



Australian Government

Commonwealth Grants Commission

**Report on
GST Revenue Sharing Relativities —
2010 Review**

Volume 1 — Main Report

Canberra

© Commonwealth of Australia 2010

This work is copyright. You may download, display, print and reproduce this material in unaltered form only (retaining this notice) for your personal, non-commercial use or use within your organisation. Apart from any use as permitted under the *Copyright Act 1968*, all other rights are reserved. Requests and inquiries concerning reproduction and rights should be addressed to the Commonwealth Copyright Administration, Attorney General's Department, Robert Garran Offices, National Circuit, Barton ACT 2600 or posted at <http://www.ag.gov.au/cca>.

2010 REVIEW REPORT

Report on GST Revenue Sharing Relativities — 2010 Review

Volume 1 — Main Report ISBN 978 1742 479361

Volume 2 — Assessments of State Fiscal Capacities ISBN 978 1742 478296

Volume 3 — Supporting Information ISBN 978 1742 478289

The report and supporting material are available on the Commission's website at <http://www.cgc.gov.au>.



Australian Government
Commonwealth Grants Commission

26 February 2010

The Hon Wayne Swan MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

As members of the Commonwealth Grants Commission appointed under the *Commonwealth Grants Commission Act 1973* we respond in this report to terms of reference received in a letter dated 26 May 2005 from Dr Sharman Stone, the then Parliamentary Secretary to the Minister for Finance and Administration, and supplementary terms of reference in a letter dated 14 October 2009 from you

The Commission was asked to review the methods used to derive the relativities for distributing the Goods and Services Tax revenue among the States and Territories and to provide a report on the relativities considered appropriate for use after 2009-10.

Yours sincerely

A G Morris
Chairman

R A Williams
Member

G P Appleyard
Member

J A Westacott
Member

G J Smith
Member

Cypress Court
5 Torrens Street
Braddon ACT 2612
AUSTRALIA

Tel: 61 2 6229 8800
Fax: 61 2 6229 8821
Email: secretary@cgc.gov.au
Internet: <http://www.cgc.gov.au>

ACKNOWLEDGMENTS

We acknowledge the ready co-operation extended to the Commission and its staff, throughout the review, by the Australian, State and Territory governments and their officials across a range of departments and agencies. We are grateful particularly for the efforts of the Australian and State Treasuries in organising submissions to the inquiry, participating in conferences and responding to our many requests for information. Staff of the Australian Bureau of Statistics, the Australian Institute of Health and Welfare and other Australian Government agencies have been most helpful in providing the data needed to complete the necessary calculations. We also acknowledge the help of other research and data gathering agencies.

We express special thanks to the staff of the Commission. The review could not have been completed without their exceptional professionalism and dedication.

TERMS OF REFERENCE



The Hon Dr Sharman Stone MP

Federal Member for Murray

Parliamentary Secretary to the Minister for Finance and Administration

Mr Alan Morris
Chairman
Commonwealth Grants Commission
Cypress Court
5 Torrens Street
BRADDON ACT 2612

Dear Mr Morris

I am writing to convey to you the attached terms of reference for the Commission's 2010 Methodology Review of State Revenue Sharing Relativities. The terms of reference provide guidance to the Commission to simplify its methodology and to develop a continuous programme of improvement of its assessments. This work programme will place the Commission's methodology on a sounder and more sustainable basis.

At the meeting of the Ministerial Council for Commonwealth-State Financial Relations on 23 March 2005, all states and territories agreed with these terms of reference.

The terms of reference require the Commission to report to the Ministerial Council in 2006 and 2007 on aspects of simplification and to provide the relativities and the Review report by 26 February 2010.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Dr Sharman Stone'.

Dr Sharman Stone

26 May 2005

TERMS OF REFERENCE FOR THE 2010 COMMONWEALTH GRANTS COMMISSION METHODOLOGY REVIEW

COMMONWEALTH GRANTS COMMISSION ACT 1973

I, Sharman Stone, Parliamentary Secretary to the Minister for Finance and Administration, pursuant to sections 16, 16A and 16AA of *the Commonwealth Grants Commission Act 1973*, hereby refer to the Commission for inquiry into and report upon, by 26 February 2010 at the latest, the question of per capita relativities which the Commission would regard as appropriate to apply after 2009-10 for the distribution of the combined pool of Goods and Services Tax (GST) revenue and Health Care Grants (HCGs) among the States, the Northern Territory and the Australian Capital Territory (the states).

2. The Commission should commence a work programme for responding to these terms of reference and consult with the states and the Australian Government in deciding the priorities for the work programme.

3. Having regard to the work progressed by Heads of Treasuries (HoTs) after the 2004 Ministerial Council and providing that to do so is consistent with the principle of Horizontal Fiscal Equalisation, the Commission should simplify its assessments by:

- (a) aggregating existing assessment categories, components and factors, in whole or in part;
- (b) eliminating category assessments found unreliable because of unsatisfactory data or methodology; and
- (c) applying a materiality threshold to current and future assessments.

4. Having regard to the work progressed by HoTs after the 2004 Ministerial Council and providing that to do so is consistent with the principle of Horizontal Fiscal Equalisation, the Commission should consider developing other ways to simplify its assessments, including by:

- (a) addressing issues relating to quality and fitness for purpose of data used by the Commission, in particular by reducing the reliance on the use of 4 digit GFS data and examining the capacity of making effective use of 2 digit and 3 digit GFS data in the assessments;
- (b) undertaking a programme of continuous improvement of assessments. This programme includes improvements to the quality and fitness for purpose of both data and methodology; and
- (c) reviewing the scope for the use of more general indicators of revenue capacity and expenditure need.

5. The Commission should also consider:

- (a) developing mechanisms to maintain simplification once achieved; and
- (b) improving quality assurance processes.

6. (a) The Commission will report to the Ministerial Council in 2006 on its conclusions in relation to paragraphs 3(b) and 3(c) and progress in relation to paragraphs 3(a), 4 and 5.

- (b) The Commission will report to the Ministerial Council in 2007 on its conclusions in relation to paragraphs 3(a) and 4(a) and progress in relation to paragraphs 4(b), 4(c) and 5.
- (c) The Commission will report to the Ministerial Council in 2006 and 2007 on any conclusions it has reached in relation to paragraphs 6(a) and 6(b) which, in the Commission's opinion, should be implemented in advance of its 2010 Report. In drawing any such conclusions, the Commission should apply the principle of Horizontal Fiscal Equalisation used for the 2004 Review.
- (d) The Commission will report on the conclusions in relation to the remaining items in paragraphs 3, 4 and 5 as part of its 2010 Report.

7. The Ministerial Council will give further instruction to the Commission on transitional arrangements, if and as necessary.

SHARMAN STONE



TREASURER

**PARLIAMENT HOUSE
CANBERRA ACT 2600**

Telephone: 02 6277 7340

Facsimile: 02 6273 3420

www.treasurer.gov.au

14 October 2009

Mr Alan Morris
Chairman
Commonwealth Grants Commission
5 Torrens Street
BRADDON ACT 2612

Dear Mr Morris

I enclose a supplementary Terms of Reference for the Commission's 2010 Methodology Review of State Revenue Sharing Relativities.

The Terms of Reference provides advice on the treatment of payments under the Federal Financial Relations framework, agreed by the Council of Australian Governments in November 2008, and provides direction in relation to the treatment of payments that the Commonwealth has previously advised should not affect the calculation of relativities.

Yours sincerely

WAYNE SWAN

Terms of Reference for the 2010 Commonwealth Grants Commission Methodology Review of State Revenue Sharing Relativities

COMMONWEALTH GRANTS COMMISSION ACT 1973

I, Wayne Maxwell Swan, Treasurer, pursuant to sections 16, 16A and 16AA of the *Commonwealth Grants Commission Act 1973*, refer to the Commission for inquiry into and report upon, by 26 February 2010, the question of the per capita relativities which the Commission would regard as appropriate to apply after 2009-10 for the distribution of Goods and Services Tax (GST) revenue among the States, the Northern Territory and the Australian Capital Territory (collectively referred to as the States).

2. This supplementary information is to be read in conjunction with the terms of reference provided by Dr Sharman Stone on 26 May 2005.
3. The Commission's assessment should take into account the Intergovernmental Agreement on Federal Financial Relations agreed to at the meeting of the Council of Australian Governments on 29 November 2008 and which has effect from 1 January 2009.
4. The Commission should prepare its assessments on the basis that:
 - (a) National SPPs and National Partnership project payments should affect the relativities, recognising that these payments provide the States and Territories with budget support for providing standard state and territory services;
 - (b) National Partnership facilitation and incentive (reward) payments should not affect the relativities, so that any benefit to a State or Territory from achieving specified outputs sought by the Commonwealth, or through implementing reforms, will not be redistributed to other States or Territories through the horizontal fiscal equalisation process; and
 - (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.
5. Notwithstanding paragraph 4, 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 State governments in providing particular services.
6. The Commission should ensure that those payments which the Commission was directed to treat so they had no direct influence on the per capita relativities in the 2004 Review or subsequent Updates, should continue to be treated in that way. Where those payments are ongoing, their treatment should not change. Where they are replaced, the treatment of the new payment should be guided by (4) and (5) above, unless otherwise directed.
7. The Commission should consult the Australian Government and the States before deciding on any changes in methods that arise as a result of the framework agreed at the Council of Australian Governments meeting on 29 November 2008.

WAYNE SWAN

CONTENTS

<i>Chapter</i>	<i>Page</i>
OVERVIEW	1
1 INTRODUCTION AND FINDINGS	18
2 RESPONDING TO THE REFERENCE	22
3 THE EQUALISATION PRINCIPLE AND ITS INTERPRETATION	29
4 IMPLEMENTING EQUALISATION	40
5 MAJOR ASSESSMENT ISSUES	53
6 SIMPLIFICATION	85
7 WHY STATE FISCAL CAPACITIES DIFFER	94
8 WHY THE DISTRIBUTION HAS CHANGED	119
9 QUALITY ASSURANCE OF 2010 REVIEW PROCESSES	131
ATTACHMENTS	
A ASSESSMENT GUIDELINES	140
B CALCULATION OF RELATIVITIES	144
C ILLUSTRATIVE POPULATIONS	151
COMMISSION TERMINOLOGY	152
ACRONYMS	161
INDEX	162

OVERVIEW

This review recognises that the equalisation landscape has been radically transformed. At the time of the 2004 Review, the two most populous States — New South Wales and Victoria — had above average fiscal capacities and together shared the cost of equalisation, while other States' capacities were below average, and the Northern Territory well below average. Now the two most populous States lie close to average and the two faster growing States — Queensland and Western Australia — have seen their fiscal capacities strengthen relative to the other States at unprecedented rates and to historically high levels. These four now share the cost of equalisation. The other four States — South Australia, Tasmania, the ACT and the Northern Territory — remain below average, with the Northern Territory still well below average.

We have made our recommendations to recognise these shifts.

Achieving equalisation in this environment, which sees the strong and growing revenue capacities of Western Australia and Queensland effectively shared with other States, requires a clearer recognition that this level of, and growth in, revenue capacity also increases the need for those States to spend to build the infrastructure required and acquire other assets in keeping with their population growth. Both have to be adequately recognised at the same time for equalisation to be achieved.

We also recognise that to achieve equalisation when State fiscal circumstances are rapidly changing requires that the distribution of GST revenue should be as relevant as possible to the circumstances of the year in which our recommendations are to be applied. We consider this can most practically be achieved by shortening the assessment period so that the distribution reflects the most recent representative data.

We have also set out to achieve equalisation using simpler, more robust methods, using data consistent with their quality. We believe that we have done so. That means that some of our methods have changed, that some of the small influences captured in the past have not been continued, and that some influences now carry less weight. We consider this is consistent with our terms of reference.

We believe the new methodologies we have used to recommend the distribution of GST revenue are responding to changing State circumstances and will be more responsive to future change than those developed in 2004.

THE TERMS OF REFERENCE¹

- 1 The Intergovernmental Agreement on Federal Financial Relations 2008 states that GST revenue will be distributed among the States in accordance with the principle of horizontal fiscal equalisation. This aims to give each State the same per capita fiscal capacity. The Commission has been asked to recommend an appropriate distribution of GST revenue to best achieve this outcome. Formally we have been asked for relativities which are appropriate to use for this purpose after 2009-10.
- 2 The Commission has also been asked, consistent with achieving equalisation, to simplify its methodology, including through the aggregation of expense and revenue categories, the use of broader indicators of differences among the States and the application of materiality thresholds. The Commission is also asked to improve the quality of data used in reaching its conclusions.

RECOMMENDATIONS

- 3 Table 1 shows the relativities we regard as appropriate for use in distributing the GST revenue among the States in 2010-11 and compares them with those used in 2009-10. It also shows shares of GST revenue in those years.

Table 1 Relativities recommended for use in 2010-11 compared with 2009-10

	Relativities used for 2009-10	Relativities recommended for 2010-11	2009-10 share	2010-11 share
			%	%
New South Wales	0.93186	0.95205	30.2	30.7
Victoria	0.91875	0.93995	22.8	23.3
Queensland	0.91556	0.91322	18.5	18.6
Western Australia	0.78485	0.68298	8.1	7.1
South Australia	1.24724	1.28497	9.2	9.5
Tasmania	1.62040	1.62091	3.7	3.7
Australia Capital Territory	1.27051	1.15295	2.0	1.8
Northern Territory	5.25073	5.07383	5.4	5.2

- 4 If States had the same fiscal capacities, we would recommend each State receive its population share of GST revenue. However State fiscal capacities differ — that is, their per capita revenue raising capacities and expenditure needs differ — and our recommended per capita relativities correspondingly differ. Our recommendations imply a redistribution of 8.0 per cent away from an equal per capita allocation; this compares with 8.1 per cent for 2009-10.

¹ A copy of the terms of reference is at the front of this report.

- 5 Our recommendations relate to 2010-11. We consider the appropriate distribution in subsequent years should be determined using the methodology we have developed, modified if necessary to reflect significant changes in federal financial relations, and using the most recent data as they become available. We have identified data that should be updated for this purpose.

WHY THE 2010 REVIEW DIFFERS FROM THE 2009 UPDATE

- 6 Table 2 shows the distributions of GST in 2009-10 and 2010-11 and how the difference arises.

Table 2 Distribution of the 2009–10 GST and the illustrative 2010-11 GST²

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Estimated 2009-10 (a)	12 774.1	9 644.4	7 839.2	3 413.0	3 908.5	1 573.0	862.5	2 285.4	42 300.0
Illustrative 2010-11 (b)	13 843.7	10 516.4	8 384.0	3 190.1	4 265.3	1 664.4	832.6	2 363.4	45 060.0
Change	1 069.6	872.1	544.8	-222.9	356.9	91.4	-29.9	77.9	2 760.0
Change caused by:									
Shortening review period	579.0	186.1	-388.0	-490.2	65.2	-12.4	13.5	46.9	0.0
Other method changes	-701.1	-35.3	878.6	107.5	21.1	-1.4	-83.8	-185.6	0.0
Total method changes	-122.1	150.9	490.6	-382.7	86.2	-13.8	-70.3	-138.8	0.0
State circumstances	399.5	72.1	-510.4	-60.2	32.2	14.4	-9.5	61.8	0.0
Total relativities (c)	277.3	223.0	-19.8	-442.9	118.4	0.6	-79.8	-76.9	0.0
Population (d)	-55.6	5.0	51.0	24.6	-22.8	-11.1	-1.2	10.1	0.0
Pool (e)	848.0	644.1	513.5	195.4	261.3	101.9	51.0	144.8	2 760.0
Change	1 069.6	872.1	544.8	-222.9	356.9	91.4	-29.9	77.9	2 760.0
Total change (\$pc)	150.0	159.7	122.3	-98.5	218.9	181.1	-84.8	344.3	125.3

(a) From the Commonwealth of Australia *Mid-Year Economic and Fiscal Outlook 2009-10*, p 76.

(b) Obtained by applying the 2010 Review relativities to estimated State populations for December 2010 and estimated GST revenue for 2010-11.

(c) Effects on the distribution of the 2009-10 estimated GST revenue of using the 2010 Review relativities instead of 2009 Update relativities.

(d) Effects on the distribution of the 2009-10 estimated GST revenue of using estimated State populations for December 2010 instead of December 2009.

(e) Effect of applying the 2010 Review relativities to estimated growth in GST revenue for 2010-11.

Source: GST revenue and the December 2009 and 2010 populations are taken from the *Mid-Year Economic and Fiscal Outlook 2009-10*.

- 7 Our recommendations have impacts solely on changes to State relativities. The actual distribution States receive will also depend on changes in the amount of revenue to be distributed and in State populations, but these impacts are outside the ambit of our review.

² In this and many other tables in this report the columns may not add due to rounding.

- 8 The relativities we have recommended change for two broad reasons: first, because we recommend changes in methodology; and second, because we incorporate data for 2008-09 in our 2010 recommendations.

Method changes

- 9 We are recommending a shortening of the averaging period for assessments from five to three years to better reflect current conditions. This has a significant, but one-off impact on the recommended relativities. Because Queensland and Western Australia have been enjoying relatively stronger economic conditions in recent years on the back of expansion in their mining industries, this change redistributes GST revenue away from them in 2010-11, primarily to New South Wales. This occurs because these more recent years have greater weight in our calculations.
- 10 Differential population growth has an immediate impact on State budgets, including on infrastructure spending, which we better recognise in our proposed assessments. Queensland and Western Australia, which are experiencing relatively high population growth, benefit as a result.
- 11 Because we have adopted new materiality and data quality guidelines we have recommended smaller impacts in a range of areas including location, cultural and linguistic diversity and urbanisation.
- 12 Overall, method changes will see some \$728m distributed differently among the States, compared with 2009-10. This is distributed away from Western Australia, the Northern Territory, New South Wales, the ACT and Tasmania, and to Queensland, Victoria and South Australia. Queensland loses from the move to three-year averaging, but that is more than offset by other changes including allowing population growth to more quickly impact on a State's assessed capital transactions.

Update effects

- 13 Our 2010 recommendations capture the effect of replacing an earlier year's data with those for 2008-09. Overall, updating changes the way some \$580m is distributed among the States, primarily away from Queensland and to a lesser extent Western Australia and the ACT, and towards New South Wales in particular. As in other updates this occurs largely because the ability of States to raise their own revenue from mining royalties and property related taxes has diverged. Western Australia remains the State with the strongest fiscal capacity, while Queensland's capacity increased the most to make it clearly the State with the second strongest capacity.
- 14 The main impacts of updating have occurred in:
 - Mining revenue. The stronger growth in export coal and iron ore royalties has strengthened Queensland and Western Australia's ability to raise their own revenue, thus reducing their GST shares;

- Stamp duty. Western Australia's property market has cooled, reducing its ability to raise this tax and increasing its GST share;
 - Commonwealth payments. The changed distribution has favoured Queensland, reducing its GST share; and
 - Infrastructure investment. Strong population growth has increased what both Queensland and Western Australia are assessed to need to invest, relative to other States, increasing their GST share.
- 15 The impact of our recommendations for individual States is captured in State summaries at the end of this Overview.

OUR APPROACH

- 16 We have undertaken this review using a clean slate, top down approach to develop a methodology which captures measureable and material differences between the States. We have applied a set of assessment guidelines to support the development of simpler methods and to ensure consistency in our approach, including the use of data in a way which is consistent with their quality.
- 17 Throughout this review we have consulted fully with the States and adapted our approach in the light of evidence they have provided.
- 18 In deciding what distribution of GST would be appropriate, we have adopted several assessment principles. The distribution should:
- reflect State practice. We do not seek to determine the best or appropriate policy; rather we observe what States do and let each play its role in determining the average policy and practice, which forms the basis of the assessment;
 - be policy neutral in that an individual State should not be able, by its own actions, to directly influence its own share of the GST distribution;
 - reflect, as closely as reliable data will allow, the conditions in the States in the year the GST is distributed; and
 - be derived in a practical way, as simply as possible, consistent with achieving fiscal equalisation and the quality of the available data.
- 19 We have sought to develop a methodology that will be resilient to changing State circumstances, contemporary, and which will continue to be relevant and appropriate as State policies change and as their economic and social circumstances change.
- 20 An important role of the Commission is the exercise of judgment in deciding what differences among the States should influence the GST and how that influence should be measured. We have used our judgment where we are satisfied that to do so improves the appropriateness of our recommendations in delivering fiscal

equalisation. We have also sought to exercise that judgment conservatively, consistent with the evidence and data available to us.

KEY ISSUES IN THE REVIEW

- 21 This section summarises our approach to the following major issues:
- ensuring the relativities are contemporary;
 - the assessment of State infrastructure requirements;
 - the assessment of State financial assets;
 - the effects of Indigenous status and cultural and linguistic diversity;
 - the effect of location (including urbanisation);
 - the treatment of Commonwealth payments; and
 - simplification.

The timeliness of recommendations

- 22 Because our recommendations can have a significant impact on the revenue States have to deliver services to their residents, they should reflect, as closely as possible, conditions in the States in the year they impact on the distribution of GST revenue.
- 23 Under the previous methodology, the data used in making the assessments was an average of five years' historical data. While the use of five year averaging reduces volatility that might be found in some of the data, when State circumstances change quite quickly, it produces relativities which are inconsistent with observed State fiscal circumstances in the year the relativities are to be applied. We recommend a shortening of the averaging period to three years, believing this strikes a better balance between capturing current developments and smoothing data volatility.

Infrastructure

- 24 We have observed that different rates of population growth are having a significant impact on State fiscal capacities, particularly through their impact on infrastructure spending for State services (such as hospitals, schools and roads). We believe this impact should be reflected in the GST distribution as quickly and comprehensively as possible. Our recommendations do this by assessing how much States would need to invest to give them comparable levels of such infrastructure in a year and having that reflected in the GST distribution in that year.
- 25 We are confident that this is an appropriate way of capturing differential needs for infrastructure, noting that States can use GST revenue for any purpose, including the acquisition of new infrastructure, and that apart from recent years when the global financial crisis impacted on their finances, this was average State practice.

Financial assets

- 26 Different rates of population growth also impact on State holdings of financial assets per capita and on State capacity to earn income from these assets. We consider the simplest way of accommodating this impact is to equalise States' net financial worth per capita, and assess them to have an equal income earning capacity from these assets.
- 27 To give effect to these recommendations we have broadened our measure of a State's fiscal capacity, from its operating budget outcome to its net financial worth. Our recommendations give States the capacity to equalise these holdings when population growth rates diverge. We determine what net lending a State would need to keep its net financial worth per capita at average levels, and incorporate that into our recommended GST distribution.
- 28 We see the approach as more comprehensive and it allows us to give greater prominence to differential population growth in our recommendations, so strengthening the intent of equalising the fiscal capacity of the States.

Indigeneity and cultural and linguistic diversity

- 29 The data and evidence presented by the States, and our own observations, make it clear that a major difference across States arises because of the uneven distribution of Indigenous Australians (particularly in more remote locations), and the higher expenditure States incur in providing services to these residents. We estimate that the Northern Territory needs to spend \$5441 per capita more than average because of this, and Victoria \$257 per capita less than average. Overall some \$2.1bn is redistributed because of the impact of Indigeneity on State service delivery expenses.
- 30 The wider multicultural nature of Australian society and how that diversity differs among States also has an impact on State fiscal conditions. States argued that cultural diversity had an impact and, while we accept it may, it was not possible to reliably estimate the costs of cultural diversity and we have made no allowance for it in our recommendations. However, the evidence for the overall impact on State per capita expenditure of linguistic diversity, and particularly lack of fluency in English, was stronger and we have incorporated a modest allowance for this in our recommendations.

Location

- 31 Where people live in Australia has a clear impact on the services they receive and the cost of those services. Costs vary between States (for example because wage costs differ) and within States (more remote regions experience higher costs) and we recognise both. On average, the cost of delivering services to more remote regions is higher than the average cost and we have recognised this differential cost in our recommendations.

- 32 In this review incorporating the impact of location in a meaningful and reliable way has been difficult. We have used our judgment to incorporate the impact of interstate freight costs because data identifying this impact were difficult to obtain. In this and other areas we have discounted the impact of the available data to reflect our concerns about their quality. This conservative approach — consistent with the requirement in the terms of reference on data quality — means that location is a smaller driver of the GST distribution than in past years. It redistributes some \$1.0bn, from the more centralised States and those with manufacturing capacity to States with more dispersed populations removed from centres of production. It also redistributes revenue from States with below average wage costs to those with above average costs.
- 33 Some States argued that large urban areas experience higher costs of service delivery per capita. Data supported this case for State expenditure on urban transport and in this category we have accepted the argument and included an explicit allowance for this influence. However, in other areas, data supporting the case were not convincing and as a result we have not incorporated an urban influences allowance in other assessments.

Commonwealth payments

- 34 We have treated Commonwealth payments on a case-by-case basis to assess their impact on State fiscal capacities. Most will have an impact on State fiscal capacities and, as envisaged by the Intergovernmental Agreement, these should have an impact on the GST distribution. Where we are directed by our terms of reference that any Commonwealth payments should not impact on the distribution, or where the payments are related to Commonwealth purchases from the States, or they flow through State Budgets with no State discretion and thus have no impact on their fiscal capacities, these are excluded from our assessments.
- 35 We have also taken this approach to major Commonwealth support for infrastructure used for State purposes where we see Commonwealth support differentially impacting on what States themselves need to spend.

Simplification

- 36 As required by our terms of reference, we have kept our methodology as simple as possible, consistent with achieving appropriate fiscal equalisation. The importance of capturing the inherent complexity of delivering services to a wide range of residents living in very different circumstances as well as differing abilities to raise revenue has constrained the extent to which simplification could be achieved.
- 37 We have captured the full range of State expenses and revenue in our assessments, but have done so in fewer, broader aggregates and using broad indicators of differences among the States. We have reduced the overall number of categories from 59 to 22. We also believe that by recognising State needs for infrastructure as

they arise, and equalising their financial assets, we have simplified the treatment of capital transactions and their impact on expenses and revenue.

- 38 A considerable part of the current methodology has been preserved in our recommendations where rigorous scrutiny has found no better approaches to deliver appropriate equalisation. However, even in these areas some simplification has been possible because, judged against our new materiality guidelines, some things currently done are no longer warranted.
- 39 There is always pressure to introduce greater complexity in an effort to more accurately reflect State differences. It will be important to maintain a careful balance between a comprehensive assessment of State fiscal capacities and an approach which is as simple and practical as possible. We consider that the focus on simplification required by the terms of reference for this review should be maintained in any future reviews and that in any future updates, methodology changes be restricted to those essential to capture major changes in average State policy, federal relations or data.

GOING FORWARD

- 40 We consider that our recommendations are appropriate to use in distributing GST to equalise State fiscal capacities, within the bounds of what is known about the differing circumstances States face in delivering services, raising revenue and providing for their capital requirements both in terms of infrastructure and financial assets.
- 41 We acknowledge that in many areas data improvements have facilitated our work, and we commend the efforts of States who worked to improve the quality of data available to the Commission through the course of the review. But data limitations remain in many areas and we consider that further efforts should be made to improve the data, particularly data that are comparable across States, in any future review of methodology.

NEW SOUTH WALES

New South Wales has the fourth highest assessed fiscal capacity due to its below average assessed costs of providing services and below average assessed requirements for infrastructure and net lending.

Those below average expenditure requirements reflect the State's below average shares of Indigenous people, people living in remote areas and below average population growth. Above average private provision of community health services and an ability to achieve economies of scale in administration also contribute, but above average wages increase its spending.

Those effects are partly offset by the State's below average revenue raising capacity, which is mainly due to its below average mining production and motor vehicle registrations, although it does have above average taxable payrolls.

Compared with 2009-10, the State's share of the GST revenue will rise from 30.2 per cent to 30.7 per cent, partly because of its lower revenue raising capacity in recent years. Those effects were, however, partly offset by the effects of new methods, especially the new investment and net lending assessments, and below average population growth. When combined with the growth in GST available, its assessed GST will rise by \$1070 million (see Table 4).

Table 3 Assessed GST, 2010-11

	\$m	\$pc
Equal per capita share	14 523.2	2 013.0
Effect of assessed		
Expenses	-1 089.1	-151.0
Investment	-315.5	-43.7
Net lending	-178.7	-24.8
Revenue	846.7	117.4
Commonwealth payments	62.2	8.6
Assessed GST	13 843.7	1 918.8

Note: The table may not add due to rounding.

Table 4 Changes in GST 2009-10 to 2010-11

	\$m
Change due to	
New relativities	
Shorter review period	579.0
Other method changes	-701.1
Updated circumstances	399.5
New population	-55.6
Growth in GST available	848.0
Total change	1 069.6

Table 5 Major changes in methods and circumstances, New South Wales

	Change (\$m)	Reason for change
Changes in methods (other than shortening the review period)		
New investment and net lending assessments	-525.1	Its below average assessed service use and population growth implied below average requirements for investment and net lending.
Community health	-334.9	Better recognition of the effects on State expenses of the State's below average share of the Indigenous population and its above average non-State provision of services.
Justice services	-95.0	Allowances for use of services by Indigenous people (who are a below average share of the State's population) have increased and previous allowances for big city effects were found to be too unreliable.
Welfare and housing	-94.0	Better recognition of the effects of Indigenous people (who are a below average share of the State's population).
Land tax	181.2	Revenue office data better measure its relative revenue raising capacity.
Services to industry	153.2	Fewer interstate differences in spending on agricultural and mining industries have been assessed.
Changes in circumstances		
Mining revenue	166.9	The effects of its below average mining production were magnified by the 95% increase in average revenue between 2005-06 and 2008-09.
Land tax	153.0	Its revenue base share fell from 42.3% in 2005-06 to 31.4% in 2008-09.

VICTORIA

Victoria has the third highest assessed fiscal capacity because of its well below average assessed costs of providing services and infrastructure requirements.

Those below average expenditure requirements are due to its below average shares of government school enrolments, Indigenous people, people in areas of low socio-economic status and people in remote areas. It also has below average wage levels and can achieve economies of scale in administration.

Those effects on its fiscal capacity are partly offset by its below average revenue raising capacity and below average Commonwealth payments, especially for road construction. Its low revenue capacity reflects well below average mining production and a below average value of property transfers.

Table 6 Assessed GST, 2010-11

	\$m	\$pc
Equal per capita share	11 174.7	2 013.0
Effect of assessed		
Expenses	-2 740.9	-493.7
Investment	-320.6	-57.8
Net lending	9.2	1.6
Revenue	1 875.9	337.9
Commonwealth payments	528.5	95.2
Assessed GST	10 516.4	1 894.5

Note: The table may not add due to rounding.

Table 7 Changes in GST 2009-10 to 2010-11

	\$m
Change due to	
New relativities	
Shorter review period	186.1
Other method changes	-35.3
Updated circumstances	72.1
New population	5.0
Growth in GST available	644.1
Total change	872.1

Compared with 2009-10, Victoria's share of the GST revenue will rise from 22.8 per cent to 23.3 per cent. This is because the relativities have been made more up-to-date by reducing the review period to three years and including 2008-09 conditions. Those effects were partly offset by other method changes. When combined with the growth in GST available, its assessed GST will rise by \$872 million (see Table 7).

Table 8 Major changes in methods and circumstances, Victoria

	Change (\$m)	Reason for change
Changes in methods (other than shortening the review period)		
Land tax	-162.5	Revenue office data better measured its relative revenue raising capacity.
New investment and net lending assessments	-160.0	Its below average assessed service use implied below average requirements for investment.
Justice services	-152.8	Allowances for use of services by Indigenous people (who are a below average share of the State's population) have increased and previous allowances for big city effects were found to be too unreliable.
Roads	158.7	The effect of road use was increased and that of length reduced.
Transport services	156.9	There has been better recognition of the effects of city size on transport subsidies.
Services to communities	143.8	Allowances for the costs of water services and assistance to Indigenous communities in remote areas have been reduced in other States.
Changes in circumstances		
Mining revenue	290.6	The effects of its below average mining production were magnified by the 95% increase in average revenue between 2005-06 and 2008-09.
Commonwealth payments	231.0	Mainly due to below average growth in revenue from payments for road construction.
Conveyances	-158.4	Its revenue base share rose from 20.3% in 2005-06 to 24.1% in 2008-09.

QUEENSLAND

Queensland has the second highest assessed fiscal capacity because of its high revenue raising capacity and above average Commonwealth payments, especially for road construction.

Its high revenue capacity reflects well above average production of export coal and above average property transfers and motor vehicle registrations, although there is a partial offset from below average payrolls.

Those effects are partly offset by its above average assessed service delivery expenses and infrastructure and net lending requirements. Its high expenditure requirements are due to above average shares of government school enrolments, Indigenous people, people living in remote areas and road use, and above average population growth. Those effects are partly offset by its below average wages.

Compared with 2009-10, Queensland's share of the GST revenue will rise from 18.5 per cent to 18.6 per cent. The large effects of better recognising the State's high revenue raising capacity in recent years are more than offset by those of other method changes (such as allowing for its high investment and net lending requirements) and population growth. That, plus the increase in the GST available, leads to a \$545 million increase in its assessed GST (see Table 10).

Table 9 Assessed GST, 2010-11

	\$m	\$pc
Equal per capita share	9 169.5	2 013.0
Effect of assessed		
Expenses	286.2	62.8
Investment	537.9	118.1
Net lending	147.8	32.4
Revenue	-1 439.9	-316.1
Commonwealth payments	-321.8	-70.7
Assessed GST	8 384.0	1 840.6

Note: The table may not add due to rounding.

Table 10 Changes in GST 2009-10 to 2010-11

	\$m
Change due to	
New relativities	
Shorter review period	-388.0
Other method changes	878.6
Updated circumstances	-510.4
New population	51.0
Growth in GST available	513.5
Total change	544.8

Table 11 Major changes in methods and circumstances, Queensland

	Change (\$m)	Reason for change
Changes in methods (other than shortening the review period)		
New investment and net lending assessments	591.4	Its above average population growth and service use implied above average needs for investment and net lending.
Services to communities	112.3	Allowances for populations in small communities in remote areas and poor water areas have been increased.
Justice services	112.2	Allowances for use of services by Indigenous people (who are an above average share of the State's population) have increased and previous allowances for big city effects were found to be too unreliable.
Roads	66.6	Road use received more emphasis and it is above average in the State.
Changes in circumstances		
Mining revenue	-314.6	Its capacity to raise revenue from export coal and bauxite increased.
Commonwealth payments	-245.4	Mainly due to above average growth in revenue from payments for road construction.
Land tax	-71.0	Its share of the revenue base rose from 15.6% in 2005-06 to 20.7% in 2008-09.

WESTERN AUSTRALIA

Western Australia has the highest assessed fiscal capacity due to its very high revenue raising capacity.

That high capacity is due to above average mining production, property transfers, payrolls, motor vehicle registrations and land values.

Those effects on its fiscal capacity are partly offset by its above average assessed service delivery expenses, above average infrastructure and net lending requirements and below average Commonwealth payments, especially for health care and transport infrastructure.

Its high expenditure requirements are due to above average shares of government school pupils, Indigenous people, people in remote areas and road use, and above average population growth. Above average wage levels and below average non-State provision of health services also contributed.

Compared with 2009-10, Western Australia's share of the GST revenue will fall from 8.1 per cent to 7.1 per cent, resulting in a decrease in assessed GST of \$223 million (see Table 13). The large effects of better recognising the State's high revenue raising capacities of recent years more than offset the effects of other method changes (such as allowing for its above average investment and net lending requirements), other changes in 2008-09 conditions, population growth and the growth in GST available for distribution.

Table 12 Assessed GST, 2010-11

	\$m	\$pc
Equal per capita share	4 665.1	2 013.0
Effect of assessed		
Expenses	1 086.9	469.0
Investment	272.1	117.4
Net lending	96.1	41.5
Revenue	-2 994.0	-1 291.9
Commonwealth payments	54.8	23.6
Assessed GST	3 190.1	1 376.6

Note: The table may not add due to rounding.

Table 13 Changes in GST 2009-10 to 2010-11

	\$m
Change due to	
New relativities	
Shorter review period	-490.2
Other method changes	107.5
Updated circumstances	-60.2
New population	24.6
Growth in GST available	195.4
Total change	-222.9

Table 14 Major changes in methods and circumstances, Western Australia

	Change (\$m)	Reason for change
Changes in methods (other than shortening the review period)		
New investment and net lending assessments	264.3	Above average population growth and service use implied above average needs for investment and net lending.
Community health	187.4	Better recognition of the effects of below average non-State provision.
Services to communities	-113.3	Allowances for the effects of low water quality and availability on State expenses have been reduced.
Roads	-90.5	The effect of rural road length on expenses was reduced.
Other expenses	-88.7	Disabilities for national parks, culture and recreation were not assessed.
Mining revenue	-83.2	Lump iron ore was grouped with the other highly taxed minerals.
Changes in circumstances		
Conveyances	215.4	Its revenue base share fell from 15.4% in 2005-06 to 10.6% in 2008-09.
Mining revenue	-268.2	Its capacity to raise mining revenue rose in 2008-09.
Land tax	-110.4	Its revenue base share rose from 9.6% in 2005-06 to 15.5% in 2008-09.

