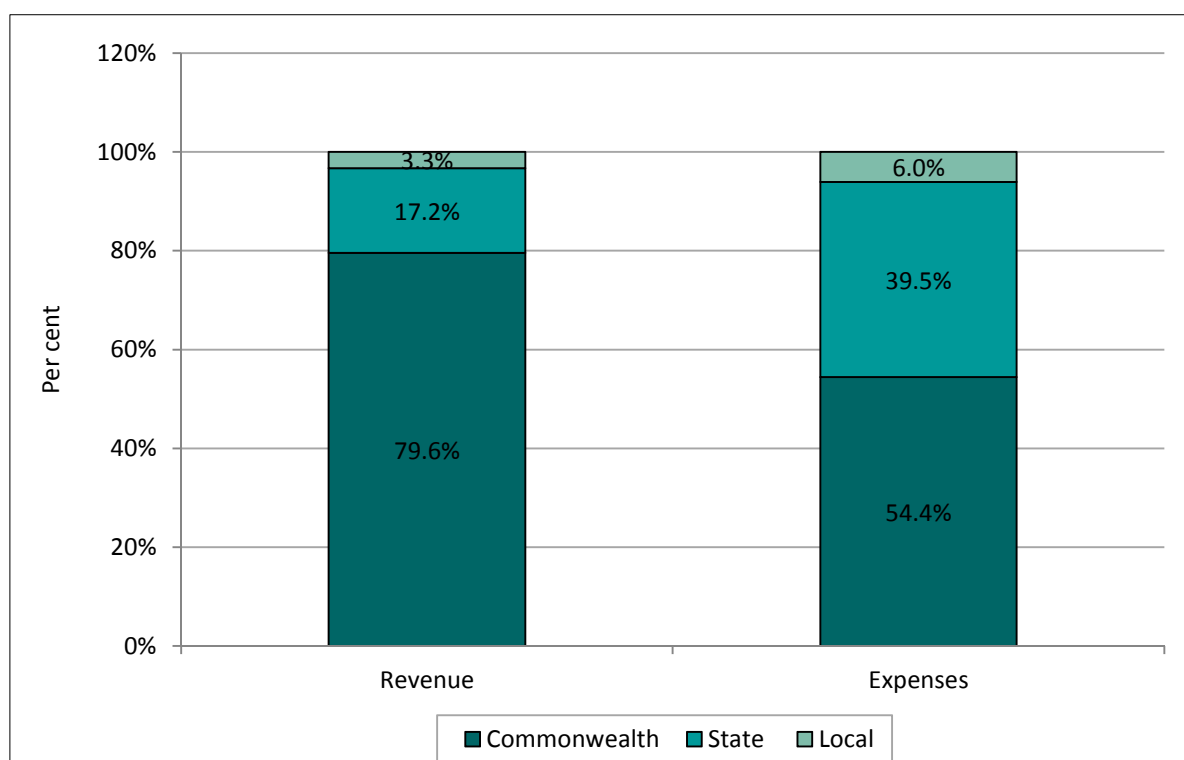
- 1 The Commonwealth and State governments access a wide range of revenue sources, deliver wide ranging services and make payments to lower levels of government, the private and not-for-profit sector and individuals. There is an overlap which means there is a relationship between what the Commonwealth does and State fiscal capacities. However, the overlap is not uniform.
- 2 There is almost no overlap on the revenue side. While there could be one in relation to revenue raising from mining, current arrangements between mining royalties and the petroleum and minerals resource rent taxes ensure there is no overlap and Commonwealth Government revenue raising does not impact on State capacities.
- 3 There is also little overlap in the making of payments to individuals, where the Commonwealth Government predominates.
- 4 However in the area of services delivered by State governments, there is significant overlap. The Commonwealth Government provides payments to States to assist in the funding of services delivered by State government departments or through instrumentalities. It also provides services or payments to third parties in the local government, private and not-for-profit sectors. This can reduce the call on State budgets in relation to the services these bodies provide.
- 5 This chapter describes how the Commonwealth makes payments to the States and why the Commission treats them in particular ways in determining the Goods and Services Tax (GST) distribution among the States. It also considers the impact other Commonwealth activities have on State budgets and how the Commission treats these indirect effects.
- 6 Lastly, it quantifies the impact Commonwealth payments and other activities have on Commission assessments and the GST distribution.

## COMMONWEALTH PAYMENTS TO THE STATES

### Vertical and horizontal fiscal imbalances

- 7 There is a large vertical imbalance in the revenue raising and expenditure powers of the Commonwealth and State governments. The amount of tax revenue raised by the Commonwealth is considerably larger than its own-purpose outlays. By contrast, the States' own-purpose outlays greatly exceed the revenue from their own taxes. Figure 1 illustrates these differences.

**Figure 1** General Government own-source revenues and expenses, 2012-13



Source: Commission analysis of data published in ABS catalogue 5512.0 Government Finance Statistics and catalogue 5506.0 Taxation revenue.

- 8 The imbalance is addressed by payments to the States. These take two main forms:
- general revenue payments which the States may use as they see fit
  - specific purpose payments (SPPs) and National partnership payments (NPPs) where the Commonwealth seeks to achieve national aims in areas of State responsibility or provides funds for particular purposes.
- 9 Agreements on the distribution of the general revenue, SPP and NPP funding to the States are made under an umbrella Intergovernmental Agreement on Federal Financial Relations (the IGA) and separate National SPP and National partnership agreements. Box 1 provides some relevant details.

## Box 1      The Intergovernmental Agreement on Federal Financial Relations, 2011

During 2008, Australian Governments, through the Council of Australian Governments, negotiated a new IGA relating to federal financial arrangements and a revised agreement was signed in 2011. It provides for a system of general revenue and specific purpose payments to the States and Territories.

Some of the main features of the current IGA are:

- the GST is to be distributed among the States on the basis of recommendations of the Commonwealth Grants Commission based on horizontal fiscal equalisation principles
- specific purpose payments are grouped into five National SPPs for healthcare, schools, skills and workforce development, disability services and affordable housing
- the distribution of each National SPP among the States is to progressively move to an equal per capita allocation (but the schools payment is to be allocated on the basis of full-time enrolments in government schools)
- a new form of payment, National partnership payments, has been introduced to:
  - provide financial contributions to the States for specific projects
  - facilitate action by States on nationally significant reforms
  - reward States which deliver on the reform process
- the National SPPs and National partnership payments (except reward and facilitation payments) paid to the States are intended to affect GST shares because they provide budget support for State services, but the Commission has discretion to determine the treatment of individual payments consistent with fiscal equalisation.

Source: <http://www.federalfinancialrelations.gov.au>

### General revenue payments

10 Since 2000, the net proceeds of the GST have been distributed to the States. This revenue replaced the previous financial assistance grants and the revenue from certain State taxes abolished when the GST was introduced. General revenue payments have been used since the early 1980s to deal with the vertical fiscal imbalance between the Commonwealth and the States and also to equalise State fiscal capacities. These differ because of differences in the natural endowments of States and their economic, demographic and geographic circumstances.

## SPPs and NPPs

- 11 In 2009, SPPs were broad banded into five National SPPs (healthcare, schools, skills and workforce development, disability services and affordable housing). These were to be distributed to the States on an equal per capita (EPC) basis (or equal per student for schools) in 2014-15 after a five year phasing in-period. The agreements covering each new payment contained objectives, outcomes, outputs and performance indicators.
- 12 NPPs were also introduced to fund specific projects, to facilitate action by States on nationally significant reforms and reward States which delivered on the reform process.
- 13 However, more recently, there have been changes to some of the SPPs which will move their distribution away from EPC. Some NPPs have been rolled into the new funding arrangements.
  - The National Health Reform Agreement replaced the National Health Care Agreement in July 2012. States are to be funded on the basis of the most efficient price of health and hospital services, commencing in 2014-15.
  - National Education Reform Agreement (NERA) funding replaced the National Schools SPP from 1 January 2014. The NERA introduces a needs-based funding model for schools, based on a Schools Resourcing Standard. The changes and how the Commission will treat them are explained in Chapter 5 on Priority Issues.
  - DisabilityCare Australia will establish a National Disability Insurance Scheme across Australia for people with a significant and permanent disability. It will be jointly funded by the Commonwealth and the States. Transitional arrangements will commence in 2016. The impact this will have on the National Disability Agreement is not yet clear. The changes and how the Commission will treat them are explained in Chapter 5 on Priority Issues.
  - The Commonwealth took over full policy and funding responsibility for all aged care in 2011, except in Victoria and Western Australia. Victoria has now agreed to the new arrangements. An adjustment to ensure budget neutrality is being made to the National Disability SPP at least until 2013-14. The Commission's treatment of these changes is explained in the welfare attachment.
- 14 Table 1 shows the size of each type of payment for selected years since 1980-81.
- 15 Figure 2 shows the contribution of State revenue, general revenue assistance and SPPs (including NPPs) to total State revenues since 1982-83. It shows that over the period since the introduction of the GST overall payments from the Commonwealth have remained broadly stable (about 50% of State revenue), but that general revenue payments declined, offset by growth in SPPs.