SOUTH AUSTRALIA

South Australia has the third lowest assessed fiscal capacity, mainly because of its below average revenue raising capacity for all State taxes, especially conveyance duty, payroll tax and mining revenue.

Those effects are reinforced by its above average assessed expenses, which reflect its above average shares of older people, people with low socio-economic status (including recipients of Commonwealth social security benefits), residents of small communities in poor water areas, rural road use and rural road length.

However, its below average population growth means it has below average investment and net lending requirements.

It also received above average revenue from Commonwealth payments, such as the National specific purpose payments for healthcare, schools, disability, and skills and workforce development.

Compared with 2009-10, South Australia's share of the GST revenue will rise from 9.2 per cent to 9.5 per cent. This is because the effects of making the relativities more up-to-date and those of other method changes (such as better recognising the effects of people in low socio-economic areas and allowing for its below average investment and net lending requirements) more than offset those of its below average population growth. That, plus the growth in the GST available, leads to a \$357 million increase in its assessed GST (see Table 16).

Table 15 Assessed GST, 2010-11

	\$m	\$pc
Equal per capita share	3 315.4	2 013.0
Effect of assessed		
Expenses	226.2	137.3
Investment	-155.5	-94.4
Net lending	-50.5	-30.7
Revenue	1 075.6	653.1
Commonwealth payments	-143.7	-87.3
Assessed GST	4 265.3	2 589.9

Note: The table may not add due to rounding.

Table 16 Changes in GST 2009-10 to 2010-11

	\$m
Change due to	
New relativities	
Shorter review period	65.2
Other method changes	21.1
Updated circumstances	32.2
New population	-22.8
Growth in GST available	261.3
Total change	356.9

Table 17 Major changes in methods and circumstances, South Australia

	Change (\$m)	Reason for change
Changes in methods (other than shortening the review period)		
New investment and net lending assessments	-171.3	Its below average population growth implied below average investment and net lending requirements.
Services to communities	-66.3	Allowances for the effects of low water quality and availability on State expenses have been reduced.
Welfare and housing	144.5	The effects on expenses of its above average share of low income people were better recognised.
Justice services	56.5	Allowances for the higher costs of low socio-economic status people (who are an above average share of the State's population) were increased and previous allowances for big city effects were removed.
Roads	49.6	Better recognition of needs for national network roads and bridges.
Changes in circumstances		
Mining revenue	83.1	The effects of its below average mining production were magnified by the 95% increase in average revenue between 2005-06 and 2008-09.
Payroll and land tax	32.5	Its revenue bases increased at below average rates between 2005-06 and 2008-09.
Conveyances	-64.0	Its revenue base share rose from 4.3% in 2005-06 to 5.4% in 2008-09.
Commonwealth grants	-29.7	Above average growth in payments for education, health and water.

TASMANIA

Tasmania has the second lowest assessed fiscal capacity. It has below average revenue capacity for the major taxes (such as payroll tax, conveyance duty and mining revenue) and above average expenses in providing the major services (including schools, health, welfare, housing and justice).

The high service delivery costs reflect the State's above average share of people in areas with low socio-economic status, older people and government school students, and below average non-State provision of community health services. It also incurs diseconomies of small scale in administration but it has below average wage levels.

A below average population growth is the main reason for below average assessed investment and net lending requirements.

Compared with 2009-10, Tasmania's share of the GST revenue remains constant at 3.7 per cent. The introduction of our new methods, such as allowing for its below average investment and net lending requirements, and the State's below average population growth reduce its share. Making the relativities more up-to-date slightly increases its share because the effects of the shorter review period are less than those of the lower revenue raising capacity in 2008-09. The growth in the GST available leads to a \$91 million increase in its assessed GST (see Table 19).

Table 18 Assessed GST, 2010-11

	\$m	\$pc
Equal per capita share	1 025.6	2 013.0
Effect of assessed		
Expenses	308.1	604.8
Investment	-64.3	-126.2
Net lending	-23.3	-45.7
Revenue	420.6	825.5
Commonwealth payments	-2.1	-4.2
Assessed GST	1 664.4	3 266.9

Note: The table may not add due to rounding.

Table 19 Changes in GST 2009-10 to 2010-11

	\$m
Change due to	
New relativities	
Shorter review period	-12.4
Other method changes	-1.4
Updated circumstances	14.4
New population	-11.1
Growth in GST available	101.9
Total change	91.4

Table 20 Major changes in methods and circumstances, Tasmania

	Change (\$m)	Reason for change
Changes in methods (other than shortening the review period)		
New investment and net lending assessments	-68.7	Tasmania's below average population growth implied below average needs for investment and net lending.
Services to communities	-29.6	Tasmania has a below average proportion of its population living in small communities in poor water areas.
Land tax	-27.6	Revenue office data better measure its relative revenue raising capacity.
Welfare and housing	65.6	The effects on expenses of its above average share of low income people were better recognised.
Community health	42.6	Better recognition of the effects of the State's above average share of the elderly population and below average non-State provision.
Changes in circumstances		
Mining revenue	30.3	The effects of its below average mining production were magnified by the 95% increase in average revenue between 2005-06 and 2008-09.
Land tax	7.7	Its revenue base share fell from 1.1% in 2005-06 to 1.0% in 2008-09.
Conveyances	-16.3	Its share of the revenue base share rose from 1.3% in 2005-06 to 1.5% in 2008-09.

AUSTRALIAN CAPITAL TERRITORY

The ACT has the fifth highest assessed fiscal capacity. It has below average capacity to raise revenue in all areas, particularly mining where there is no industry, and below average revenue from Commonwealth payments, because it received low road building payments.

Those effects are partly offset by below average assessed costs of providing services, especially for admitted patients, welfare, public housing, roads and services to communities. This is because the impact of the relatively young, affluent population, the lack of remote centres and the small rural road network is greater than the higher unit costs caused by above average wage levels and diseconomies of small scale in administration.

Its below average population growth is a major reason for below average assessed investment and net lending requirements.

Compared with 2009-10, the ACT's share of the GST revenue will fall from 2.0 per cent to 1.8 per cent. This is mainly due to changes in the methods for deriving the relativities (such as recognising its below average investment and net lending requirements) and the inclusion of 2008-09 conditions, which include a sharp increase in its capacity to raise payroll tax. Those effects more than offset the growth in GST available, reducing the ACT's assessed GST by \$30 million.

Table 21 Assessed GST, 2010-11

	\$m	\$pc
Equal per capita share	721.3	2 013.0
Effect of assessed		
Expenses	-74.8	-208.6
Investment	-51.5	-143.9
Net lending	-4.0	-11.1
Revenue	173.8	485.0
Commonwealth payments	68.4	190.8
Assessed GST	832.6	2 323.8

Note: The table may not add due to rounding.

Table 22 Changes in GST 2009-10 to 2010-11

	\$m
Change due to	
New relativities	
Shorter review period	13.5
Other method changes	-83.8
Updated circumstances	-9.5
New population	-1.2
Growth in GST available	51.0
Total change	-29.9

Table 23 Major changes in methods and circumstances, the ACT

	Change (\$m)	Reason for change
Changes in methods (other than shortening the review period)		
New investment and net lending assessments	-35.9	Recognising the effects of its below average population growth implied below average needs for investment and net lending.
Justice services	-35.6	Reduced assessment of use by New South Wales residents and greater influence of Indigenous people of whom the ACT has a low share.
Payroll tax	-32.1	Data on compensation of employees were revised up and higher education payrolls, where the ACT has an above average share, are included in the tax base.
Welfare and housing	-31.2	Better recognition of the expenses of providing services to people with low socio-economic status and Indigenous people, who are a below average share of its population.
Community and other health	39.0	Better recognition of the cost disadvantages of the ACT's below average provision of services by general practitioners and other private providers.
Changes in circumstances		
Commonwealth grants	25.4	Below average growth in road building and schools payments.
Mining revenue	20.6	Rapid growth in average revenue magnified the effects of its below average capacity to raise revenue.
Payroll tax	-13.0	Above average growth in private sector payrolls between 2005-06 and 2008-09.
Conveyances	-11.0	Its revenue base share rose from 1.3% in 2005-06 to 1.6% in 2008-09.

NORTHERN TERRITORY

The Northern Territory has the lowest assessed fiscal capacity due to its above average assessed expenses, infrastructure requirements and net lending and below average revenue raising capacity.

Its high expenditure requirements are due to above average shares of government school pupils, Indigenous people, young males and people in remote areas, and above average population growth. It also has below average non-State provision of health services, above average wage levels and diseconomies of scale in administration.

The effects of its above average mining production are more than offset by those of the below average bases for all other State taxes.

Those effects are partly offset by its above average revenue from Commonwealth payments (such as the National specific purpose payments for remote Indigenous and affordable housing, schools, healthcare, substance abuse and Indigenous welfare).

Compared with 2009-10, its share of the GST revenue will fall from 5.4 per cent to 5.2 per cent. The combined effects of making the relativities more up-to-date, recognising its above average infrastructure requirements and its population growth are more than offset by other method changes which reduced the assessed effects of location on costs and removed unreliable assessments. Its assessed GST will rise by \$78 million due to growth in the GST available.

Table 24 Assessed GST, 2010-11

	\$m	\$pc
Equal per capita share	465.2	2 013.0
Effect of assessed		
Expenses	1 997.4	8 642.6
Investment	97.4	421.5
Net lending	3.5	14.9
Revenue	41.4	179.0
Commonwealth payments	-246.1	-1 065.1
Assessed GST	2 363.4	10 226.3

Note: The table may not add due to rounding.

Table 25 Changes in GST 2009-10 to 2010-11

	\$m
Change due to	
New relativities	
Shorter review period	46.9
Other method changes	-185.6
Updated circumstances	61.8
New population	10.1
Growth in GST available	144.8
Total change	77.9

Table 26 Major changes in methods and circumstances, the Northern Territory

	Change (\$m)	Reason for change
Changes in methods (other than shortening the review period)		
Investment and net lending assessments	105.4	Its above average population growth and service use implied above average needs for investment and net lending.
Roads	-97.8	Road use was shown to have more effect on expenses than length.
Services to communities	-89.2	Allowances for the effects of community size on Indigenous community development could not be justified nor could differential subsidies for water and electricity services in Indigenous communities.
Other expenses	-73.1	Disabilities for national parks, culture and recreation were not assessed.
Welfare and housing	-46.8	Previous allowances for extra costs arising from people with low English fluency and remote Indigenous people could not be justified.
Changes in circumstances		
Welfare and housing	80.9	Costs of services to Indigenous people who are a large proportion of its population rose between 2005-06 and 2008-09.
Schools education	18.5	An above average increase in enrolments and wage levels.
Commonwealth grants	-58.4	Above average growth in payments for Indigenous welfare and housing.
Conveyances	-16.8	Its share of the revenue base rose from 0.6% in 2005-06 to 1.1% in 2008-09.
Admitted patients	15.5	The 34% increase in average expenses magnified the Territory's needs.

CHAPTER 1

INTRODUCTION AND FINDINGS

- 1 On 26 May 2005, the Commonwealth Grants Commission received terms of reference asking it to review and simplify the methods used to calculate the relativities for distributing the pool of goods and services tax (GST) and health care grant revenue among the States and Territories¹. A supplementary terms of reference was received on 14 October 2009, asking for relativities to distribute the GST only and to provide guidance on the treatment of Commonwealth payments. The terms of reference seek a final report on the relativities considered appropriate for use after 2009-10 by 26 February 2010. A copy of the terms of reference is at the front of this report.
- 2 The Commission has approached this review from the basis of a clean slate. We have developed the methods outlined in this report with the aim of achieving equalisation as simply and transparently as possible.
- 3 In the process, we have rigorously evaluated potential methods and data using assessment guidelines which set strong reliability and materiality criteria. Importantly, the methods have been developed with the benefit of extensive consultation with the States.
- 4 We have focussed on devising the most appropriate methods of assessment for individual taxes and services from which an appropriate distribution of the GST is derived.
- 5 Many of the resulting assessment methods are substantially the same as those in the 2004 Review. These include the revenue assessments, other than land taxation, and the assessments of expenses on admitted patients, education and police. Other methods are quite different from the previous ones. Most assessments are modified by the use of data consistent with the new quality standards and simplified by the removal of immaterial influences.

¹ In the rest of this report, the term State(s) means the States, the Northern Territory and the Australian Capital Territory, unless the context indicates otherwise.

THE FINDINGS

Recommended relativities

- 6 Table 1-1 shows the per capita relativities we regard as appropriate for use in distributing the GST revenue among the States in 2010-11 and compares them with those used in 2009-10. Details of the calculation of the recommended relativities are in Attachment B.

Table 1-1 Per capita relativities

	Relativities used for 2009-10	Relativities recommended for 2010-11
New South Wales	0.93186	0.95205
Victoria	0.91875	0.93995
Queensland	0.91556	0.91322
Western Australia	0.78485	0.68298
South Australia	1.24724	1.28497
Tasmania	1.62040	1.62091
Australian Capital Territory	1.27051	1.15295
Northern Territory	5.25073	5.07383

Applying the relativities

- 7 State shares of the GST revenue implied by the 2009-10 relativities and the recommended relativities for 2010-11 are shown in Table 1-2. The changes in State shares are due to changes in the relativities and in State shares of the total population.

Table 1-2 State shares of GST, 2009-10 and 2010-11

	2009-10 share	2010-11 share
	%	%
New South Wales	30.2	30.7
Victoria	22.8	23.3
Queensland	18.5	18.6
Western Australia	8.1	7.1
South Australia	9.2	9.5
Tasmania	3.7	3.7
Australian Capital Territory	2.0	1.8
Northern Territory	5.4	5.2

Note: Derived by applying the relativities for each year to estimated State resident populations in December of that year.

- 8 Illustrative estimates of the GST revenue each State would receive in 2010-11 if the recommended relativities are accepted and the latest Commonwealth estimates of the 2009-10 GST distribution are shown in Table 1-3. The amounts for each State differ because of

changes in the total amount of GST available and State shares of it. Further discussion of the reasons for the changes is in Chapter 8.

Table 1-3 Distribution of the 2009–10 GST and the illustrative 2010-11 GST

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Estimated 2009-10 (a)	12 774.1	9 644.4	7 839.2	3 413.0	3 908.5	1 573.0	862.5	2 285.4	42 300.0
Illustrative 2010-11 (b)	13 843.7	10 516.4	8 384.0	3 190.1	4 265.3	1 664.4	832.6	2 363.4	45 060.0
Change	1 069.6	872.1	544.8	-222.9	356.9	91.4	-29.9	77.9	2 760.0
Change caused by new:									
Relativities (c)	277.3	223.0	-19.8	-442.9	118.4	0.6	-79.8	-76.9	0.0
Population (d)	-55.6	5.0	51.0	24.6	-22.8	-11.1	-1.2	10.1	0.0
Pool (e)	848.0	644.1	513.5	195.4	261.3	101.9	51.0	144.8	2 760.0
Change	1 069.6	872.1	544.8	-222.9	356.9	91.4	-29.9	77.9	2 760.0
Total change (\$pc)	150.00	159.71	122.33	-98.52	218.92	181.07	-84.76	344.26	125.33

(a) From the Commonwealth of Australia *Mid-Year Economic and Fiscal Outlook 2009-10*, p 76.

(b) Obtained by applying the 2010 Review relativities to estimated State populations for December 2010 and estimated GST revenue for 2010-11.

(c) Effects on the distribution of the 2009-10 estimated GST revenue of using the 2010 Review relativities instead of 2009 Update relativities.

(d) Effects on the distribution of the 2009-10 estimated GST revenue of using estimated State resident populations for December 2010 instead of December 2009.

(e) Effect of applying the 2010 Review relativities to estimated growth in GST revenue for 2010-11.

Source: GST revenue and the December 2009 and 2010 populations are taken from the *Mid-Year Economic and Fiscal Outlook 2009-10*.

- 9 The GST revenue each State actually receives in 2010-11 will vary from that in Table 1-3 in accordance with revised estimates of GST revenue for 2010-11 and December 2010 State populations, and decisions taken at the 2010 meeting of the Ministerial Council for Federal Financial Relations, including whether the recommended relativities should be applied.
- 10 It is clear that, if accepted, our recommendations would see State shares of the GST change from the 2009-10 shares. The change in shares brought about by the new methods does not reflect a lessening of equalisation, rather it reflects new approaches aimed at improving equalisation by being more up-to-date, incorporating the impacts of rising infrastructure needs and, consistent with our terms of reference, achieving equalisation in a simpler way and with greater concern for data quality.

STRUCTURE OF REPORT

- 11 Box 1-1 provides details of the structure of this report.

Box 1-1 Structure of report

This report provides our response to the terms of reference.

- Chapter 2 outlines the requirements of the terms of reference, how we interpreted them and our processes for conducting the review.
- Chapters 3 and 4 outline how we interpreted and implemented the horizontal fiscal equalisation principle that underlies the review.
- Chapter 5 outlines the major issues that arose during the review and our responses.
- Chapter 6 describes how we simplified the assessment methods and how the simpler processes might be maintained in the future.
- Chapter 7 explains why the overall fiscal capacities of the States differ.
- Chapter 8 explains why the recommended allocation of GST for 2010-11 differs from the 2009-10 allocation.
- Chapter 9 outlines quality assurance processes applied during the review.
- The attachments contain the assessment guidelines we applied during the review, details of State populations used in the calculations, and the calculation of the recommended relativities.

12 This report is accompanied by two other volumes:

- Volume 2 — Assessments of State Fiscal Capacities; and
- Volume 3 — Supporting Information.

13 Volume 2 provides details of the methods we have used in each revenue, expense, investment and net lending assessment, and for the major disability factors used in the assessments. It also explains how the individual assessments are brought together to derive relativities.

14 Volume 3 provides supporting information. It summarises the assessments and provides detailed analysis of the relativities and the changes that have occurred. It also provides information on State tax rates and conditions.

15 Further supporting information, including Commission papers and State submissions relating to the review, is available at <http://www.cgc.gov.au/>.

CHAPTER 2

RESPONDING TO THE REFERENCE

THE CONTEXT OF THE 2010 REVIEW

- 1 The Commission was established in 1933 to formalise part of the processes for providing Commonwealth financial assistance to the States. Since then, and particularly since the late 1970s, Australia has developed a comprehensive fiscal equalisation process for distributing general revenue payments among the States. The Australian Capital Territory and the Northern Territory were included in that system when they became self-governing.
- 2 Since 1985, the Commission has regularly reviewed the methods used to distribute the payments — reviews were completed in 1988, 1993, 1999 and 2004. Since the 1988 Review, the calculations have been updated annually by applying the methods from the latest review to the most recent data. This cyclical process is intended to ensure the current circumstances are reflected in the distribution and the methods used to calculate it.
- 3 The *Intergovernmental Agreement on Federal Financial Relations 2008* (the IGA), agreed by the Commonwealth and all State governments, provides for the revenue collected from the GST to be paid to the States for them to use for any purpose. It also says the GST is to be distributed among the States in accordance with the principle of horizontal fiscal equalisation (equalisation). Similar provisions were in the previous *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, 1999*.
- 4 At its simplest, equalisation aims to put all States on a level fiscal playing field. It aims to ensure they all have the same fiscal capacity to provide services to their residents.
- 5 Determining a distribution of the GST that equalises State fiscal capacities involves a comprehensive examination of the impact of State demographic, physical, and economic circumstances on the costs of providing the full range of State general government services and acquiring the associated infrastructure and the revenues they can raise. This approach ensures all fiscal advantages and disadvantages of the States are taken into account.

The 2004 and 2005 Ministerial Council meetings

- 6 In its 2004 Review Report, the Commission noted that while simplification was a priority at the start of that review, the methods remained complex and detailed. It said simplification of methods should be a priority going forward and recommended the next Commission and the States develop a work program to consider issues, such as:
- whether the highly disaggregated and comprehensive approach of assessing virtually all revenues and expenses in State operating budgets was necessary; and
 - the robustness and comparability of key datasets.
- 7 The 2004 meeting of the Ministerial Council for Commonwealth-State Financial Relations agreed to a work program to review the Commission's methods. The Ministerial Council agreed the work would aim to simplify the methods but would not examine the underlying principles of equalisation. It also agreed the work would be done by the Heads of Treasuries, with assistance from the Commission.
- 8 Heads of Treasuries undertook substantial analysis of the Commission's methods and alternative approaches. They also commissioned the Australian Bureau of Statistics (ABS) and two consultants to review aspects of the data and methods.
- 9 Heads of Treasuries concluded a program of simplification could be beneficial, provided it was consistent with the equalisation principle. They suggested four options that singularly or in combination could result in significant simplification. They were: the aggregation of assessments; the adoption of materiality thresholds; the elimination of unreliable assessments; and the use of more general indicators of State needs. They concluded more work was required to ensure those options were workable and to the satisfaction of the States.
- 10 They recommended that:
- the Commission be given terms of reference to review its methods by 2010;
 - as part of that review, the Commission be asked to undertake work on simplification that is consistent with the equalisation principle and builds on the work by Heads of Treasuries; and
 - the Commission be asked to report on its progress to the 2006 and 2007 meetings of the Ministerial Council.
- 11 The 2005 Ministerial Council meeting accepted those recommendations and agreed to terms of reference for the Commission, which were supported by all States.

REQUIREMENTS OF THE 2010 REVIEW TERMS OF REFERENCE

- 12 The terms of reference ask the Commission to recommend per capita relativities it regards as appropriate to use in distributing the GST revenue among the States after 2009-10.

- 13 The terms of reference contain instructions and guidance on how we should approach our task. They direct us to simplify the work, having regard to the work previously done by Heads of Treasuries and provided that doing so is consistent with the principle of equalisation, by:
- aggregating assessments;
 - eliminating assessments found unreliable because of unsatisfactory methods or data; and
 - applying materiality thresholds.
- 14 They also suggest we should consider other ways of simplifying our work, such as:
- addressing issues relating to the quality and fitness for purpose of data;
 - undertaking a program of continuous improvement; and
 - reviewing the scope for the use of more general indicators of revenue capacity and expenditure need.
- 15 Box 2-1 identifies the matters the terms of reference required us to address and indicates where we have responded to them in this report or in the 2006 and 2007 Progress Reports to the Ministerial Council.

Box 2-1 Requirements of terms of reference and where we responded

2010 Review reference clause	Response
Per capita relativities which the Commission would regard as appropriate to apply after 2009-10.	See the Overview and Chapter 1 of this report.
The Commission should simplify its assessments by: (a) aggregating existing assessments; (b) eliminating category assessments found unreliable; and (c) applying materiality thresholds.	The strategy for simplifying the assessments was set out in the 2006 Progress Report to Ministerial Council and is summarised in Chapter 2 of this report. The materiality and other assessment guidelines are in Attachment A and have been implemented in the assessments. Steps taken to simplify the assessments are in Chapter 6.
The Commission should consider developing other ways to simplify its assessments, including by: (a) addressing issues relating to quality and fitness for purpose of data; (b) undertaking a program of continuous improvement of assessments; and (c) reviewing the scope for the use of more general indicators.	The strategies for addressing these matters and progress in implementing them were set out in the 2006 and 2007 Progress Reports to Ministerial Council. Measures taken to improve data quality are in Chapter 9. Steps taken to use general indicators are summarised in Chapter 6.
The Commission should also consider: (a) developing mechanisms to maintain simplification once achieved; and (b) improving quality assurance processes.	Simplification mechanisms are in Chapter 6. Steps for improving quality assurance are in Chapter 9.

THE APPROACH TO THE 2010 REVIEW

A clean slate/top down approach

- 16 In our 2006 Progress Report to the Ministerial Council, we laid the foundations for a comprehensive review of the implementation of the equalisation principle. We said we would vigorously pursue equalisation and simplification and that we believed both objectives could be achieved. We also said simplification could improve the reliability and robustness of the processes and the acceptability of the outcomes.
- 17 The report set out our strategy and a work program developed in consultation with the Australian and State Treasuries. Essential features of the strategy included:
 - devising assessment methods by starting with a clean slate rather than the existing methods;
 - adopting a top down approach, where State revenues and expenses would be disaggregated into specific services and taxes only if it materially improved equalisation and could be done reliably;
 - seeking broad indicators of the drivers of State expenses and revenues and introducing further detail, such as the impact of groups within State populations, only if it materially improved equalisation and could be done reliably;
 - adopting new assessment guidelines with stronger reliability and materiality criteria; and
 - introducing all the new assessment methods as a package in the 2010 Review Report.
- 18 We considered a clean slate, top down approach offered the best opportunities for simplifying methods while still capturing what is important to State budgets and, hence, achieving equalisation. We made it clear the onus of proof would be on demonstrating that capturing the main differences between States required disaggregation and greater detail rather than the other way around.
- 19 The Heads of the Australian and State Treasuries broadly agreed with this strategy and we applied it during the review.

Addressing the reliability of data and methods

- 20 Since there were concerns about the quality of some of the data the Commission previously used, we established a comprehensive process for reviewing the quality of those data and the associated assessment methods and developing guidelines to help our decision making.
 - The 2006 Progress Report established protocols for improving the quality and comparability of data provided by State and Australian Government agencies and guidelines for ensuring data are used appropriately.
 - The 2006 Progress Report set out a timetable for reviewing the major datasets. The 2006 and 2007 Progress Reports outlined the findings of data reviews completed in the previous year.

- The 2007 Progress Report also noted that, in consultation with the States and external consultants, we completed a comprehensive quality assurance strategic plan and were implementing it.

The work program and consultation

- 21 The work program for the review is shown in Box 2-2. The program contained three stages (some of which ran concurrently) and was built on a consultative and iterative approach that provided States with several opportunities to contribute to the development of the final methods.
- 22 In the first stage, which began in 2005 and continued through 2006 and 2007, we:
 - considered the broad architecture of equalisation, including how the principle should be defined, interpreted and implemented; and
 - reviewed and refined our guidelines for making decisions on assessment methods (including the approach to issues of materiality and reliability) with the aim of improving the clarity and transparency of its work.
- 23 During this stage, the Commission implemented the data protocols and examined the fitness for purpose and reliability of the main datasets used in its assessments. Those examinations built on the ABS report into a selection of datasets, commissioned by Heads of Treasuries for their 2005 review of the implementation of equalisation. As set out in the 2006 and 2007 Progress Reports, in many cases, potential concerns had immaterial effects or the data were found to be sufficiently robust and reliable. In others, the specifications of data collected for the 2006 to 2009 Updates were varied to improve their quality and comparability and, in a few cases, alternative data or methods were used.
- 24 In the second stage of the review, which covered 2006 and 2007, we considered how State activities should be disaggregated to facilitate the assessment of State fiscal capacities.
- 25 The third stage, covering 2007, 2008 and 2009, involved developing assessment methods for each assessment category.
- 26 The methods for this review have been developed jointly with the States. To this end, we adopted iterative processes involving: consideration of the issues within the Commission; the circulation of discussion papers outlining proposals developed by the Commission or its staff; several discussions between Commission staff and State officials and/or written State submissions; and the circulation of a Commission preliminary position paper. There were also conferences involving the Commission and Heads of Treasuries in 2005, 2006 and 2007. During 2008, the Commission visited each State for discussions with senior officials of State treasuries and service delivery agencies.
- 27 The Commission circulated a comprehensive draft report in July 2009 which contained proposed assessment methods and illustrative relativities apart from placeholder assessments for water subsidies and land tax. The draft was discussed with Heads of Treasuries in August 2009. States provided final submissions responding to the draft in September and October.

Box 2-2 Work program for 2010 Review

2005		
April	Working party of Commission and State officials established to examine data quality and reliability issues.	
June	Commission paper on reliability and materiality criteria circulated.	
September	State submissions on reliability and materiality criteria.	
November	Discussions with Heads of Treasuries and data working party report to Commission.	
2006		
February	Progress report to Ministerial Council outlining the strategy for the review and proposed assessment guidelines.	
February/March	Commission circulated issues papers calling for submissions on: <ul style="list-style-type: none"> • the principles and implementation of equalisation; and • aggregation, data quality, and use of broad indicators. 	
July	Discussions with Heads of Treasuries and State submissions.	
August to November	Papers by Commission staff on proposed assessment categories circulated, staff level conference on those proposals and State submissions.	
December	Commission paper on proposed assessment categories, initial views on assessments and revised assessment guidelines circulated.	
2007		
February	Progress report to Ministerial Council.	
April to October	First iteration of papers by Commission staff on proposed assessments circulated, staff level conferences and State submissions.	
May	Commission paper on the principles and interpretation of equalisation circulated.	
November	Discussions with Heads of Treasuries.	
2008		
February to June	Commission visits to States for workplace discussions on assessment issues.	
February to August	Second iteration of papers by Commission staff on proposed assessments circulated, staff level conferences and State submissions, including working parties of Commission and State officials on roads and the effects of location.	
September	Commission position papers on assessment methods circulated to States.	
October	Staff level conferences on assessment methods.	
2009		
January	State submissions on assessment methods.	
March	Staff level conference on assessment methods.	
June	Release of draft report presenting proposed assessment methods.	
July	Commission staff visits to States to discuss the draft report.	
August	Discussions with Heads of Treasuries and State submissions on draft report.	
September/October	State submissions on draft report.	
2010		
February	Release of final report.	

- 28 We are satisfied the iterative approach to reaching our final recommendations provided opportunities for meaningful engagement with the States. As in past reviews, the better the conceptual arguments and supporting data in State submissions, the more they assisted the review. We expected to, and did, change our approach to some issues after receiving State views and arguments. That is the strength of a genuine iterative approach.
- 29 In addition to seeking State views, the Commission sought advice from expert consultants on many matters. Box 2-3 lists the advice sought from consultants. Copies of the consultants' reports, excluding any confidential information, are available on the Commission's website.

Box 2-3 Consultants engaged by the Commission for the 2010 Review

Consultant	Advice requested
Mr P Hagan	A reconsideration of urban influences on State spending
University of South Australia, Prof M Taylor	The impact of urban size on public transport subsidies
University of Melbourne, Prof J Borland	Validating measures of interstate wage differences
Curtin University, Dr J Petchey	Measuring State expense needs through econometric analysis
National Centre for Social Applications of Geographical Information Systems	Recalibrating a State-based accessibility and remoteness index for Australia using 2006 Census data
University of Melbourne, Prof S Lamb	Modelling post-compulsory school enrolments
Australian National University, Prof J Butler	A review of the proposed approach to the assessment of community and other health services
MapInfo	Advice on length of roads outside urban areas
Blake Dawson	Conveyance duty differences between the States
Blake Dawson	A comparison of land tax provisions across the States
Australian Valuation Office	Comparing total residential land valuations across States
Dr A McHugh	An evaluation of the application of the assessment guidelines

CHAPTER 3

THE EQUALISATION PRINCIPLE AND ITS INTERPRETATION

- 1 This chapter outlines how the Commission defined and interpreted the equalisation principle and the guidelines it applied in making decisions on assessment methods.

THE EQUALISATION PRINCIPLE

- 2 In the early stages of this review States were given opportunities to provide their views on issues such as: the objectives of the distribution of the GST; whether full or partial equalisation should be pursued; the implications of the emphasis in the reference on simplification; and how equalisation should be implemented. Those processes included the circulation of a Commission paper identifying relevant issues, a conference between the Commission and Heads of Treasuries, discussions among Commission staff and State officials and written State submissions. The Commission set out its position in May 2007¹.

Objectives of the GST distribution

- 3 Some States argued the objectives of the GST distribution should be broadened to include:
- economic efficiency, because the sole pursuit of equalisation created disincentives for the efficient allocation of resources across the country and for economic development thereby reducing aggregate national welfare; and
 - the stability of the GST revenue they received, because the GST represents a large part of their total revenue and the sizeable and often unpredictable changes in GST arising from equalisation create difficulties for budget management.
- 4 However, others said the terms of reference do not require the objectives of the GST distribution to be considered, but would have if this had been intended. They noted the Heads

¹ See Commission information paper *2007/12 Principles, Interpretation and Scope of Horizontal Fiscal Equalisation, May 2007*.

of Treasuries review which preceded the terms of reference was directed not to review the equalisation principle and a broad examination of objectives was not supported by Heads of Treasuries at their November 2005 conference with the Commission.

- 5 It is clear the States hold different views on the continued appropriateness of distributing the GST solely on the basis of equalisation. However, the IGA, which all States signed, says the GST distribution is to be based on equalisation principles. We have not augmented the equalisation objective with other objectives. We consider the terms of reference, the context in which they were developed and the IGA all strongly imply the relativities we recommend should be based on a single objective, fiscal equalisation. We consider that if governments wanted us to include other objectives they would tell us to do so through explicit terms of reference.

Alternative perspectives on equalisation

- 6 The definition of equalisation used in the 2009 Update of State Revenue Sharing Relativities was:

State governments should receive funding from the goods and services tax revenue such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.

- 7 Its aim may be simplified to ‘if States levied comparable taxes, then with their GST revenue they would have the same capacity to fund comparable services’.
- 8 Early in this review, some States argued for less comprehensive interpretations of equalisation. They argued this might be achieved by explicitly aiming for partial equalisation and/or by reducing the scope of State functions and influences on State finances examined.
- 9 *Full, partial or proximate equalisation.* Some States suggested different interpretations of equalisation under which:
- South Australia, Tasmania and the Northern Territory would be supported, but the relatively prosperous States of New South Wales, Victoria, Queensland, Western Australia and the ACT would not be equalised. It was said this would improve economic efficiency and national welfare by increasing competition between the States, reducing disincentives for development and improving service delivery efficiency;
 - States would be equalised to a predetermined proportion (say 80 per cent) of the average which would be akin to the ‘safety net’ philosophy that applies in Australia’s welfare system and would improve interstate competition and incentives for development; or
 - each State would be given the capacity to provide a standard of service ‘not appreciably different from’ that of the other States rather than the ‘same’ as that of the other States (that is, apply a proximate equalisation approach) because it better reflects the practical constraints on the analysis and the use of the ‘same’ standard was a relatively recent change to the definition.

- 10 The explicit partial equalisation approaches were opposed by many States because they would result in Australians in different States being treated differently. Some, however, acknowledged that, despite an aim of equalising States to the same fiscal capacity, equalisation has always been proximate because it is limited by practical issues, such as data availability.
- 11 The arguments in favour of not equalising some States and equalising to a proportion of the average rely on a view that equalisation reduces national welfare. We acknowledge that redistributive processes such as equalisation may affect aggregate national welfare. However, past attempts to measure the direction and size of the effects produced a range of results that were affected by the assumptions made by the researchers. Consequently, we could not say whether the effects are sufficient to warrant changes to the equalisation principle.
- 12 In any case, we consider the explicit partial equalisation approaches would represent a fundamental change in the nature of federal financial relations, with substantial effects on the level of GST received by some States. Moreover, we have no basis for making judgments about which States should or should not be equalised or the extent of partial equalisation that should be sought. We consider our terms of reference ask us to equalise the fiscal capacities of the States; they do not give us a mandate to move from a broad view of equalisation to only partially equalise capacities. All States agreed further direction from Government would be required before partial equalisation approaches could be applied.
- 13 However, equalisation is not improved by including allowances that are not supported by reliable data or evidence, or which make only marginal changes to the distribution of the GST, especially when this brings more complexity and less transparency. This view is fully consistent with the requirements in the terms of reference to implement equalisation using simpler, more reliable methods than before and in a way that reflects only material influences on State GST requirements.
- 14 We think the implementation of equalisation can be made more transparent by varying the definition to more clearly reflect what is actually done and to better align it with the materiality and simplification requirements in the terms of reference.
- 15 *Changing the scope of equalisation.* In the past, equalisation covered a comprehensive range of State revenues and expenses and the influences affecting them. It covered virtually all revenues and expenses (including revenues from Commonwealth specific purpose payments and the expenses they fund) that had a direct impact on State general government operating accounts. The direct subsidies from State budgets to public trading enterprises (such as those providing urban transport services, electricity and water) were included because they may be funded from the GST. The enterprises' contributions to the budget were also included because they contribute to the funding of other services. However, the detailed operating revenues, expenses and capital acquisition of these enterprises were excluded.
- 16 Equalisation also recognised that States needed different levels of infrastructure to provide the average level of State services. States were given the capacity to acquire those assessed infrastructure stocks by recognising that they would hold different levels of debt and have

different interest obligations. This was consistent with what States did when capital was debt funded. The assessment also recognised States would face different borrowing costs per capita arising from differential population growth.

- 17 In this review, most States supported a continuation of the comprehensive approach, but some sought changes to:
- limit the range of services examined to ‘core’ State services (such as health, education, and law and order) because all States deliver those services whereas policy choices have a greater effect on which other services are provided;
 - limit the range of influences on State expenses by making allowances for differences in the use of services but omitting allowances for differences in unit costs because they encourage over-provision of services in high cost areas and the data supporting them are less reliable; and
 - include local government and/or the effects of services provided by the Australian Government, local governments and private organisations on the quantity of services States must provide.
- 18 Since the IGA makes the GST revenue available to the States to spend according to their priorities, we have no basis for making judgments about whether some areas of State activity are more or less important in determining State fiscal capacity. Nor is there a sound basis for making judgments about which cost drivers should or should not be recognised. In the absence of strong reasons, any partial approach could have large effects on the distribution of the GST and the assessed fiscal capacities of the States. For example, there are substantial differences between States in the costs of providing ‘non-core’ services such as roads, other transport, community amenities and industry regulation and they differ from the disabilities affecting ‘core’ services.
- 19 Accordingly, we have continued to base our recommendations on a comprehensive coverage of State activities and the material factors that affect them.
- 20 We continue to base the scope of State activities on general government sector activities and to exclude the detailed internal operations of public trading enterprises (PTEs). We are aware there are differences among PTEs with some, such as housing authorities, being closer in nature to general government activities than others, such as energy enterprises. In the absence of an objective basis for sub-dividing PTEs, we have continued to set the scope of equalisation using the definition of general government activities applied by the ABS in its Government Finance Statistics. However, we understand the ABS is reviewing its definitions of the general government sector and PTEs. It may be necessary to review the scope of equalisation in the light of the outcome of that work.
- 21 We do not consider the terms of reference give us a mandate to equalise local government activities. However, if State-type services provided by non-State providers (including local government) materially affect the quantity of services States must provide, we have recognised that in our assessments.

- 22 *Capital transactions.* No State disputed that differential capital needs should be recognised, although there were different views on how that should be done.
- 23 The 2004 Review approach of recognising differences between States in their level of accumulated debt failed when States as a whole moved from holding net debt to holding net financial assets in 2003-04. On the advice of Heads of Treasuries, disabilities arising from State capital requirements were not assessed in the years 2003-04 to 2006-07. Thus, interstate differences in the infrastructure required to provide services had a declining effect on the allocation of the GST since the 2005 Update and had no effect in the 2009 Update.
- 24 In recent years, economic circumstances and the collective financial policies of the States have meant the recurring costs of general government services and spending on the acquisition of infrastructure required to provide them have been met from State tax revenue, the GST and other Commonwealth payments. Data from the ABS show the financial assets of the State general government sector as a whole have exceeded liabilities since at least 1998-99 and the sector had total net lending of \$10 billion between July 1998 and June 2008. In 2008-09, the sector incurred net borrowing of \$10.5 billion to fund increased capital spending. However, State longer term policies appear to involve a return to funding capital acquisitions from recurrent sources.
- 25 Because the GST is untied, States have used it to fund recurrent activities, investment in new infrastructure and acquisition of financial assets. In that sense, the GST can be said to comprise both recurrent and capital grants.
- 26 Since States use the GST to fund services and investment and we have no basis for determining the relative importance of needs relating to operating and capital transactions on State fiscal capacity, we adopted a uniform approach. Specifically, we have recognised differential needs for services and the investment required to provide them as they arose, because that reflects recent State practice.
- 27 Recognising interstate differences in recurrent service delivery and associated investment at the same time does not change the range of State activities included in the assessments, but it means infrastructure spending and other investments have a more immediate impact.
- 28 The distribution of the GST arising from our recommendations continues to be based solely on equalisation and a broad interpretation of what should be equalised. As in previous reviews, we have taken account of the financial consequences of all State activities associated with the provision of services and the raising of revenue to fund them, including the consequences arising from State holdings of infrastructure used in providing services and financial assets.
- 29 We have, however, changed the way we capture these consequences. We have done so because States have changed the way they use GST revenue to acquire assets and we consider letting these consequences have a faster impact on the GST distribution better reflects the different fiscal capacities of the States. We have also changed the way we recognise the revenue raising implications of State holdings of financial assets. As a result we have changed how we measure fiscal capacity.

- 30 Previously, States were considered to have the same fiscal capacity if they had the same net income (after providing the same level of services, meeting interest expenses on borrowings accumulated to acquire the associated infrastructure and making the same effort to raise revenue). In this review, States are considered to have the same fiscal capacity if they have the same net financial worth (after providing the same level of services, making the same additions to their stock of associated infrastructure and making the same effort to raise revenue).
- 31 This is a better measure of State fiscal capacity because not only does it allow for factors affecting their net income but it also allows for differences in their asset holdings. It is a more complete measure of fiscal capacity that is consistent with measures used by the States themselves. This approach allows us:
- to incorporate the consequences of infrastructure spending when the need for it arises; and
 - to simplify the handling of the financial consequences of State holdings of financial assets.
- 32 We consider our methods better reflect fiscal practices in the States and provide an equalisation outcome more in keeping with the fiscal realities they face.
- 33 Further details of our approach to measuring the financial consequences of capital are in Chapter 5 and in Volume 2 (Chapters 21 and 22).

The 2010 Review definition of equalisation

- 34 For the 2010 Review, we have revised the definition of equalisation to better reflect the scope of State activities examined and to make it clear that only material influences are measured. The definition we applied is:
- State governments should receive funding from the pool of goods and services tax revenue 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.
- 35 We have included the concept of dealing with only material differences between the States because we are directed to do so in the terms of reference and it simplifies our assessments without a significant impact on the distribution of GST revenue.
- 36 We have included reference to State infrastructure to make it explicit that we recognise States' need to provide infrastructure and that this has financial consequences. The 2004 Review methods also recognised the need for infrastructure, but it was not made explicit in the definition of equalisation.
- 37 The amended wording makes it clear that:
- the aim is to equalise the fiscal capacity of the States to deliver services and to acquire the infrastructure used in their provision. Equalisation does not aim to equalise actual

service levels. Since States have the right to spend the GST revenue according to their policy priorities, the GST distribution cannot equalise the actual level of services provided unless States choose to do so; and

- the equalising GST distribution is determined on the basis that all States make the same effort to raise their own revenue and operate with equal efficiency. States are not obliged to follow any particular service delivery or revenue raising policies. However, if any State adopts revenue raising or service delivery policies that differ from the others, the GST distribution would not compensate it for any lost revenue or extra expenses; nor would it offset any extra revenues or cost savings.

SUPPORTING PRINCIPLES

38 In the 2004 Review, we introduced guidelines to help the interpretation and implementation of equalisation. They were:

- capacity equalisation, which emphasised that the aim was to give each State the same financial capacity to deliver services as other States;
- equalising to internal standards, which meant States were equalised to standards derived from an average of what all States actually do; and
- policy neutrality, which meant that a State's own policies should not directly affect its share of GST.

39 We have revised the guidelines in the light of the emphasis in the terms of reference on simplification, our revised definition of equalisation and State views. The new principles indicate equalisation should be implemented through methods that:

- reflect what States collectively do;
- are policy neutral;
- are practical; and
- deliver relativities most appropriate to the application year.

40 *What States do.* This principle means, as far as practical, Commission assessments should reflect what States collectively do. It leads us to adopt internal standards, which remove the need for judgments on what States could or should do. More specifically:

- the scope of the assessments reflects the average range of services provided by States and the average range of taxes imposed by them;
- the level of services and associated infrastructure States are funded to provide, and the revenue raising efforts they are presumed to reflect, are an average of those actually provided or made; and
- the range of disabilities assessed reflects the material factors affecting the cost of delivering State services and the capacity to raise State taxes.

- 41 Using internal standards based on an average of what States collectively do ensures each State's assessed fiscal capacity would enable it to provide the average level of services provided by the States, if it so chose. It implies interstate differences in the factors affecting the costs of providing State services and revenue from State taxes are taken into account.
- 42 Equalisation does not attempt to equalise the capacity of States to provide services to a standard required to achieve an external policy objective — for example, reducing hospital waiting lists or increasing literacy and numeracy levels. Such an approach would require judgments about matters that are the province of Government. Governments have not asked us to do that.
- 43 Similarly, equalisation is not directed to interpersonal, community or regional equality because States do not follow such policies. States do not provide residents of rural and remote areas with the same access to services as people in metropolitan areas. Accordingly, the equalisation standards reflect the different amounts States spend per person in different areas and on different groups of people. Equalisation is not intended to provide States with the capacity to implement policies they do not, on average, already follow. The Australian Government has other policy measures such as the tax and social security systems to address interpersonal equity.
- 44 One State proposed changing the standards from an average of what all States do to ones:
- based on what is done by the financially strongest or the middle ranking States; or
 - based on the State that is the most efficient provider of services.
- 45 The first approach would give the benchmark States an increased influence on the assessments. We are not convinced it is more desirable or simpler than the current approach.
- 46 We can see the conceptual merits of basing the service standards on the highest observed level of technical efficiency. However, we do not know how we could reliably determine it and no State has been able to explain how it could be done. For practical reasons, therefore, we have used the average level of efficiency, which emerges readily from our data and methods.
- 47 *Policy neutrality.* Policy neutrality means policy differences between the States do not affect the recommended GST distribution. We implement policy neutrality by applying the same policies for delivering services and raising revenue to all States (that is, by applying average policies to all).
- 48 Policy neutrality is intended to ensure the actual policies of an individual State and interstate differences in the policies do not directly affect the GST they receive. It is also intended to ensure the GST distribution process itself does not provide the States with incentives to vary their policies.
- 49 There is some overlap between the 'policy neutrality' and 'what States do' principles. We implemented both by assessing each State's GST requirement on the basis that it applies the same policies as all other States, with those same policies being an average of the policies

States collectively adopt. The policies of each State have some effect on the averages we apply.

- 50 Some States said, because each State's policies affect the average and some States more than others, we should adopt a nominal policy-free approach. Under that approach the standard policies would be defined broadly and without reference to the more detailed policies States adopt in implementing them — for example, they might be expressed as States' tax payrolls and land holdings without reference to the exemptions for small employers and land used for principal residences and primary production.
- 51 A policy free approach would mean that in the many situations where the policies of the individual States are 'variations on a common theme', policy neutrality would be achieved by ignoring both the common theme and the variations around it. That approach implies policy neutrality is more important than 'what States do' and the Commission's assessments might be seen as implying what the policy should be.
- 52 We concluded pursuing policy neutrality by basing GST requirements on the average revenue collection and service provision policies of the States is a more balanced and realistic approach, because it reflects what the States do. It also prevents each State's own policies having an undue effect on its GST outcome.
- 53 *Practicality.* This principle means the assessments should be based on sound and reliable data and methods, be well constructed and be as simple as possible while also reflecting the major influences on State expenses and revenues. It recognises that, while State fiscal capacities are affected by a wide variety of factors, the suitability and acceptability of the recommended GST distribution may not be improved by including factors when sufficient data are not available to measure their effects or whose effects are small.
- 54 This principle reflects the emphasis in the terms of reference on simplification, reliability and materiality. It is supported by the inclusion of materiality and reliability criteria in the assessment guidelines.
- 55 *Relativities are contemporary.* This principle means, as far as possible, equalisation should reflect State circumstances in the year the funds are used. 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.
- 56 This principle, therefore, is constrained by the need for reliable data. Moreover, since 1991, the terms of reference have required the Commission to base its recommendations on an average of the five most recent completed financial years, meaning the recommendations were based on data that preceded the year they were used by between two and six years.
- 57 Consequently, the Commission determines the GST distribution required to achieve equalisation in the historical years and assumes the fundamental structure of those years continues in the year its recommendations are used. An exception is federal financial arrangements where the assessments are adjusted to reflect any major changes that occur

between the historical years and the year the recommendations are applied. Consequently, since State economic and demographic circumstances change over time, the recommended GST distribution may not be fully consistent with the circumstances in the year they are used.

- 58 The averaging process smooths the effects of data irregularities and short term events thereby making State shares of the GST less volatile. Many States value this over a more up-to-date assessment because it provides some stability in a major source of revenue, despite volatility in State own-source revenue.
- 59 In this review, we have made our recommendations more contemporary, consistent with the need for simple, reliable and robust assessments and States' preference for stability, by:
- using data for the three most recent completed years instead of five as before — this reduces the average age of the data from four years to three years; and
 - directly assessing State infrastructure requirements.
- 60 There may be scope for trade-offs between the principles — for example, between what States do and policy neutrality and between practicality and contemporary relativities. 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. Each case has been considered on its merits and judgment used to devise the best overall result consistent with the aim of achieving fiscal equalisation.

THE ASSESSMENT GUIDELINES

- 61 To ensure that the assessments achieve equalisation in a reliable and simple way, we established, in consultation with the States, a set of assessment guidelines to assist decisions on assessment methods and which influences on State expenses and revenues we should include.
- 62 Those assessment guidelines are summarised in Box 3-1 and set out in full in Attachment A. They include amendments made following the report of an external audit of our decision making processes, which suggested transparency would be improved if we clearly set out the basis for discounting assessments to use data consistently with their quality.
- 63 The materiality thresholds established by these guidelines are inevitably subjective. Some States would have preferred lower thresholds while others preferred higher ones. However, we consider they reflect a reasonable compromise between the requirements to avoid excessive detail and recognise factors that have significant effects on State relative fiscal capacities.

Box 3-1 Summary of assessment guidelines for the 2010 Review

A category (expense or revenue) will be considered for separate assessment, if:

- it is clearly a major State service or revenue source distinct from others;
- it is affected by disabilities that are markedly different from those of other categories;
- data used to estimate the average expense or revenue are satisfactory;
- it is expected that satisfactory assessments of disabilities can be made; and
- the category is expected to be material; meaning, making a separate assessment rather than aggregating the service or revenue with broadly similar ones would redistribute more than \$30 per capita for any one State in the reference period.

The Commission will include a disability in a category when:

- a presumptive case for the disability is established; meaning, there is a sound conceptual case and sufficient empirical evidence of differences between States in the use and/or unit costs of services or in the capacities to raise revenues;
- a reliable method has been devised that is conceptually rigorous, implementable and, where used, consistent with external review outcomes;
- data are fit for purpose (they measure what is trying to be measured), of suitable quality (implying the collection processes are appropriate and the data are comparable across States and over time and are not subject to large revisions) and from a reputable source; and
- there is a material effect on the distribution of the GST — the disability redistributes more than \$10 per capita for any State in the reference period.

Where a case for including a category or a disability 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; or
- to make no assessment.

The option chosen will reflect the specific circumstances of the assessment and will depend on: the strength of the conceptual case; the reliability of the method and data; the sensitivity of the assessment to the data used; and consistency with State circumstances.

When the assessment is to be discounted, a uniform set of discounts is used, with higher discounts being applied when there is less confidence in the outcome of the assessment or more uncertainty attached to the information. The discounts range between 12.5 and 50 per cent.

CHAPTER 4

IMPLEMENTING EQUALISATION

- 1 This chapter outlines the processes the Commission uses to assess the GST required by each State to achieve equalisation.
- 2 An equal per capita distribution of the GST would equalise fiscal capacities if State circumstances were the same. However, State circumstances are not the same and State fiscal capacities differ because:
 - the per capita revenues raised from any given tax rate differ because 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 people 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; and
 - States receive different amounts of National specific purpose and partnership payments from the Australian Government.
- 3 The distribution of the GST aims to allow for those differences by providing the States with different 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 services are low or they are better able to raise their own revenue.
- 4 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.

THE ASSESSMENT APPROACH

Overview

- 5 The GST revenue a State requires in a year to give it the same fiscal capacity to provide services as the other States is calculated by:
 - summing the expenses it would incur in providing the average level of services to its population (called its ‘assessed expenses’) and its expenditure on acquiring the associated infrastructure (called its ‘assessed investment’);
 - subtracting the revenues it would raise if it applied the average tax policies (called its ‘assessed revenues’) and its actual revenues from Commonwealth payments; and
 - adding the net lending (or borrowing) it would undertake to make its share of total State net financial assets at the end of the year equal to its share of the population, assuming its share of net financial worth and population were equal at the beginning of the year.
- 6 If the GST available in that year was distributed in accordance with the assessments, each State would have the same per capita net financial worth at the end of the year, if all States applied the same (average) policies.
- 7 Ideally, the assessments would be based on data for the year in which the recommendations are to be used (2010-11 for this review). However, reliable data for that year are not available. GST requirements for the application year, therefore, must be based on historical data.
- 8 Basing GST requirements on calculations for historical years implies the average policies and the economic, social and demographic conditions in those years are a good guide to the application year. If there are trends over time in State policies and conditions, the closer the application and historical years are to each other, the more likely this assumption is to be true. However, if conditions are cyclical, being close together is less important and using more assessment years is valuable and reduces the effects of data irregularities.
- 9 The Commission seeks to reconcile these competing concerns by using an average of the calculations for a number of past years. Previously, the recommended relativities were an average of those assessed for the most recent five historical years. For example, the relativities recommended for use in 2009-10 were an average of those calculated for 2003-04 to 2007-08.
- 10 In this review, we have made the recommended relativities more up-to-date by basing them on the average of three historical years (2006-07 to 2008-09). They may not fully reflect the relative circumstances of the States in 2010-11 (on average they reflect State circumstances in 2007-08, three years prior to 2010-11). Nevertheless, we think they are an appropriate balance between the competing needs for contemporary relativities and reliability. They are

appropriate for use in distributing the GST in 2010-11. Using the same methods and updated data will produce relativities appropriate for later years.

- 11 The Commission derives the relativities by, first, assessing how the GST available in the three past years would have been distributed to achieve equalisation. Second, converting those results into a set of per capita relativities which reflect the relative fiscal positions of the States in each of the three historical years — each State's calculated GST requirement per capita is expressed as a ratio of the average per capita GST distributed in the year. Third, deriving the recommended relativities as an average of each State's relativity in the three historical years. A per capita relativity below one indicates a State requires less than an equal per capita share of GST revenue, while a relativity above one indicates it requires more than an equal per capita share. This process illustrates that no State can have its relativity increased without one or more others having theirs reduced.
- 12 The relativities can then be applied to the populations for the application year to determine State shares of the GST in that year. In this way, each State would be allocated sufficient GST to provide the average level of services to its population in the application year provided there is no change in relative fiscal positions and State shares of the population between the historical and application years.
- 13 Our approach to implementing equalisation also requires us to consider the following issues:
 - What State activities are examined?
 - How are the standard (or average) policies determined?
 - How do we determine what revenue a State would raise and the expenses it would incur if it adopted the standard policies?
 - What data are used?

What State activities are examined?

- 14 To reflect what States do, we adopt a comprehensive coverage of State activities associated with raising revenue, providing services and acquiring the associated infrastructure. We examine all general government sector activities included in the ABS Government Finance Statistics (GFS). This includes all operating expenses (such as salaries, purchases of goods and services, superannuation and depreciation), net capital expenditure on new assets and all revenues from State taxes and charges and Commonwealth payments. We include the net contributions to (or the net receipts from) State public trading enterprises by the general government sector, but not the direct transactions of those enterprises¹.
- 15 Since the costs of different services are driven by different factors, accurate assessments require total spending to be disaggregated by service — for example, spending on vocational

¹ For example, it includes the payments from the State budget to authorities providing urban transport services and any dividends paid by those authorities to the State budget but the expenses of the authorities, their expenditure on infrastructure and the fares collected by them are excluded.

education needs to be considered separately from that on roads. Similarly, State revenues need to be disaggregated because most State taxes are levied on different bases (such as wages and salaries paid, the value of real estate sales and mining production). In previous reviews, the pursuit of full equalisation resulted in a high level of disaggregation of States expenses and revenues. The resulting assessments were detailed and some of the allowances had quite small effects on State GST requirements.

- 16 As part of the strategy for simplifying the assessments, we followed a top down approach in deciding how State revenues and spending would be disaggregated. Under this approach, revenues and spending were disaggregated into specific taxes and services only when:
- the revenues or expenses were large — meaning the average across all States exceeded \$50 per capita;
 - they were affected by factors that differed from those affecting other taxes and services;
 - it materially affected the distribution of the GST — defined as changing the distribution for at least one State by \$30 per capita or more; and
 - it could be done reliably.
- 17 This process resulted in 8 categories of State revenue and 14 categories of State expenditure (see Box 4-1).

Box 4-1 Categories of State revenue and expenditure — 2010 Review

Revenue	Expenditure (b)
Payroll tax	Schools education
Land tax	Post-secondary education
Stamp duty on conveyances	Admitted patients
Insurance taxes	Community and other health services
Motor taxes	Welfare and housing services
Mining revenue	Services to communities
Other revenue (a)	Justice services
	Roads
	Transport services
	Services to industry
	Depreciation
	Investment (c)
	Net lending
Revenue from Commonwealth payments	Other expenses (d)

(a) Includes gambling taxes, emergency levies, user charges and any other revenue in GFS.
 (b) Includes expenditure funded by State revenue, the GST and Commonwealth payments.
 (c) Investment on new infrastructure and equipment only. Replacement of existing assets is assumed to be funded by depreciation expenses.
 (d) Includes State legislatures, central administrative agencies, national parks and cultural services and a balancing item to ensure the expenses equal those in GFS.

- 18 The collection of State revenues and spending included in the assessments, disaggregated into the chosen revenue and service categories, is called the adjusted budget.
- 19 *Dealing with National specific purpose payments and National partnership payments from the Australian Government.* Under the IGA, payments from the Commonwealth to the States may be made in the form of:
- National specific purpose payments (SPPs);
 - National partnership project payments (NPPs);
 - National partnership facilitation and reward payments;
 - the GST; and
 - other general revenue assistance.
- 20 The IGA indicates governments expect the GST distribution would:
- be affected by the revenues States receive through National SPPs, National NPPs and general revenue assistance because they provide budget support for standard State services; and
 - not be affected by revenues from National partnership facilitation and reward payments and the expenditure they fund.
- 21 However, the IGA gives the Commission discretion, following consultation with the Australian Government and the States, to treat any NPP or general revenue assistance differently if it considers that treatment more appropriate. The Treasurer may also give the Commission directions on the treatment of individual NPPs, if he considers that appropriate.
- 22 In this review, we have exercised our discretion by asking, on a payment by payment basis, if the payment affects State fiscal capacities differentially and should affect the distribution of GST revenue among the States. In doing so, we examined payments made for both recurrent and capital purposes.
- 23 A Commonwealth payment should have an impact where it provides revenue which a State can use to provide a service or to acquire an asset and the State has discretion on how it is spent. Where a State has no discretion, for example, it is required to pass the revenue to a third party, the Commission considers the payment should not affect the GST distribution because the payment and the expenditure of it have no net impact on a State's fiscal capacity.
- 24 However, some Commonwealth payments through the States, to State public trading enterprises, to non-government agencies or to individuals may reduce the need for a State to provide a service or acquire assets and thus affect the relative fiscal capacities, even though they do not directly impact on State budgets. In those cases, the assessment for the relevant service should include an allowance to recognise that the Commonwealth's actions reduce the amount some States need to spend from their own resources. For example, the level of general practitioner services, which is largely funded by the Commonwealth, affects the level of

primary health care services States need to provide (especially in remote areas) and we have allowed for those effects in our assessments.

- 25 Where the Commonwealth makes payments to States to fund programs at levels or in areas defined by the Commonwealth and beyond the usual range of practices of the States, the Commission may consider that payment to be a reflection of Commonwealth policy and that it should not influence the GST distribution. A similar approach may be taken to a payment that rewarded a State which had funded such a program. There may be cases where the Commission will need to exercise judgment in considering the character of the payment, taking account of all the relevant facts and circumstances.

How are the standard policies determined?

- 26 To ensure the distribution of the GST is policy neutral, it is determined on the basis that each State follows the same policies in providing services and raising revenue. Those same policies are an average of what the States collectively do. Deriving our standards from what States collectively do, recognises that how States raise revenue and what they do with it can affect their fiscal capacities. It also means we make no explicit, or implicit, judgments about what States could or should do.
- 27 At the simplest level, the average policy is encapsulated in the State average² per capita revenue and expense for each tax and service and the average per capita investment. Those averages are a weighted average of the per capita revenues and expenses of each State where the weights are determined by the State populations. While this ensures the policies applicable to each person have the same weight in determining the average, the policies applied by the more populous States have a greater impact on it.
- 28 Those average per capita revenues and expenses reflect the outcome of applying the average policies to the average circumstances.
- The average revenues capture the average tax rates, average concessions, average anti-avoidance efforts and the average level of taxable activity as defined by the average scope of the tax base.
 - The average service delivery expenses and average expenditure on new infrastructure reflect the average scope and level of a service, average eligibility requirements, average service delivery efficiency, the average service user and the average use of capital in providing services.
- 29 Determining the average policies is straightforward when all States are active in the field and the activity can be measured. This situation is facilitated by the broader categories used in this review. However, determining the average can be more difficult when some States do not impose the tax or provide the service.

² This may also be referred to as ‘the Australian average’. However, Commonwealth and local government activities are not included. The State averages are calculated as the total revenues or expenses of the States divided by their total populations.

- 30 In these cases, the Commission aims to distil the main thrust of State policies from their often disparate policies in as neutral a way as possible. We do that and maximise policy neutrality by applying a threshold test. We consider the average policy is not to impose a tax or provide a service, unless a majority of States do so and it affects a majority of the aggregate tax base or relevant population. If that threshold is met, the average policy is based on the average observed effective tax rate or level of spending. If the threshold is not met, any revenue or expenses are treated in a way that does not differentially affect State GST requirements. Some examples of our approach are outlined below.
- The imposition of land tax is considered the standard policy because it is imposed in all States except the Northern Territory and the average policy is derived by treating the Northern Territory as if it levied the tax at a zero rate.
 - The agreement between the Commonwealth and the States to phase out certain taxes on business at known but different rates creates further examples of this situation. However, in these cases the tests are based on the tax policies expected to apply in the year the relativities are to be used. If it appears the tax would not apply in a majority of States and to a majority of the aggregate tax base in the application year, we conclude the average policy is also not to impose the tax. Any revenue raised from the tax during the assessment years is treated in a way that does not differentially affect State GST requirements.
 - In the expense assessments, as far as possible, we construct the average policies for services for Indigenous people from the policies applied by all States, with each State's policy given a weight based on its proportion of the total Indigenous population.
- 31 If a minority of States raise a tax because they have all or the vast majority of the tax base, such as with royalties on iron ore, the Commission's usual approach is to group that activity with others which exist in more States and which receive similar tax treatment.
- 32 There are also cases where States exempt certain transactions from a tax, such as employers with small payrolls, but the precise definition of the exempt transactions varies between States. In these cases, the exemption is treated as average policy if it applies in a majority of States and they have a majority of the tax base. The exempt transactions, which were often defined by a threshold level, are determined as a weighted average of those in all States, with the weights reflecting each State's contribution to the aggregate tax base.

How we estimate the revenue a State would raise and the expenses it would incur if it adopted the standard policies

- 33 The largest part of the Commission's task is to determine the revenue each State would raise if it applied the average revenue raising policies and how much it would spend under average service delivery policies. This involves estimating how the circumstances in each State depart from the average circumstances and how that affects its per capita revenue or expenses.
- 34 This assessment task could be done by either:

- starting with the observed average revenue or expenditure in a category (the outcome of average policy) and adjusting it for differences between the State's actual characteristics and the average characteristics which affect the tax base or service use; or
 - starting with the amount each State actually raised or spent in a category and adjusting it for differences between its policies and the average policy.
- 35 Conceptually, both approaches would lead to the same outcome. However, the first is preferable, especially for expense assessments, because it is:
- more policy neutral — it preserves the average policies and efficiency whereas under the second approach any unidentified differences in policy or efficiency would affect the assessed GST requirements; and
 - more practical — it is usually easier to find reliable data to make adjustments for differences between the States in their underlying economic, social and demographic conditions than it is to make adjustments for the impact of differing State policies.
- 36 There are instances, however, when it can be established that:
- all States adopt the same policy and any differences in efficiency are immaterial. In these cases, differences in actual revenues and expenses can be taken as the effect of differences in State circumstances on State GST requirements; or
 - all interstate differences in per capita revenues or expenses reflect policy differences between the States or there may be differences in State circumstances affecting their revenues and expenses, but those differences cannot be reliably measured. In these cases, it is considered that all States could collect the average per capita revenue if they applied the average revenue policy or could provide the average service if they spent the average per capita amount.
- 37 *Revenue assessments.* Revenue assessments estimate the per capita revenue each State would raise if it applied the State average tax rates to its tax bases.
- Each State's tax base is measured using the value of transactions in the State that would be taxed under the average tax policy. In doing so, no account is taken of potential tax elasticity effects (the potential change in the level of activity caused by the difference between the tax rate actually imposed by the State and the average rate).
 - The average tax rate is an effective rate measured by dividing the total tax collections in all States by the total revenue base.
- 38 In most cases, the revenue base for each State tax is clearly evident from an examination of State tax policies. The revenue base we have used for each tax and how we have measured it are summarised in Table 4-1.

Table 4-1 Indicators of revenue bases

Category	Indicators and source of data
Payroll tax	The value of payrolls in each State, excluding small employers, the general government sector of the Commonwealth, the States and local government and the exempt portions of payrolls. Measured using ABS data on compensation of employees, private sector wages and salaries and public sector gross earnings.
Land tax	The value of commercial, industrial and non-principal residential land, adjusted for the effects of tax free thresholds and sub-divided into value ranges. Measured using State provided data on land values.
Mining revenue	Gross value of minerals produced in each State plus an adjustment for revenue received under revenue sharing arrangements with the Commonwealth. Measured using ABS data on value of mining production.
Stamp duty on conveyances	The value of property conveyed, based on a common range of taxable transactions and sub-divided into value ranges. Measured using data provided by States.
Insurance tax	Total premiums paid for life, general and compulsory third party insurance. Measured using Australian Prudential Regulation Authority data on premiums.
Motor taxes	The number of light and heavy vehicles registered and the value of vehicles sold. Vehicle registration data were from the annual ABS motor vehicle census, while State provided data were used for vehicle values.
Other revenue	All States were considered to be able to raise the average per capita revenue for this category, implying the revenue base is the State population.

- 39 Under these processes, a State has a revenue raising advantage (often described as an ‘above average revenue raising capacity’) if the per capita value of its tax base exceeds the national value. Consequently, applying the average tax rate (that is, making the average tax effort) would yield above average per capita revenue.
- 40 *Expense and net investment assessments.* The aim is to measure the amount each State would spend on each service if it followed the average policies and provided its residents with the average service and acquired the average amount of new infrastructure. This is done by adjusting the average per capita expenses and net investment for the effects of differences between the State average circumstances and the actual circumstances of each State.
- 41 The Commission calls these differences in circumstances ‘disabilities’. Disabilities are more precisely defined as ‘circumstances beyond the control of individual States that require a State to spend more (or allow it to spend less) per capita than other States to provide the average level of service’. Disabilities arise from the demographic, economic and geographic circumstances of the States. They are positive for some States and negative for others because they are measured as differences from the average State position.
- 42 In broad terms, there can be differences between States in the following areas.
- The per capita number of service users and/or intensity of use — called ‘use disabilities’. These differences generally reflect differences between States in the characteristics of their population, such as the age distribution, the proportion of people who are Indigenous or who have low incomes.

For example, schoolchildren make up a greater proportion of the population in some States raising their per capita use of education services. Similarly, elderly people and Indigenous people generally use hospital services more intensively than other groups of people and they make up greater proportions of the population in some States which raises the per capita use of hospital services in those States.

Service use disabilities may also be assessed for the ACT in cases where its services are used extensively by residents of New South Wales and there are no arrangements for New South Wales to contribute to the costs.

- The level of resources required to provide a service to members of specific groups in the population compared with the rest of the population. Providing a given service to Indigenous people is often more resource intensive than providing the service to non-Indigenous people. For example, extra expenses are incurred to provide the service in a culturally appropriate way or to provide additional levels of care.
- The price of delivering a service — called ‘cost or price disabilities’. These are broad influences that affect most services in a similar way. For example, wage levels could be higher in a State for reasons outside its control, raising the cost of delivering services in the State, and the price of some inputs used to provide services is higher in remote areas.

43 Most services are affected by all three disabilities.

44 We have also recognised that each State’s need to provide services or acquire infrastructure may be affected by the extent to which similar services are provided by other bodies (such as, the Commonwealth, local government or non-government bodies). In cases where reliable information indicated there are material differences between the States in the extent to which State-type services are directly funded by non-State bodies, we took those differences into account. For example, States where more services are directly funded by the Commonwealth are treated as having a reduced need to incur expenses and so a reduced GST requirement. This happened in the case of Community and other health services.

45 A top down approach was also followed in considering how we should measure the influences on State expenses, especially the influences affecting service use. Under this approach, we initially considered broad indicators of needs, such as the total population, the population in a broadly defined target group for the service or outcome measures, such as mortality rates in the case of admitted patient services. While such measures would have been simple, they were invariably found to inadequately capture major influences on the use and cost of services. Indicators were subsequently disaggregated, or adjusted, in an attempt to better reflect the material influences.

46 Table 4-2 summarises the indicators we have used to measure the service specific disabilities. These are predominantly the disabilities arising from use and the resources devoted to members of specific population groups. The table does not show the general cost or price disabilities (such as those arising from diseconomies of small scale in administration, interstate differences in wage levels and the cost effects of remoteness) which apply to most services.

47 Overall, the outcome of the expenditure assessments is that all States would receive sufficient funds to provide the same level of service to people in similar circumstances.

What information is used?

48 The Commission's calculations require large amounts of information:

- to establish the Australian averages or standards, which may be:
 - the average State revenues and expenses for each tax and service;
 - the Australian average use of services by the population as a whole or groups within it; and
 - the Australian average cost of providing each unit of service to each population group; and
- to measure the circumstances of each State, which include:
 - the revenue base for each tax in each State; and
 - the population and other potential service users³ for each State, which may be sub-divided to identify particular groups.

49 As far as possible, data were obtained from national collections or independent sources (such as the ABS and the Australian Institute of Health and Welfare (AIHW) because it helped ensure they were comparable across States and reliable. States were the second most important source of data, providing data on their policies, service users, the additional expenses for certain user groups and some revenue bases such as the value of land and the value of property transferred.

50 Further discussion of data sources and reliability is in Chapter 9.

³ There are also data on other variables that reflect the number of services provided, such as the number of primary industry and manufacturing businesses, road lengths, numbers of pensioners.

Table 4-2 Indicators of service specific disabilities

Category	Assessment approach
School education	Actual enrolments for compulsory ages plus estimated policy neutral enrolments for students aged 5 and below and 15 and above, with adjustments for: <ul style="list-style-type: none"> • differences in the cost of providing services to students who are Indigenous and students from low socio-economic backgrounds; • differences in the use of government and non-government schools and the costs to the States of students attending each; • use of ACT services by New South Wales residents; and • the costs of school transport in rural and urban areas.
Post-secondary education	The population aged 16 to 64 with adjustments for: <ul style="list-style-type: none"> • differences in the use of services by Indigenous people, people with low English fluency and people in remote areas and in the cost per contact hour of services provided to them; and • use of ACT services by New South Wales residents.
Admitted patients	Total expenses with adjustments for: <ul style="list-style-type: none"> • differences in expenses on people in different age groups, Indigenous people, people living in remote areas, and people with low socio-economic status (SES).
Community and other health services	Total expenses (including those incurred by non-State providers) with adjustments for: <ul style="list-style-type: none"> • differences in expenses on people in different age groups, Indigenous people (including those living in remote areas), and non-Indigenous people with low SES. • access to non-State providers; and • use of non-hospital based ACT services by New South Wales residents.
Welfare and housing	Expenses on recipients of Commonwealth income support, weighted to reflect the use of State services by the type of support, and non-beneficiaries, with adjustments for: <ul style="list-style-type: none"> • differences in expenses on Indigenous people; and • use of ACT services that are not delivered to the home by New South Wales residents.
Services to communities	A combination of indicators of the: <ul style="list-style-type: none"> • the number of people living in small communities with adjustments for the effects on cost of the availability and quality of water; • population in remote and very remote areas; • people with Commonwealth pensions and health care cards; • people living in discrete Indigenous communities; and • total population.
Justice services	Total population with adjustments for differences in the intensity of use by, and cost in providing services to: <ul style="list-style-type: none"> • males aged 15 to 34; • Indigenous people; • people with low SES; and • those living in different parts of the State.