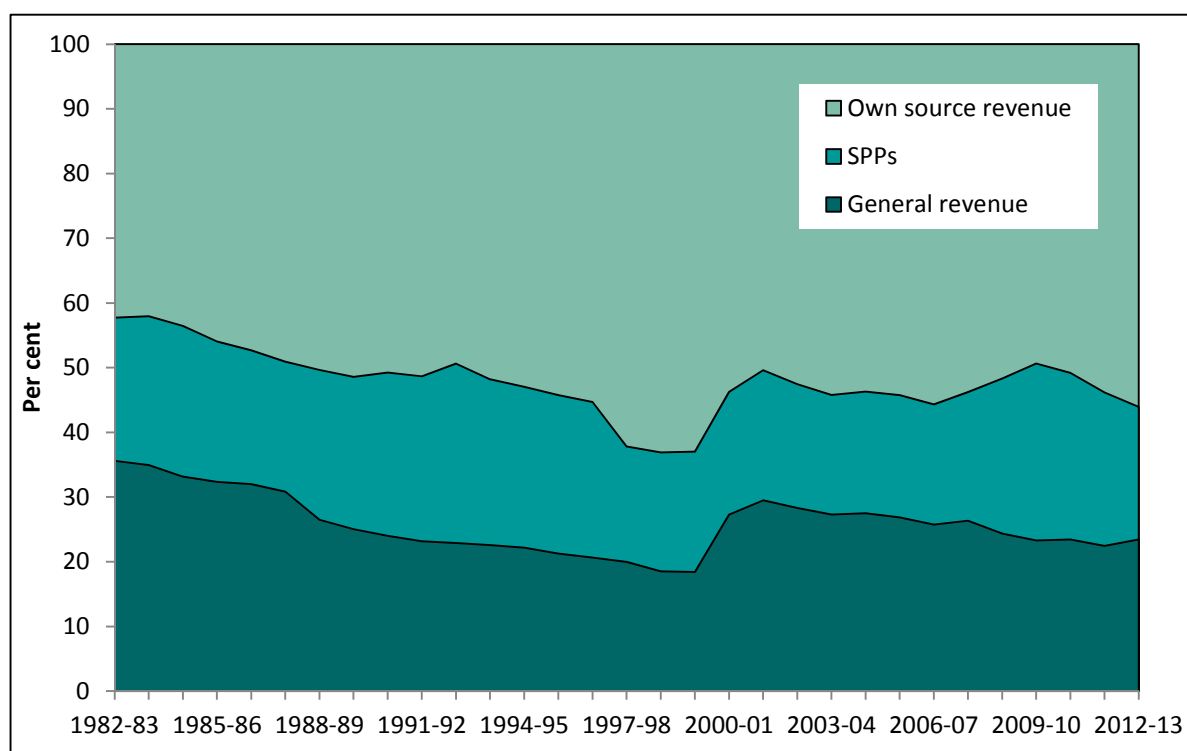
**Table 1 Commonwealth payments to States, selected years**

	1980-81	1990-91	2000-01	2010-11	2011-12	2012-13	2013-14
	\$m	\$m	\$m	\$m	\$m	\$m	\$m
General revenue payments	7 090	13 932	27 635	46 953	47 149	49 255	
Specific purpose payments (a)	5 683	14 638	19 207	48 207	51 337	41 252	
<b>Total</b>	<b>12 773</b>	<b>28 569</b>	<b>46 841</b>	<b>95 159</b>	<b>98 486</b>	<b>90 507</b>	

(a) Includes National partnership payments paid to and through States and direct payments to local government published in Commonwealth’s Final Budget Outcome. Adjustments have been made to the accounting treatment of payments under the natural disaster recovery and rebuilding arrangements (NDRRA) for 2010-11 to 2012-13 to ensure consistency with earlier years.

Source: Commonwealth of Australia’s Final Budget Outcome, various years.

**Figure 2 Total State revenue by source, 1982-83 to 2012-13**



Source: Commission analysis of State budgets.

## TREATMENT OF COMMONWEALTH PAYMENTS TO STATES

### Terms of reference

- 16 The terms of reference provide guidance to the Commission on the treatment of Commonwealth payments. They ask 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



- to treat national SPPs, national health reform funding, NPP project payments and general revenue assistance (GRA), other than the GST, so that they would affect GST shares, but treat facilitation NPPs so that they would not.
- 17 However, the Commission is given discretion to vary the treatment of the second group of payments where it is appropriate, reflecting the nature of the payment and the role of State governments in providing services.
  - 18 These instructions, which are consistent with the IGA, make it very clear that where it has discretion, the Commission should exercise that discretion in deciding if and how payments should affect the GST distribution.
  - 19 We consider that in exercising our discretion we can be guided only by the objective of the GST distribution which is the principle of horizontal fiscal equalisation (HFE). The appropriate treatment of a particular payment where we have discretion is that which improves the HFE outcome.
  - 20 We are aware there are other policy objectives behind the distribution of Commonwealth payments. However, we do not consider we have been asked to choose among objectives in advising on the GST distribution. We have no discretion other than that which improves the HFE outcome. If that discretion is not to be exercised for a specific payment we should be advised in the terms of reference.

## Achieving horizontal fiscal equalisation

- 21 The GST distribution is designed to offset the measured financial consequences of differences among States in what they need to spend to provide average services and their own revenue capacities. Without any Commonwealth payments, all these innate differences are reflected in, and compensated for, in the GST distribution.
- 22 If Commonwealth payments can be used to completely or partially offset the fiscal consequences of innate differences, then only the residual fiscal consequences should impact on the GST distribution. In this way, these Commonwealth payments affect the GST distribution. If these payments were not treated in this way, some States would have the capacity to deliver above average services and others only a below average service.
- 23 However, Commonwealth payments should not affect the GST distribution if they are used to address differences the Commission does not take into account in its calculations.
- 24 Therefore, we have decided to use the following guideline to decide the treatment of all payments on a case by case basis:
  - payments which support State services, and for which expenditure needs are assessed, will impact the relativities.

- 25 Assessed expenditure needs are differences among the States which affect the cost of delivering services. In some cases, on conceptual grounds, we conclude there are no differences in per capita service delivery costs and assess expenditure EPC (a deliberative EPC assessment). Where such an assessment is made, related payments would affect the GST distribution.
- 26 However, where there is a conceptual case but needs have not been assessed because they are not material, this is not a deliberative EPC assessment and any associated payments should not affect the GST distribution.
- 27 Adopting the guideline and applying it on a case by case basis to Commonwealth payments will therefore result in some payments having an impact on the relativities and others not. The decision is made purely on the basis of whether the payment is available to support State services and whether needs have been assessed. We make no judgment about the worth of any Commonwealth program or the appropriateness of the basis on which funding is allocated among States.
- 28 In all cases, we consider we should be guided by the HFE objective and our single guideline which interprets that. It makes it clear that payments for Commonwealth rather than State services and payments to support services where needs are not assessed should not have an impact. We will consider each payment on its merits and ensure payments which the Commission considers impact on State fiscal capacities have an impact on the relativities. Of course, payments which the terms of reference specify as not having an impact will be treated in that way.
- 29 If the Commission decides a payment should impact on the relativities, this does not mean we are changing the payment in any way, or overriding its purpose. The State still receives the payment and must comply with its conditions. However, its GST receipts will adjust to reflect any above or below average per capita receipt of the payment to ensure, when taken together, a State's GST, Commonwealth payment receipts and own source revenue give the State the capacity to deliver average services.
- 30 We are also aware that the arrangements for the provision of Commonwealth payments can provide information on differences among States affecting their fiscal capacities, which we should reflect in the assessments. Where this information allows us to reliably incorporate a new material disability, we would seek to do so as soon as practicable. For example, new schools funding arrangements might provide new information on the distribution of disabled students, a disability we recognised conceptually in 2010, but were unable to incorporate into the methodology because of concerns about the reliability of the existing data.
- 31 During this review we have been asked to look at the appropriate treatment of Commonwealth payments for infrastructure, especially those for 'nationally significant projects'.

- 32 In that context, the Northern Territory proposed the development of a set of additional criteria which could be used to determine whether the needs the payment is addressing are captured in the assessment.
- 33 We consider we cannot develop guidelines to judge between nationally significant projects and other projects supported by the Commonwealth. We consider that best done by government, which can then advise us on the appropriate equalisation treatment of the funding. Chapter 2 considers this issue in more detail.
- 34 We do not consider the development of additional criteria, which would proliferate boundary and interpretative issues, practical. The Commission believes it can only examine all relevant information relating to each program, take advice from States, and make a judgment based on the guideline above.