Table 4-2 Indicators of service specific disabilities (continued)

Category	Assessment approach
Services to industry	A combination of indicators of: <ul style="list-style-type: none"> • number of agricultural businesses; • factor income of agricultural and other businesses; and • total population.
Roads	A combination of indicators of: <ul style="list-style-type: none"> • length of roads in rural areas; • length of roads in remote, low population density areas; • population in urban areas; • volume of traffic (vehicle kilometres) in rural and urban areas; • road use by heavy vehicles in rural and urban areas; and • total population.
Transport services	Total population, with adjustments for differences in the intensity of use by, and cost of providing services to, rural and urban populations in centres of differing sizes.
Other expenses	A combination of indicators of: <ul style="list-style-type: none"> • one tenth of unfunded superannuation liabilities; • net natural disaster expenses; • people born in non-English speaking countries; and • total population.
Depreciation	A combination of indicators of: <ul style="list-style-type: none"> • aggregate use of services; and • the effects of location on the cost of capital.
Investment	A combination of indicators of: <ul style="list-style-type: none"> • aggregate use of services derived from all other categories; • the effects of location on the cost of capital; and • population growth.
Net lending	Population growth.

Note: The table does not include indicators that reflect general influences on the costs of services, such as diseconomies of small scale in administrative tasks, interstate and regional differences in prices of labour and other inputs. Those influences are assessed in addition to the use-related disabilities measured by the indicators in this table.

CHAPTER 5

MAJOR ASSESSMENT ISSUES

INTRODUCTION

- 1 Our top down, clean slate approach means every aspect of the methods has been examined in this review and decisions have been made in accordance with the assessment guidelines. This chapter summarises our approach to the following major issues:
 - ensuring the relativities are contemporary;
 - the assessment of State infrastructure requirements;
 - the assessment of State net lending requirements;
 - the treatment of capital grants to public trading enterprises;
 - the effect of location (including urbanisation) on State expenses;
 - the effects of Indigenous status and cultural and linguistic diversity on State expenses;
 - the treatment of Commonwealth payments; and
 - the use of judgment and discounting.
- 2 The details of issues considered in deriving the assessment methods for each revenue and service are described in Volume 2, Assessments of State Fiscal Capacities.

ENSURING THE RELATIVITIES ARE CONTEMPORARY

Overview

- 3 Since 1990 the Commission has based its recommendations on the latest available data for the five most recently completed financial years, implying the data were between two and six years old when the relativities were used to distribute GST. This meant the relativities may not accurately reflect State circumstances in the year they were used.

The main issues

- 4 The principles adopted in this review indicate the recommended relativities should be appropriate to the year they are applied (be contemporary) and be based on reliable data.
 - Contemporary relativities require information on State finances and circumstances in the future when the relativities are used. However, such data are either not available or are generally considered unreliable.
 - Reliable relativities require reliable and robust data. Those data come from historical years and so require a decision about how the results are best applied to the future. The methods adopted prior to this review assumed the relative circumstances of the States in the historical years were the most reasonable guide to the future — that is, the historical relativities were applied in the future.
- 5 Ways of making the relativities more contemporary we have examined included:
 - a fully contemporary approach, which would use projections of State financial, demographic and economic circumstances to estimate relative circumstances in the year the relativities are used;
 - reducing the number of years for which data are taken into account, which would reduce the average age of the data used in determining the relativities;
 - giving greater weight to the circumstances of the more recent years, which would also reduce the average age of the data used in determining the relativities;
 - an indexing approach where the GST each State required in the historical years is explicitly indexed to the application year by estimated movements in price levels, with any additional (or any shortfall) GST available in the application year allocated on an equal per capita (EPC) basis; and
 - a two part process where an initial allocation is made and subsequently adjusted when data become available to accurately measure relative fiscal capacities.
- 6 The States opposed:
 - a fully contemporary approach because the data would be unreliable and it would increase complexity;
 - a two part approach because it would increase complexity; and
 - giving more weight to the most recent years because there was no reliable way of setting the weights applied to each year.
- 7 Some States suggested the indexing approach was worth considering, but others thought it would add complexity and reduce reliability by requiring judgment to determine the indexing factor and the method of distributing any residual GST. While States valued the stability produced by including data for five years, none opposed reducing the number of years to three, although Western Australia suggested it be phased in over three years. New South Wales suggested the effect of reducing the number of years on the volatility of the relativities be monitored and transition arrangements be considered if it is excessive.

- 8 We concluded the two most viable approaches were reducing the number of years of data included and the indexing approach because:
 - a fully contemporary approach would be more complex, unreliable and unacceptable to the States;
 - there is no objective way of deciding how to give more weight to more recent years; and
 - a two part approach could produce a reliable and more up-to date GST allocation but it would reduce transparency and be more complex.
- 9 The main difference between the two remaining approaches is in the way they move from the historical data to the GST allocation in the application year. The three year version of the existing approach implies changes in State circumstances between the historical and application years do not affect the relative fiscal capacities of the States whereas the indexing approach implies they do not affect the absolute fiscal capacities.
- 10 We have decided to make the relativities more contemporary by basing them on the average of the relativities assessed for the three most recent years because it is the simplest method of making the relativities better reflect State GST requirements in the application year.

THE ASSESSMENT OF STATE INFRASTRUCTURE REQUIREMENTS

Overview

- 11 One of the key challenges facing governments today is meeting the needs of rapidly growing populations for government services, including acquiring the social and economic infrastructure needed to deliver the services. State public documents have clearly identified these challenges and the major effect of population growth and changes in State circumstances on the need for new infrastructure¹.
- 12 States also demonstrated during Commission visits that population growth has placed pressure on road networks, transport systems and water and power infrastructure and created the need for new schools, hospitals, police stations and prisons. Queensland highlighted its population growth of 22.5 per cent between 1996 and 2006 compared with 10 per cent in New South Wales and 12.6 per cent in Victoria. It experienced some 35 per cent of the national population growth between 2001 and 2005. As a result, its need for new infrastructure is substantial.
- 13 Queensland, Western Australia and the Northern Territory argued strongly in this review that past capital assessments did not adequately address State infrastructure needs resulting from changing State circumstances and population growth.

¹ See the New South Wales, *State Infrastructure Strategy 2008-09 to 2017-18*, Introduction, and Victoria *2009-10 Budget Paper No. 2, Strategy and Outlook*, page 34.

- 14 States require large amounts of infrastructure to provide their services. They may choose to own the infrastructure themselves or lease or rent it. However, the vast majority of it is owned by the States² and they can finance its acquisition in several ways. They can use their revenue in excess of what they spend to deliver services, sell existing assets or they can borrow. In the years on which this review is based, the average State policy has been to use revenue, including the GST, to deliver services, replace infrastructure used up in service delivery and invest in new infrastructure. We consider all these uses of revenue need to be included in the equalisation process if State fiscal capacities are to be equalised.
- 15 We have therefore designed assessments which recognise State infrastructure needs when State circumstances change and new infrastructure must be acquired. The resulting effect on the GST distribution is more immediate and States most affected by population growth receive support sooner.

The assessment approach

- 16 In the 2004 Review, the Commission used a debt charges assessment to recognise the financial implications of State requirements for new infrastructure and a depreciation assessment to recognise the financial consequences of the use of existing infrastructure. A debt charges assessment was used for new infrastructure. States were assessed as needing to borrow different amounts, and therefore incur different per capita debt charges, to hold the level of infrastructure they were assessed to require to provide the average level of services.
- 17 An EPC assessment of net interest was introduced on the advice of Heads of Treasuries in the 2005 Update because average State policy had changed and States became net lenders, implying they had net interest revenue. Differential needs for new infrastructure did not affect the GST distribution in three of the four subsequent updates.
- 18 At a meeting in November 2007, a clear majority of the Heads of Treasuries agreed differential infrastructure needs should be recognised. They agreed it was not desirable to try to redevelop the debt charges approach because of its complexity and the problems of obtaining a meaningful average expense. They agreed a more direct assessment of infrastructure needs was desirable. We have tried to meet these objectives in a way that would accommodate future changes in State policy on how infrastructure is financed.
- 19 The assessment approach, as in the 2004 Review, involves two steps:
- Assessing the stock of infrastructure a State needs to deliver the average per capita services in its circumstances.
 - Assessing fiscal capacity in a way that recognises the financial consequences of giving each State the capacity to have its assessed level of infrastructure. We aim to provide States with the capacity to fund the annual depreciation of their infrastructure holdings

² To the extent that States lease or rent infrastructure, it is captured in Commission assessments of recurrent service delivery expenses.

and the investment in new infrastructure they require to maintain their assessed level of infrastructure.

- 20 *Assessing State infrastructure requirements.* Our assessments of investment and depreciation are based on the view that each State needs the average stock of infrastructure per capita, adjusted for its infrastructure stock disabilities, to deliver the average per capita services. Those disabilities recognise differences between the States in the quantity of infrastructure required to provide average services and the unit cost of providing that infrastructure.
- 21 The assessments of the disability adjusted stock of infrastructure, and the depreciation flowing from it, are largely the same as the 2004 Review assessment and are relatively uncontroversial. Most States agreed infrastructure stocks are influenced by the same factors as recurrent expenses, although not necessarily to the same extent. Most also agreed the same disabilities would affect depreciation because it relates to the assessed infrastructure stock States require to provide services³.
- 22 We drew on relevant expense disabilities to assess the quantity of infrastructure each State requires to provide services and its unit costs. We consider the quantity of infrastructure required is affected by disabilities such as socio-demographic composition and cross-border use. We discounted those quantity disabilities by 12.5 per cent (because some may not be fully relevant to infrastructure needs) and averaged them over three years (because State responses to changes in their circumstances may not be as rapid as indicated by annual changes in disabilities). The effects on the unit costs of capital, which we measured using the recurrent location disabilities, were not discounted or averaged.
- 23 Only road stock requirements have been assessed using measures other than the expense disabilities. This is because we have specific information from the National Transport Commission on the drivers of State investment in roads. As roads investment is approximately 30 per cent of total investment in a year, we considered it consistent with equalisation to use the extra available information.
- 24 Some States said other stock specific disabilities should be recognised, such as the impact on infrastructure needs of the physical environment, historical factors and urban development. However, other than for roads stock, no infrastructure specific disabilities have been assessed because there was either no clear conceptual case for recognising them, no reliable method of measuring them or they were not material.
- 25 *Recognising the financial consequences of new infrastructure.* Extensive debate has occurred over when State needs relating to new infrastructure should be recognised — when the investment takes place or spread over time as the infrastructure is used.

³ Initially, we intended to allocate depreciation expenses to categories and assess them as part of the costs of delivering a service. However, applying the stock disabilities to depreciation was more easily done by undertaking a separate assessment of depreciation expenses.

- 26 The Commission considered the alternative approaches in the light of the views of all parties. The two options considered were:
- the direct approach — recognising the financial consequences in the year new assessed infrastructure needs arise. This approach recognises the effects of differential population growth and changing stock disabilities on infrastructure in the year they occur; and
 - the holding cost approach — recognising the financial consequences over the life of infrastructure. This approach is based on the implicit opportunity cost of the assessed level of infrastructure.
- 27 Both approaches, correctly implemented, would achieve equalisation. At our meeting with Heads of Treasuries in August 2009 we explicitly asked if they considered one or other of these approaches would not achieve equalisation. No State argued convincingly one or other would not deliver equalisation.
- 28 Both approaches to infrastructure assessments assume States require the average per capita quantity of stock with the national average asset life, adjusted for their disabilities, to deliver average services. (This is similar to the expense assessments which assume equal per capita expenses, adjusted for disabilities, are required to provide average services.) The major difference between the approaches to assessing infrastructure needs is the timing with which they recognise the effects of disabilities on infrastructure requirements.
- 29 We think the equalisation outcome is improved by assessing State capital needs upfront when State circumstances change and new assets are acquired instead of providing States with the capacity to fund their infrastructure requirements over time as the holding cost or debt charges approaches do.
- 30 Queensland, Western Australia and the Northern Territory supported our view. They argued it was conceptually sound, better recognised the pressures States face in providing infrastructure to their growing populations, was more contemporary and transparent and the simplest way of assessing capital needs. Victoria provided qualified support, preferring the Commission's approach to others under consideration, but retaining concerns over its conceptual basis.
- 31 New South Wales, South Australia, Tasmania and the ACT, did not support the direct approach. They said equalisation is about equalising State capacity to provide services in the application year only and should not be extended to include investment in infrastructure which has implications for future years. They consider a holding cost approach better recognises the annual use of infrastructure in service provision and means it is not necessary to move away from either the accrual concepts used by States to manage their operations or the equalisation of State net operating balances. They also said there was no need to recognise the impact of population growth on State infrastructure needs because States do not adjust infrastructure stocks annually in response to changes in population or other State characteristics.
- 32 We recognise the direct approach to the infrastructure assessment involves extending the equalisation framework beyond the net operating balance measure used in the 2004 Review.

As discussed in Chapter 3 we consider this is appropriate because it better reflects State needs and average State practice.

- 33 In summary, we favour an approach that recognises infrastructure needs as they arise because:
- It is consistent with State practices of using their revenue, including the GST revenue, to fund investment in new infrastructure.
 - It is responsive to changes in State population and other key drivers of the need for investment in new infrastructure.
 - It is contemporary because it provides States with the capacity to fund investment in new infrastructure when the need arises.
 - It applies the same assessment principles to investment as we apply to service delivery costs. It gives each State the capacity to fund the average per capita investment in new infrastructure adjusted for their circumstances, just as they are given the capacity to fund their assessed service delivery expenses. While it implies each State follows the average policies relating to investment and the stock of infrastructure required to provide services, it does not impede their decisions on the stock of infrastructure required or whether to own, rent or fund it through public private partnerships.
 - It is simple to implement and uses reliable data. It uses data on capital expenditure, depreciation, stocks of non-financial assets and total estimated State resident population data from the ABS and expense disabilities that satisfy Commission assessment guidelines. By contrast, a holding cost approach would require us to impute a holding cost, and the GST distribution would be sensitive to our decision on an appropriate rate.
- 34 States raised other concerns about how the Commission's approach would be implemented. They are addressed in Chapter 21 of Volume 2.

THE ASSESSMENT OF STATE NET LENDING REQUIREMENTS

Overview

- 35 States earn revenue from their net financial worth in the form of interest earnings on cash and other holdings and dividends from public trading enterprises (PTEs). Therefore, State holdings of net financial worth influence their revenue raising capacity and create differences in State fiscal capacities.
- 36 States build their net financial worth directly through the accumulation of net lending. They can also increase their net financial worth by providing capital grants from the general government sector to their PTEs for the purchase of assets which is equivalent to an equity injection. These actions stem from deliberate decisions by State governments on how they use their GST or own-source revenue. Conversely, States can reduce their net financial worth by increasing their borrowings to fund infrastructure, incurring budget deficits or funding less of their superannuation liabilities.

- 37 State net financial worth can also change as a result of periodic revaluations of assets to reflect their market values. For example, the equity States hold in PTEs and of their superannuation holdings are often revalued. Changes can also occur as a result of non-transactional changes and public private partnership arrangements.
- 38 As the GST can influence only State net lending and equity equivalent payments (capital grants for infrastructure purchases) to their PTEs, we have assessed only those transactions in equalising State net financial worth. We consider this the simplest way of including the impact of net financial worth in the equalisation framework since each State can then be assessed as having the same capacity to earn income from that per capita stock. As explained in Chapter 3, we have redefined the measure of horizontal equalisation to be the equalisation of net financial worth to facilitate this approach.

The assessment approach

- 39 The approach is implemented by calculating the net lending a State would need for its end of year net financial worth per capita to be equal to the average, if it started the year with the same net financial worth per capita as other States. Having equalised net financial worth per capita, an equal per capita assessment of States' capacity to earn revenue from those financial assets is appropriate.
- 40 In this framework, differential population growth is the only determinant of assessed net lending. By themselves, population increases and decreases change a State's net financial worth per capita. For example, faster growing States would experience a greater decline in per capita net financial worth than slower growing States. We decided this effect should be recognised by assessing the differential amount of net lending each State would need to maintain the national average net financial worth per capita in each year.
- 41 Some States considered other disabilities should be recognised, including differences in the starting net financial worth of each State, the impact of asset revaluation on net financial worth and the rates of return States can earn on their assets. We have not recognised any other disabilities for the following reasons.
- 42 *Unequal starting points.* New South Wales and Tasmania said net financial worth has not been fully equalised in the past and so all States start with unequal net financial worth and therefore have unequal capacity to earn or pay net interest. As a result, the net lending assessment would permanently entrench those differences unless an adjustment is made.
- 43 We accept States may not start the year with equal per capita net financial worth but consider this is the result of past policy and non-policy influences and would be difficult to untangle. Moreover, assuming States have equal assessed net financial worth per capita at the start of the year is reasonable and consistent with the previous equal per capita assessments for dividend income and net income earnings (an assessment that was based on the advice of Heads of Treasuries). In any case, since we want to adjust the GST in a year for population changes in that year, the difference between the average starting and finishing net worth positions of the

States is all that is relevant. Since the actual starting or finishing positions of each State are not relevant, it is not necessary to reflect them in the assessment.

- 44 *Revaluation disabilities.* Our approach assumes States revalue their financial assets at the average rate. This assumption implies differences in per capita net financial worth arise only from differences in population growth or net lending per capita.
- 45 New South Wales, South Australia, Tasmania and the ACT said States with faster growing populations and economies would see their equity in PTEs grow faster than slower growing States. They argued higher population growth would increase the profits of PTEs and the relative scarcity of some PTE assets, such as land. Other States disputed this.
- 46 In our view, the available data do not conclusively show faster growing States have higher rates of PTE revaluations. We consider other factors, such as the State land release policies and price regulation, may be more important influences on those revaluations.
- 47 We have not assessed a revaluation disability because there is neither a strong conceptual case nor reliable empirical evidence that States with higher population growth experience greater increases in the value of their per capita equity.
- 48 *Rate of return disabilities.* New South Wales, Victoria and the ACT were concerned that not all components of net financial worth earned the same rate of return. New South Wales and Victoria said the reason States held equity in PTEs was not related to revenue generation but to service provision on which a commercial rate of return was not expected. The ACT said it was unable to earn dividends from ports and this represented an income earning disability.
- 49 We acknowledge States hold their net financial worth in different ways, which may influence the rates of return they earn. However, we do not assume the rate of return on PTE equity is the same as that on financial assets, but that States hold the same share of their financial assets in different asset classes. The average rate of return is then equal.
- 50 We have not been able to identify non-State policy reasons for States having different holdings of PTE equity. We note New South Wales owns its electricity PTEs but Victoria does not and some States own their public transport networks but others do not. While there may be non-policy reasons for these sorts of differences, identifying them is difficult and may require a more detailed accounting of PTEs than that currently in the equalisation framework. We, therefore, have not assessed a rate of return disability in the net lending assessment and have continued to assess interest and dividend earnings equal per capita.
- 51 *Other disabilities.* States also raised concerns about other factors, such as the costs of borrowing, special circumstances in the Northern Territory and transitional issues, which are addressed in Chapter 22 of Volume 2.
- 52 *Discounting.* Because there is some uncertainty about the assumptions underlying the assessment, we have discounted the net lending assessment by 25 per cent.

THE TREATMENT OF CAPITAL GRANTS TO PUBLIC TRADING ENTERPRISES

- 53 State PTEs receive capital grants or equity injections from State governments and Commonwealth payments for infrastructure purposes through the States. The influence of these transfer payments on State fiscal capacities has been a difficult issue for this review.

Capital grants to PTEs by States

- 54 Victoria suggested the different treatments of capital grants and equity injections could influence how States make these contributions in the future because it may affect their GST shares.
- 55 From the perspective of the PTE, both can achieve a similar outcome — they provide funds for acquiring infrastructure. However, they are treated differently in the GFS operating statement and our assessments. Capital grants are included with other expenses in the relevant categories and are subject to the same disabilities. Equity injections, however, are balance sheet transactions which change the composition of a State's financial assets but not its net worth. They are part of the net lending outcome in the GFS operating statement (which reflects the net change in financial assets, liabilities and equity arising from transactions). Our assessments would treat them as being subject to a population change disability only.
- 56 An examination of grants made to State PTEs suggested the issue mainly related to transport PTEs where some States provided large capital grants and others provided equity injections for the construction of infrastructure. Grants to PTEs in the water, electricity and housing areas appear to be more in the nature of operating subsidies.
- 57 Since capital grants to PTEs increase State equity in the PTE, they have an effect on State fiscal capacity equivalent to that of net lending. If we were to assess differential capital subsidies, their differential effects would need to be offset in our Net lending assessment. Otherwise, States with larger assessed capital grants would have the capacity to hold greater equity in PTEs than States with lower assessed capital grants and net financial worth would not be equalised. Making an assessment for capital grant needs and offsetting the effects in the Net lending assessment would introduce complexity with no equalisation impact.
- 58 As a result, we decided to treat capital grants to transport PTEs like equity injections. They have been assessed EPC in the Transport category. In this way we have also avoided the potential grant design defect identified by Victoria.

Capital grants to PTEs by the Commonwealth

- 59 The Commission's guidelines for the treatment of Commonwealth payments say payments through the States to third parties which have no impact on State fiscal capacities should not affect the relativities. However, Commonwealth payments to PTEs may affect State fiscal capacities because they may reduce the assessed level of subsidies States need to provide to their PTEs or they may increase State equity and, hence, their net financial worth.

- 60 We have ensured such payments have an impact on the relativities. If that was not done, States with above average per capita amounts of these payments would have above average net financial worth and would be over-equalised. Those with below average per capita amounts would have below average net financial worth and would be under-equalised.
- 61 All Commonwealth capital grants made to PTEs (either through States or directly) have an impact on the relativities. This includes the large payments for transport infrastructure made to PTEs under the Nation building program and Nation building plan for the future. Payments for National network roads also have an impact on the relativities because they increase State infrastructure holdings. However, in that case, we recognised the Australian Government Department of Transport assessment of State roads investment needs included broad national considerations which we were unable to assess. We therefore treated half those payments as having no impact on State fiscal capacities.

In the future

- 62 Since the 1999 Review, the Commission has equalised the subsidies paid to PTEs and treated the detailed internal activities of PTEs as being outside the scope of equalisation. In this review, we have found that, because PTEs are fully owned by the States, the distinction between a State government and its PTEs is blurred and our assessments may be simpler and more robust if it was not made. The way that distinction is made is being examined by the ABS and others. If that work leads to changes, there may be implications for the Commission's assessments in future updates.

THE EFFECT OF LOCATION ON STATE EXPENSES

- 63 The location assessment aims to measure the extent to which the cost of delivering services varies in different regions. These costs can vary between and within States. The Commission recognises that the influences that give rise to variations between States are different from those that give rise to variations within States. Consequently, it has assessed the effects of location in three parts:
- interstate differences in wage costs;
 - interstate differences in the cost of freight and travel; and
 - intrastate regional differences in wage and non-wage costs.
- 64 We have also assessed service delivery scale effects to reflect the additional staffing levels required in small isolated communities.
- 65 Some States had concerns about whether each element of the disability existed and how it might be measured.

Interstate wage costs

- 66 The Commission observed the wages paid for similar employees differ across the States. Some States, such as New South Wales and the ACT, argued they compete in the market for employees and that the observed differences are reflected in the wages they must pay their employees. They concluded the Commission should recognise them as disabilities.
- 67 However, other States (such as Queensland, South Australia and Tasmania) argued the Commission should not assess a disability. They argued there was no economic theory that would explain such differences in the medium or longer term and that:
- the observed differences in wages arose because the methods used to measure them did not adequately compare like with like — for example, the processes did not appropriately control for all structural differences between the States; and
 - differences in the public sector reflected policy choice, not an underlying disability, because State wage bargaining pays close attention to the wages paid in other States.
- 68 We are aware some economic and labour market theories support the view that the wages paid to comparable employees in competitive markets may vary as a result of features of the location where people work. Others do not. Nevertheless, analysis of data from the ABS Survey of Education and Training (SET) spanning some 12 years, consistently reveals interstate differences in wage levels, after controlling for differences in State industrial structure and employee characteristics such as education and experience. Those differences in wages exist in both the private and public sectors.
- 69 We are convinced there is a strong conceptual case for the existence of underlying differences between the States in the wages paid to comparable employees. Moreover, analysis, based on a reliable method and data that are fit for the purpose (the ABS SET), indicates the differences are material. The model we used for that analysis was reviewed by an independent expert and found to be conceptually and statistically sound.
- 70 The private sector is by far the major source of employment in all States except the ACT and the Northern Territory. Therefore, using interstate differences in average wages paid to comparable employees in that sector to measure the disabilities should ensure they are not directly affected by State wage policies. In the ACT, it may be more appropriate to base the disability on the private sector plus the Australian Government sector, but the data for the public sector cannot be split between the Australian and ACT Governments.
- 71 We have decided to make allowances for the effects of interstate differences in underlying wage levels on the basis of the differences in average private sector wages produced by our analysis of SET data for 2005. However, we made the following adjustments:
- the results for Tasmania have been discounted by 25 per cent because we consider there is a bounded range in which public sector wages can reasonably fall and Tasmania's public sector has less downward flexibility than its private sector;

- the ACT's disability has been set at its modelled outcome plus one per cent because the omission of the Australian Government from the calculation of average wage levels understated the ACT's disadvantage.
- 72 Since the SET data refer to 2005 and private sector wage levels can change rapidly over a short period, we have decided to adjust the disabilities annually on the basis of movements in the price of labour as measured by the ABS Labour Price Index. In this way, we better measure the wage differentials in each assessment year.
- 73 Finally, adjustments have been made for the ACT and the Northern Territory to allow for the higher wage-related costs they incur. Those costs are higher because some of their employees were Commonwealth employees before self-government and are still members of the Commonwealth Superannuation Scheme, which is more expensive than State schemes, or receive other benefits not generally offered to State government employees.
- 74 These disabilities for interstate differences in wage levels have been applied to the proportion of average expenses in each category that are wage related. That proportion was derived from the national average wages component of service delivery expenses incurred directly by the States (derived from ABS GFS data) plus the national average wage proportion applied to the expenses incurred by States on outsourced service provision, grants and subsidies to non-State service providers.
- 75 *Discounting.* We have a high level of confidence in the interstate wage level disabilities because of the strength of the conceptual case and the reliability of the analysis used to measure it, but a comparatively low level of uncertainty remains about their size arising from residual concerns about:
- the reliability of the SET data;
 - how accurately the model we used to measure the wage differences controls for differences in productivity; and
 - how well private sector wages proxy wage pressures in the public sector.
- 76 Accordingly, we discounted the disabilities by 12.5 per cent.

Interstate non-wage costs

- 77 There is a conceptual case that the cost of delivering services will vary from State to State because in some States (especially the Northern Territory, Tasmania, Western Australia):
- high freight costs are incurred because above average proportions of materials used in providing services must be imported into the State from the main centres of production or importation in south-eastern Australia; and
 - each State incurs a comparable amount of interstate travel by its officials rather than an EPC amount and the costs of that travel are greater than the costs of moving between New South Wales, Victoria and Queensland.

- 78 While most States accepted a conceptual argument that interstate freight and travel costs could differentially affect the costs of State services, some doubted that it actually would, because:
- Darwin and Perth are closer to the South East Asian origins of many imports and may pay less for certain goods; and
 - many suppliers have national pricing policies in which they cross subsidise the costs of freight.
- 79 Evidence presented in State submissions, especially by the Northern Territory, during State visits, and the Commission's experience, indicates the conceptual case is strong and the amounts involved are material. However, we acknowledge limited data are available to permit an accurate measure of the disabilities.
- 80 The States were divided on how the Commission should respond to this. Some, particularly New South Wales, said that in the absence of a reliable assessment method the Commission could not make a differential assessment. Others accepted a differential assessment had to be made to achieve equalisation and, in the absence of data, it was necessary to rely on Commission judgment.
- 81 ABS Input-Output tables suggest State governments directly or indirectly spend nearly \$800 million on freight per year. There is virtually no other information upon which to base an assessment.
- 82 We consider there is a strong conceptual case that non-wage costs are higher in some States than others. It is clear to us that these additional costs are material. We are convinced a better equalisation outcome would be delivered by making an assessment than not. Accordingly, we have derived interstate non-wage disabilities as the sum of allowances for interstate freight and interstate travel, with the assessment of each component relying heavily on judgment.
- 83 *Interstate freight costs.* To estimate the interstate freight costs, we assumed:
- half of State freight expenses (that is, nearly \$400 million) were affected by these interstate non-wage disabilities; and
 - the allocation of that expense among the States broadly related to the proportion of goods manufactured in the State or entering the country through the State and the cost of freight between State capital cities. Table 5-1 compares State population shares and the assumed shares of freight costs.

Table 5-1 Comparison of State shares of population and freight costs, 2008-09

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	%	%	%	%	%	%	%	%
Share of freight costs	17.50	12.50	17.50	20.00	10.00	10.00	5.00	7.50
Population share	32.54	24.79	20.10	10.18	7.45	2.31	1.61	1.02

Source: Commission calculation.

- 84 The disabilities were then derived by comparing the State population shares and the assumed shares of interstate freight expenses.
- 85 Our estimated interstate freight costs represent around 0.3 per cent of State direct costs. So the interstate freight disabilities have been applied to 0.3 per cent of total costs in each category
- 86 *Interstate travel.* We built an assessment based on data from four States (Victoria, Queensland, Western Australia and the ACT). We estimated total interstate travel costs for each State by:
- assuming the travel patterns of officers from the States that provided data was representative of the average policy;
 - costing the estimated travel using published airfares for each origin-destination; and
 - allowing for longer trips by some officers, using Australian Taxation Office guidelines for the additional accommodation and travel allowance costs.
- 87 Our estimated interstate freight costs represent around 0.04 per cent of State direct costs. So the interstate travel cost disabilities have been applied to 0.04 per cent of total costs in each category.
- 88 *Other costs.* There may also be interstate differences in other costs, such as office accommodation. However, we think those differences are likely to be small and to offset each other. Given the extent of judgment involved in the assessment, we are not confident equalisation would be improved by including allowances for any such extra costs.
- 89 *Discounting.* While we consider the conceptual cases for assessing interstate freight and travel disabilities are strong, the measurement of them has been constrained by data deficiencies. Therefore, we have discounted the disabilities consistent with our view of the uncertainty attached to them. We have discounted the interstate freight disability by 50 per cent because the limited data implied a high level of uncertainty. The uncertainty surrounding the interstate travel disability was lower because data on travel patterns and costs were available from some States and other inputs to the calculation came from policy neutral sources. Consequently, we applied our medium level 25 per cent discount to the interstate travel disability.

Intrastate regional wage and non-wage costs

- 90 Conceptually, the cost of delivering services increases with remoteness because:
- higher wages are needed to entice people to work in remote locations;
 - additional inputs (such as employee housing) are required to provide services there;
 - extra costs are incurred in freighting goods and staff travel within a State; and
 - extra and more expensive inputs are required in remote areas.
- 91 Submissions from most States and evidence gathered during State visits support the conceptual case. However, some States, especially the ACT, argued that while there may have been large cost differences in the past, the increasing ability of States to use technology to deliver services

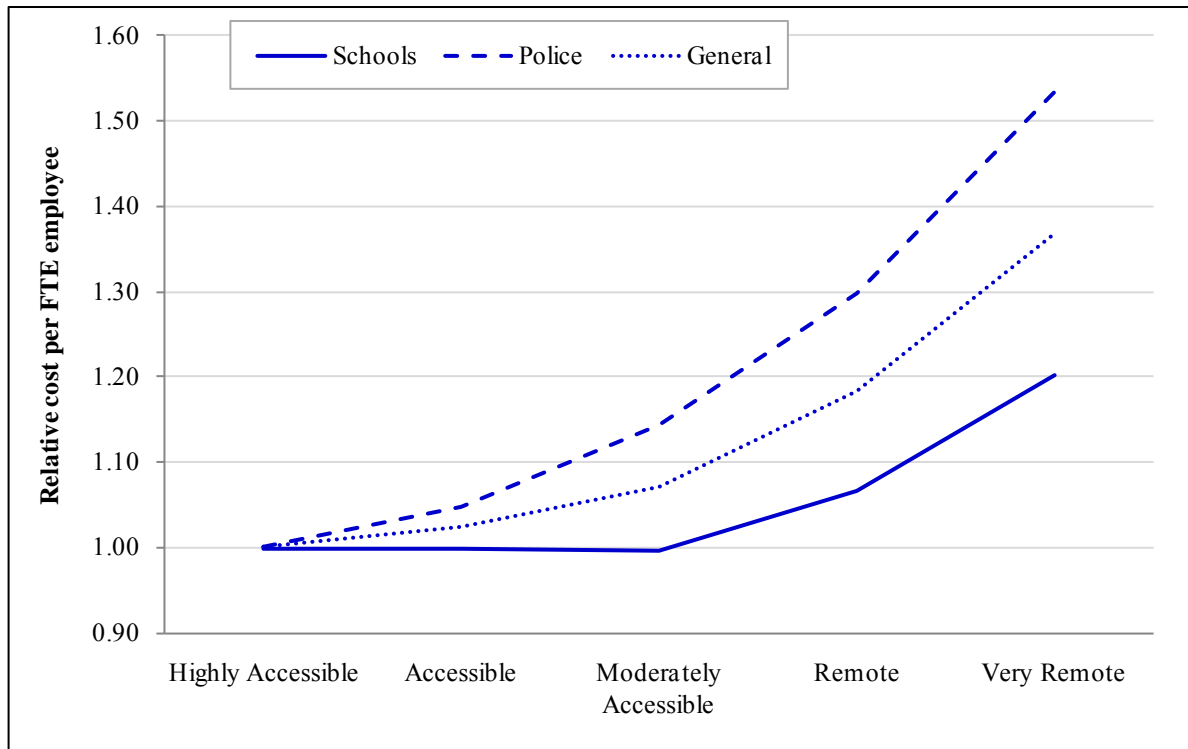
remotely has considerably reduced the relative cost of providing services in remote locations. It also suggested that while costs per unit of service may be higher in remote areas, the level of service provision in those areas was lower, and that the two effects largely cancelled each other out. Victoria has argued that the higher costs in regional areas should not be assessed, or should not be fully assessed, because the number of people living in remote areas reflects the policies of certain States to heavily subsidise services to those areas. As such, the distribution of population is heavily policy contaminated.

- 92 The Commission is convinced there is a strong conceptual case that costs increase with remoteness and the differentials in regional costs are material. We acknowledge that the provision of less extensive services in remote areas and the more widespread availability of technology may mean the differentials in regional costs are smaller than in the past. In this context, we note it is not clear whether the use of technology is aimed at reducing costs or increasing the level of service in remote areas. We also acknowledge that State government policies may have some effect on population distribution but consider it is overwhelmingly driven by economic activity, employment opportunities and social considerations, which are not directly affected by States. In the absence of a measure of the population distribution that would exist if all States followed the same policy, we intend to use the actual distribution in the assessments.
- 93 This is an area where the Commission believes sufficient data are available for it to build a model that measures what States actually spend on delivering services in different regions. Data permitting, this approach would measure the costs of providing services in each region that reflect the mode of service delivery States actually use and the level of service they actually provide in different areas.
- 94 We asked the States for information on the costs incurred in providing services in regions classified on a State-based version of the accessibility and remoteness index (SARIA). However, States were able to provide comprehensive data for schools and police services only. We have used them to measure the way costs vary with increasing remoteness in each State.
- 95 The results for the States have been combined to produce representative pictures of the way school and police costs per employee varied with reducing accessibility and increasing remoteness — see Figure 5-1. The data from New South Wales and Victoria have been excluded from the analysis because they were not comparable with the data from other States. Separate analysis using data from the census on the salaries of police officers also show wage costs increase with remoteness.
- 96 These patterns of variations have been used to assess intrastate wage and non-wage disabilities for schools and police. The disabilities have been calculated by weighting each State's assessed client base in each SARIA region⁴ by the average costs. In doing so, we have used

⁴ The assessed client base was assessed enrolments for schools and population adjusted by the Indigenous allowances for police.

the same staff to client ratio in all regions, thereby avoiding any double counting of service delivery scale and service use disabilities.

Figure 5-1 Estimated relative costs per full-time equivalent employee, by region



Note: The regions are those in the State-based accessibility and remoteness index for Australia.

Source: Commission calculation.

- 97 Only a few States were able to provide information on how their costs for services other than schools and police varied with increasing remoteness. Nevertheless, we consider the conceptual case to be strong and supported by the available evidence. The evidence also indicated the cost differences are material.
- 98 Most States accepted that, in the absence of a direct measure of the effects of regional location on costs, any assessment for categories other than schools and police would be better made by extrapolating from police and schools, rather than the experience of only one or two States. Some States, however, had concerns with extrapolating to other services and considered the disabilities should at least be discounted.
- 99 We consider the case for regional cost differences in other categories is strong, and that equalisation is better served by including allowances based on judgment than not making the allowances. In the absence of better information, we have extrapolated from the experience of schools and police and assumed the average effect of remoteness in these two areas is representative of the effect in the following other categories:
- Community and other health services;
 - Welfare and housing services;

- rural roads within the Roads category;
 - subsidies for water , electricity and community development in the Services to communities category; and
 - culture and recreation and national park expenses and some other expenses in the Other expenses category (estimated as about a quarter of expenses in the category).
- 100 The evidence available to us broadly supports the average relationship between remoteness and the costs for those categories. The averaged location effects are shown in Figure 5-1 (they are called the general factor).
- 101 It is not necessary to extend the intrastate location factor to Admitted patient and Post-secondary education services because allowances for the effects of remoteness on use and costs are already included in the assessments using category specific data on service use and costs. Nor have we extended the disability to the Transport services or Services to industry categories because we consider remoteness has little effect on them.
- 102 Some States, notably the ACT, were concerned an assessment of intrastate location effects could double count certain socio-demographic disabilities. For example, they suggested that if costs in remote areas were increased by the large Indigenous populations rather than the cost of remoteness per se, there would be double counting if Indigenous influences were also assessed. We consider our approach to assessing the location effects avoids this possibility. Indigenous influences generally affect the number of staff per capita but the intrastate location allowances have been measured using the effects of location on the cost per staff member.
- 103 *Discounting.* We consider the conceptual case for assessing intrastate regional wage and non-wage disabilities is strong and they have a material effect on State expenses. While the data used to measure the disabilities are not fully comprehensive, we consider they are sufficiently representative of the conditions facing the States. Nevertheless, some concerns about the reliability of the schools and police data remain and the necessity to extrapolate the disabilities derived from those data to other services also leads to uncertainty. Overall, that uncertainty is relatively low and, while it may vary between the schools, police and other categories, we consider the simplest approach is to discount all the intrastate regional cost disabilities by 12.5 per cent.

Effects of urbanisation

- 104 Urban areas may affect State expenses because:
- service use and/or unit costs may be higher or lower than in rural or remote areas; and
 - it may be more expensive to provide services in very large urban areas due to the greater population density and complexity of service provision.
- 105 New South Wales said urbanisation effects on State expenses should receive as much attention from the Commission as the effects of remoteness. It said its expenses were affected by:

- the need to provide infrastructure for a growing population in particular ways given the high population densities and shortage of space;
 - the need to run services near capacity, which limited the ability to increase throughput and increasing capacity involved significant capital spending;
 - the need for traffic management facilities and out-of-hours maintenance to maximise the use of existing infrastructure; and
 - urban issues such as ethnic relations, vandalism and security.
- 106 The arguments were supported by Victoria. The other States said they faced similar issues, which indicated the case for big city effects was not clear cut. They also said reliable data were not available to support the case and that, up to a point, big cities lead to economies of scale and it is not clear that Sydney and Melbourne have passed that point.
- 107 Many effects of urban areas on State expenses are reflected in the allowances we make for:
- socio-demographic composition, which recognise that certain groups of people and where they live affect service use and, hence, staffing and infrastructure requirements; and
 - intrastate regional cost structures, which allow for the effects of where services are provided on the unit costs. They do so by comparing the average cost per full time equivalent employee in each region to those in highly accessible areas (which are primarily the State capital cities).
- 108 Those allowances mean that, subject to the constraints of data availability, the average effects of urban areas on State expenses are reflected in the recommended distribution of the GST. However, they do so on an average basis, which implies all urban areas receive similar per capita allowances. They do not recognise that the effects in big cities, such as Sydney and Melbourne, may differ from those in other cities.
- 109 The 2004 Review methods included some allowances for big city effects, but they required the extensive use of judgment to overcome data deficiencies. Early in this review, we engaged a consultant⁵ to devise methods for measuring big city effects. The consultant proposed an approach but noted it was not simple and the necessary data may not be available.
- 110 Since States did not support that approach, we examined arguments for big city effects on a case-by-case basis. Some States said big city effects arose from the implications of:
- the more extensive and capital intensive urban transport services required in big cities;
 - the large and specialised hospitals in big cities;
 - the greater security measures and repairs following vandalism of schools in big cities;
 - the greater opportunity for crime (including terrorism, drug related activity, organised crime and major fraud) and the increased difficulties of detection in big cities;

⁵ Hagan, P, *Urban influences reconsidered*, October 2005.

- high traffic flows on road maintenance costs and infrastructure requirements; and
 - population density and land prices on the cost of infrastructure.
- 111 Our assessments for transport services are designed to allow for the effects of city size on the per capita operating subsidies States make to transport providers — for example, the assessed per capita subsidies are significantly higher in Sydney than in Canberra. The material effects of big cities on hospital costs have been captured by the combination of our Admitted patient assessment and arrangements in the Health Care Agreements for States to reimburse one another for interstate treatment costs.
- 112 We have not made other specific allowances for big city effects. The arguments for those effects were strongest for police services. However, even there, links between big cities and State expenses were not well supported by data. Data on victims of crime, offenders apprehended by police and police staffing did not provide strong support for arguments that per capita police expenses or crime rates in Sydney and Melbourne were higher than other cities. While drug seizures were highest in Sydney, the implications for State, as opposed to federal, police expenses were not clear.
- 113 In the case of roads, data indicated maintenance costs in Sydney were higher than in Newcastle and Wollongong. However, after allowing for traffic volume, annual whole of life costs in urban areas appear to be lower than in rural areas, and we already capture traffic volume effects in our assessments. Moreover, it was not possible to identify what the residual higher maintenance costs might be after allowing for the road use and traffic volume effects. Other costs, such as traffic management costs, may also be higher in big cities, but the differences were not material.
- 114 Our capital assessments allow for the average effects of urban and rural areas on general government sector infrastructure (schools, hospitals, police stations and roads) and for differences in population growth rates on infrastructure requirements. The case for additional effects in big cities was not well supported by data. Moreover, we note that much of the infrastructure in cities (such as transport, water, drainage and power) is provided by public trading enterprises whose internal activities are outside our comparisons.
- 115 We concluded the very limited amounts of available data did not provide strong support for the argument that big cities materially affected the relative levels of State expenses, other than in the areas where we made allowances. It was not clear that costs per capita or per service user were higher in big cities and it was difficult to identify and measure factors that might lead to higher costs. Moreover, the available data suggested big city effects were not material, other than for transport services.
- 116 Big city effects could not be included in Commission assessments without substantial research which demonstrates their existence, identifies their causes and identifies and collects data to reliably measure them.

THE EFFECT OF INDIGENOUS STATUS AND CULTURAL DIVERSITY ON EXPENSES

Overview

- 117 Before making allowances for the effects on State expenses of a particular group of people, the Commission requires:
- a sound conceptual argument that the group affects State expenses, which may be because they use services more (or less) intensively than others and/or each unit of service delivered to them is more (or less) costly;
 - reliable data or other supporting evidence that the intensity of service use and costs per unit of service for that group differ materially from those for other people; and
 - reliable data on the number of people in the group in each State, which are defined and measured in the same way as the data on service use and costs.
- 118 Analysis of the drivers of State expenses indicated there was a strong conceptual case that Indigenous status affected State expenses for many services and that those effects were large. Even with the strengthened guidelines on data reliability and materiality, there was extensive, reliable evidence of a higher national average intensity of use of many services by Indigenous people. There was also evidence of higher unit costs for some services, especially health services.
- 119 While some States provided arguments to support a conceptual case for assessing the impact of culturally and linguistically diverse people, this case was less compelling. The evidence suggested the net effects on State expenses were only just material because the higher costs per unit of service were largely offset by relatively low intensity of service use.

The effect of Indigenous people on State expenses

- 120 Many States have argued strongly that Indigenous people have substantial effects on their budgets because they use many services extensively and, for a variety of reasons, the cost of providing a service to them is higher than that of a similar service provided to non-Indigenous people. Some States also said the assessments of these effects should recognise that, while the expenses incurred in providing services to Indigenous people in general were higher than for non-Indigenous people, the extra expenses associated with some sub-groups of Indigenous people were much greater. They argued distinguishing between Indigenous people living in remote and non-remote areas captured some of those effects but omitted others.
- 121 Western Australia said the needs of its Indigenous population were greater than those in comparable (remote and urban) regions of other States. It provided evidence that:
- Indigenous home ownership in Western Australia is the second lowest of all States after the Northern Territory;
 - infant mortality is about a third higher in Western Australia compared with New South Wales, Queensland and South Australia; and

- hospital admissions for the Indigenous population in Perth are higher than in most other capital cities.
- 122 It argued those higher needs arose from higher rates of community dislocation, the impact of the ‘stolen generation’ and the greater marginalisation of urban Indigenous populations. It said Indigenous people should be classified into three groups: those who are assimilated into mainstream society; those who live in or around cities or towns, but who are disconnected from mainstream society; and those who live according to traditional culture.
- 123 New South Wales, Victoria and the ACT did not support further disaggregation. They were not convinced the impact of distinct subgroups on State budgets could be measured reliably. New South Wales noted that high levels of disadvantage existed in the urban Indigenous population as well as in remote areas.
- 124 There is little doubt that, on average, Indigenous people use many services (especially health, welfare and justice services) more intensively than non-Indigenous people. The national focus on Indigenous issues has led to Australian Government and State agencies collecting much good quality data to measure the level of Indigenous disadvantage and Indigenous use of services⁶. Many of those data collections are overseen by central agencies or use agreed definitions and protocols to ensure the data are comparable across States.
- 125 Data on the extra costs of providing many services to Indigenous people are also available but tend to be less extensive. State submissions and the Commission’s State visits and data requests also provided illustrative information on the extra costs of providing services to Indigenous people in remote areas. However, some of this information was not sufficiently comprehensive or reliable to meet the data reliability guidelines used in this review.
- 126 Finally, the large variations across States in the proportion of their population who are Indigenous and the proportion of Indigenous people living in remote areas means the differences in service use and unit costs have material effects on State budgets and the GST distribution.
- 127 Given the strong case and the consistent evidence of material effects, we have assessed allowances for Indigenous influences in many expense categories and in the investment assessment. In the Admitted patients, Community health and Post-secondary education categories, where good quality cross-classified data were available, we have made different allowances for expenses associated with Indigenous people in remote and non-remote areas. Details of the disabilities assessed in each case are in the relevant chapters in Volume 2.
- 128 In their submissions, States raised some other issues relating to Indigenous people.

⁶ Data on Indigenous disadvantage and use of services are available from sources such as: the Productivity Commission’s biennial report on Overcoming Indigenous Disadvantage; the AIHW national hospital morbidity database; the ABS/AIHW collection on health and welfare of Indigenous people; the Australian Institute of Criminology juvenile detention data and police custody survey; the ABS schools data collection; the National Centre for Vocational Education Research; and collections by housing and welfare agencies. Data on the extra costs of providing services to Indigenous people can be obtained from some of those collections and from States but they are less extensive and comparable.

- Western Australia and the Northern Territory argued their shares of the GST revenue were adversely affected because the Indigenous population, especially in remote areas, was substantially under-counted in ABS population statistics. They provided administrative data, including school enrolments, to support their arguments.
The accuracy of data on the Indigenous population is a long standing issue that, depending on the extent of any under-enumeration, could have material effects on the GST distribution and other public policy issues. However, the ABS has indicated that the data are the best estimates they can produce. In this context, we have used the data published and provided by the ABS.
- Western Australia said measuring the socio-economic status (SES) of Indigenous people on the basis of ABS Socio-Economic Indexes for Areas in which they live could underestimate the number of Indigenous people with low SES. This was because the relatively small numbers of Indigenous people in most areas means they have little effect on the overall SES of the area. Western Australia suggested Indigenous SES would be better measured using data on level of education and income. However, we think our assessments, which include remoteness as a cross-classifier in the Indigenous data, adequately capture those effects because there is a strong correlation between remoteness and low education attainment and low income.
- There is evidence that alternative disaggregations of the Indigenous population based on social circumstances as suggested by Western Australia may better reflect their effect on State expenses. While the population may be classified into those groups, reliable data are not available from more than one State to measure the effect of each group on service use and unit costs. Consequently, we have not made differential allowances for sub-groups of the Indigenous population based on their social circumstances.

The effects of culturally and linguistically diverse people on State expenses

- 129 New South Wales and Victoria said they incur extra expenses in providing education, health, welfare, housing and justice services to migrants with low English fluency because it takes longer to provide services, interpreter services are required, service delivery methods need to be culturally appropriate and more extension and liaison services are required. The cases were supported by information from various sources on the extra time taken in dealing with non-English speaking clients, and the costs of interpreter and other matters.
- 130 Obtaining reliable and comparable data to test this case has been problematic. While the relevant group of people may be best defined as people born in non-English speaking countries and who do not speak English at home, limited information was available on that basis. Some information on the cost per unit of service provided was available on that basis (for example, from a survey of three hospitals done by Victoria), but matching data on service use were not. The need for comparable, reliable data on service use and unit costs meant the relevant population had to be defined more broadly as people born in non-English speaking countries.
- 131 Our analysis indicated there was a case for assessing a disability but it was not strong because:

- the data provided mixed messages on whether migrants from non-English speaking backgrounds used services more or less intensively than other people; and
- it was not clear that extra time per service translated into a similar proportional increase in resources devoted to the service or to State expenses because the extra expenses identified by States were not large.

132 For service use:

- AIHW data indicated inpatient expenses (which reflected use and unit cost effects) attributed to people born in non-English speaking countries and aged 65 or more were above average but expenses attributed to those under 65 were below average;
- National Health Survey data indicated people born in non-English speaking countries and aged 18 or more used casualty, outpatient, day clinic and general practitioner services more than other people but used other health services (including inpatient services) less intensively;
- Commonwealth-State disability service data indicated people born in non-English speaking countries used disability services less intensively than others;
- data from the Commonwealth home and community care national database indicated people born in non-English speaking countries used the services less intensively than others but data collected for New South Wales indicated they used the services more intensively in that State;
- people born in non-English speaking countries used public housing services more intensively than others;
- migrant and refugee communities used family and child services with about the same intensity as others; and
- ABS data showed people born in non-English speaking countries were under-represented in the prison population.

133 Data on the extra costs incurred by States in providing services to people born in non-English speaking countries or people with low English fluency were limited to the cost of education initiatives aimed at people for whom English was their second language, and data for three Victorian hospitals on the cost of hospital services provided to people who requested interpreter services. Illustrative evidence on extra time taken to deal with people with low English fluency in some facilities was also available, but it was not clear whether this was reflected in State resource allocation decisions. There were no comprehensive data on interpreter costs and the available data suggested the costs were not large⁷.

134 The Commission specifically asked States what extra information they could provide on the use and cost of services for culturally and linguistically diverse people. The responses indicated little extra data could be provided and that any additional costs would be small.

⁷ New South Wales said the costs incurred by its housing agency were \$1.4 million in 2007-08 and Queensland said its costs were about \$2.2 million in 2003-04.

- 135 Putting the information together indicated:
- for Schools education, extra resources were directed towards migrant students with low English fluency (measured as students born in non-English speaking countries and who do not speak English at home), but the effects on the GST distribution were immaterial;
 - for Admitted patient services, the combined service use and unit cost effect on expenses of people born in non-English speaking countries fell well short of the materiality threshold;
 - for Community health services, the combined service use and unit cost effect on expenses of people born in non-English speaking countries was well below the materiality threshold; and
 - for Welfare and housing services, the effects of lower use of welfare services by people born in non-English speaking countries partly offset the effects of higher unit costs and their higher use of housing services. However, the above average propensity of people born in non-English speaking countries to claim Commonwealth social security benefits (which was the basis of our measure of the use of State welfare and housing services) meant that effect was already captured in our assessments.
- 136 In the case of Post-secondary education, special initiatives were directed to all people with low English fluency (which included a large proportion of Indigenous people) rather than just those who were born overseas. When measured on that broader basis, low English fluency materially reduced expenses (because the effects of higher unit costs were more than offset by the lower use of the services, especially for Indigenous people with low English fluency).
- 137 Our analysis indicated the aggregate effects of people born in non-English speaking countries across the School education and health categories were just material. For reasons of simplicity, we have decided not to make separate allowances in those categories but to include a single allowance of approximately the same total size in the Other expenses category⁸. We consider the assessments for Welfare and housing and Justice adequately capture any net effects on State expenses of people born in non-English speaking countries and have not included any further allowance for them. For Post-secondary education, the effect of low English fluency was predominantly an Indigenous effect. It was material and has been included in the Post-secondary education assessment.

TREATMENT OF COMMONWEALTH PAYMENTS

- 138 State fiscal capacities are affected by Commonwealth payments because they help fund the provision of State services or the acquisition of assets. In the words of the IGA, such payments are available to provide ‘budget support for state and territory services’. Like other revenues, these payments should be taken into account in deriving the relativities.

⁸ That allowance was calculated by reference to the population of each State which was born in non-English speaking countries and average expenses of \$15 per capita a year.

139 In 2008, the Australian and State Governments established a new intergovernmental agreement which:

- streamlined Specific purpose payments (SPPs) and introduced National partnership payments (NPPs), which may be project payments, facilitation payments or reward payments. The classification of Commonwealth payments is decided by the Australian Government — the Commission has no role in that process; and
- indicated governments expect SPPs, project NPPs and general revenue assistance other than the GST to affect State financial capacities and the relativities but that facilitation and reward NPPs would not.

However, the agreement gives the Commission discretion to decide the appropriate treatment of NPPs and general revenue assistance, other than the GST, subject to consultation with the Australian and State Governments, and provides for the Treasurer to issue terms of reference directing the Commission on the treatment of NPPs.

140 Most States welcomed the discretion given to the Commission. They said that, unless directed otherwise by terms of reference, the Commission should consider the treatment of each Commonwealth payment on a case-by-case basis with the aim of achieving equalisation. They agreed that payments that affect State fiscal capacities and in relation to which needs were assessed for the expenses should impact on relativities.

141 Part 2 of the terms of reference for this review directs the Commission to treat a payment which is on-going and the subject of direction in previous terms of reference as per that direction. However, where new arrangements replace old arrangements, even if they are for similar purposes, the Commission has discretion on the treatment of that payment.

142 New South Wales, South Australia, Tasmania and the Northern Territory have encouraged the Commission to exclude reward payments so they remain effective and because they will reflect above average effort on the part of States. They consider facilitation payments genuinely aimed at overcoming disadvantage, meeting backlogs or achieving reform should also be excluded. Western Australia said reward payments, if included in the Commission's assessments, might need to be adjusted to reflect a policy neutral level of efforts by States to receive these payments.

143 Other States also had views about payments which should not impact on the relativities, including:

- payments for services for which the Commission has not assessed needs (Western Australia);
- payments to PTEs because these are outside the scope of equalisation (South Australia) and payments to other third parties which do not affect State fiscal capacities (Northern Territory); and

- extraordinary, or very significant, payments that are one-off and serve Commonwealth purposes, such as those made under the Nation building for the future plan (New South Wales and Victoria).

144 After considering State and Australian Government Treasury views, we have concluded that, after following any directions in the terms of reference, we should decide the treatment of each payment on the basis of equalisation principles. Payments that are available for usual State functions and for which needs have been assessed, including a deliberative EPC assessment, will impact on the relativities. The size of payments should not influence the treatment of a payment. We have used the guidelines set out below to assist in the decision-making process.

Guidelines for dealing with Commonwealth payments

145 *Payments in State budgets.* The guidelines cover transactions treated as payments to the States and Commonwealth own-purpose expenses which relate to State-type services. They cover support for recurrent expenses and capital grants. If the Australian Government were to provide loans these would be treated in the same way as other borrowing by State Governments. However, any debt forgiveness would be treated as a capital grant to the relevant State.

146 We have used the following guidelines in dealing with all on-going Commonwealth payments to the States. The treatment of payments that have terminated or are terminating as a result of the IGA will be continued until those payments are no longer in the assessment years.

- Any treatment prescribed by the terms of reference will be applied, including to any on-going payments quarantined in previous terms of reference.
- National SPPs will have an impact on the relativities — these are available for State budget support and needs are assessed. The exception is non-government schools payments where their disposition does not impact on State fiscal capacities.
- All other payments should have a direct impact on the relativities unless:
 - they are a purchase by the Australian Government;
 - they are for programs implemented at the behest of the Australian Government and which lead to above average or unique State outcomes (such as a trial program which is not part of services delivered under average State policy);
 - they are a payment to a third party that has no impact on State fiscal capacities (States act as an intermediary and the payment does not reduce or increase State needs);
 - needs have not been able to be assessed for the State expenditures to which the payment relates⁹.

⁹ If an EPC assessment has been made because the Commission considers there are no differential disabilities or the assessment would be immaterial, then needs have been assessed.

- 147 *Payments not made to States.* The Australian Government also makes payments, including Commonwealth own-purpose expenses to State PTEs, non-government agencies and individuals. Those payments are not included in our measures of State revenue or expenses. However, they may indirectly affect State fiscal capacities by reducing the call for State provided services. For example, Commonwealth payments direct:
- to transport PTEs could reduce the subsidies States are required to provide;
 - to Indigenous community housing authorities may reduce the amount of Indigenous housing States need to provide; or
 - to individuals, such as the Medicare rebates, can reduce the quantity of community health services States provide.
- 148 A State with above average Commonwealth payments to these third parties may need to spend less than the average per capita amount. Similarly, a State with less than average may be required to spend more. Any such indirect effects on State fiscal capacities need to be recognised if they are material and can be reliably measured.
- 149 Queensland said any indirect impact should be proven and quantifiable and the Commission's treatment transparent. It suggested this could be done by evaluating:
- whether the third-party services and State provided services are 'perfect substitutes';
 - whether States would provide program funding if the third-party payments ceased; and
 - which Commonwealth payments to third parties indirectly reduce State assessed expenses and which do not.
- 150 Western Australia was concerned that there may be incentives for States to structure payments in certain ways to ensure the Commission treats them in a particular way. Similarly, Queensland was concerned that States without non-government organisations to deliver services may be penalised if payments go to the States rather than to the non-government organisations.
- 151 We propose to recognise the indirect effects of Commonwealth own-purpose expenses on State budgets if:
- there is a conceptual case that they reduce the level of services the States must provide (which will require evidence that the Commonwealth funded services are close substitutes for State services); and
 - there are reliable data to measure that impact and it is expected to be material.
- 152 This would be done by acknowledging that these payments result in a disability — States receiving more or less than a per capita share should have this recognised in determining their assessed expenses. The approach means Commonwealth payments to the State or to non-government organisations for similar purposes would have a similar effect and so ensure States have no incentive to structure their Commonwealth payments in a particular way.

153 Volume 2 provides details of where we assessed such disabilities¹⁰.

Treatment of each Commonwealth payment

154 Appendix B in the Adjusted budget chapter of Volume 2 shows the treatment of each Commonwealth payment.

Backcasting

155 If there are major changes in federal financial relations between the historical years used in our assessments and the year the recommended relativities would be applied, we ‘backcast’ the new arrangements, unless the terms of reference direct us not to do so or it cannot be done reliably. Under this backcasting process, State revenues and expenses in the historical years are adjusted to what they would have been if the new federal financial arrangements had been in place at that time. It makes the relativities more contemporary by ensuring they better reflect the range, level and interstate allocation of Commonwealth payments that will exist in the application year.

156 The IGA made major changes in the distribution of National SPPs and substantially increased the level of funding available. From 2010-11, the distribution of each National SPP¹¹ will be:

- 2010-11 — 80 per cent by the historical distribution plus 20 per cent distributed EPC;
- 2011-12 — 60 per cent by the historical distribution plus 40 per cent distributed EPC;
- 2012-13 — 40 per cent by the historical distribution plus 60 per cent distributed EPC;
- 2013-14 — 20 per cent by the historical distribution plus 80 per cent distributed EPC;
- 2014-15 onwards — based on population share.

157 Since the application year for the 2010 Review is 2010-11, we have:

- backcast the 2010-11 distribution of National SPPs into the assessment years because this is a major change in federal financial arrangements affecting the year the relativities will be applied;
- not backcast the funding increase because it is not practical to estimate the assessment period equivalent amounts or in which expense categories States would have increased their spending; and
- retained the treatment in past assessment years of payments changing their classification or terminating.

158 For subsequent updates, we consider the application year distribution of National SPPs should be backcast into the assessment years.

¹⁰ Such assessments have been made in the Community and other health services category and for remote Indigenous housing in the Welfare and housing services category.

¹¹ For the government schools component of the National schools SPP, the relevant population will be each State’s share of full time student enrolments in government schools.

- 159 All States support the Commission's decisions to backcast only major changes in federal financial relations, provided the new arrangements are known, and the application year distribution of National SPPs.

THE USE OF JUDGMENT AND DISCOUNTING

- 160 Our top down, clean slate approach means every aspect of the methods has been examined in this review and decisions have been made in accordance with the assessment guidelines. Those guidelines were intended to ensure we would assess only factors that were conceptually sound, reliably measured and have a material effect on the GST distribution.
- 161 In some cases, it has been necessary to strike a balance between practicality, including data reliability, and achieving equalisation. The assessment guidelines indicate that to achieve outcomes that are more consistent with equalisation we may apply our judgment in using the available information consistently with its quality, provided we are convinced there is a strong conceptual case for the issue and we believe it would materially affect the GST distribution.
- 162 This use of judgment has been contentious. Some States said it reduced the reliability of the relativities. Others said equalisation would not be achieved without it because practical matters often limited data availability. They considered judgment was inevitable and part of the reason for the Commission's role in the GST distribution process.
- 163 Western Australia and the Northern Territory supported the use of judgment but expressed concerns about the use of discounting to deal with data deficiencies and uncertainty. They said in the absence of other information, uncertainty meant the true answer could be above or below the estimated outcome but discounting implied every State's factor was more likely to be below it. They concluded that in some cases, discounting may move the assessment further from the correct outcome. Tasmania supported the use of judgment and discounting, where they are justified and used consistently. It said discounting was preferable to the alternative of not making an assessment when it was clear a disability existed. However, it suggested a uniform set of discounts be adopted.
- 164 We see our task as deriving a distribution of the GST that achieves equalisation as simply and reliably as possible. However, in practice, sufficient data were not always available to reliably measure all the material factors that affect State fiscal capacities. In such cases, we consider equalisation is better served by making a conservative assessment on the basis of judgment or the available evidence, rather than not making an assessment. In this context, we interpreted evidence broadly to include reliable statistics, indicative figures and qualitative information such as our observations during State visits.
- 165 We have exercised our judgment with equalisation principles in mind and on the basis of the available evidence. States were informed during the review if we proposed to use judgment and were given opportunities to comment.

166 Depending on the circumstances, we have used data without adjustment, discounted the data to make a conservative assessment, or made no assessment. When we discounted the data, we chose from a uniform set of discounts with higher discounts being applied when we have less confidence in the outcome of the assessment or more uncertainty attaches to the information. We reviewed all the discounts at the same time late in the review and in the light of final submissions from all States.

167 The discounts we used were:

- 12.5 per cent, if we were not fully confident about the size of an effect because of a low level of uncertainty around the information;
- 25 per cent, if there was a medium level of confidence about the size of an effect or a medium level of uncertainty about the information;
- 50 per cent, if we were confident of the direction of the effect on States and that it was large but we had limited confidence in the measurement of its size due to a high level of uncertainty in the information; and
- no assessment was made, if we were not confident of the direction of an effect or its size.

168 Cases where we discounted an assessment are listed in Table 5-2.

Table 5-2 Discounts using in Commission assessments, 2010 Review

Category/factor	
50 per cent discount	
Location — freight	In the absence of data, judgment has been used to determine State shares of a broadly estimated interstate cost. The resultant factor has been discounted by 50 per cent due to the high level of uncertainty associated with this assessment.
25 per cent discount	
Land tax	A 25 per cent discount has been applied because of a medium level of uncertainty about the reliability and comparability of State Revenue Office data. These data are affected by individual State policies including differences in the tax free threshold, aggregation and disaggregation policies and enforcement.
Services to communities	The water subsidy factor has been discounted by 25 per cent because of a medium level of uncertainty arising from the lack of comprehensive, reliable data. The data from a number of States suggest small communities, water quality and availability, the need for pipelines, Indigeneity and location affect subsidy levels. The Commission was convinced by the strength of the conceptual case but has been able to reliably recognise only the higher subsidies paid in areas of poor water and location costs. Nevertheless, the assessment appears to move GST in the right directions.
Justice services — police custody weights	Police custody use weights have been discounted by 25 per cent to allow for differences in the complexity of police investigations, concerns about the quality of the data and the fact 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.
Location — air fares & travel & accommodation	Airfares data have been provided by four States, and assumptions have been made about the need for interstate accommodation. Together these create a medium level of uncertainty which warrants a 25 per cent discount.
Net lending	A 25 per cent discount has been applied to assessed net lending because there was a medium level of uncertainty about whether all relevant disabilities have been assessed.

Table 5-3 Discounts using in Commission assessments, 2010 Review (continued)

Category/factor	
12.5 per cent discount	
Community and other health services — non-State services	A 12.5 per cent discount has been applied due to concerns that some non-State services may not be fully comparable to State services.
Services to industry	Expense weights for the business activity disabilities (sector size and number of businesses) derived from State data have been discounted by 12.5 per cent. This has increased the proportion of service expenses assessed equal per capita by about 1 or 3 percentage points (depending on the industry sector). This has been done because, while the data collection used to derive the weights was comprehensive and of high standard, subjectivity was involved in determining the degree to which sector size and business count influence State spending. A low level discount is appropriate because all State totals are used (rather than individual State data) and all data have been reviewed by staff and States.
The infrastructure stock factor in the depreciation and investment assessments	A 12.5 per cent discount has been applied to assessed capital stock disabilities for each service because some factors might not fully apply to capital requirements. A discount of this size is consistent with an estimate of the effect of removing irrelevant disabilities.
Location — regional costs	The regional cost factors have been discounted by 12.5 per cent because: data are not available from all States; there is some inconsistency in the data provided by States; and the need to extrapolate disabilities to categories other than schools and police.
Location — interstate wages	The factors have been discounted because of a low level of uncertainty arising from concerns about whether: Survey of Education and Training data are sufficiently reliable; the econometric model controls for all relevant factors may cause differences in wage levels; and the private sector experience is a good proxy for the pressures on public sector wages.
Location — service delivery scale	The factors have been discounted by 12.5 per cent due to some low level concerns about data reliability, specifically: the comparability of data from different States; the absence of data from some States; and whether the simple geographic classification (areas more than 50 km from a centre of 5000 people) adequately identifies the areas that experience service delivery scale disabilities. The need to extrapolate from police and schools to courts, Community and other health and Welfare and housing also creates some uncertainty.
Other discounts	
Post-secondary education	The data obtained from the States for low English fluency are not fit for purpose, so data for Schools have been used as a guide in setting the cost weight. Given the uncertainty about whether Post-secondary has the same cost structure as Schools, the Commission used a cost weight of 6, reflecting a 25 per cent discount on the weight of 8 derived from data for schools.
Location — interstate wages	State specific discounts for Tasmania and the ACT. The modelled disability for Tasmania has been discounted by 25 per cent because its economic activity is broadly consistent with that in regional areas of other States and the model has understated underlying wage levels. The ACT relative wage level has been set at its modelled outcome plus one per cent because the data used in the model omit wages paid by the Australian Government.

CHAPTER 6

SIMPLIFICATION

- 1 Given the requirements of the terms of reference and the Commission's experience in the 2004 Review, we have approached this review with the aim of achieving equalisation in a simpler way. Our efforts produced limited simplification in the revenue assessments. However, significant gains have been made in the expense assessments, although they are the areas where important decisions and judgments were required to ensure the simplified approach was consistent with equalisation principles.
- 2 The simplification achieved is summarised in Table 6-1.

Table 6-1 Comparison of detail in assessments

	2004 Review	2010 Review
Revenue assessments	13 categories of taxes and other revenues and 8 categories of user charges, some of which were sub-divided and each sub-division had a revenue base measure. In total, there were 29 sub categories.	7 categories of taxes and other revenues, some of which are sub-divided and each sub-division has a revenue base measure, plus Commonwealth payments (8 categories in total). In total, there are 13 sub categories (a).
Expenditure assessments	39 expense categories, most of which were divided into components and multiple disabilities were assessed for each component. In total, there were 171 components and 344 disabilities.	12 expense categories, which are divided into components and multiple disabilities are assessed for each component, plus an Investment category and a Net lending category (14 categories in total). In total, there are 43 components and 93 disabilities.

(a) There are no categories of user charges because they are mostly included in the Other revenue category.

BACKGROUND

- 3 The Commission's task of determining a distribution of the GST revenue that equalises the fiscal capacities of the States will inevitably contain some complexities because State government is complex. States raise revenue from a range of taxes and provide a wide range

of services to residents with a myriad of needs living in a variety of regions throughout the State. They also manage extensive assets for the benefit of their residents, including equity in significant public trading enterprises.

- 4 By the end of the 2004 Review, there was a strong view that the pursuit of more accurate and comprehensive equalisation had made the process unhelpfully detailed and complex. The high levels of detail and disaggregation may have also reduced the reliability of the data used.
- 5 The 2005 report of the Heads of Treasuries review of the Commission's methods also concluded simplification was desirable. Subsequently, the terms of reference for this review asked us to simplify the methods. However, they also said those actions should be consistent with equalisation principles.
- 6 Consequently, we approached this review with a major focus on simplification. Our consultation with States during 2005 indicated they also accepted simplification must be pursued. However, some registered concerns that simplification should not be a goal in its own right and it should not lead to a diminished focus on equalisation.

ACHIEVING SIMPLIFICATION

- 7 Our strategy for achieving equalisation and simplification is set out in Chapter 2. It has been a multi-pronged approach based on:
 - beginning from a clean slate, rather than seeking to adapt existing methods, which implies all assessment methods have been devised from first principles;
 - a top down approach to deciding how total State expenses and revenues would be disaggregated into categories for assessment purposes, rather than attempting to aggregate previous categories;
 - a broad indicator based approach for deciding the most appropriate measures of revenue bases and expense disabilities; and
 - applying strengthened assessment guidelines, including materiality thresholds and criteria for judging the reliability of data and methods.
- 8 We began with broad assessments and introduced detail only if it were necessary to improve equalisation and it materially changed the GST distribution. Through this approach we sought to limit the number of separate revenues and services examined, to recognise fewer influences on them and to have fewer moving parts in the assessments.
- 9 Some developments in federal financial relations have helped the simplification process. For example, the agreement between the Australian Government and the States to phase out some taxes on business removed the need to make assessments for those taxes.

The reliability criteria

- 10 To improve the reliability of the assessments and to discourage excessive detail, we developed data reliability guidelines that aimed to ensure data were fit for the intended purpose and were of suitable quality.
- 11 Those guidelines have led to an increase in the use of national datasets, less disaggregation (for example, population data have fewer and broader age and regional groups) and less use of detailed data from States (for example, we no longer use highly detailed data on the effects of location on costs). Those actions have led to simpler assessments.

The materiality thresholds

- 12 The inclusion of quantified materiality thresholds in the assessment guidelines was an important step in achieving simplification.
- 13 We set materiality thresholds for:
 - the minimum average revenue or expenses required for a separate category — average revenues or expenses in a category had to be at least \$50 per capita;
 - the minimum effect on the GST distribution of disaggregating a category — assessments based on disaggregated categories had to change the GST distribution by at least \$30 per capita for at least one State, compared with the aggregated assessment;
 - the minimum effect on the GST distribution of including a disability or recognising extra population characteristics as part of a disability — a disability or an extra population characteristic (such as low socio-economic status) was not included in the assessments unless it changed the GST distribution for at least one State by \$10 per capita across all relevant categories, but it should not be recognised in individual categories where its effect was minor; and
 - adjustments aimed at improving comparability of data — they were not made unless they changed the GST distribution by at least \$3 per capita for at least one State.
- 14 We consulted the States on the size of the thresholds. While some would have preferred higher thresholds and others lower ones, there was a consensus that they were a reasonable compromise and they should reduce the level of detail in the assessments while still recognising important influences on State fiscal capacities. It was accepted that we would proceed on the basis of these thresholds and that they may be reviewed in the light of knowledge gained in applying them.
- 15 We saw no convincing case for changing the thresholds during this review.