## Applying the guideline

- 35 We consider the rationale supporting our approach to the treatment of Commonwealth payments to be clear, and note that it has the support of States. For most payments, making decisions on their treatment using the guideline is straightforward.
- 36 However, for a minority of payments, making decisions can be both difficult and contentious. In our experience, this arises because of difficulties in deciding whether the payments support a State service or relate to a Commonwealth function; or because of difficulties in deciding what the payment is actually for, and in that context, whether expenditure needs have been assessed.

We provide some examples below.

- ***Is the payment for a State or Commonwealth function?*** While it is easy to discern what a payment is for at the extremes, there is a broad area where responsibilities can overlap, making a judgment difficult. For example, the ‘Royal Darwin Hospital – prepared, equipped and ready’ program could be seen as providing support to Territory health services. Alternatively, it could be seen as a Commonwealth purchase of services to ensure the Royal Darwin Hospital is able to respond to major international health incidents in the region. Most likely the payment provides assistance for both. (Fortunately, uncertainty in this case was resolved as terms of reference told the Commission it should not have an impact on the relativities.)
- ***What service does the payment support?*** Deciding on an appropriate treatment of a payment can be difficult if limited explanatory material on the nature of the payment is available, or if the payment appears to support one or more State programs. We need this information to decide if expenditure needs have been assessed. For example, difficulties arise when the purpose of a payment is broadly described but, after further consideration, the payment appears to have multiple funding elements, each addressing a different

objective. Also the nature of payments can change over time. Water for the Future is such a program, aimed at assisting the agricultural industry, ensuring adequate domestic water supplies and protecting the environment. The treatment of this payment has been reconsidered in this review because South Australia considers the relative importance of parts of the program has changed.

- ***How closely do the disabilities we assess correspond to the differences being addressed by a Commonwealth payment?*** Of necessity, the differences we assess are often measured broadly, while a Commonwealth payment can be quite narrowly focussed. To decide an appropriate treatment, the Commission has to consider the extent to which what we assess and what the Commonwealth payment addresses overlap. For example, if the different needs of State populations in five age groups are recognised in our assessments, have needs been assessed in relation to a different specific age group targeted by a particular Commonwealth program? The answer is yes, if further differentiation of age to distinguish more age groups is not material.

- 37 States have raised other concerns. Tasmania has noted one of the guidelines the Commission adopted in the 2010 Review - that payments for programs implemented at the behest of the Australian Government and which lead to above average or unique State outcomes should not impact on the relativities - did not function effectively. Queensland, however, would prefer this guideline be retained because it considers HFE requires that such payments, which relate to services which are not delivered as average policy, should not impact on the relativities.
- 38 The guideline did not work well because it was often difficult to distinguish such programs. Where they related to a function which only one State was undertaking on behalf of the Commonwealth, it was appropriate to ensure the payment had no impact on State GST shares. However, in other cases, where the payment appeared to allow one State to provide an above average service in an area in which all States had responsibilities, the appropriate treatment would normally have been the opposite. We have concluded it would be best if payments which the Commonwealth Government does not want to have an impact on the relativities were identified in the Commission's terms of reference. In the absence of such specification, the Commission will take its new streamlined approach, considering the treatment of payments using a single guideline; that is, we will consider whether the payment supports a service for which needs have been assessed.
- 39 New South Wales had concerns about the way the Commission treated payments through States to Public Non-Financial Corporations (PNFCs) for capital purposes in the 2010 Review. They impacted on the relativities because they were considered to increase the net financial worth of States through increases in equity holdings. As State needs for increases in net financial worth due to population growth were

assessed, the Commission considered it appropriate to recognise the extent to which these needs had already been met through other Commonwealth payments.

- 40 New South Wales said all payments to PNFCs should not affect the relativities because they have no direct impact on operating budgets and only marginally increase State net financial worth. South Australia also considered Commonwealth payments to commercial PNFCs should not impact on the relativities if it could be demonstrated that the payments flow to the benefit of user charges or services funded by user charges. In such cases, the payments would have no impact on equity or on dividends received.
- 41 In both cases, we again believe our single guideline can be followed: if needs are assessed, the payment should have an impact on the relativities.
- 42 Other payments made through States to third parties, such as to local governments, can have indirect rather than direct effects on fiscal capacities. For example a payment to a local government in one State might mean the State itself can provide a lower service level than other States and still achieve average service levels. As for payments to PNFCs, we consider these other indirect impacts should be reflected in the GST distribution.
- 43 ***What Commonwealth payments should we look at?*** Conceptually all Commonwealth payments to the States for which needs have been assessed should be included within the Commission's processes. However in practice, the Commission can only consider those payments which can be readily identified. In the past, the Commission has used Commonwealth budget documents (Budget Paper No 3 (BP3) and Final Budget Outcome (FBO)) to define most of the payments considered. This has meant the treatment of payments made for recurrent or capital purposes<sup>3</sup> direct to States and through the States to third parties has been considered. Because payments made direct to local government are also included, we can easily consider whether they have an impact on State fiscal capacities as well.
- 44 We propose to continue this approach in the 2015 Review.

## OTHER ASSESSMENT ISSUES

### Materiality

- 45 We have decided not to adopt a materiality threshold for Commonwealth payments in this review. Although the use of a threshold could simplify decisions on the

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<sup>3</sup> This included any debt forgiveness which is treated as a capital grant.

treatment of Commonwealth payments by reducing the number considered<sup>4</sup>, we agree with all States that a materiality threshold is not needed for Commonwealth payments. If a materiality threshold were applied, it should be applied in the same way the materiality of disabilities is judged - in aggregate. This would mean the treatment of every payment would need to be considered because, in aggregate, the effect on the GST of impacting payments would be material. The impact of non-impacting payments would also be material.

- 46 States said the Commission should consider the treatment of each to avoid arbitrary consequences for different States.
- 47 States also said the grouping of Commonwealth funding (and therefore the size of payments) under different agreements was arbitrary and they were concerned a materiality threshold could result in funding arrangements being developed and structured in a manner to remain under the threshold (that is, splitting funding into several smaller agreements rather than one). This could lead to further proliferation of funding agreements. We agree this should be avoided.

## Dealing with State policy differences

- 48 Issues can arise where States adopt different policies towards Commonwealth payment programs which result in the interstate pattern of a payment reflecting State policy not their individual underlying circumstances.
- 49 In principle, the impact of policy choices should be removed before the payment is incorporated into our assessment process. This is analogous to our treatment of some revenue items. For example, in the land tax assessment, a decision by one State not to raise this form of revenue is seen as its choice and an imputation of revenue is made for that State in the assessment.
- 50 Most payments are not affected because they are the result of Commonwealth policy decisions and individual States have no influence on what they receive.
- 51 However, there are payments which States decide not to accept, and other payments where the behaviour of States can influence the amount paid. For example, 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). It treated Western Australia as if it had received the additional funding for the purpose of determining its GST share. We did not accept

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<sup>4</sup> A materiality threshold could have been used automatically to decide that payments below the threshold would automatically impact, or not impact, on the relativities, without the Commission needing to consider their treatment. 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.

that this treatment meant Western Australia was unable to deliver the average level of service for reasons outside its control.

- 52 The difficulty we face is attributing payments – their size, distribution among States or non-receipt of a payment - to State and Commonwealth policy decisions. We can only have regard to the facts and circumstances of each payment to make a judgment on a case by case basis. We will be guided by policy neutrality considerations and attempt to ensure decisions by individual States will not affect their GST or the approach we adopt does not influence a State’s behaviour.

## Backcasting

- 53 The Commission’s methodology uses historical data. On occasions, we will use a ‘backcasting’ approach to improve the contemporaneity of our methods. We adjust the historical data for known changes that will affect the year in which the relativities will be applied. This approach is largely limited to major changes in Commonwealth-State financial arrangements. State policy changes are not generally backcast. Backcasting is only done when the application year changes are reliably known.
- 54 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. The Commission 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.
- 55 With the introduction of the national health reforms and the national education reform agreement, the distribution of national SPPs is now moving away from EPC. There have been further changes in the recent Commonwealth budget, including the ceasing of a number of NPPs. Following our contemporaneity principle, we will continue to backcast, but only if the change is reliably known and material. Whether we should backcast the cessation of this group of programs, even if they would not warrant that treatment individually, will be considered in our final report.
- 56 All States but Western Australia agreed the Commission should continue to backcast major changes in Commonwealth-State financial arrangements for contemporaneity reasons. They agreed such changes should only be made if they can be made reliably and are material.
- 57 Victoria said any proposed changes in State taxation policy should not be subject to backcasting. However, Queensland and Tasmania accepted this could not be applied in a blanket manner, particularly if the change were associated with a major change in Commonwealth-State financial arrangements (as it was when States agreed in 2006 to abolish certain State taxes).

- 58 South Australia noted the change in Commonwealth-State financial relations should be a step change occurring in the application year in respect of the roles and responsibilities of Commonwealth and State governments. A gradual change, such as that being introduced with the National Health Reform Agreement (2011), should not be backcast.
- 59 Western Australia continues to hold the view that only lagged equalisation is actually achievable. It argues that if backcasting is to continue, it should only be done where there is certainty. It notes that Commonwealth budget estimates are often not sufficiently reliable.
- 60 We consider 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 did not occur. However, on practicality grounds, only large and known changes should be backcast. Our experience suggests 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. 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 materiality of the change and the reliability of that information.

## Treatment of the impact of other Commonwealth activities on State budgets

- 61 The Commonwealth Government conducts a range of other activities which can relieve the State of the need to fund a service or reduce the amount of State type services that need to be provided. They take different forms, such as payments *direct* to local governments, PNFCs, other third parties and individuals.
- 62 In this review, we propose examining Commonwealth own-purpose expenses (COPEs) in the same way we examine Commonwealth payments to States. Their treatment will be decided on the basis of whether they impact on State fiscal capacities. Where a COPE funds a State service (or a substitute for that service) for which needs are assessed, it should be taken into account when determining the GST distribution.
- 63 COPEs we consider should affect the GST distribution could be treated either as if they were a Commonwealth payment, or as a material disability. The approach adopted makes no difference to the impact on the GST distribution. We will adopt the simplest and most transparent approach in each case.
- 64 The ACT has argued Commonwealth payments made direct to third parties for the purpose of industry support, development and support costs should have an impact on the relativities if needs relating to such payments are assessed. It says that



payments of this nature generally supplement or potentially replace the need for States to provide additional support. It gives as an example payments to the shipbuilding industry.

- 65 While in principle we should consider whether such payments support or are substitutes for State services, it is often hard to identify them or their impact. As there is no consolidated source of these payments, we will rely on our knowledge of State and Commonwealth service delivery and advice provided by the States or the Commonwealth Government.

## TREATMENT OUTCOMES

- 66 Appendix 2 provides details on each payment listed in the FBO for 2011-12 and 2012-13 (2013-14 will be included in the final report), whether the terms of reference has required that they not affect the relativities and, where not so stipulated, the Commission's decisions on the treatment. (The final report will also provide details on all payments commencing in 2014-15 and 2015-16 to support the Commission's backcasting decisions).
- 67 Major changes in Commonwealth State financial relations that have been backcast into the assessment years currently are those related to national SPPs, including the Health Reform payments, and the National Education Reform Agreement.
- 68 Table 2 shows how the approach to deciding the treatment of different payments works in practice.
- 69 Table 3 provides details of those payments where the Commission decided there should be no impact on the GST distribution. The only SPP treated in this way is the Commonwealth Government support for non-government schools.
- 70 Table 4 sets out the Commission's treatment of other Commonwealth activities (COPEs) that impact on relativities.

**Table 2 Commonwealth payments (a) 2011-12 to 2013-14 — Method of treatment**

		2011-12	2012-13	2013-14	2011-12	2012-13	2013-14
		\$m	\$m	\$m	%	%	%
<b>No impact required by terms of reference</b>							
No impact	General revenue assistance	0	0		0.0	0.0	
	Specific purpose payment	0	0		0.0	0.0	
	National partnership payment	2 289	1 814		4.4	4.0	
Total		2 289	1 814		4.4	4.0	
<b>Method decided by the Commission</b>							
Impact	General revenue assistance	0	0		0.0	0.0	
	Specific purpose payment	20 118	21 175		39.0	47.1	
	National partnership payment	9 896	5 496		19.2	12.2	
	Sub-total	30 015	26 671		58.1	59.4	
No impact	General revenue assistance	36	37		0.1	0.1	
	Specific purpose payment	7 576	7 984		14.7	17.8	
	National partnership payment	10 558	7 183		20.4	16.0	
	Sub-total	18 170	15 204		35.2	33.8	
State revenue	General revenue assistance	998	1 158		1.9	2.6	
	Specific purpose payment	0	0		0.0	0.0	
	National partnership payment	158	76		0.3	0.2	
	Sub-total	1 157	1 234		2.2	2.7	
Total		49 341	43 108		95.6	96.0	
<b>All payments</b>							
Impact	General revenue assistance	0	0		0.0	0.0	
	Specific purpose payment	20 118	21 175		39.0	47.1	
	National partnership payment	9 896	5 496		19.2	12.2	
	Sub-total	30 015	26 671		58.1	59.4	
No impact	General revenue assistance	36	37		0.1	0.1	
	Specific purpose payment	7 576	7 984		14.7	17.8	
	National partnership payment	12 848	8 998		24.9	20.0	
	Sub-total	20 459	17 018		39.6	37.9	
State revenue	General revenue assistance	998	1 158		1.9	2.6	
	Specific purpose payment	0	0		0.0	0.0	
	National partnership payment	158	76		0.3	0.2	
	Sub-total	1 157	1 234		2.2	2.7	
All payments total		51 631	44 922		100.0	100.0	

(a) Excludes GST.

Note: Payments for non-government schools and half the National network roads NPP have no impact.

Source: Commonwealth of Australia's *Final Budget Outcome 2011-12, 2012-13 and 2013-14* (not yet available).

**Table 3 Commonwealth payments — ‘no impact’ method decided by the Commission, 2012-13**

Payment	Amount	% of ‘no impact’ payments
	\$m	%
Non-government schools SPP	7 984	52.5
Natural disaster recovery and rebuilding	1 892	12.4
Local government FAGs – general purpose assistance	1 526	10.0
National network roads 50% no impact payment	776	5.1
Local government FAGs – local roads	677	4.5
Highly specialised drugs COPE	392	2.6
Nation building program – local government payment	348	2.3
Other payments	1 613	10.6

Source: Commonwealth of Australia’s *Final Budget Outcome 2012-13*.

**Table 4 COPEs which impact on relativities, 2012-13**

COPEs	Amount	% of ‘impact’ payments
	\$m	%
Treated as Commonwealth payment		
Indigenous payments to States and third parties	68	0.2
Treated as an economic environment factor		
Health Services	481	1.6

Source: Data collected from Commonwealth departments.

## IMPACT OF COMMONWEALTH PAYMENTS ON THE GST DISTRIBUTION

- 71 Because Commonwealth payments are not, for the most part, distributed on an EPC basis, they affect each State’s fiscal capacity differently. Table 5 shows the amount received by each State of payments which impact on the relativities in the assessment years compared with the average. The Northern Territory receives significantly more than an EPC share of these payments, and this reduces its need for GST. Similarly, South Australia and Tasmania receive a greater than EPC share of Commonwealth payments, while Victoria and the ACT receive considerably less.
- 72 The closer Commonwealth payments in total are to an EPC distribution, the more work the GST has to do in meeting State needs. A larger proportion of the GST will be required for equalisation purposes. If the payments are distributed in a manner consistent with the Commission’s assessment of needs, this will reduce the extent to which GST is redistributed. State needs have already been met by the Commonwealth payments.

**Table 5 Per capita revenue from Commonwealth payments (a), 2011-12 to 2013-14**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$	\$	\$	\$	\$	\$	\$	\$	\$
2011-12	1 761	1 735	1 923	1 766	2 142	1 735	1 529	2 802	1 822
2012-13	1 571	1 587	1 616	1 604	1 611	1 697	1 533	2 370	1 601
2013-14									

(a) Commonwealth payments that the Commission treated as impacting on relativities.

Source: Commonwealth of Australia's Final Budget Outcome 2011-12, 2012-13 and 2013-14 (not yet available).

73 Table 6 shows the impact Commonwealth payments have on the GST distribution, including those payments which have the largest impact in the 2014 Update.

74 However, Table 6 only shows the impact on States' fiscal capacities of the revenue they receive. Because these payments also increase State spending, those States which are assessed as needing to spend more than average correspondingly have their assessed spending increased by more than the average revenue from the Commonwealth payment. Queensland, Western Australia, South Australia, Tasmania and the Northern Territory are assessed as needing to spend more than average, so the spending of Commonwealth revenue increases their GST requirements.

**Table 6 Illustrative effect on the GST distribution of Commonwealth payments, 2014-15**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Rail infrastructure payments (a)	242	-279	164	-34	-110	-9	16	10	431
Road infrastructure payments (a)	-177	261	-119	16	32	12	22	-46	342
Health and hospital fund	112	27	-2	-63	6	-69	-1	-11	145
Water for the future	36	-4	58	32	-105	-18	6	-4	131
Other	85	331	-132	-31	-81	-84	22	-112	439
Total	298	336	-31	-80	-258	-168	65	-163	699

(a) Includes the relevant components of the Nation building plan for the future; Nation building program; and Building Australia fund.