Broader assessment categories

- 16 The top down approach to determining assessment categories began with an initial disaggregation of revenue and expenses into a few large aggregates. We proposed four categories of State revenues (taxes on economic rent or corporate profits, personal income or wages, wealth, and the value of other taxable transactions) and four categories of expenses

(education, health and welfare, law and order, and other services). Those categories were determined on the basis of broad perspectives on what States do, the types of costs in a category and the factors affecting them.

- 17 The subsequent views of the States and research by Commission staff convinced us further disaggregation was required to achieve equalisation. For example, most States said more than four revenue categories were needed to accurately measure the interstate differences in the revenue bases States tax.
- 18 As shown in Table 6-2, we have decided seven categories are required to properly measure State own-source revenue raising capacities. Most disaggregation was in relation to taxes based on the value of taxable transactions because the revenue bases are substantially different from each other and distributed differently across the States, and material amounts of revenue are collected from each tax. We renamed the others to more clearly reflect what States tax.

Table 6-2 Development of category structure — own-source revenue

Initial disaggregation	Why was this category disaggregated?	Final categories	Why no further disaggregation?
Taxes on economic rent	The category was renamed.	Mining revenue	Higher rates of tax on some minerals are reflected in the assessment method.
Taxes on personal income or wages	The category was renamed.	Pay-roll tax	There is only one tax in this category.
Taxes on value of other taxable transactions	Taxes are imposed on different tax bases and material revenues are collected from each.	Stamp duty on conveyances	This is the only tax in the category. State policy influences on the value of State assets sold and corporate reconstructions are recognised in the assessment.
		Insurance taxation	Third party insurance is not material.
		Motor vehicle taxes	Different rates of tax on light and heavy vehicle registrations and on vehicle sales are reflected in the assessment.
Taxes on wealth	The category was renamed.	Land taxation	There is only one tax in this category.
		Other revenue	Interstate differences in these revenues are driven by differences in State policies. Reliable measures of revenue bases for gambling tax and emergency service levies could not be found.

- 19 For expenditures, we concluded the factors affecting health and welfare services were too disparate, and too many, to include in one assessment. The main users of hospital inpatient services and the unit costs of delivering them differed markedly from those of community health services, housing and welfare services and other community services, such as water subsidies. Similarly, we concluded the factors affecting schools education costs were materially different from those affecting post-secondary education costs and those affecting roads and other transport services differed from those affecting other general services. We have 14 categories of State expenditures, as shown in Table 6-3.

Table 6-3 Development of category structure — expenditures

Initial disaggregation	Why was this category disaggregated?	Final categories	Why no further disaggregation?
Education	School and post-secondary education are major, distinct services with materially different target groups and cost drivers.	Schools education	A separate assessment for State expenses on pre-schools would not be material. The assessment allows for the specific influences on school transport expenses and the lower costs of non-government school pupils.
		Post-secondary education	A separate assessment for State expenses on universities would not be material.
Health and welfare	Admitted patients and community and other health are both major services that are distinct from the welfare services. Each has its own focus and different cost drivers. The target group for welfare and housing services (people with low socio-economic status) is materially different from that for health and services to communities.	Admitted patients	No further disaggregation is needed — all material influences on expenses are reflected in the assessment.
		Community and other health services	The drivers of costs of non-admitted patients, community and public health are similar.
		Welfare and housing services	The assessment allows for differences in the use and cost of services by different groups of people.
		Services to communities	Expenses for all services in this category cannot be measured reliably, but allowances for the different cost drivers are made within the assessment.
Law and order	The services are affected by similar factors, except for public safety expenses which were classified to the other expenses category.	Justice services	Police, courts and corrective services are affected by broadly similar factors.
All other expenses	This initial category covered some major State services that are affected by materially different cost drivers.	Roads	All material cost drivers are adequately recognised.
		Transport services	The assessment allows for the different drivers of State subsidies for urban and non-urban services.
		Services to industry	Reliable data are not available to split expenses into those for business regulation and support. The different drivers of expenses for agricultural businesses are recognised in the assessment.
		Other expenses	Services in this group are delivered to the total population or specific factors could not be identified, except for natural disaster relief expenses which are treated as a component within the category.

Table 6-3 Development of category structure — expenditures (continued)

Initial disaggregation	Why was this category disaggregated?	Final categories	Why no further disaggregation?
	Depreciation on assets used to provide services was to be part of the relevant service categories. However, a separate category is simpler because factors affecting it are the same as for investment and differ from those for the services.	Depreciation	The different drivers affecting the assets required for each service are recognised in the assessment.
Capital related transactions	It is separate from expenses because it is affected by changes in service use (not the level) and population growth. Net lending is affected only by population growth.	Investment Net lending	The assessment allows for the different factors that drive investment in roads and other new infrastructure.

- 20 Consistent with the requirement in the terms of reference to consider ‘reducing the reliance on the use of GFS data’, we have defined most expense categories on the basis of the more aggregated 2- or 3-digit General Purpose Classifications. However, there were cases where we needed to disaggregate those classifications to assess them properly. (For example, expenses on non-admitted patients had to be moved from the Admitted patients category to the Community and other health services category using 4-digit data.) The ABS advised us the 3- and 4-digit General Purpose Classification data we have used in those processes are sufficiently reliable and fit for our purposes.

Broader indicators of revenue bases

- 21 The initial proposals for measuring revenue bases used broad measures without allowances for exemptions, thresholds or progressive tax rates because the assessments would be simpler and more reliable. Many States opposed those proposals because they did not adequately reflect what States do. In particular, they did not take account of common features of State revenue raising policies (such as exempting small business from payroll tax and applying progressive tax rates in stamp duty on conveyances and land tax) which have materially different effects across the States.
- 22 To better reflect what States do, we measured the taxable part of potential revenue bases and allowed for progressive tax rates by applying an average of the exemptions, thresholds and rates in all States, if it materially affected the GST distribution, reliable data were available, and it was not unduly complex.
- 23 As a result, the assessments for most revenue categories are broadly similar to those under the 2004 Review methods, except some small adjustments have been omitted. The greatest contribution to simplification in the revenue assessments has been made by combining several revenues in the Other revenue category and not making differential assessments for them.

Broader measures of cost drivers

- 24 We examined separately drivers affecting the quantity of specific services provided (which generally reflect differences between States in population and economic characteristics) and those affecting the costs of most services (such as diseconomies of small scale, interstate wage levels and regional cost effects).
- 25 We began by considering broad indicators of service use (such as people in the school age range and people in receipt of Commonwealth income support benefits) and outcome measures (such as literacy and numeracy rates and mortality rates). However, State views and our further research indicated outcome measures were unsuitable broad indicators because they are not policy neutral and do not capture influences known to affect States' cost of providing services. Capturing the main influences on State expenses also often required more than one indicator or required an indicator to be disaggregated because there are material differences:
- in the use of services by groups of people in the population or in the cost of providing a unit of service to them; and
 - between the States in the size of those groups as a proportion of the total population.
- 26 As a consequence, the determination of assessed use for services delivered to people (such as schools education, post-secondary education, admitted patients, community and other health services and justice) continues to be based on national profiles of service use by relevant groups in the population. However, the number of relevant groups has been reduced, as has the extent to which many of them are disaggregated. For example:
- the Schools education assessment no longer includes allowances for higher costs in urban and remote areas;
 - the Post-secondary education assessment no longer allows for the effects of age or unemployment on use and the effects of location are based on only two groups (remote and non-remote) instead of five;
 - in Admitted patients, the assessment no longer allows for the effects on State expenses of gender, country of birth and English fluency and it has reduced the disaggregation of age — the overall outcome is that the number of separate population groups recognised has fallen from 2080 to 210;
 - while the Justice services assessment continues to allow for the effects on service use of males aged 15 to 34, Indigenous people and people from low SES backgrounds, it no longer allows for the effects on unit costs of court appearances in higher courts, court appearances by people with low English proficiency, court appearances by remote Indigenous people, prisoners in secure prisons and some other small factors.
- 27 For Welfare and housing services, six categories comprising over a dozen components each with sub-components have been combined into one category with three components and only one driver of State expenses (beneficiaries of Commonwealth income support). However, ensuring the broad indicator accurately reflected the pattern of use of State services required

the reintroduction of some complexity. Overall, there has been a noticeable reduction in the level of detail and volume of calculation across these services.

- 28 We no longer make differential assessments for culture and recreation, national parks and services to mining, tourism and manufacturing industries because cost drivers could not be reliably identified and measured or they were not material.
- 29 Our assessment of the effects of location on the unit costs of State services, especially the effects of population dispersion within States has been greatly simplified. In the 2004 Review, this assessment examined the way many different types of costs (such as the costs of communication, travel, freight, staff regional allowances and maintenance) varied with remoteness or distance from regional centres. Each element required sample data from the States on the importance of each type of expense in the cost structure of each service and assumptions about the relationship between costs and remoteness or distance. The approach in this review measures the effects of remoteness more broadly using data for schools and police services, which we have extrapolated to other services.

The new assessments of Investment and Net lending

- 30 We have sought to improve equalisation by recognising the effects of State circumstances on their ability to acquire the average level of new infrastructure associated with service provision and equalising their per capita net financial worth.
- 31 The new Investment assessment replaces the 2004 Review assessment of debt charge expenses. That assessment suffered because crucial data were difficult to reliably estimate and it involved considerable complexity. (For example, it involved the aggregation of State expenditures on new fixed assets since 1961-62.) While the new approach may appear more complex, it more explicitly reflects the effects of unique State circumstances on the stock of infrastructure — those circumstances were also recognised in the previous debt charges assessment but subsumed in the calculations. We consider the improved equalisation outcomes more than offset any superficial increase in complexity.

Limits to simplification

- 32 We consider we have the right balance between equalisation and simplification. We consider further aggregation of categories and broader indicators of revenue bases and expense disabilities would be unlikely to produce a GST distribution that equalised State fiscal capacities measured on the basis of what States do. Given the many ways States raise revenue and the diverse range of services they provide, substantial further simplification would require much higher materiality thresholds and/or a different concept of equalisation in which the standards to which States are equalised are based on very broad interpretations of what States do, or are determined externally. Some simplification may, however, occur as a result of new data collections or changes in federal financial arrangements.

MAINTAINING SIMPLIFICATION

- 33 The terms of reference also asked us to consider ways of maintaining simplification once it is achieved. We provide comments on this in the context of future annual updates of the relativities and future method reviews.

Annual updates

- 34 We consider annual updates of relativities should continue if the GST distribution is to remain up-to-date and reflect the circumstances of the States. While discontinuing annual updates and freezing relativities at current levels would simplify processes, the events of recent years which produced large changes in the relative fiscal capacities of the States show it would not achieve equalisation. Similarly, selective updating, such as updating revenue assessments only, would not produce equalisation and would not greatly simplify the processes.
- 35 The simplification achieved in this review would be maintained by continuing past practices for updates. Under those practices, the terms of reference require the principles and methods in the latest review to be applied unless changes are necessary to accommodate major changes in federal fiscal arrangements, budget developments or data availability, and subject to consultation with the Australian and State Governments. If unexpected events arise that may require reconsideration of methods, they would be explicitly mentioned in the terms of reference.

Future reviews

- 36 We consider simplification should be retained in the terms of reference for any future review and the Commission should be asked to use strong assessment guidelines which emphasise materiality and reliability of data and methods. We further suggest the materiality thresholds be at least indexed for future reviews to reflect movements in price levels to prevent their impact being progressively reduced.
- 37 Since data from the regular population censuses are major inputs to Commission assessments, the simplification agenda would be assisted by aligning future reviews with the release of the results of the censuses. This alignment would remove the need for large scale recalculation of disabilities in a future update, as happened in the 2008 Update. Since the results of the census may necessitate reconsideration of particular disabilities or the methods used to measure them, this is best done in the broader context of a method review.

CHAPTER 7

WHY STATE FISCAL CAPACITIES DIFFER

- 1 This chapter identifies the factors that cause differences in the assessed fiscal capacities of the States. It provides insights into why, with the same policies, States may raise different amounts of revenue per capita and why their per capita costs of providing services, investment expenditure and net lending differ.

HOW DIFFERENT ARE STATE FISCAL CAPACITIES?

- 2 If all States shared the same fiscal conditions, implying no imbalances need correcting, the GST would be distributed equally per capita. However, States do not have the same fiscal conditions, so we have recommended an unequal distribution of the GST to achieve equalisation. How our recommendations vary from equal per capita (EPC) is a measure of the differences among the States in their fiscal capacities.
- 3 We express fiscal capacities as per capita relativities, where the average position is 1.00. States with relatively strong fiscal capacities (a per capita relativity below 1.00) would receive below average GST per capita under the recommended distribution and conversely. In this review, the assessed fiscal capacities vary from 0.68 for Western Australia to 5.03 for the Northern Territory. These relativities imply Western Australia requires 68 per cent of the average GST per capita and the Northern Territory 5.03 times the average to equalise their fiscal capacities.
- 4 Table 7-1 compares the illustrative distribution of the estimated 2010-11 GST (\$45.06 billion¹) implied by our recommendations with an EPC distribution. It shows the equalisation distribution would provide Western Australia, Queensland, Victoria and New South Wales with less than an EPC distribution of GST revenue, indicating they have relatively strong (above average) fiscal capacities. Conversely, the Northern Territory, Tasmania, South Australia and the ACT have below average fiscal capacities.

¹ This is the estimated GST collections for 2010-11, as reported in the Commonwealth of Australia *Mid-Year Economic and Fiscal Outlook 2009-10*.

Table 7-1 Comparison of equalisation and equal per capita distributions of the 2010-11 GST

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Review distribution (a)	13 843.7	10 516.4	8 384.0	3 190.1	4 265.3	1 664.4	832.6	2 363.4	45 060.0
EPC distribution	14 523.2	11 174.7	9 169.5	4 665.1	3 315.4	1 025.6	721.3	465.2	45 060.0
Difference	-679.5	-658.2	-785.5	-1 475.0	950.0	638.8	111.3	1 898.1	0.0
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Review distribution (a)	1 918.8	1 894.5	1 840.6	1 376.6	2 589.9	3 266.9	2 323.8	10 226.3	2 013.0
EPC distribution	2 013.0	2 013.0	2 013.0	2 013.0	2 013.0	2 013.0	2 013.0	2 013.0	2 013.0
Difference	-94.2	-118.6	-172.4	-636.5	576.8	1 253.9	310.7	8 213.3	0.0

(a) Calculated by applying the recommended 2010-11 relativities to the 2010-11 GST and estimated State resident populations as at December 2010.

5 Table 7-2 shows the extent to which the unequal GST distribution was caused by differences between States in their: expense requirements; requirements for additional infrastructure; revenue raising capacity; revenue from Commonwealth payments (other than the GST); and net lending requirements.

Table 7-2 Source of difference between equalisation and equal per capita distributions of the 2010-11 GST

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Expense requirement	-1 089.1	-2 740.9	286.2	1 086.9	226.2	308.1	-74.8	1 997.4	3 904.8
Investment requirement	-315.5	-320.6	537.9	272.1	-155.5	-64.3	-51.5	97.4	907.4
Net lending	-178.7	9.2	147.8	96.1	-50.5	-23.3	-4.0	3.5	256.5
Revenue raising capacity	846.7	1 875.9	-1 439.9	-2 994.0	1 075.6	420.6	173.8	41.4	4 433.9
Commonwealth payments	62.2	528.5	-321.8	54.8	-143.7	-2.1	68.4	-246.1	713.8
Total difference from EPC	-679.5	-658.2	-785.5	-1 475.0	950.0	638.8	111.3	1 898.1	3 598.3

Note: The total redistribution arising from each group of assessments, and the total movement from EPC, is calculated as the sum of the positive (or negative) items in the row.

Source: Commission calculation.

6 Table 7-2 indicates, on the basis of data for the years 2006-07 to 2008-09:

- New South Wales, Victoria and the ACT have below average costs of providing services and the other States have above average costs;

- Queensland, Western Australia and the Northern Territory have above average requirements for investment while the other States have below average requirements;
- Victoria, Queensland, Western Australia and the Northern Territory have above average net lending requirements while the other States have below average requirements;
- Queensland and Western Australia have above average capacity to raise revenue from their own sources and the other States have below average capacity; and
- Queensland, South Australia, Tasmania and the Northern Territory received above average per capita amounts of Commonwealth payments and the other States received below average per capita amounts.

- 7 In simplified terms, high revenue raising capacities drive the fiscal strength of Western Australia and Queensland. The below average costs of providing services and below average investment requirements of Victoria and New South Wales are responsible for their fiscal strength. The relatively low fiscal capacities of South Australia, Tasmania and the ACT stem mostly from below average capacities to raise revenue while the Northern Territory faces very high costs of providing services.
- 8 The main demographic, economic and other factors causing the differences in State capacities to raise revenue and in their expense and investment requirements are shown in Table 7-3 and are discussed in the following sections.

FACTORS AFFECTING STATE REVENUE RAISING CAPACITIES

- 9 Interstate differences in economic characteristics are important drivers of the assessed State fiscal capacities because they lead to large differences in revenue raising capacities. The economic characteristics which have the largest effects on our assessments of State revenue raising capacities are: mining production, property sales, the total value of wages and salaries paid and land values.

The level of mining activity

- 10 Mining production is very unevenly distributed across the States. This is the largest single driver of the differences in State fiscal capacities, even though only 6.7 per cent of State revenue was directly collected from it during 2006-07 to 2008-09.
- 11 Table 7-4 shows the 2008-09 mining revenues for each State and their importance as a source of the State's revenue.

Table 7-3 Causes of differences in fiscal capacity

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Effects on revenue raising capacity									
Mining production	1 122.5	1 501.0	-972.7	-2 097.2	292.3	107.4	103.3	-56.7	3 126.6
Property sales	94.7	436.3	-713.0	-323.6	342.1	120.1	10.8	32.7	1 036.7
Payrolls paid (a)	-474.4	-57.7	368.5	-228.2	238.5	112.9	6.9	33.6	760.3
Motor vehicle registrations and sales	298.9	-38.5	-100.9	-198.7	18.4	-3.6	16.5	7.9	341.7
Land values	-77.8	9.5	-66.2	-151.5	174.9	65.5	28.5	17.2	295.5
Other effects on revenue	-117.2	22.7	46.4	10.1	6.9	17.3	7.4	6.5	117.2
Effects on expenditure requirements									
Demographic features									
Indigeneity	-465.9	-1 425.6	441.1	426.8	-183.8	17.9	-68.1	1 257.5	2 143.3
Effects of where people live (b)	-458.0	-631.0	290.4	561.2	130.6	-100.2	-170.7	377.6	1 359.9
Socio-economic status (c)	268.6	-66.4	-208.7	-396.0	441.1	169.2	-188.3	-19.4	878.9
Population growth	-178.7	9.2	147.8	96.1	-50.5	-23.3	-4.0	3.5	256.5
Other demographic effects on service use (d)	71.5	-10.0	266.5	-29.0	-73.7	100.2	38.2	-363.7	476.4
Economic activity - effects on expenses									
Interstate differences in wage levels (e)	773.2	-200.8	-484.8	22.8	-125.6	-87.4	61.9	40.8	898.7
Non-state service provision (f)	-526.5	-115.5	114.6	346.8	-51.9	27.6	28.8	176.1	693.9
Road use	-74.8	-19.0	47.1	34.5	27.4	4.0	-23.4	4.2	117.1
Other economic influences (g)	-118.3	-94.3	20.2	90.7	36.9	37.9	-3.0	29.9	215.6
Diseconomies of small scale (h)	-358.3	-221.0	-136.6	45.4	89.0	179.3	186.2	216.0	715.9
Geographic and related influences (i)	-20.0	2.9	73.4	-21.9	-29.5	-5.5	-6.5	7.3	83.5
Revenues from the Commonwealth	-15.8	547.0	-334.2	54.4	-125.4	-20.2	86.8	-192.5	688.1
Other influences on expenditure (j)	-423.0	-307.0	415.8	282.5	-207.7	-80.3	-0.1	319.8	1 018.1
TOTAL	-679.5	-658.2	-785.5	-1 475.0	950.0	638.8	111.3	1 898.1	3 598.3

Note The redistribution is the total movement from the EPC distribution. It is the sum of positive (or negative) items in the row.

- (a) The effects of interstate differences in taxable payrolls on capacity to raise payroll tax revenue.
 (b) Includes the effects on the unit costs of services of remoteness and service delivery scale plus transport subsidies that relate to location, road length effects and the water and electricity subsidies. It does not include effects of location on use of hospitals.
 (c) Includes the effects of people receiving Commonwealth benefits and people with Commonwealth pension and health care cards.
 (d) Includes the effects of interstate differences in age structure and cultural and linguistic diversity.
 (e) The effects of interstate differences in wage levels on the costs of providing services.
 (f) Includes the effects of non-State service provision, especially for health, on State expenses.
 (g) Includes the effects of different industry sizes and differences in interstate freight and travel costs.
 (h) The effects of administrative scale disabilities.
 (i) Includes effects of State size and climate effects.
 (j) Includes interactions between disabilities and components of disabilities.

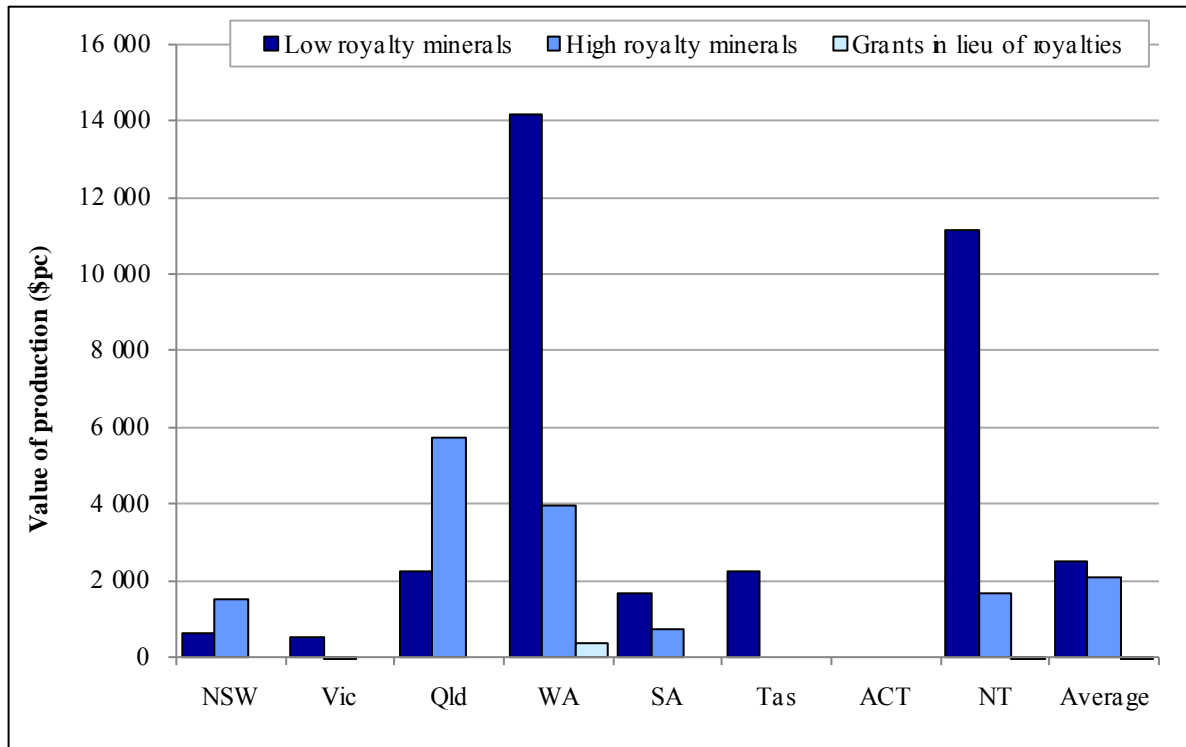
Table 7-4 Mining royalties and proportion of State revenue, 2008-09

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Category revenue (\$m)	1 278.5	46.4	3 364.6	3 184.4	152.4	32.0	0.0	227.6	8 286.0
Category revenue (\$pc)	181.58	8.65	773.55	1 444.82	94.55	63.96	0.00	1 026.88	382.87
Proportion of State revenue (%)	5.18	0.23	16.72	29.32	2.40	1.93	0.00	21.56	9.51

Source: Commission calculation using ABS GFS data.

- 12 Figure 7-1 shows the average annual per capita value of production of highly taxed minerals (onshore oil and gas, export coal, bauxite and lump iron ore) and lower taxed minerals (iron ore fines, heat coal and other minerals) over the three years 2006-07 to 2008-09. It also shows the average per capita revenue States receive from offshore oil and gas, and uranium under their revenue sharing arrangements with the Australian Government. Mining production has been disaggregated into these groups because States impose materially different royalties on them.
- 13 The figure shows the differences between the States are very large and they are quite different for each group of minerals. (For example, Queensland’s and Western Australia’s average per capita value of production of high royalty minerals was 2.7 and 1.9 times the average respectively and that of New South Wales was 0.7 times the average. For other minerals, Western Australia’s and the Northern Territory’s average per capita value of production is 5.7 and 4.5 times the average respectively.

Figure 7-1 Per capita value of mining production, average for 2006-07 to 2008-09



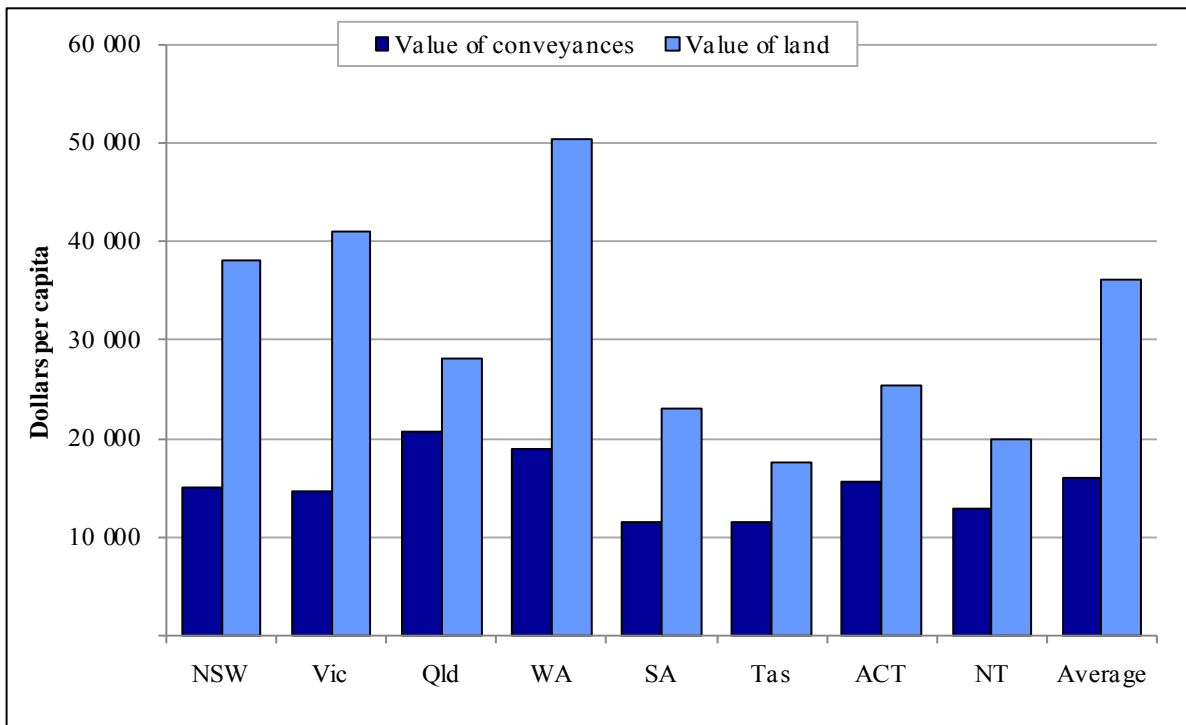
Source: Data provided by States and ABS Cat. No. 8155.0 Australian Industry, 2007-08, data cube.

- 14 The above average mining production in Western Australia, Queensland and the Northern Territory reduces their assessed GST shares. Conversely, the below average mining production in the other States increases their assessed GST shares, by \$156 per capita for New South Wales, rising to \$270 per capita for Victoria and \$289 per capita for the ACT.

The value of land and related assets

- 15 States tax land and related assets in several ways — they impose stamp duty on the transfer of ownership and they impose an annual land tax on land owners, except for land they use for their principal place of residence and primary production. Stamp duty on conveyances accounted for about 14 per cent of State own-source revenues between 2006-07 and 2008-09 and land tax almost 6 per cent.
- 16 The importance of these taxes in State budgets and the differences between the States in the level of activity in their real estate markets and the value of land and buildings mean they have a major influence on the GST distribution. Together, stamp duty on conveyances and land tax redistributed \$1.2 billion of GST compared with an EPC distribution.
- 17 That redistribution was away from Western Australia and Queensland and towards the other States, including New South Wales which had below average per capita values of conveyances. This reflects the high levels of activity in property markets and the relatively high value of taxable land in Western Australia and Queensland during 2006-07 to 2008-09.
- 18 Figure 7-2 shows the per capita values of conveyances and taxable land holdings in each State for the years 2006-07 to 2008-09.

Figure 7-2 Per capita values of conveyances and taxable land, average 2006-07 to 2008-09



Source: Data on the value of conveyances and land provided by State Revenue Offices.

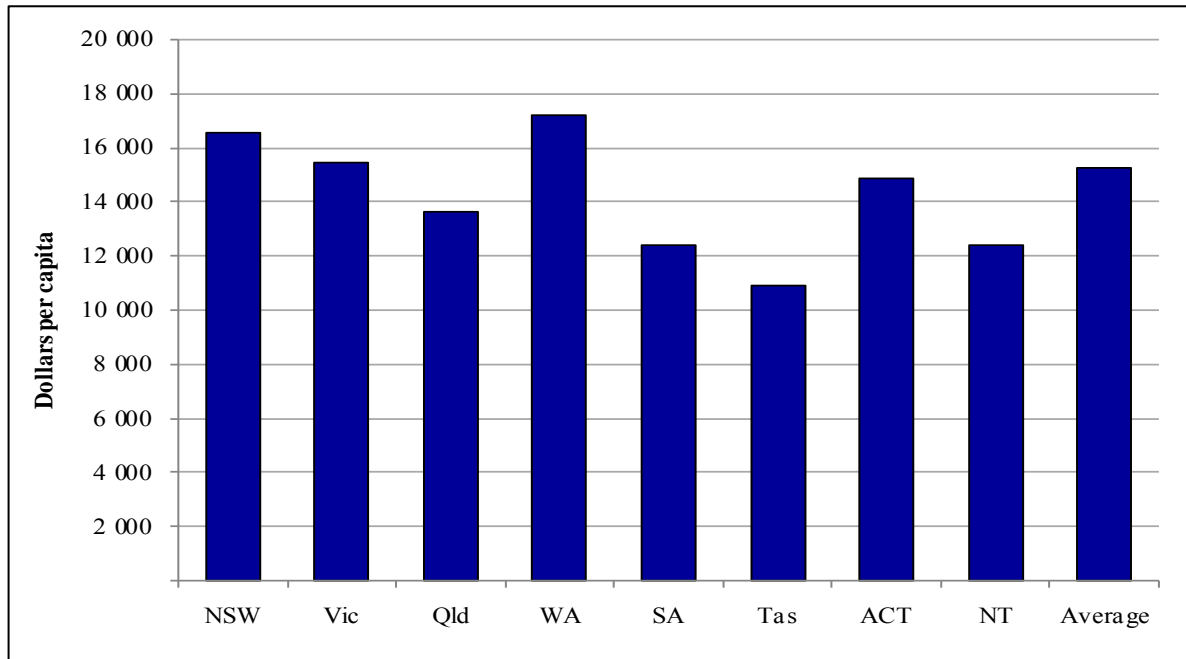
Payrolls

- 19 Interstate differences in the total value of wages, salaries and other remuneration paid by employers² affects State capacities to raise revenue because it is the base for payroll tax, the largest single State tax. States with higher per capita payrolls have higher fiscal capacities because they are better able to raise their own revenue.
- 20 However, some of the effects of interstate differences in payrolls on State overall fiscal capacities are offset by the effects of differences between States in the average level of wages paid, which affect the relative costs States face in providing services and acquiring infrastructure. In this case, above average wage levels increase the relative costs of providing services which in turn leads to lower relative fiscal capacities.
- 21 We have measured the payroll tax revenue base of each State using ABS data on the total value of compensation paid to employees in the State. However, we exclude amounts below the average tax free threshold (because all States have a tax free threshold to exempt small businesses from the tax) and the payments by the general government sector. In this way, our assessment recognises that States whose economic activity is more dependent on small business, or the public sector, have lower revenue raising capacities.
- 22 Figure 7-3 shows the average per capita taxable payrolls in each State over the years 2006-07 to 2008-09. They were above average in Western Australia, New South Wales and Victoria because the private sector and medium to large businesses accounted for above average proportions of their total wages and salaries. The relatively high wage levels in New South Wales and Western Australia have also contributed. These factors helped increase the relative fiscal capacities of those States.
- 23 Queensland's average per capita taxable payrolls have increased in recent years but remain below the average partly because of relatively low wage levels and an above average proportion of small businesses where payrolls are below the taxable threshold. The below average per capita taxable payrolls in the ACT arise largely because the Australian Government, its largest employer, is not subject to payroll tax.

Motor vehicles

- 24 Motor vehicles and their use also affect State fiscal capacities in several ways which may partly offset each other:
 - the number of vehicles on the register and the value of vehicle sales determine State capacities to raise motor tax; and
 - road use affects road maintenance costs and the need for investment in new or upgraded roads.

² Payments by Commonwealth and State general government sectors are excluded because States cannot or do not tax them.

Figure 7-3 Per capita value of taxable payrolls, average for 2006-07 to 2008-09

Source: Special collection from ABS of data on compensation of employees.

- 25 New South Wales and the ACT have below average capacities to raise motor tax because, on a per capita basis, they have below average numbers of vehicles on the register and values of vehicles sold. However, the effect on their overall fiscal capacity is partly offset because their below average road use contributes to their below average assessed expenses on roads. The opposite situation of relatively high vehicle registrations, values of vehicle sales and road use arises in Queensland, Western Australia and Tasmania.
- 26 Specific features of the other States mean the effects on revenue raising capacity and road expenses do not offset each other — Victoria has above average capacity to raise motor taxes but its comparatively compact nature contributes to relatively low per capita road use, while South Australia and the Northern Territory have below average registrations and vehicles sales but the dispersed nature of their rural areas contributes to above average per capita road use.

FACTORS AFFECTING THE COSTS OF PROVIDING SERVICES, INVESTMENT AND NET LENDING

Demographic characteristics

- 27 Differences between the States in the characteristics of their populations create substantial interstate differences in per capita spending on services and infrastructure because they affect:
- the quantity of services States need to provide. The level of service use affects the number of teachers, health professionals, schools and health facilities States require; and
 - the cost of each unit of service provided, because some groups of people are more expensive to service than others.

- 28 The effect of each population group on the GST distribution depends on its size, the interstate variation in that size and the level of expenses States direct to the group. The availability of data to measure the effect of each group on service use and costs is also relevant.
- 29 Our assessments take account of the effects of many socio-demographic features of State populations (such as the age distribution, socio-economic status, where people live, Indigenous status and country of birth) on State expenses. We also take account of the effects of population growth on investment and net lending requirements. Since these socio-demographic features often overlap (for example, Indigenous people are disproportionately represented in remote area populations and in the population with low socio-economic status), most calculations use demographic data which are cross-classified by the various characteristics. The use of cross-classified data helps avoid double counting. However, it also makes estimating the effects of single groups, such as the elderly, very difficult and we have not done so for all groups.