Source: Commission calculation, 2014 Update.

75 The net effect of Commonwealth payments for any State is a combination of the impact on their assessed expenditure, including infrastructure spending, and on their assessed revenue. Table 7 shows the net effect on the GST distribution of Commonwealth payments.

**Table 7 Net effect on the GST distribution of Commonwealth payments, 2014-15**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Revenue effect									
Expenditure effect									
Net effect									

Source: Commission calculation. (Data not yet available)

## CONCLUSION

76 The appropriate treatment of Commonwealth payments and other activities is a major part of the Commission's work. They have a large impact on the fiscal capacities of the States and it is important that the relativities capture this. The constantly changing Commonwealth environment presents a major challenge for the Commission in keeping the relativities up-to-date. We consider the best way of doing that is by deciding the treatment of each payment or other activity on a case-by-case basis, assisted by the use of a guideline: payments which support State services or other Commonwealth activities that affect them, and for which expenditure needs have been assessed, will impact the relativities.

## CHAPTER 5

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### PRIORITY ISSUES

- 1 The terms of reference for the 2015 Methodology Review ask the Commission to progress a number of matters as a priority, and undertake early consultation with the Commonwealth and the States. Those matters are:
  - the Mining revenue assessment
  - the treatment of Mining related expenditure
  - ensuring educational disadvantage funding embedded in the National Education Reform Agreement (NERA) is not unwound and there is no windfall gain for non-participating States
  - the appropriate treatment of the National Disability Insurance Scheme arrangements
  - the development of a Transport infrastructure assessment and the appropriate treatment of transport infrastructure payments
  - appropriately capturing Indigeneity (including socio-economic status) in the assessments.
- 2 State Treasurers were consulted on these issues in August and September 2013 and Commission staff included proposals on how the Commission might deal with them in an October 2013 discussion paper. State submissions have since been received and considered by the Commission. This chapter briefly outlines our response to each matter. Implementation details are covered in the appropriate assessment attachments.

### THE MINING REVENUE ASSESSMENT

#### Background

- 3 The terms of reference ask the Commission to:
  - ... have regard to the recommendations of the final report of the GST Distribution Review to ... develop a new mining revenue assessment.
- 4 In the 2010 Review, the Commission adopted a two-tier mining assessment. The GST Distribution Review panel found the two-tier mining assessment could produce excessively large GST share effects when a commodity moved between groups. It

recommended the Commission and stakeholders develop a new mining revenue assessment that:

- avoids excessively large GST share effects, such as when a commodity moved between groups under the two-tier assessment (Recommendation 7.1)
- treats iron ore, coal and petroleum differently from minerals that are not subject to the Commonwealth resource rent taxes (Recommendation 7.2).

- 5 The States had differing views on how mining revenue raising capacity should be assessed. Western Australia favoured a mineral by mineral approach. Most other States favoured assessing minerals in groups, although their views varied on the number and composition of groups.
- 6 Queensland and Western Australia argued the mining assessment should be discounted by up to 50%. They considered discounting as a means of addressing policy neutrality, unassessed mining related expenditures, the assessment's sensitivity to royalty rate changes, the need for judgment and intergenerational risk.

## Commission response

- 7 For the 2015 Review, we have decided to adopt a mineral by mineral approach. We have done this because we consider this achieves HFE more accurately. We acknowledge that this has the potential to make the assessment less policy neutral because changes in State policies may have a larger impact on their shares of GST. However, we consider that the goal of policy neutrality is subsidiary to the requirement to achieve HFE. We also consider that while it is theoretically possible for changes in State policies to affect GST shares, in practice we do not observe this to be an issue.
- 8 Under our mineral by mineral approach, we will separately assess a mineral if it is material to do so.
- 9 This approach means the seven minerals that generate most royalties will be separately assessed. These are iron ore, coal, gold, on-shore oil and gas, copper, bauxite and nickel. The remaining minerals will be assessed together. All coal will be assessed together and all iron ore will be assessed together.
- 10 The only movement of minerals between groups relate to entry or exit from the balance of minerals group. These minerals generate small royalties (less than \$20 million) and a separate assessment would not materially affect the GST distribution. Therefore, the new mining assessment avoids excessively large GST share effects arising from minerals moving groups.
- 11 We have not discounted the assessment because we use discounting when we have concerns about the reliability of our measure of fiscal capacity, concerns we do not have in relation to the mining assessment.

## **Iron ore fines**

- 12 Compared to our assessment in the last update, where we were directed not to capture the full fiscal consequences of Western Australia's decision to raise the effective royalty rate on iron ore fines, an iron ore royalty assessment including fines significantly increases Western Australia's assessed fiscal capacity. Had previous updates more closely tracked the evolution of Western Australia's fiscal capacity, the change from the 2014 Update would have been considerably smaller.
- 13 We consider that some phasing of this 'bringing to book' of higher iron ore fines royalty rates is appropriate, consistent with the usual three year phasing embedded in our assessment methodology. As an illustrative placeholder we have provided an allowance based on the impact on Western Australia's fiscal capacity in 2012-13 had iron ore fines been moved to the high royalty rate in that year.

## **MINING RELATED EXPENDITURE**

### **Background**

- 14 The terms of reference ask the Commission to:
  - ... have regard to the recommendations of the final report of the GST Distribution Review to ... consider the appropriate treatment of mining related expenditure.
- 15 The GST Distribution Review concluded that, while most of the direct mining related needs of Queensland and Western Australia are recognised in the Commission's assessments, some small gaps exist. It recommended the Commission re-examine mining related expenditures in the next methodology review.

### **Commission response**

- 16 The Commission understands that States with rapidly expanding mining sectors have experienced significant budgetary pressures dealing with the growth in demand for State services and in the provision of related infrastructure. While the nature of the expansion in mining appears to be changing, with many projects moving from investment to production phases, that pressure is likely to remain. We are also aware that the impact of a smaller but fast growing mining sector might have a bigger budgetary impact than one which is larger, but stable.
- 17 The Commission has in this, as in past reviews, given careful consideration to how well its assessment methodology captures the impact of mining activity on State fiscal capacities and whether a given size mining sector with certain growth characteristics has a different impact than say a similar sized finance sector with the same growth profile.



- 18 We consider our decision in 2010 to change the way we assessed State infrastructure investment, to more directly capture the impact of population growth, captured the impact of fast growing economies, driven by mining or other sectors.
- 19 However, we entered this review seeking to determine if there were fiscal impacts from mining activity which were not captured by our assessments. For example, while we consider the growth in demand for schools education driven by mining related population growth is captured in what we do, we sought to understand and measure what channels of influence had been overlooked in past reviews.
- 20 To facilitate this consideration we asked States to identify and classify all expenditures they consider are influenced by the presence of a mining sector and the nature of that influence. Table 1 below provides the data we have received to date.

**Table 1 Mining related expenditure, average 2010-11 to 2012-13**

	NSW	Vic	Qld	WA	SA (a)	Tas	ACT	NT	Total	Category or component expense
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Recurrent expenses (net)										0
Roads	0		90		0	0	0		90	7 272
Service to industry										
Business development (b)	0		56		0	0	0		56	3 478
Regulation	72		7		18	5	0		103	227
Protection of the environment	0		22		0	0	0		22	1 803
Other	0		27		0	0	0		27	188 391
Total recurrent expenses	72	na	203	nya	18	5	0	nya	299	201 171
Capital expenditure										
Roads	0		87		0	0	0		87	6 880
Non-roads	0		43		0	0	0		43	7 909
Total capital expenditure	0		131		0	0	0		131	14 790
Total State expenditure	72	na	334	nya	0	5	0	nya	411	215 960

(a) Two year average used for South Australia because comparable data for 2010-11 were not available.

(b) While most business development expenses are classified to services to industry, this group includes some that are classified to Other expenses.

na not able to provide data.

nya not yet available.

Source: State provided data

- 21 In most cases, the expenditure States have identified as relating to mining is a small part of what States spend on these activities. The data received to date indicate direct mining expenditure is less than half of 1% of total State expenditure.
- 22 We have systematically considered potential influences on these expenditures category by category. Our responses to the issues raised have been addressed in the

relevant assessment attachments. Where a conceptual case has been established and reliable data are available, we have made an assessment. We are still considering our response for roads linked to mining activity. We will consult with the States on the appropriate way to assess these expenses before the final report is produced. Our responses are summarised in Table 2.