Indigenous status

- 30 Differences between States in the Indigenous proportion of their population have large effects on assessed fiscal capacities. We have estimated they would redistribute \$2143 million away from an EPC distribution — the Northern Territory would receive \$1258 million more and Victoria would receive \$1426 million less. However, these are partial estimates because they include only the effects on State expenses and investment requirements. Indigenous people also have differential effects on the revenue raising capacities of the States (for example they have a lower level of home ownership). These effects are captured in our measures of State revenue bases, but they cannot be separately identified.
- 31 This large redistribution arises because the differences between States in the Indigenous proportion of their population are large. As shown in Table 7-5, Indigenous people are 2.5 per cent of the Australian population but they are less than one per cent of Victoria's population and over 30 per cent of the Northern Territory's population. It is also the case that:
- on average, Indigenous people make greater use of many health, welfare, housing, and justice services — Indigenous people use hospital inpatient and welfare services more than twice and 3.5 times as frequently as non-Indigenous people, and they are about 7 times more likely to come in contact with justice services; and
 - after allowing for other factors, the average costs incurred by the States in providing some services to Indigenous people are higher than the costs of providing services to non-Indigenous people — for example, education costs are 10 to 40 per cent higher per student, community health service costs are 300 per cent higher and housing services are 30 to 80 per cent higher.

Table 7-5 Indigenous proportion of State populations, 2006

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	'000	'000	'000	'000	'000	'000	'000	'000	'000
Indigenous	152.7	33.5	144.9	71.0	28.1	18.4	4.3	64.0	516.8
Non-Indigenous	6 663.4	5 093.0	3 946.0	1 988.4	1 539.8	471.5	329.8	146.6	20 178.7
Total	6 816.1	5 126.5	4 090.9	2 059.4	1 567.9	490.0	334.1	210.6	20 695.5
	%	%	%	%	%	%	%	%	%
Indigenous	2.24	0.65	3.54	3.45	1.79	3.76	1.28	30.39	2.50
Non-Indigenous	97.76	99.35	96.46	96.55	98.21	96.24	98.72	69.61	97.50
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Note: Based on ABS June 2006 estimated resident populations.

Source: ABS *Cat. No. 3238.0 Experimental Estimates and Projections, Aboriginal and Torres Strait Islander Australians, 1991 to 2021*.

- 32 The allowances we have made for Indigenous status are intended to ensure each State has sufficient funds to be able to provide the average level of services States actually provide to Indigenous people — that is, they are based on what States actually do. The allowances are not intended to provide States with the funds necessary to raise the level of services provided to Indigenous people to an optimum level because that is not the task of fiscal equalisation. Our allowances are not affected by perceived unmet needs of Indigenous people.

Where people live within States

- 33 Where people live can affect the costs States incur in providing services because the data indicate that across Australia as a whole:
- people living in different regions use some services more or less intensively than others — for example, on a per capita basis, people living in remote and very remote areas use hospital services more than those living in highly accessible areas;
 - some services are provided for people in certain areas — for example, States subsidise public transport services provided in urban areas, with the level of those subsidies increasing as the size of the urban area increases, and States provide subsidies to electricity and water providers operating in remote and very remote areas;
 - the per unit wage and non-wage costs incurred in providing many services, especially schools and police services, increase with remoteness (see Figure 5-1); and
 - more staff per client are required when services are provided in the small and relatively dispersed communities that tend to be associated with less accessible and remote areas.
- 34 Table 7-6 shows the proportion of each State's population living in highly accessible areas, mainly the State capital cities, accessible and remote areas. Other things being equal, States with above average proportions of their population living in remote areas, especially the Northern Territory and Western Australia, incur above average costs in providing most services. While Queensland has a dispersed population, a large proportion of its population

lives in urban centres (often along the coast), rather than in remote or very remote areas. Consequently, population location has a lesser effect on its relative costs of providing services.

Table 7-6 Proportion of population living in SARIA regions, 2006-07 to 2008-09

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	%	%	%	%	%	%	%	%	%
Region									
Highly accessible	65.2	75.1	59.9	75.2	72.9	34.0	99.9	46.9	67.8
Accessible (a)	33.6	24.8	36.8	18.5	24.6	65.4	0.1	14.4	29.9
Remote (b)	1.2	0.1	3.3	6.2	2.5	0.6	0.0	38.8	2.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

(a) Includes accessible and moderately accessible areas.

(b) Includes remote and very remote areas.

Source: ABS, Estimated Resident Population, special data request.

- 35 The above average proportion of the population in highly accessible areas in the ACT (a city-state), Victoria, South Australia and Western Australia increases their relative expenses on urban transport services. Although New South Wales has the country's largest city, the proportion of its population living in highly accessible areas is lower than in the ACT, Victoria, Western Australia and South Australia.
- 36 Box 7-1 provides an estimate of how average State expenses in total vary with the region in which the services are provided and the characteristics of the people living in those regions, such as their Indigenous status.

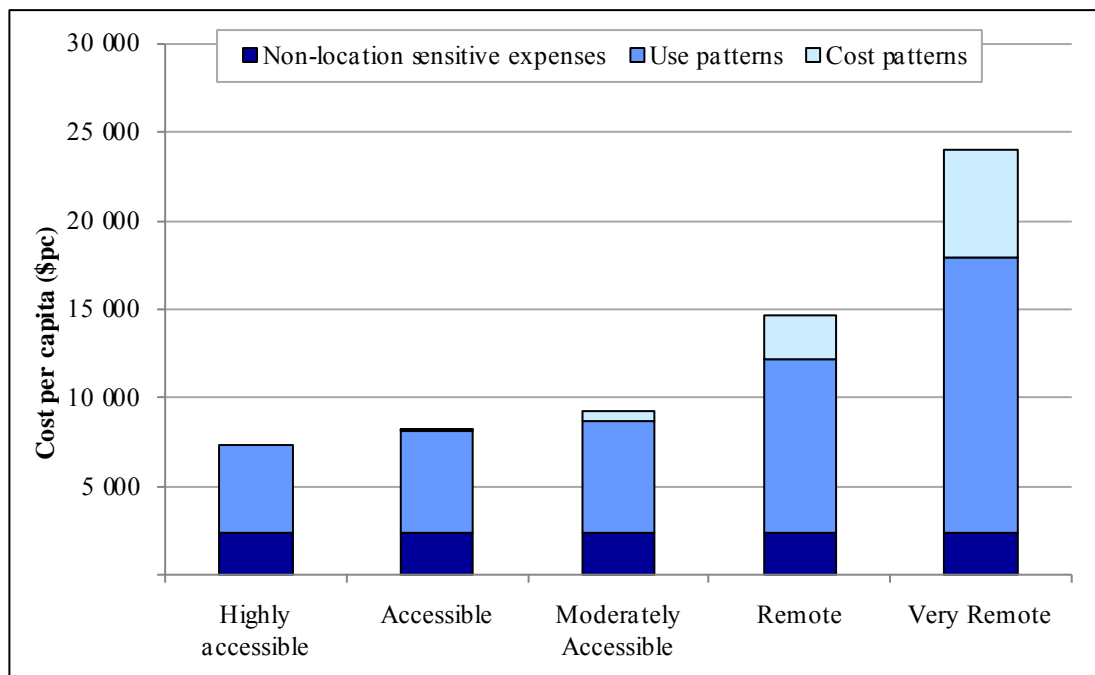
Socio-economic status

- 37 The socio-economic status of the population has significant implications for the expenses States incur in providing school education, health, welfare, housing and justice services. It also drives expenses on concessions for water and electricity services. For example:
- in schools education, States on average spend six per cent more on students from low socio-economic areas than they do on other students;
 - State expenses on admitted patients from low socio-economic areas are 27 per cent greater than for patients living in the middle ranked socio-economic areas, and a large part of this extra cost is incurred by State services because those people tend to have a low use of private services;
 - people living in areas with low socio-economic status use outpatient and emergency department services up to 50 per cent more than other people and see general practitioners up to 20 per cent more often. On the other hand, people living in areas with high socio-economic status use dentists and health practitioners other than general practitioners (GPs) more often others, such that the overall use of community health services by these two groups is similar;

- for justice services, our analysis indicated people living in low socio-economic areas lead to State expenses that are 50 per cent above the average, while people living in high socio-economic areas lead to expenses 30 per cent below the average;
- State welfare and housing expenses are largely directed to disadvantaged people; and
- States provide substantial subsidies to water and electricity providers to fund the tariff concessions they give disadvantaged people.

Box 7-1 Variations in assessed total expenses per capita by region

The figure shows how average State expenses per capita vary across regions and the effects of differences in service use and unit costs.



The per capita costs of providing major services, especially schools, health, welfare, justice and roads increase with remoteness due to:

- more intensive use of services per capita in more remote areas, reflecting:
 - greater use of services by all people, especially Indigenous people who tend to be concentrated in remote and very remote areas and have high use of health, welfare and justice services;
 - the very low population density, which leads to high per capita road lengths and associated costs; and
 - some services, such as subsidies for electricity, water and community development tend to be associated with remote areas. Some other services, such as urban transport, are concentrated in highly accessible areas, but the per capita expenses are not as high; and
- higher costs of providing services in remote areas because of higher staff to client ratios and higher wage, freight, travel and other costs.

- 38 Consequently, differences between the States in the socio-economic profile of their populations have substantial effects on their relative fiscal capacities. Other things being equal, States with higher proportions of their populations with a lower socio-economic status would be assessed as having to incur above average expenses per capita, implying they have below average fiscal capacities.
- 39 We have measured socio-economic status in several ways, with the choice of the measure depending on the service and its target population.
- 40 In the Schools education, Health and Justice services categories, we have based our measure on the ABS Socio-Economic Index for Areas. More specifically, we used the Index of Relative Socio-economic Disadvantage which determines the relative disadvantage of the population of each region using 17 indicators of disadvantage including low income, low education qualifications, low English proficiency, unemployment, people living in over-crowded dwellings, and people who are separated or divorced.
- 41 Table 7-7 shows the proportion of each State's population living in areas with low, middle and high socio-economic status. It shows well above average proportions of the population of the Northern Territory, Tasmania, South Australia and New South Wales live in highly disadvantaged areas (in the lowest quintile). Other things being equal, this increases the relative costs of providing school and health services. Conversely, the relative costs of providing those services in the ACT, Western Australia and Victoria are lower.

Table 7-7 Socio-economic profile of States, 2006-07 to 2008-09

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	%	%	%	%	%	%	%	%	%
Low SES	22.47	17.55	19.01	14.96	26.04	33.45	3.03	37.22	20.16
Middle SES	55.06	62.13	63.77	60.53	61.42	59.79	53.88	51.73	59.64
High SES	22.47	20.32	17.23	24.51	12.54	6.76	43.10	11.05	20.20
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Note: Socio-economic status is based on the ABS Socio-economic Index for Areas and uses the Index of Relative Socio-economic Disadvantage. Low SES is measured as the proportion of each State's population living in areas in the most disadvantaged quintile. High SES is the proportion of each State's population living in areas in the least disadvantaged quintile.

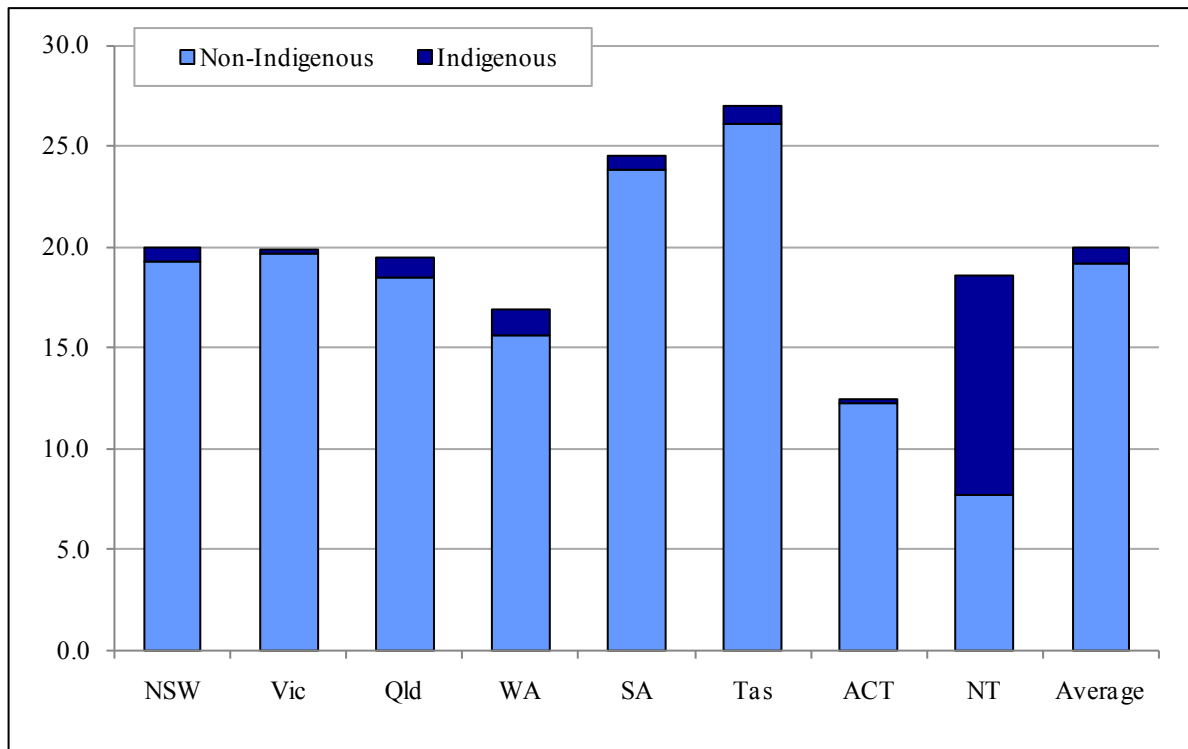
Source: ABS data on estimated resident populations.

- 42 At the other extreme, the ACT, Western Australia, New South Wales and Victoria all have above average proportions of their populations living in the least disadvantaged regions. This tends to reduce their relative costs of providing some services, but it increases the costs associated with community health services because those people tend to use some services with above average intensity.
- 43 State welfare and housing services are provided predominantly to disadvantaged people. Our analysis indicated over 80 per cent of the users of those services depended on Commonwealth social service benefits of one kind or another as their main source of income. Therefore,

interstate differences in the proportion of people in receipt of Commonwealth benefits provide a good indicator of the relative need for States to provide welfare and housing services.

- 44 Figure 7-4 shows the proportion of each State’s population that receive Commonwealth benefits. The figure does not reflect adjustments we make to better reflect the use of State services by Indigenous and non-Indigenous people on each form of benefit (details of the adjustments are in the chapter on Welfare and Housing in Volume 2). However, it still points to why Tasmania and South Australia incur above average costs in providing welfare and housing services.

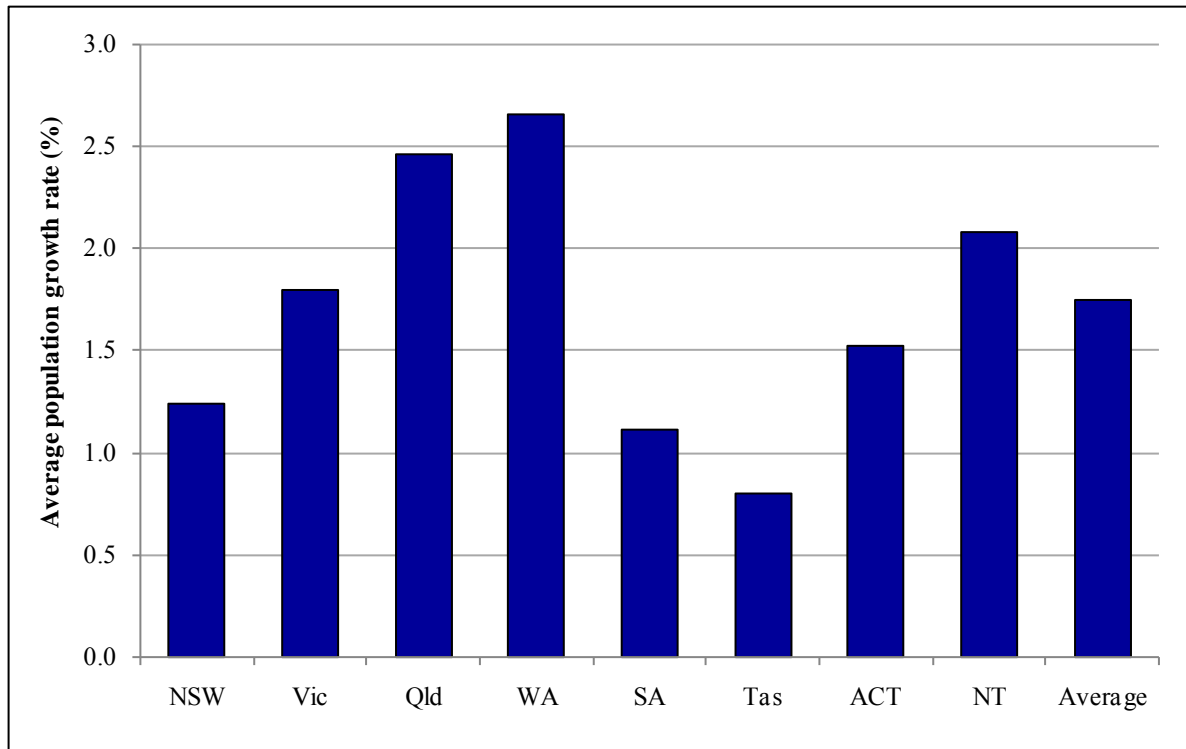
Figure 7-4 Proportion of population receiving Commonwealth benefits, 2006-07 to 2008-09



Source: Centrelink, special data request.

Population growth

- 45 Interstate differences in population growth were not recognised as having an effect on State fiscal capacities in previous reviews. However, in this review, we have recognised population growth is a primary driver of the need for extra infrastructure and changes in per capita net financial worth. Since there are significant differences between States in their population growth rates, this decision has large effects on the assessed GST distribution.
- 46 Figure 7-5 shows the average rate of population growth in each State over the years 2006-07 to 2008-09. Over those years, the average rate of population growth was 1.7 per cent but it varied from 0.8 per cent in Tasmania to 2.6 per cent in Western Australia.

Figure 7-5 Average population growth rate, 2006-07 to 2008-09

Source: ABS Estimated Resident Population, Cat. No. 3101.0.

- 47 States with above average population growth (Queensland, Western Australia and the Northern Territory) require above average per capita investment and net lending to ensure they have the infrastructure needed to provide the average services and the average net financial assets. States with below average population growth (New South Wales, South Australia, Tasmania and the ACT) require below average per capita investment and net lending.

Economic characteristics affecting State expenses

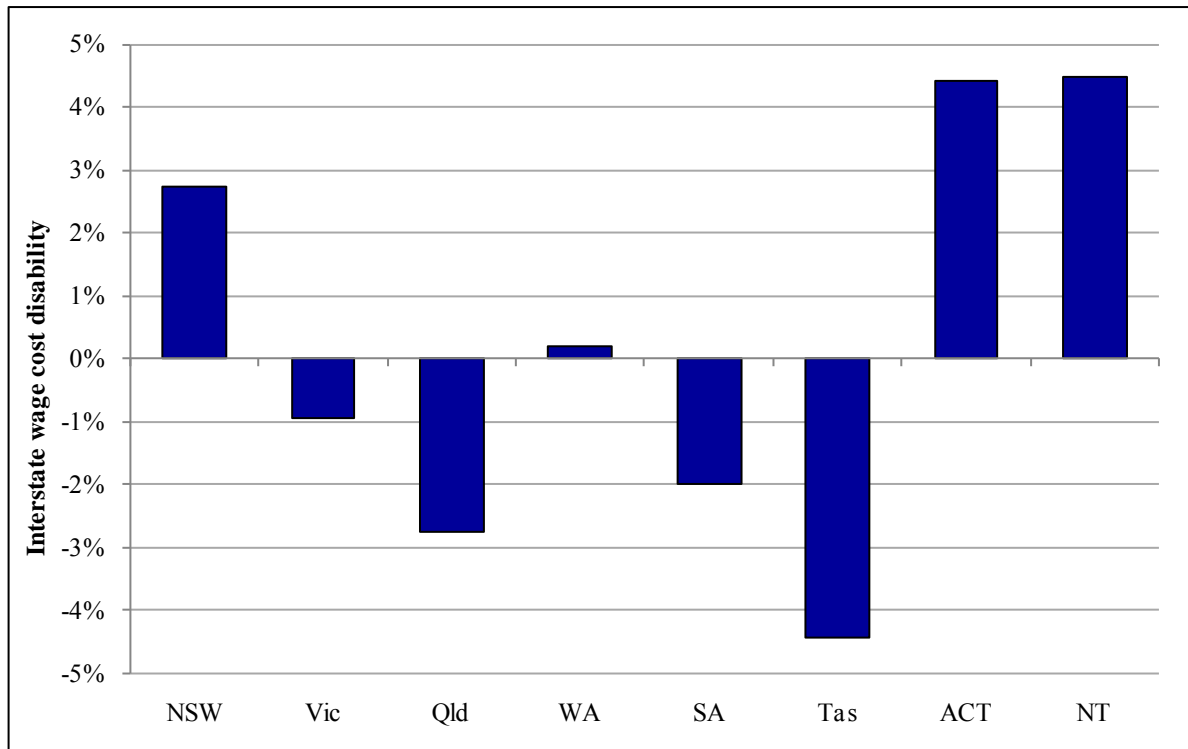
- 48 As noted earlier, interstate differences in economic characteristics lead to large differences in revenue raising capacities. They also affect the relative costs of State services (because wage levels differ between States), the quantity of some services States must provide, and the need to invest in associated infrastructure because, for example, States with fewer private health providers must provide relatively more health services.

Interstate differences in wage levels

- 49 Interstate differences in the underlying wage levels States must pay their employees mean States incur different costs to provide the same level of services and acquire the associated infrastructure. In measuring the interstate differences in wage levels we have compared, as far as possible, the wages paid to similar employees in the private sector. We used private sector wages because they are largely unaffected by State government wage and related policies and they generally set the market in which State governments compete for labour.

50 Our analysis shows a consistent picture of: above average underlying wage levels in New South Wales, the ACT and the Northern Territory; and below average wages in Victoria, Queensland, South Australia and Tasmania. Average wage levels in Western Australia have risen in recent years and moved above the average in 2007-08. The average wage levels for 2006-07 to 2008-09 are shown in Figure 7-6.

Figure 7-6 Relative wage levels, average for 2006-07 to 2008-09



Source: Commission calculation.

Non-State provision

51 Interstate differences in the availability of non-State provided services, in particular Commonwealth and privately funded health services, can affect the use of State services. Costs of providing admitted patient services increase with remoteness, in part due to the lack of private hospitals in more remote regions, leading to greater use of State hospital facilities. Therefore, States with a higher proportion of their populations in more remote areas will face relatively higher costs in providing admitted patient services.

52 For community and other health services, there is a level of substitutability between services provided by the States and non-State (Commonwealth and private) providers. Consequently, differences between the States in the extent of Commonwealth and private provision affects the relative level of services States must provide. Per capita Medicare benefit rebates paid in New South Wales are around 10 per cent greater than the national average, and there are more people with ancillary private health insurance cover than average. This indicates people in New South Wales would use State provided health services less, on average, compared to other States. Conversely, Western Australia, the ACT and the Northern Territory not only

experience a shortage of GPs, but also have difficulties in attracting and retaining other health professionals, which acts to increase the need for State services and increases their assessed GST distribution.

DISECONOMIES OF SMALL SCALE IN ADMINISTRATION

- 53 States with small populations incur diseconomies of small scale because the basic governance, administrative and policy formulation tasks of State governments lead to an irreducible level of fixed costs which, when spread over fewer people, increases per capita costs.
- 54 Based on analysis undertaken during earlier reviews, those minimum fixed costs were \$213.5 million per State in 2008-09, which represented \$30.3 per capita in New South Wales but \$990.3 per capita in the Northern Territory.
- 55 Our assessments of diseconomies of small scale in administrative tasks reduce the assessed GST distribution of New South Wales, Victoria and Queensland and increase those of the other States.
- 56 States also incur other administrative and policy formulation costs over and above these minimum fixed costs. However, for assessment purposes, we do not distinguish them from other direct service delivery expenses because we consider they are driven by similar factors.

PAYMENTS FROM THE COMMONWEALTH, OTHER THAN THE GST

- 57 The Australian Government provides considerable support for State budgets through National SPPs, NPPs and general revenue assistance other than GST.
- 58 The interstate distribution of those payments is reflected in our assessments because they help fund State spending that is included in the expense and infrastructure assessments.
- 59 Commonwealth National SPPs, NPPs and general revenue assistance other than GST are treated as a source of revenue States may use to fund their activities. Consequently, if States have above average per capita receipts of these Commonwealth payments their assessed GST distribution would be reduced. Conversely, States with below average per capita receipts of these Commonwealth payments would have their assessed GST distribution increased.
- 60 Table 7-8 shows the payments that have the greatest effects on the GST distribution. These payments tend to be large and their interstate distribution differs substantially from an EPC distribution.

Table 7-8 Effect on GST distribution of Commonwealth payments

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Nation building program - construction	-93.6	294.8	-279.3	-23.6	39.2	24.9	38.1	-0.6	397.0
National health care	-46.6	51.3	45.2	9.4	-67.4	8.1	24.3	-24.4	138.4
NBPF Roads	-5.6	67.4	-123.4	28.2	20.0	6.2	4.4	2.8	128.9
National schools SPP	55.4	-5.0	17.2	25.5	-45.6	5.5	-13.5	-39.4	103.5
Remote Indigenous housing	31.0	31.3	-13.9	-5.1	4.5	2.7	2.0	-52.6	71.5
All other Commonwealth payments	121.5	88.7	32.4	20.3	-94.4	-49.6	13.1	-132.0	276.0
Total	62.2	528.5	-321.8	54.8	-143.7	-2.1	68.4	-246.1	713.8

Note: The total is the sum of positive or negative items in the row.

Source: Commission calculation.

THE MAIN TAXES AND SERVICES AFFECTING THE GST DISTRIBUTION

- 61 The previous sections outlined the main underlying drivers of interstate differences in fiscal capacity. However, for some purposes, it is useful to consider the extent to which individual taxes and services cause the assessed distribution of the GST to move away from an EPC distribution. Table 7-9 shows the revenues and expenses which make the largest contributions to the difference between the assessed and an EPC distribution of the GST.
- 62 *Mining revenue.* This revenue category redistributes \$3127 million and is the largest single reason why the recommended distribution of the GST differs from an EPC distribution. The underlying, very uneven distribution of mining production is shown in Figure 7-3 — Queensland and Western Australia, with average per capita value of production of \$7968 and \$18 131 respectively over the three years 2006-07 to 2008-09, together accounted for 74 per cent of onshore mineral production, but Victoria and the ACT, with per capita production of \$497 and zero respectively, accounted for less than 3 per cent.
- 63 *Stamp duty on conveyances.* This revenue category has the second largest effect on the recommended distribution of the GST — it redistributes \$1037 million. The large redistribution arises because:
- the interstate differences in the per capita value of property transfers are large (see Figure 7-2); and
 - they affect a substantial proportion of State revenue — about 14 per cent of total State own-source revenue across the years 2006-07 to 2008-09.

Table 7-9 Taxes and services contributing to differences in fiscal capacity

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Mining revenue	1 122.5	1 501.0	-972.7	-2 097.2	292.3	107.4	103.3	-56.7	3 126.6
Stamp duty on conveyances	94.7	436.3	-713.0	-323.6	342.1	120.1	10.8	32.7	1 036.7
Investment	-315.5	-320.6	537.9	272.1	-155.5	-64.3	-51.5	97.4	907.4
Payroll tax	-474.4	-57.7	368.5	-228.2	238.5	112.9	6.9	33.6	760.3
Schools education	-20.2	-637.6	216.3	170.0	-57.1	79.8	-9.8	258.7	724.7
Commonwealth payments	62.2	528.5	-321.8	54.8	-143.7	-2.1	68.4	-246.1	713.8
Community and other health services	-439.6	-201.4	52.0	328.7	-39.9	56.6	44.1	199.5	680.9
Welfare and housing	-122.0	-422.1	52.3	-13.1	131.8	87.8	-58.4	343.8	615.7
Justice services	-103.4	-477.9	80.8	119.2	-29.6	32.3	4.6	374.1	610.9
Services to communities	-190.6	-279.4	68.9	172.9	29.9	-34.9	-34.5	267.6	539.3
Admitted patients	101.0	-272.3	-115.2	-28.2	159.8	52.5	-70.8	173.1	486.5
Roads	-183.5	-164.7	85.1	160.2	50.2	-3.7	-26.2	82.6	378.1
Transport services	175.9	176.2	-123.0	-53.3	-58.8	-67.1	-18.6	-31.3	352.2
Motor taxes	298.9	-38.5	-100.9	-198.7	18.4	-3.6	16.5	7.9	341.7
Other expenses	-123.5	-156.1	-61.5	41.2	1.8	74.4	86.0	137.7	341.1
Depreciation	-109.1	-187.8	48.6	110.9	21.4	8.7	-18.5	125.8	315.4
Land tax	-77.8	9.5	-66.2	-151.5	174.9	65.5	28.5	17.2	295.5
Net lending	-178.7	9.2	147.8	96.1	-50.5	-23.3	-4.0	3.5	256.5
All other revenue	-117.2	22.7	46.4	10.1	6.9	17.3	7.4	6.5	117.2
All other expenses	-75.2	-120.8	-17.8	79.3	17.0	22.1	27.3	68.1	213.7
TOTAL	-679.5	-658.2	-785.5	-1 475.0	950.0	638.8	111.3	1 898.1	3 598.3

Note: Differences in fiscal capacity have been measured by extent to which the assessment for each category moves the recommended distribution of the GST away from an EPC distribution — the distribution that would arise if all States had the same fiscal capacity.

The redistribution is the total movement from the EPC distribution. It is the sum of positive (or negative) items in the row.

- 64 *Payroll tax.* This assessment redistributes \$760 million away from an EPC distribution. The assessed distribution moves money from the States that had above average per capita taxable payrolls over the years 2006-07 to 2008-09 (New South Wales, Western Australia and Victoria). Major reasons for those above average payrolls are discussed in paragraphs 19 to 22.
- 65 While the interstate differences in per capita taxable payrolls are not as great as the differences in mining production or property sales, payroll tax accounts for a larger proportion of State own source revenue (an average of about 18 per cent over the years 2006-07 to 2008-09), which means its effect on the recommended GST distribution is large.

- 66 *Motor taxes.* The relative capacity of States to raise revenue from these taxes is driven by the number of vehicles on register and the value of vehicles sold. Motor taxes redistribute \$342 million of GST to New South Wales, South Australia, the ACT and the Northern Territory and away from the other States, especially Western Australia and Queensland.
- 67 Over the years 2006-07 to 2008-09, New South Wales had below average per capita registrations of light and heavy vehicles and a below average per capita value of vehicle sales whereas Queensland and Western Australia were above average in each of those areas. The below average revenue raising capacity of the ACT reflects its below average heavy vehicle registrations and vehicle sales. The Northern Territory had well below average light vehicles registrations and South Australia had well below average per capita value of vehicle sales.
- 68 *Land tax.* This tax leads to the redistribution of \$296 million of GST relative to an EPC distribution because of the interstate differences in the per capita value of taxable land. Over the years 2006-07 to 2008-09, land values were above the average in Western Australia, Queensland and New South Wales which gave them above average capacities to raise revenue from land tax and reduced their assessed GST requirements. Per capita land values were below average in the other States, increasing their assessed GST requirements.
- 69 *Investment.* The redistribution of \$907 million away from an EPC distribution attributable to investment reflects different requirements for infrastructure flowing from differences in population growth, the assessed use of services and per unit costs of providing infrastructure. Queensland, Western Australia and the Northern Territory have been assessed as needing to spend more because they experienced above average population growth, assessed use of services and per unit costs.
- 70 While Victoria's population growth is above average, it has relatively lower assessed use of services and lower per unit costs which together reduce its assessed distribution. All other States have below average population growth, which reduces their assessed distribution. The effects of the below average population growth in New South Wales are compounded by below average assessed use of services but partially offset by greater per unit costs. South Australia, Tasmania and the ACT are assessed as needing to spend less than average on extra infrastructure mainly because they have below average population growth and below average per unit costs.
- 71 *Schools education.* The redistribution of \$725 million away from an EPC distribution attributable to schools education arises because of the substantial differences between States in the numbers of assessed enrolments, especially for students where the costs to the States are high (Indigenous students and students from low socio-economic backgrounds). On the other hand, States with relatively high numbers of non-government school enrolments have been assessed to require less GST because State spending on them is less than for government school students. The fact that school education is a very labour intensive service and is provided close to where people live means States with above average wage levels and higher proportions of their enrolments in high cost remote and very remote areas also require greater GST.

- 72 Consequently, the redistribution away from Victoria reflects its below average level of high-cost enrolments (especially enrolments of Indigenous students and those from low socio-economic backgrounds) and its relatively high proportion of non-government school enrolments. It also has a low proportion of enrolments in remote and very remote areas. The opposite applies in the Northern Territory which also faces above average wage levels.
- 73 The redistributions towards Queensland and Tasmania reflect above average assessed enrolments, especially for high cost student groups, and their below average non-government school enrolments. However, those effects are partly offset by below average wage levels.
- 74 *Community and other health services.* The difference from an EPC distribution attributable to community and other health services (\$681 million) arises because there are differences between States in the proportion of people in their population who impose high community health costs on the States. Higher cost groups of people include the elderly, Indigenous people (in particular remote Indigenous people) and people with lower socio-economic status. Those groups of people tend to use community health services more than others and they tend not to use the services of non-State providers, leaving the States with relatively larger service provision tasks. High wage costs associated with health professionals and the fact that primary health care services are generally provided close to where people live means States with above average wage levels and higher proportions of their populations in high cost remote and very remote areas also require greater GST.
- 75 The redistribution away from New South Wales largely reflects the high level of private services in this State, particularly through general practitioners. This effect is partly offset by a slightly older population, an above average proportion of people living in low socio-economic areas and higher wage costs. The redistribution towards Western Australia, Tasmania, the ACT and the Northern Territory all largely reflect their lower levels of general practitioners and other private health providers. For Western Australia and the Northern Territory, this is reinforced by the relatively large Indigenous populations, many of which live in remote areas.
- 76 *Welfare and housing.* Welfare and housing services create a redistribution away from an EPC distribution of \$616 million primarily because of differences between States in the proportion of people in low socio-economic circumstances. States with relatively high Indigenous populations also tend to have high service expenses because Indigenous people use the services more intensively. The labour intensive nature of welfare services and the greater use of State housing by Indigenous people in less populated regions means States with above average wage levels and high proportions of Indigenous people living in remote and very remote areas also require greater GST shares.
- 77 Consequently, the assessed redistribution away from Victoria and the ACT reflects their below average proportion of Indigenous people. Victoria has a relatively low share of supporting parents and unemployed people, while the ACT has a below average proportion of people in low socio-economic circumstances. These States also deliver services in compact, highly settled regions.

- 78 The assessed redistribution toward South Australia and Tasmania is largely due to their relatively high shares of disabled people and low income aged people, along with the higher costs associated with delivering services to sparsely settled areas. These effects are partially offset by lower wage costs. The Northern Territory has a high Indigenous population, which draws disproportionately on welfare and housing services. It also faces high costs in providing services to sparsely settled regions and above average wage costs.
- 79 *Justice services.* The \$611 million move away from an EPC distribution attributable to justice services arises because of the differences between States in the proportions of their population that tend to have more involvement in the justice system — Indigenous people, males aged 15-34 and people from a low SES background. States with relatively high numbers of these population groups have been assessed to require more GST. In addition, because police, courts and corrective services are very labour intensive services and police services are provided in remote regions, States with above average wage levels and higher proportions of their populations in high cost remote and very remote areas require greater GST.
- 80 Consequently, the below average assessed GST distribution for New South Wales and Victoria reflects their below average proportion of Indigenous people and people living in remote and very remote areas. For New South Wales this is partly offset by above average wage levels.
- 81 The above average assessed GST distributions for Queensland, Western Australia, Tasmania and the Northern Territory arise because they have above average proportions of Indigenous people in their populations. While South Australia has a below average proportion of Indigenous people, this is partly offset by its above average proportion of people from a low SES background. The ACT has above average needs because of the above average salaries paid by the Australian Federal Police and diseconomies of small scale in administration.
- 82 *Services to communities.* The redistribution away from an EPC distribution attributable to service to communities of \$539 million arises because of the large differences between States in the population that receive subsidies for water services (the population in small communities in poor water areas), electricity services (the population living in remote and very remote regions) and community development services (the population of Indigenous communities). Interstate differences in the size of the population with Commonwealth pension and health care cards, which influence concession expenses, also affect the GST distribution.
- 83 The above average share of the populations of Queensland, Western Australia and the Northern Territory living in discrete Indigenous communities, remote and very remote communities, and communities requiring water subsidies increases their assessed GST shares.
- 84 The redistribution for South Australia arises because of its above average share of people: living in communities with greater need for water subsidies; living in remote and very remote regions; and with concession cards. This is partially offset by its below average share of people living in discrete Indigenous communities.
- 85 New South Wales, Victoria, Tasmania have below average shares of all population groups that receive these services, other than people with Commonwealth concession cards. The ACT has

below average shares of all groups. Consequently, the services to communities assessments lead to lower assessed GST shares for these States.