23 We have concluded that, in most areas, States with significant mining sectors face no higher expenses per capita than States with a different industrial composition. For example:

- **Business development expenses.** All States spend on developing their industries. The nature of their economy will determine which industries are supported, but we do not consider the nature of a State's economy determines how actively it attempts to develop its economy. This issue is covered in more detail in the attachment on Services to industry.
- **Environmental protection expenses.** We have not been able to discover data which would enable us to discriminate between industries on the environmental costs they impose, and we suspect any such analysis would be heavily influenced by both site specific considerations and State policy choices. As a consequence we have not incorporated a mining factor into our assessment of State spending on environmental protection.
- **Non-road capital expenditure.** Queensland undertook residential (\$31 million) and industrial (\$11 million) development works in mining communities. These expenses are assessed in the Investment category which recognises the impact of population growth on infrastructure provision. We do not consider development in communities linked to the mining industry is unique. It therefore does not warrant an additional disability. The treatment of this expenditure is described in the Infrastructure attachment.

**Table 2 Mining related expenditure issues raised by States, 2015 Review**

Issue	Reference	Commission response
<b>Capital costs.</b> Actual capital costs should be used instead of the recurrent cost disability proxy to measure infrastructure costs.	Attachment — Infrastructure	We have used the Rawlinsons construction costs index as the basis for the capital cost disabilities.
<b>Intrastate migration.</b> The infrastructure assessments should recognise the impact of intrastate migration on State infrastructure provision.	Attachment — Population growth	We have not made an assessment for the impact of intrastate migration on State infrastructure provision.
<b>Growth investment.</b> New asset values should be used to calculate the new investment required.	Attachment — Population growth	We have not made an assessment but more consultation is needed.
<b>Roads.</b> There is inadequate recognition of road maintenance and construction for mining related roads.	Attachment — Roads	We are still examining State provided data on roads related to economic activity.
<b>State specific remoteness costs.</b> The very high regional and remote costs in Western Australia are not recognised in the location assessments.	Attachment — Wages and Regional costs	We considered but did not assess a State specific regional loading for States with high regional wages. We are still considering how well ABS remoteness areas capture the fiscal consequences of more remote communities.
<b>Mining regulation.</b> There should be explicit recognition of mining industry regulation costs.	Attachment — Services to industry	We have included a separate assessment in the Services to industry category for mining industry regulation.
<b>Local government and community amenities.</b> There is inadequate recognition of support for local governments and community amenities in mining regions.	Attachment — Services to communities	We have not made an assessment for these expenses as they appear very different across States and highly policy influenced.
<b>Fly-in fly-out workers.</b> There is no recognition of the impact of fly-in/fly-out (FIFO) and drive in/drive out (DIDO) workers on services and infrastructure in mining regions.	See this chapter	The States were unable to provide reliable data to demonstrate the conceptual case for making an assessment.
<b>Regulatory costs associated with investment projects.</b> There is no recognition of the higher regulatory costs of investment projects in States with relatively high levels of investment including private sector mining investment.	Attachment — Services to communities	We have not made an assessment for these expenses as it would not be material.
<b>Opportunity cost and risk.</b> The assessment should recognise the opportunity cost and risk linked to mining related activity and economic development more generally.	Attachment — Population growth	We have not made an assessment.
<b>Past policy influences.</b> The mining revenue assessment should recognise the contribution of past and present State policies on the development of revenue bases, for example, the North West Shelf.	Attachment — Mining revenue	We have decided not to adjust current mining revenue bases for past policy because we do not accept there have been previously unequalised expenditures.

### *Previously unequalised expenditure*

- 24 Queensland and Western Australia have asked that the equalisation process recognise they incurred costs in developing their mining industries which were not recognised at the time.
- 25 The Commission has considered mining development expenditures in previous reviews but States were unable to identify expenses on mining or mining related activities which warranted a material assessment in addition to category specific assessments like infrastructure investment. As such we do not accept there have been previously unequalised expenditures.

### *Fly-in-fly-out workers*

- 26 We accept a community with a large proportion of fly-in-fly-out (FIFO) residents can have a different impact on the demand for State services than a similar sized community of permanent residents. However we have no data to suggest they impose greater net costs than a permanent community or different costs, depending on whether they are a mining or other transient community, such as in a tourist town. Nor do we have evidence to show, in relation to fly-out communities, that FIFO workers have a different cost profile than other people. States were unable to provide such data either.
- 27 We consider unrecognised costs due to FIFO work practices are likely to arise because FIFO workers could be recorded as residents in one State but work and use services in another (the cross border effect). Or they might reside in one part of a State, but work and use services in another part of a State where the cost of service provision is markedly higher. We consider the latter is the most likely source of any additional cost of FIFO workers. However, while the cost of services provided to FIFO workers in remote areas may be higher than we assess, the range of services provided may be lower, as the mining companies provide some services. The net effect of this is difficult to determine without data and in its absence we consider any assessment of higher costs inappropriate.
- 28 We recognise there is anecdotal evidence which indicates FIFO work arrangements can have negative social impacts, or at least the potential to exacerbate existing problems.<sup>5</sup> How these impact on State service demands in both the resident community and the work location is unclear. For example, some younger FIFO

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<sup>5</sup> *FIFO challenges for 'source' communities* <http://www.abc.net.au/news/2013-10-23/fifo-communities-under-services-pressure/5040848>, and Aileen Hoath & Fiona Haslam McKenzie, *The socio-economic impacts of long distance commuting (LDC) on source communities*, 2013. The House of Representatives Standing Committee on Regional Australia, 2013. *Cancer of the bush or salvation for our cities? Fly-In, Fly-Out' and 'Drive-In, Drive-Out' Workforce Practices in Regional Australia*. Chapter 3 and related submissions.

workers might impose higher policing costs in their fly-out times, given the strict behavioural standards imposed in mining operations, but their net cost is unclear.

- 29 We are not convinced FIFO workers give rise to duplication of infrastructure and service provision, as argued by Queensland. We consider fly-in communities to have a relatively stable population at any point in time, which determines the level of services required. Having a population of a certain size cycle through an area, rather than permanently living there, does not change the needs for State recurrent or capital expenditure.

## NATIONAL EDUCATION REFORM AGREEMENT

### Background

- 30 The terms of reference ask the Commission to:

... ensure that the GST distribution process will not have the effect of unwinding the recognition of educational disadvantage embedded in the National Education Reform Agreement (NERA) funding arrangements. The Commission will also ensure that no State or Territory receives a windfall gain through the GST distribution from non-participation in NERA funding arrangements.

- 31 NERA funding arrangements commenced on 1 January 2014.<sup>6</sup>

### Commission response

- 32 Our proposed treatment of the Commonwealth NERA funding is based on our current understanding of how it will be implemented.
- 33 In the 2014-15 budget, the Commonwealth Government announced changes to schools funding from 2018. We will need to discuss consequential changes to the methodology proposed below with the States and Commonwealth either in the course of this review or in subsequent updates.
- 34 Under the current NERA funding arrangements the Commonwealth is providing schools funding determined by a base amount per student and loadings for educational disadvantage for particular groups of students; for example, Indigenous students. Commonwealth funding of the base amounts varies among States and loadings are calculated as a percentage of this funded amount.

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<sup>6</sup> From January 2014, National Education Reform funding is referred to as Students First funding. We continue to refer to the payments as NERA funding since this is the terminology used in the terms of reference.

## *Unwinding*

- 35 We consider unwinding occurs when the net financial impact of a Commonwealth payment on State budgets differs materially from the direct impact because of the way the equalisation process deals with the payment and its expenditure. Some unwinding occurs in the case of most payments unless terms of reference direct the Commission to ensure this does not occur.

## *Scope of the no unwinding instruction*

- 36 In this case, we have been directed to ensure there should be no unwinding of measures of educational disadvantage embedded in funding arrangements. We consider that requires us to ensure the impact on State budgets of loadings for educational disadvantage contained in Commonwealth payments for both government and non-government is not unwound.
- 37 We consider the terms of reference contain no direction on how the equalisation process should deal with States' own funding of government and non-government schools, nor that part of the interstate distribution of Commonwealth payments which is not based on measures of educational disadvantage. We propose that the normal equalisation treatment apply in these areas.
- 38 Some States consider unwinding should have a broader meaning.
- 39 Some consider the equalisation process should provide States with the capacity to apply the NERA educational loadings to States' own funding for schools (mirroring the support provided by the Commonwealth) and not to do so would unwind the loadings embedded in NERA funding arrangements. However, as States appear to remain free to fund schools with their own money on their own criteria, we do not consider NERA's recognition of educational disadvantage is 'embedded' in State own source funding and as a consequence will limit the direction to Commonwealth payments.
- 40 Other States consider the Commonwealth has provided funding for disadvantage and the equalisation process does not need to do more in relation to State own spending. Doing so would unwind the Commonwealth's intent. However as Commonwealth and States' own funding of disadvantage appear to be complementary in NERA, we consider that equalisation applied to States own funding does not constitute unwinding.

## *Relevance of the no windfall gain instruction*

- 41 We have concluded the 'no windfall gain' instruction is no longer relevant. This follows the December 2013 announcement of agreements between the Commonwealth Government, and the Queensland, Western Australia and Northern

Territory Governments. There is no longer any potential for windfall gains because the funding amounts for all States are determined on the same basis.

### **Implications for the Schools assessment**

- 42 Commonwealth payments to States for non-government schools have no impact on the GST distribution because we assess that every State has to spend exactly what it receives from the Commonwealth. As a result, there is no impact on State fiscal capacities. We are therefore, not unwinding any of the educational disadvantage embedded in the payments for these schools.
- 43 Our proposed assessments are built so that the impact on State fiscal capacities of Commonwealth payments for government schools will be the difference between what States actually receive and what they would have received had the Commonwealth funds been distributed among States only on the basis of loadings for educational disadvantage. The difference reflects factors such as different base funding negotiated between the Commonwealth and States, which should be the subject of equalisation.
- 44 We consider this approach ensures the impact of funding for educational disadvantage on State budgets is not unwound by the GST distribution.
- 45 While we ensure that funding for educational disadvantage embedded in Commonwealth funding is not unwound, we will recognise other cost influences affecting what States need to spend to deliver schools services, such as the impact of interstate wage cost differentials. We consider that recognising these cost differences does not unwind the impact of loadings for educational disadvantage because they are independent influences determining the allocation of a pool of untied funding.
- 46 Because we base our recommendations on historical data, to give effect to the no unwinding direction, we will modify the relevant historical data to reflect changed funding arrangements and the assessment approach outlined above.

## **NATIONAL DISABILITY INSURANCE SCHEME**

### **Background**

- 47 The terms of reference ask the Commission to:
  - ...consider the most appropriate treatment of disability services during the transition to DisabilityCare Australia (the National Disability Insurance Scheme) and once the full scheme is operating nationally.
- 48 The process for implementation of the National Disability Insurance Scheme (NDIS) involves three phases: trials, transition and full implementation. All States have signed on to the NDIS and the timelines of the launch phase, transition periods and

full implementation dates in each State have been agreed. The launch phase has already started. We currently expect that the transition phase will start in 2016-17 (the application year of a 2016 Update) and full implementation to be achieved by 2019-20.

## Commission response

- 49 Our proposed treatment of the NDIS, of which States are generally supportive, is based on our current understanding of how it will be implemented. If this changes, we may need to adapt our proposals, in consultation with the States and Commonwealth during updates.

### *Launch phase*

- 50 The first stage of the implementation began in July 2013. As directed by the 2014 Update terms of reference, we have treated the Commonwealth payments and expenses associated with the launch as having no impact on the relativities.

### *Transition phase*

- 51 During transition, disability services will be provided and funded in two separate ways: each State will make a contribution to the NDIS reflecting the number of people covered by NDIS in the State in the year and they will fund their own existing disability services for other State residents. The relative importance of the two service delivery methods will adjust over time as the coverage of NDIS and State contributions to it rise and their direct service delivery expenditures fall. In each transition year the proportion of services provided through the NDIS is likely to differ State by State as they have different transition schedules.
- 52 To reflect the changing service delivery modes, the Commission has decided to introduce a 'dual' assessment approach, with concurrent assessments of State needs in relation to the NDIS and current disability services.
- State contributions to NDIS in a transition year will be assessed assuming that the NDIS provides the observed national average coverage of NDIS eligible populations in each State (the average transition).<sup>7</sup> Assessments will be based on a State's proportion of the total number of people eligible in a year to be covered by NDIS when fully operational. The alternative of using actual numbers of people covered in transition years, whether set out in the bilateral agreements or not, would not be policy neutral. For example, if a State were to move at a relatively fast rate towards full implementation, this would be

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<sup>7</sup> The question of whether this should be the assessment year or the year in which the relativities will apply (backcasting) is discussed below.



considered a matter of policy choice which should not be taken into account in the equalisation process.

- The existing disability services assessment for State spending on current State disability services will be retained, but simplified, and is discussed further in the Welfare attachment.

- 53 We did not adopt a ‘switch’ approach, as suggested by New South Wales and South Australia. Under this approach, the current assessment would switch to an assessment of needs under NDIS arrangements at the point when the NDIS is judged to cover the majority of users or when it has been fully implemented in most States. We have not done so because this will not reflect what States are proposing to do during the transition years.
- 54 While there is currently some uncertainty surrounding the estimates of the NDIS eligible population, we understand that by the time transition is initiated, firmer estimates, at the State level, will be available.

### **Full implementation**

- 55 When the NDIS becomes fully operational, anticipated to be in 2019-20, State contributions will change from payments which recognise the number of people covered by the scheme in each State to contributions based on State population shares at Census time. Because at that time, State policies will have no influence on their NDIS expenses, we have decided to assess State contributions actual per capita (APC).
- 56 In both transition and full implementation phases we will treat any associated Commonwealth payments to States, including State draw-downs of the Medicare Levy from the DisabilityCare Australia Fund, as affecting State fiscal capacities and therefore as having an impact on the GST distribution. Commonwealth contributions to NDIS funding will have no effect on State budgets and will be ignored. Similarly, any purchases by the NDIS of State services would have no impact on the relativities.
- 57 It remains to be seen whether States will continue to operate their own disability services once the NDIS is fully operational. Western Australia, Tasmania and the ACT have indicated that there may be some residual service delivery expenses. We propose to continue the dual approach until the non-NDIS service provision assessment is no longer material. On current indications, this is likely to happen in 2019-20 – the year in which most jurisdictions are currently expected to have fully implemented the NDIS.

## Backcasting

- 58 The Commission has decided to backcast the introduction of the NDIS because it considers it to be a major change in Commonwealth-State financial relations and it will improve the contemporaneity of the assessment.
- 59 This requires the State policies operating in the year GST shares are to be used to be retrospectively applied in the historical years used to calculate those shares. To do this, the Commission would require the prospective ratios of State NDIS and non-NDIS expenses in the application year. That data would need to be provided by States and based on their own expense forecasts.
- 60 With a dual system commencing in 2016-17, this would require the incorporation of such projections beginning in the 2016 Update. At that time, we will review the availability and reliability of the uptake and expenses projections. If data are not considered reliable, we will need to consider an alternative, such as using the data for the latest available year.

## TRANSPORT INFRASTRUCTURE

### Background

- 61 The terms of reference ask the Commission to have regard to the recommendations of the GST Distribution Review (October 2012) to:
- ... develop a new transport infrastructure assessment. This should include, if appropriate, a framework to identify payments for nationally significant transport infrastructure projects which should affect the relativities only in part and options for providing that treatment (Recommendation 6.1).
- 62 The GST Distribution Review report said the Commission's decision to equalise States' net financial worth in the net lending assessment imposed a constraint on the recognition of capital needs for subsidised Public Non-Financial Corporations (PNFCs). The report suggested the Commission review its approach so capital needs for subsidised PNFCs could be fully recognised.
- 63 The GST Distribution Review report also noted that, while all States supported the general principle of *including* Commonwealth payments for capital purposes in the equalisation process, there were concerns about the treatment of large payments for infrastructure purposes. It said that Commonwealth payments for road and transport infrastructure should not be treated differently. Therefore, it recommended only 50% of nationally significant payments for road and rail infrastructure be recognised in the equalisation process, because of their dual national and State purposes.

## Commission response

### *An urban transport infrastructure assessment*

- 64 **Scope.** We noted in the 2010 Review that the distinction between PNFCs and General Government services was sometimes blurred and that assessments might be simpler and more robust if it were not made. Since then, a number of States have further integrated their urban transport and housing services into their General Government sectors. In reviewing how we should treat them, we have concluded they have strong similarities to the services provided by General Government agencies, even when they are delivered by PNFCs. They are not fully commercial and depend on government funds to meet recurrent costs and pay for major investment; the services stem from social policy objectives; and government departments make the policy on service delivery and charges. This is unlike other PNFCs, such as ports or freight rail, which operate on a commercial basis and often return a dividend to the General Government budget.
- 65 In this review, we have decided urban transport and public housing should not be treated as PNFCs from an HFE perspective. This means the infrastructure needed to provide urban transport services (including rail and buses) and public housing will become part of our infrastructure assessments. Differences in the quantity of stock required to provide these services and other changes in State circumstances will be recognised as well as the impact of population growth.
- 66 **Our assessment.** We have not, however, developed a single transport infrastructure assessment. We consider the roads infrastructure assessments (in investment and depreciation) should continue largely as they are, but be augmented by an assessment of urban transport investment and depreciation expenses. This will allow the different drivers of roads and urban transport infrastructure to be recognised in a transparent way. As for roads infrastructure, we consider that recurrent drivers of urban transport subsidies are not the same as drivers of infrastructure requirements. We have therefore developed a new assessment of urban transport stock requirements which will be undertaken as a separate component of the investment assessment. Details of the current placeholder assessment are provided in the Infrastructure attachment.
- 67 We note the assessment:
- appropriately recognises larger cities require more urban transport infrastructure per capita than smaller cities
  - will recognise needs as urban populations change, but not necessarily at the same time as they might receive Commonwealth funding to assist with large urban infrastructure projects.

### *Treatment of Commonwealth payments for transport infrastructure*

- 68 The Commission has concluded it would be conceptually and practically difficult to develop and implement a framework to identify payments for nationally significant transport infrastructure projects. All States agreed that deciding which projects are nationally significant would be difficult, even arbitrary and contentious.
- 69 Using Infrastructure Australia's (IA's) list of priority projects to determine payments relating to projects of 'national significance' is not attractive to us. IA undertakes technical assessments of projects submitted for inclusion on the list. A project is not only evaluated in terms of its strategic fit and how it addresses national infrastructure priorities, it must be economically viable (its benefits must outweigh its costs) and it must demonstrate it is deliverable (it has a clear and robust delivery plan). A number of States did not accept that the list included only projects of national significance. They argued the list could include projects which were of considerable benefit to only one State and could exclude projects of national significance which did not meet the other criteria.
- 70 South Australia and the ACT proposed criteria relating to spillover benefits to other States or where there are direct economic benefits extended to other States. Queensland suggested a nationally significant rail project was one which would facilitate national economic growth and productivity gains in the long term.
- 71 We can see conceptually how identifying the 'interstate spill over benefits' of projects could form the basis of treating part of Commonwealth projects so that they have no effect on the GST distribution. However we doubt we would be able to quantify the size of such benefits or apportion project expenditure to that outcome. No State was able to propose a methodology which would solve this problem.
- 72 We do not accept New South Wales' suggestion that all infrastructure grants to the States might be treated as having no impact on the relativities. Nor do we accept Western Australia's proposal to apply a general discount to all State revenues, including Commonwealth payments, is consistent with HFE. Both proposals appear too broadbrush, capturing some projects of only State significance. They would also see Commonwealth payments and GST provided, at least in part, for a single project.
- 73 Victoria said there should be consistent treatment of Commonwealth funding for rail and national network road projects. It saw no reason why NNR funding should not be subject to the same level of equalisation as Commonwealth rail funding. Road and rail payments should either be both fully assessed, both fully excluded or both discounted by 50%.
- 74 We consider our current approach, using the existing guidelines provides the flexibility for dealing appropriately with Commonwealth payments.

- 75 The crucial issue in considering Commonwealth support for infrastructure projects is whether the funding is directed to meeting differential State infrastructure requirements which are also captured in our assessment methodology. If so, we consider Commonwealth payments should be brought within the equalisation process, otherwise States will have different fiscal capacities. If not, those payments should fall outside the equalisation process.
- 76 On this basis, we propose to fully include the Commonwealth payments for rail and NNR projects in this review. We also consider there are national needs associated with NNR projects and in the absence of other information the roads investment assessment includes allowances which are measured by reference to the interstate distribution of half the NNR payments. We have not, however, made a similar allowance in the urban transport assessment because we were unable to identify national needs associated with rail projects.
- 77 Most States agreed the important decision was whether or not all disabilities had been assessed.
- 78 Based on experience, we know that deciding how closely the purpose of Commonwealth payments aligns with the spending needs captured in our assessments can be very difficult. While States and the Commonwealth provide us with information on individual projects, translating that and calibrating it to what we assess is complex and often a matter for judgment.
- 79 However, we do not consider it necessary to develop another set of criteria which could be used to determine whether the needs the payment is addressing are captured in the assessment. We consider the existing guidelines for the treatment of Commonwealth payments are sufficient. The processes where the Commission proposes a treatment of a new payment based on its understanding of the nature of the project and consults States on that treatment is open, transparent and allows relevant information to be assembled before a final Commission decision is made.
- 80 If governments want to ensure Commonwealth payments relating to projects of national significance are not subject to equalisation, it can direct the Commission in the terms of reference to ensure those payments and the associated projects do not influence the GST distribution. Some States have said such quarantining dilutes HFE and could lead to States receiving financial recognition for the same project twice – once through the Commonwealth payment and once through the GST. However, this is a matter for governments to resolve.
- 81 The Commission's decisions on the treatment of all Commonwealth payments are set out in Appendix 2.
- 82 Box 1 illustrates how a State's budget might be impacted over a ten year period by the introduction of an urban transport infrastructure assessment and the receipt of a

Commonwealth payment for urban transport infrastructure which is treated as having an impact on the relativities.

**Box 1            Impact on a State’s budget of an urban transport infrastructure assessment and a Commonwealth payment**

Assume the GST distribution process gives a State (with 30% of the population) the fiscal capacity to invest \$100 million each year in infrastructure. This enables it over time to have the stock of infrastructure underpinning the average level of services. The GST is not provided only in the year in which lumpy capital investment is made but cumulatively over time.

The State receives a payment from the Commonwealth of \$1 000 million to support a major infrastructure investment. It receives the grant in Year 1 and it is spent in that year.

The State can decide to either invest the \$100 million capacity given to it through the GST process, in addition to the grant from the Commonwealth, and have a standard of service above the average, or provide an average service and use the fiscal capacity provided through the GST for another purpose, here assumed to be to acquire financial assets.

The payment has no impact on the GST in the first two years, but the State’s GST is reduced over the next three years as the GST processes reflect the grant in its assessed fiscal capacity.

Year	1	2	3	4	5	6	7	8	9	10	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Assessed needs	100	100	100	100	100	100	100	100	100	100	1 000
Impact on GST of payment	0	0	-233	-233	-233	0	0	0	0	0	-700
Net impact on GST	100	100	-133	-133	-133	100	100	100	100	100	300
Grant	1 000										1 000
Project spending	-1 000										-1 000
Budget impact	0										300

The table shows that, over the period that the GST would have provisioned the State with the ability to acquire the \$1 000 million asset. \$1 000 million grant would give the State the capacity to acquire the assets needed for average service provision and \$300 million in financial assets (its population share of the \$1 000m).

All State budgets are better off over time because the Commonwealth has provided additional funds. However, the State receiving the payment is better off fiscally than average in the first two years (has \$100 million each year to spend on other services because the urban transport infrastructure has been funded by the Commonwealth). It is worse off than average in years 3, 4, 5 and better off over the remaining period.

This outcome depends on the assessment appropriately recognising the State needs for the investment. If it does not, then the State may be fiscally disadvantaged. With an EPC assessment of investment in the GST process, the State would have its GST reduced by \$700 million, meaning it would retain only the equivalent of \$300 million of the payment but need to spend \$1 000 million.

## INDIGENEITY

### Background

83 The terms of reference ask the Commission to:

... develop methods to appropriately capture the changing characteristics of the Indigenous population.

### Commission response

84 The Indigenous population is not homogenous and different groups of Indigenous people use State services at different rates. To appropriately capture the characteristics of the Indigenous population, we consider it is necessary to identify attributes of Indigenous people that will allow us to reflect the different profile of use of State services of different groups of Indigenous people.

85 In the 2010 Review, we measured socio-economic status using the Socio-Economic Index for Areas (SEIFA), which measures the average socio-economic status of a region. This meant that in areas where Indigenous people represent a small minority of the population, their socio-economic status was largely defined by the relative socio-economic status of their non-Indigenous neighbours. This is generally a reasonable assumption (Indigenous people in high SES suburbs tend to be better off than Indigenous people in low SES suburbs). However in this review, we have developed a more accurate approach, of using SEIFA-like area based measures of socio-economic status developed separately for the Indigenous and non-Indigenous populations. We consider our new approach is a significant improvement in capturing the characteristics of the Indigenous population.

86 Using a measure of socio-economic status that relates specifically to the Indigenous population means we better measure the different levels of use and cost of State government services by different groups of Indigenous people, and we better reflect the interstate distribution of the different groups of Indigenous people.

87 The characteristics of the Indigenous population have changed in recent years, as large numbers of people who had previously not identified as Indigenous, did so in the 2011 Census. We consider that our approach means that following each census we will appropriately capture the characteristics of the Indigenous population.

88 Western Australia and the Northern Territory consider this to be a significant improvement to the way we measure Indigenous costs. Other States were more cautious, expressing concerns that it would add complexity, that the Indigenous socio-economic status index was a measure of advantage, not disadvantage, that it was constructed at too broad a level of geography, and that administrative data may not be reliable enough to allow a detailed disaggregation of the Indigenous

population. However, all States agreed this is an appropriate approach to addressing the terms of reference requirement, given the short time frame for the review.

- 89 Details of our approach for capturing the changing characteristics of the Indigenous population and how it has been applied in expense categories are described in the Indigeneity attachment.