- 86 *Admitted patients.* The redistribution of \$487 million away from an EPC distribution attributable to admitted patients arises because of the substantial differences between States in the numbers of people where the cost to States to provide admitted patient services is high. Higher cost groups of people include the very young and the very old, Indigenous people, people living in remote and very remote areas and people with lower socio-economic status. High wage costs associated with health professionals means that States with above average wage levels also require greater GST.
- 87 Consequently, the redistributions away from Victoria and the ACT reflect the below average proportions of Indigenous people, people living in lower socio-economic areas and people living in remote and very remote regions in their populations. The ACT also has a relatively younger population while Victoria has below average wage levels.
- 88 South Australia and Tasmania have older populations, along with above average proportions of their populations living in lower socio-economic areas, leading to redistributions toward these States. These effects are partially offset by lower wage levels. The redistribution towards the Northern Territory reflects its above average proportions of Indigenous people and people residing in remote and very remote areas, as well as the higher wage costs.
- 89 *Roads.* The main cause of the \$378 million movement away from an EPC distribution in the Roads assessment is the rural roads disability. Expenditure on rural roads is about 40 per cent of total roads expenditure and is affected by road length, traffic volume and heavy vehicle use. The second largest effect arises from State expenses on local roads, which relate to roads in unincorporated areas and local government areas with insufficient population to adequately fund road maintenance. While these expenses account for only five per cent of State roads expenditure, there are large differences between States in the share of their population living in these areas which causes a material effect on the assessed GST shares.
- 90 Queensland, Western Australia, South Australia, Tasmania and the Northern Territory have above average per capita rural networks and above average traffic volume and heavy vehicle use of them. These States also have above average assessed local roads needs — the Northern Territory's assessed per capita expenses for local roads are nearly ten times the average.
- 91 New South Wales and Victoria have relatively small rural networks per capita, below average traffic volume and heavy vehicle use of rural roads and few local roads in sparsely settled areas. The ACT is at the extreme with no assessed rural network and no need to fund local roads in sparsely settled areas. Consequently, the assessed GST for all these States is reduced.
- 92 *Transport services.* Transport services lead to a redistribution of \$352 million compared with an EPC distribution. State expenses for subsidies to public transport providers are the major expenses in this category. Since different factors affect the subsidies for urban and non-urban transport, we assessed different disabilities for each. For urban public transport, the evidence showed public transport subsidies increase with urban size because of the greater propensity to

use public transport and higher average trip lengths in larger cities. Hence, States with very large cities (New South Wales and Victoria) were assessed to need above average shares of GST and the greater proportion of Victoria's population living in cities of over 40 000 people increased its share above that of New South Wales.

- 93 For non-urban public transport, we considered the need for subsidies was related to the proportion of a State's population living outside the State capital city. States with above average shares in this population group (New South Wales, Queensland, Tasmania and the Northern Territory) were assessed to need above average shares of GST for this function.
- 94 When the urban and non-urban disabilities were combined, the urban effects dominated due to the much greater spending by States on transport in these areas. The assessed GST distribution was, therefore, largely influenced by the size of urban areas in States and the proportion of State populations living in them, resulting in above average needs being assessed for New South Wales and Victoria.
- 95 *Other expenses.* This is a residual category containing a variety of State functions. The main reasons for the \$341 million move away from an EPC distribution arising from this category are:
- the large allowances for diseconomies of small scale in administration because they affect the legislative and administrative infrastructure required to support State governments which are in this category — these allowances increase the assessed distributions of Western Australia, South Australia, Tasmania, the ACT and the Northern Territory;
 - the interstate differences in wage levels — which increase the assessed distributions of New South Wales, Western Australia, the ACT and the Northern Territory;
 - expenses associated with natural disasters, where we consider State actual expenses reflect their needs; and
 - the number of people born in non-English speaking countries because the aggregate allowances we assessed for the effects of low English fluency on the costs of providing schools and health services are in this category — this increased the assessed GST distributions of New South Wales and Victoria.
- 96 *Depreciation.* The assessed redistribution of \$315 million away from an EPC distribution attributable to depreciation expenses arises because of the differences between States in the assessed stocks of infrastructure which themselves reflect differences in the assessed use of services and per unit costs of providing infrastructure.
- 97 New South Wales, Victoria and the ACT have been assessed to need less infrastructure per capita to deliver services because of relatively lower use of services. This results in below average depreciation needs, which in the case of New South Wales are partly offset by high per unit costs stemming from its above average wage levels.

- 98 The other States are assessed as needing above average infrastructure per capita to deliver services because of their relatively high use of services. This results in higher depreciation needs, which in the cases of Queensland, Western Australia and the Northern Territory are augmented by their above average per unit costs of infrastructure. South Australia and Tasmania face below average per unit costs of infrastructure, which partially offset their above average need for infrastructure.
- 99 *Net lending.* The redistribution of \$257 million away from an EPC distribution attributable to net lending is the result of different population growth rates. Victoria, Queensland, Western Australia and the Northern Territory have above average population growth rates which, other things being equal, would imply they require above average per capita GST to maintain their net financial worth at national average per capita levels. The opposite applies to New South Wales, South Australia, Tasmania and the ACT which have below average population growth.
- 100 *Commonwealth payments.* The main differences were shown in Table 7-8.
- 101 *Further details.* More information on the effects of individual categories, including the per capita effects, is in Chapter 4 of Volume 3.

CHAPTER 8

WHY THE DISTRIBUTION HAS CHANGED

- 1 The previous chapter discussed the factors that cause the fiscal capacities of the States to differ from one another. This chapter outlines why the illustrative distribution of GST for 2010-11 derived from the recommendations in this report differs from the estimated distribution for 2009-10.

DIFFERENCES BETWEEN THE DISTRIBUTION OF GST FOR 2009-10 AND 2010-11

- 2 Table 8-1 shows the differences between the estimated GST distribution for 2009-10 and the illustrative distribution for 2010-11.
- 3 The two distributions differ because:
 - the relativities used to distribute the GST have changed — the illustrative 2010-11 distribution is based on the relativities recommended in this report whereas the 2009-10 distribution is based on relativities derived in the 2009 Update;
 - State populations have changed — the illustrative 2010-11 distribution is based on estimated State populations as at December 2010 whereas the 2009-10 distribution is based on populations for a year earlier; and
 - the amount of GST revenue available for distribution has changed.
- 4 The contribution of each of those factors to the total change is also shown in Table 8-2. The Commission's work affects only the changes in the relativities, although they are also affected by many other changes in the underlying circumstances of the States.
- 5 In making these comparisons, we have not sought to identify the differences between the amount each State would receive under the illustrative distribution and the forward estimates of 2010-11 GST revenues they have included in their budget documents.

Table 8-1 Distribution of the 2009–10 GST and the illustrative 2010-11 GST¹

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Estimated 2009-10 (a)	12 774.1	9 644.4	7 839.2	3 413.0	3 908.5	1 573.0	862.5	2 285.4	42 300.0
Illustrative 2010-11 (b)	13 843.7	10 516.4	8 384.0	3 190.1	4 265.3	1 664.4	832.6	2 363.4	45 060.0
Change	1 069.6	872.1	544.8	-222.9	356.9	91.4	-29.9	77.9	2 760.0
Change caused by new:									
Relativities (c)	277.3	223.0	-19.8	-442.9	118.4	0.6	-79.8	-76.9	0.0
Population (d)	-55.6	5.0	51.0	24.6	-22.8	-11.1	-1.2	10.1	0.0
Pool (e)	848.0	644.1	513.5	195.4	261.3	101.9	51.0	144.8	2 760.0
Change	1 069.6	872.1	544.8	-222.9	356.9	91.4	-29.9	77.9	2 760.0
Total change (\$pc)	150.00	159.71	122.33	-98.52	218.92	181.07	-84.76	344.26	125.33

(a) From the Commonwealth of Australia *Mid-Year Economic and Fiscal Outlook 2009-10*, p 76.

(b) Obtained by applying the 2010 Review relativities to estimated State populations for December 2010 and estimated GST revenue for 2010-11.

(c) Effects on the distribution of the 2009-10 estimated GST revenue of using the 2010 Review relativities instead of 2009 Update relativities.

(d) Effects on the distribution of the 2009-10 estimated GST revenue of using estimated State resident populations for December 2010 instead of December 2009.

(e) Effect of applying the 2010 Review relativities to estimated growth in GST revenue for 2010-11.

Source: GST revenue and the December 2009 and 2010 populations are taken from the *Mid-Year Economic and Fiscal Outlook 2009-10*.

WHY THE RELATIVITIES HAVE CHANGED

- 6 The relativities recommended for use in 2010-11 are the product of this major review of principles and methods and the most recent data available in February 2010. By contrast, the relativities used to distribute the GST for 2009-10 were based on methods devised in the 2004 Review and the most recent data available in February 2009. Thus, the relativities have changed from those recommended in 2009 due to a combination of changes in the methods we used to measure State fiscal capacities and the circumstances of the States.
- 7 To help explain the changes, we have broken the total changes into those due to each of the main causes. We have done so by beginning with the relativities recommended in the 2009 Update and sequentially introducing changes in methods and data on State circumstances. The sequence we followed was to:
- revise the 2009 Update relativities to reflect the shorter review period (the three years ended in 2007-08) but without changing other aspects of the assessment methods; then
 - applying the assessment methods decided in this 2010 Review, including any revisions to data for 2005-06 to 2007-08, but without including data for 2008-09; and
 - including recent State circumstances by including data for 2008-09 and deleting 2005-06 data.

¹ In some tables in this report the columns may not add due to rounding.

- 8 Table 8-2 shows the changes in the GST distribution attributable to each of those steps. The figures in the table, and the rest of this chapter, are based on the estimated 2009-10 GST revenue of \$42.3 billion.

Table 8-2 Effect of changes in Commission methods and State circumstances

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Effects of changes in methods									
Shorter review period	579.0	186.1	-388.0	-490.2	65.2	-12.4	13.5	46.9	890.6
Other method changes (and data revisions)	-701.1	-35.3	878.6	107.5	21.1	-1.4	-83.8	-185.6	1 007.2
Total method changes (a)	-122.1	150.9	490.6	-382.7	86.2	-13.8	-70.3	-138.8	727.7
State circumstances (b)	399.5	72.1	-510.4	-60.2	32.2	14.4	-9.5	61.8	580.0
Change in relativities	277.3	223.0	-19.8	-442.9	118.4	0.6	-79.8	-76.9	619.3

Note: The table is based on the 2009-10 GST revenue of \$42 300.0 million and December 2009 populations.

The redistribution is the sum of the positive (or the negative) items in the row.

- (a) The effect on the GST distribution of applying relativities derived using 2010 Review methods, including the change in the review period from 5 to 3 years, instead of 2009 Update methods to State circumstances for years up to 2007-08.
- (b) The effect on the GST distribution of updating relativities based on 2010 Review methods to include State circumstances for 2008-09 and delete those for 2005-06.

Source: Commission calculations.

- 9 The effects of the main changes in methods and State circumstances are outlined in the following sections.

Changes in methods for measuring State fiscal capacities

- 10 Changes in methods introduced in this review fall into three groups:
- the reduction in the length of the review period from five to three years, which is intended to make the relativities more contemporary;
 - changes necessary to reflect changes in federal financial relations introduced since early 2009; and
 - other changes in methods, stemming from research undertaken during the review, which are intended to improve equalisation and achieve it in simpler and more reliable ways.
- 11 *Reduction in the length of the review period.* The 2009 Update relativities used to distribute the GST for 2009-10 were based on data for the five years 2003-04 to 2007-08.
- 12 In this review, we decided the relativities should be more up-to-date to better reflect State circumstances in the year they are applied. We therefore based them on data for the three most recent completed financial years.
- 13 We have recalculated the 2009 Update relativities on the basis of the shorter three year review period of 2005-06 to 2007-08. These recalculated relativities are more contemporaneous because they are not affected by State circumstances that existed five and six years prior to

2009-10. Moreover, the State circumstances in each of the three most recent years have a greater effect on them — they have a 33 per cent weight in the relativities compared with a 20 per cent weight under the longer review period.

- 14 The change in the distribution of the 2009-10 GST that would have arisen if relativities based on three years of data had been applied instead of the actual distribution is shown in Table 8-2. This change will substantially reduce the GST received by Queensland and Western Australia and increase it for the other States, except Tasmania. It arises because the effects of the high revenue raising capacities experienced by Queensland and Western Australia flowing from their strong economic growth in 2006-07 and 2007-08 are not tempered by their lower revenue raising capacities in 2003-04 and 2004-05. Tasmania's assessed GST falls because the relatively high disabilities it experienced in providing services in 2003-04 and 2004-05, especially health and welfare services, no longer affect the relativities.
- 15 These changes in assessed GST arising from the use of a shorter review period are one-off changes and will not arise in future updates.
- 16 *The effects of changes in federal financial relations and other method changes.* The effects of these method changes on the GST distribution are summarised in Table 8-3.

Table 8-3 Effect of major changes in methods

Effect of change in	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Federal financial relations (a)	42.8	-34.4	-20.8	2.2	-2.0	-1.4	0.3	13.4	58.6
Other method changes									
Treatment of capital (b)	-525.1	-160.0	591.4	264.3	-171.3	-68.7	-35.9	105.4	961.2
Land revenue	181.2	-162.5	-32.8	61.1	-24.1	-27.6	15.2	-10.4	257.5
All other revenue	55.4	37.3	43.2	-61.1	-17.5	-36.3	-21.2	0.2	136.0
Community and other health	-326.6	20.3	39.7	184.3	9.2	43.2	35.1	-5.2	331.7
Welfare and housing	-90.1	-15.0	41.0	-43.5	141.0	64.2	-29.1	-68.4	246.2
Services to communities	45.5	143.8	112.3	-113.3	-66.3	-29.6	-3.3	-89.2	301.6
Justice services	-95.0	-152.8	112.2	38.6	56.5	30.9	-35.6	45.4	283.4
Roads	-70.5	158.7	66.6	-90.5	49.6	-13.1	-2.9	-97.8	274.9
Depreciation	-86.7	-133.0	36.0	89.9	23.7	-1.2	-17.6	88.9	238.5
All other expenses	168.1	262.4	-110.0	-224.5	22.2	38.4	11.4	-168.0	502.5
Total effect of method changes	-701.1	-35.3	878.6	107.5	21.1	-1.4	-83.8	-185.6	1 007.2
Change in location effects (c)	-32.5	125.9	-20.8	-47.2	95.8	46.9	-11.5	-156.6	268.6

Note: The table is based on the 2009-10 GST revenue of \$42 300.0 million and December 2009 populations.

The redistribution is the sum of the positive (or the negative) items in the row.

- (a) Includes effects of the progressive move to an EPC distribution of National SPPs and changes in the treatment of certain payments.
- (b) Includes effects of the investment and net lending assessments.
- (c) These data have been revised and updated since the printed version of the report was released. They compare the effects of regional costs and interstate non-wage costs in the 2010 Review with the effects of dispersion, urban influences, isolation and accommodation and electricity input costs in the 2009 Update. These effects are part of those shown for individual services.

Source: Commission calculations.

- 17 *Changes necessary to reflect new federal financial relations.* Changes in this group include the effects of:
- revising the data for each year up to 2007-08 to reflect the COAG decision to progressively move the distribution of National SPPs from their historical pattern to an EPC distribution by 2015-16; and
 - changing the way we treated some NPPs — for example, there is now no effect on the relativities arising from the essential vaccines program (because they are Commonwealth purchases) and half the payments for the construction of national network roads (because our assessments do not reflect all the relative needs identified by the Australian Government).
- 18 *Other method changes.* Given our clean slate, top down approach, changes have been made to the methods used in assessing every category of State revenue and expenses and in measuring every revenue base and every expense disability. The most important of these changes were in the areas discussed below.
- *The approach to recognising the effects of investment in new infrastructure and changes in net financial worth.* In the 2009 Update relativities, there was no practical recognition of these effects² but under the 2010 Review methods we recognised the effects of State circumstances, including population growth, on State investment on infrastructure required to provide services and their per capita net financial worth. As a result, Queensland, Western Australia and the Northern Territory are assessed as needing to spend more than average, because of above average population growth, assessed service use and cost of services. The other States are assessed as needing to spend less than average on investment because of below average population growth and/or below average assessed use and cost of services. The effects of the above average population growth in Victoria are more than offset by its below average assessed use and cost of services. For South Australia and Tasmania, above average assessed use and cost of services are more than offset by below average population growth. New South Wales and the ACT recorded below average population growth and below average assessed use and cost of services.
 - *The assessment of State capacity to raise land revenue.* We used data on the value of land provided by State Revenue Offices rather than Valuers-General because it better recognised both the way States aggregate the land held by individual owners and the principles used in taxation of residential land. Use of these data also meant the allowances for the interaction between progressive tax rates and interstate differences in the value distribution of land covered all taxable land instead of just commercial and industrial land as in the 2009 Update. However, because of concerns about the

² The Commission's 2004 Review methods for assessing debt charge expenses took account of the main drivers of the quantity of infrastructure needed to provide the average level of services. However, for the years 2003-04 to 2007-08, those calculations had no effect because the States as a whole earned net interest revenue and their capacities to earn that revenue were assessed on an equal per capita basis.

interstate comparability of the land value data, we discounted the State needs by 25 per cent. These changes reduced the assessed revenue raising capacity of New South Wales, Western Australia and the ACT and increased it for all other States, especially Tasmania, the Northern Territory and South Australia.

- *The assessment of State costs of providing community and other health services.* In this review we have made a broader assessment which explicitly recognises that the States are one of many service providers and the proportion of total services provided by the other providers (the Commonwealth and the private sector) varies across States. We have done this by considering the throughput of the other service providers, rather than just their numbers. This results in the assessed expenses New South Wales needs to incur to provide the average level of services being reduced by the above average provision of services by non-State providers. Assessed expenses for Western Australia and the ACT are increased by a below average non-State provision of services.
- *The assessment of State costs of welfare and housing services.* We have used a broad indicator for assessing costs to States in providing welfare and housing services. We have observed the main income source of users of State welfare and housing services is a Commonwealth pension or benefit, and Indigenous people are heavy users of these services. We therefore used the number of Commonwealth benefit recipients in each State as the principal driver of State costs. States with an above average proportion of Commonwealth beneficiaries, such as South Australia and Tasmania, are assessed as having above average expenses. The Northern Territory, which has a high proportion of Indigenous people in its population, also incurs above average expenses. States with a below average proportion of Commonwealth beneficiaries, such as Western Australia and the ACT, are assessed as having below average costs.
- *The assessment of State costs of services to communities.* This category covers State expenses on subsidising water, sanitation, electricity and gas services, the provision of environmental protection services, and other services to communities. The assessments have been substantially simplified, largely because of the absence of reliable data to identify and measure the drivers of State expenses, especially those for subsidies given to water and sanitation service providers. The assessment of water service subsidies allows only for differences between the States in the proportion of their population living in small communities that are not in highly accessible regions but which have poor water. We no longer treat Indigenous communities differently from non-Indigenous communities because it was not clear that different subsidies would be paid to them under the average policy. Nor do we explicitly recognise any effects of poor water quality on the level of subsidies paid by States. These changes reduced the assessed expenses of the Northern Territory, Tasmania, Western Australia and South Australia.
- *The assessment of State costs of providing justice services.* In this review, changes in the methods and data used to measure the use of police services by Indigenous people

indicated those effects were greater than previously assessed. We have also recognised that people from a low socio-economic background use justice services more intensely than others. On the other hand, we no longer allow for any effects of people from culturally and linguistically diverse backgrounds or big cities because it was not clear that they materially affected State expenses. Finally, recent data indicate there was no net provision of justice services by the ACT to residents of New South Wales. Taken together, these changes reduced the assessed expenses of New South Wales, Victoria and the ACT and increased them for the other States.

- *The assessment of State costs of providing roads.* We simplified the assessment method by focussing on the primary drivers of the roads task — length and use. We constructed the assessment using only data and methods that met the more stringent reliability criteria for this review. We considered other disabilities such as physical environment and bridges and tunnels but decided not to assess them because we could not do so reliably.
- 19 Part of the changes identified for each State service arises because of the changes we made in the methods used to measure the effects of location on State costs. We made major changes in the way we measured the differences in interstate freight and travel costs and the effects of differences in regional settlement patterns on expenses. The changes noticeably reduced the effects of those influences compared with the 2004 Review methods. They reduced the assessed GST distribution for the Northern Territory and Western Australia and increased those for Victoria and South Australia.

Changes in State circumstances

- 20 These are the effects of accounting for the most recent economic and demographic circumstances of the States. More specifically, they are the effects of including data for 2008-09 and omitting data for 2005-06 from relativities calculated using the 2010 Review methods.
- 21 Table 8-4 shows the most important changes included:
- changes in State revenue raising capacities in 2008-09 compared to 2005-06, especially for mining revenue, stamp duty on conveyances and payroll tax;
 - changes in the net investment States need to make to have the infrastructure required to provide the average level of services;
 - changes in factors affecting the cost of services, especially changes in relative wage levels; and
 - changes in the per capita revenue received from National SPPs and NPPs.

Table 8-4 Effect of major changes in State circumstances on the GST distribution

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Revenue raising capacities									
Payroll tax	54.7	37.2	15.5	-109.9	16.0	1.5	-13.0	-2.1	125.0
Stamp duty on conveyances	-1.3	-158.4	52.4	215.4	-64.0	-16.3	-11.0	-16.8	267.8
Mining revenue	166.9	290.6	-314.6	-268.2	83.1	30.3	20.6	-8.7	591.5
All other revenue	170.6	15.6	-96.7	-124.2	27.1	5.4	1.2	1.0	220.9
Total revenue	390.9	185.1	-343.4	-286.9	62.2	20.9	-2.2	-26.6	659.2
Cost of providing services									
Schools education	4.6	-65.2	16.2	20.1	8.8	4.8	-7.8	18.5	73.0
Admitted patients	-1.3	-32.5	-8.4	12.3	16.8	4.7	-6.9	15.5	49.2
Community and other health services	-30.8	-20.4	9.8	33.3	-6.6	2.6	1.5	10.5	57.8
Welfare and housing	-0.5	-78.5	10.7	-14.4	4.9	4.8	-7.8	80.9	101.3
All other expenses	-49.9	-18.9	0.1	42.1	-2.2	-8.3	4.4	32.9	79.4
Total expenses	-77.9	-215.6	28.4	93.3	21.6	8.6	-16.6	158.4	310.2
Investment	60.7	-134.0	70.1	55.1	-16.1	-11.2	-15.7	-8.8	185.8
Net lending	2.0	4.4	-19.6	24.6	-6.3	-2.6	-0.4	-2.2	31.1
Revenue from other									
Commonwealth payments	23.5	231.0	-245.4	54.9	-29.7	-1.4	25.4	-58.4	334.8
Total effect of changes in circumstances	399.5	72.1	-510.4	-60.2	32.2	14.4	-9.5	61.8	580.0

Note The table is based on the 2009-10 GST revenue of \$42 300.0 million and December 2009 populations.

The redistribution is the sum of the positive (or the negative) items in the row.

Source: Commission calculations.

- 22 *Mining revenue.* Between 2005-06 and 2008-09, mining revenue has become a more important source of State own-source revenue. Total mining revenue raised by all States increased from \$197 per capita in 2005-06 to \$383 per capita in 2008-09 (a 95 per cent increase). It rose from 5.2 per cent of State own-source revenue in 2005-06 to 9.5 per cent in 2008-09. This substantial increase in revenue from mining amplifies the effects of the very large differences between States in the per capita value of mining production on the assessed GST distribution. The GST distribution of Western Australia, Queensland and the Northern Territory were all reduced. Details of the changes in mining royalties and the value of mining production are in Chapter 8 of Volume 2.
- 23 *Stamp duty on conveyances.* The level of real estate market activity fell in most States in 2008-09 which reduced the average revenue from about \$516 per capita in 2005-06 to \$431 per capita in 2008-09 (or from 13.6 per cent of State own source revenue in 2005-06 to 10.7 per cent in 2008-09, although it reached 16.2 per cent of State revenue in 2007-08). However, the reductions in market activity and revenue were well above average in Western Australia (its revenue fell from \$935 per capita in 2005-06 to \$457 per capita in 2008-09)

above average in Queensland and just above average in New South Wales. These changes greatly reduced the relative revenue raising capacity of Western Australia, with smaller reductions in Queensland and New South Wales, and dampened the effect of the interstate differences in revenue raising capacity on the GST distribution.

- 24 *Payroll taxation.* The value of taxable payrolls increased at above average rates in Western Australia, the ACT and the Northern Territory between 2005-06 and 2008-09 leading to reductions in their assessed GST distribution.
- 25 *Net investment.* The Investment and Net lending assessments are new, and the changes for these in Table 8-4 are therefore notional, reflecting changing circumstances as if the assessments had applied in previous years.
- 26 Population growth is relatively stronger in New South Wales, Victoria and Western Australia compared with four years ago. These changes resulted in an increase in GST shares for these States and a reduction for the others. For New South Wales, this result was strengthened by an increase in the assessed quantity of infrastructure required because of increases in the use of services in the State compared with the average. For Victoria, it was offset by a significant fall in the assessed quantity of infrastructure required. Western Australia's assessed infrastructure requirements declined slightly, partly offsetting the effects of population growth. South Australia and Tasmania recorded increases in the assessed quantity of infrastructure they required, which partly offset the impact of their lower relative population growth. The ACT and the Northern Territory experienced a fall in relative infrastructure requirements, which reduced their assessed GST shares.
- 27 *Schools education.* In 2008-09, States moved to increase the age of compulsory schooling to include 15 year olds. Recognising this in our assessments reduced the share of assessed enrolments in Victoria and the ACT, partly because their proportions of 15 year old students in non-government schools are above average. Relative wage levels in those two States have also fallen since 2005-06. This reduced their assessed GST shares and increased them for the other States.
- 28 *Admitted patients.* State spending on admitted patient services has increased rapidly and continues to grow at a faster rate than the GST revenue. GST has been redistributed to the States whose assessed expenses are above average, namely New South Wales, South Australia, Tasmania and the Northern Territory. However, in New South Wales these effects were more than offset by a decline in its relative wage levels. Relative wage levels in Western Australia increased, increasing its assessed costs.
- 29 *Community health.* The proportion of community and other health expenses attributed to Indigenous people increased, increasing the costs for States with an above average proportion of Indigenous people, such as Western Australia and the Northern Territory. Assessed costs fell for States with a below average proportion of Indigenous people, such as Victoria. The provision of non-State services grew at an above average rate in New South Wales, reducing

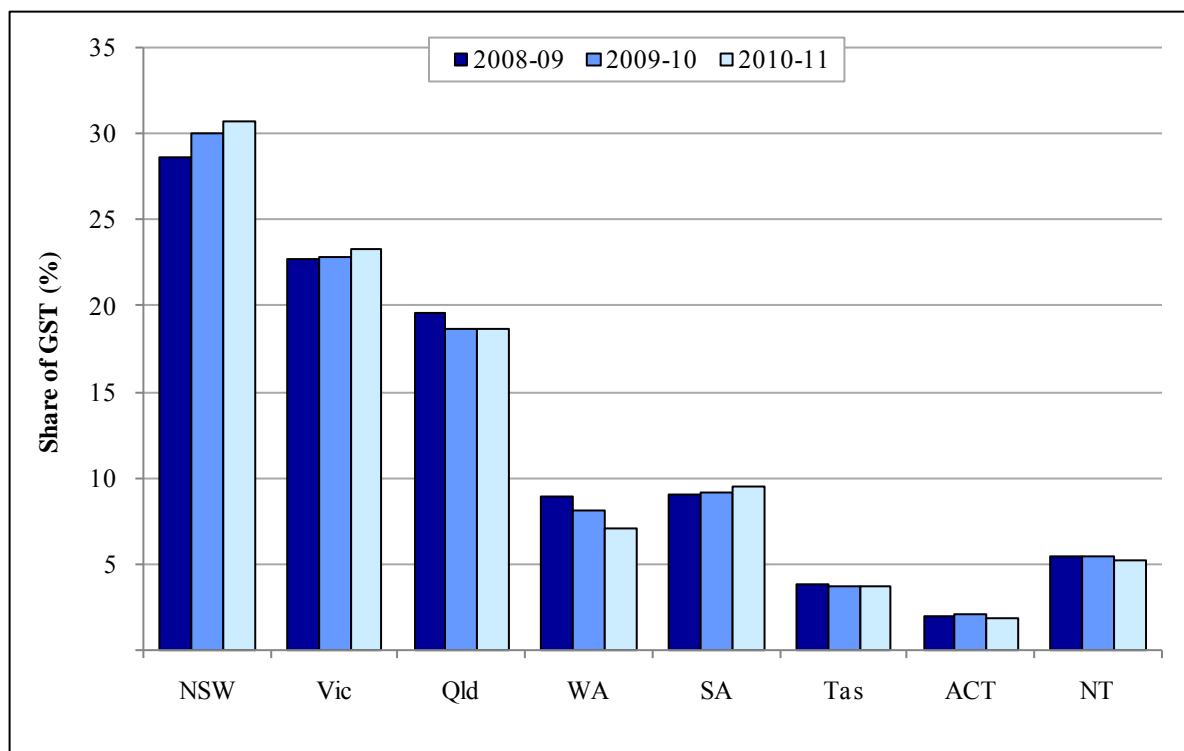
the State's assessed costs, while they grew at a below average rate in Queensland, increasing the proportion of services provided by the State and its associated costs.

- 30 *Welfare and housing.* The costs of providing services to Indigenous people increased between 2005-06 and 2008-09, increasing the assessed costs for States with an above average proportion of Indigenous people, such as the Northern Territory, and reducing assessed costs for States with a below average proportion of Indigenous people, such as Victoria. For Western Australia, this effect was more than offset by the decrease in the proportion of its population on Commonwealth benefits, reducing its assessed relative costs of providing services. Finally, an increase in the average expenses on welfare and housing services between 2005-06 and 2008-09 amplified the effects of the disabilities, most noticeably the comparatively low disabilities of Victoria and the very high disabilities of the Northern Territory.
- 31 *Revenue from National specific purpose payments and National partnership payments.* Between 2005-06 and 2008-09, there were changes in the interstate distribution of some Commonwealth SPPs (especially payments for road construction and remote Indigenous housing), which had repercussions on the GST distribution. In particular, Queensland received an above average increase in these payments which led to a reduction in its assessed GST distribution, while the opposite applied in Victoria's case. The Northern Territory also received an above average increase in the payment for remote Indigenous housing, offsetting some of its assessed expenses in the Welfare and housing category.
- 32 *Further details.* More information on the changes arising from the assessments for individual categories, including the per capita effects, are in Chapter 5 of Volume 3.

RECENT CHANGES

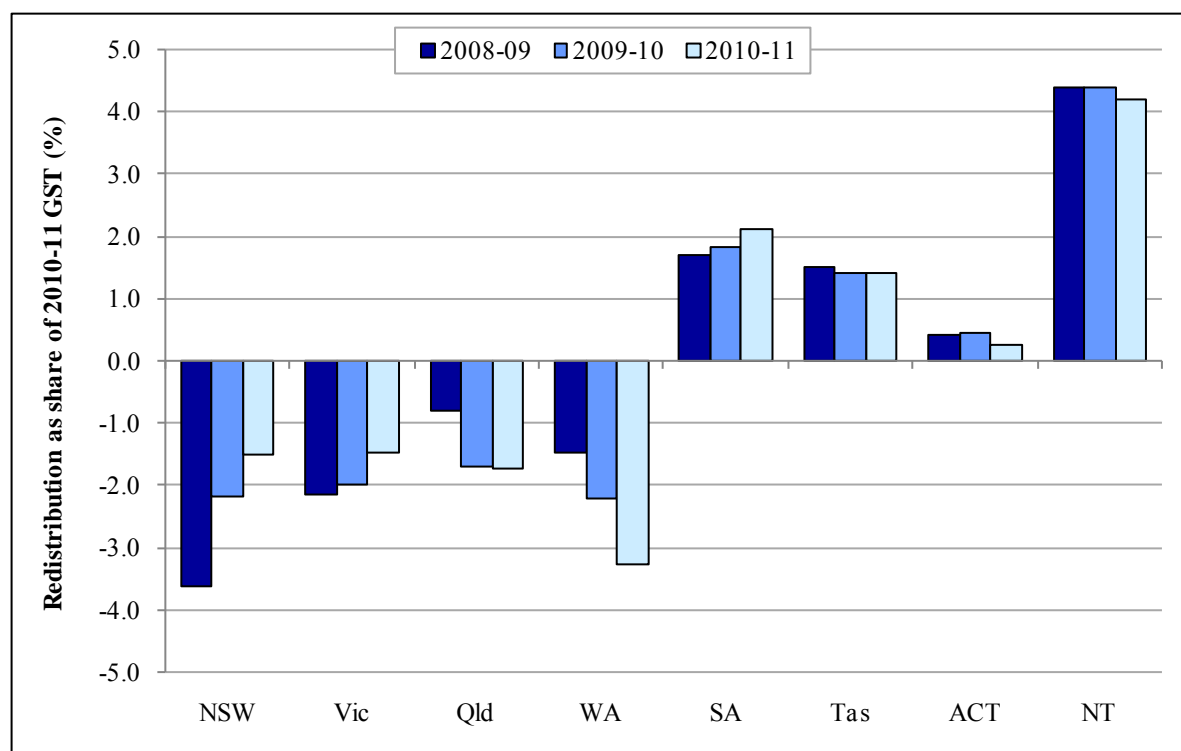
- 33 Figure 8-1 shows how each State's share of the GST revenue is expected to change over the three years 2008-09 to 2010-11 as a result of the Commission's assessment of their relative fiscal capacities³. It shows New South Wales, Victoria and South Australia are expected to experience steadily growing shares, while those of Queensland and Western Australia are expected to decline. Tasmania's share is expected to remain relatively steady. The shares of the ACT and the Northern Territory are expected to fall in 2010-11.
- 34 There has been a small decline in the proportion of the GST revenue required to achieve equalisation between 2009-10 and 2010-11. In 2009-10, 8.1 per cent of the GST revenue was redistributed from New South Wales, Victoria, Queensland and Western Australia to the other States, especially the Northern Territory, to achieve equalisation. Under the recommended distribution for 2010-11, that proportion is 8.0 per cent.

³ To remove the effect of the changing shares of the Australian population, the shares for each year have been calculated on the basis of estimated State populations in December 2010.

Figure 8-1 Share of GST revenue received by each State, 2008-09 to 2010-11

Source: Commission calculations.

- 35 While the proportion of the GST revenue required to achieve equalisation has not changed greatly, the recent changes in the economic conditions of the States have produced substantial changes in the way it is spread across the States. In 2009-10, 4.2 per cent of the GST revenue was distributed away from New South Wales and Victoria but under the recommended distribution for 2010-11 that proportion has fallen to 3.0 per cent. On the other hand, 3.9 per cent was redistributed from Queensland and Western Australia in 2009-10 but the proportion has risen to 5.0 per cent under the recommended 2010-11 distribution. These changes are shown in Figure 8-2.
- 36 Table 8-5 shows how the per capita State relativities underlying the GST distribution have changed. The declining relativities of Queensland and Western Australia reflect their strengthening of the fiscal capacities arising from their increasing capacities to raise revenue from their own taxes.

Figure 8-2 Proportion of total GST revenue redistributed, 2008-09 to 2010-11

Note: The amounts shown for each State are the difference between its assessed distribution and the EPC distribution of the GST revenue for the year, expressed as a proportion of the total GST revenue.

Source: Commission calculations.

Table 8-5 Relativities from 2008 and 2009 Updates and 2010 Review

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
2008 Update	0.88779	0.91393	0.96118	0.85782	1.23151	1.66332	1.25457	5.25633
2009 Update	0.93186	0.91875	0.91556	0.78485	1.24724	1.62040	1.27051	5.25073
2010 Review	0.95205	0.93995	0.91322	0.68298	1.28497	1.62091	1.15295	5.07383

Note: The 2008 Update relativities have been re-calculated on the basis of GST revenue only.

Source: Commission analysis.

CHAPTER 9

QUALITY ASSURANCE OF 2010 REVIEW PROCESSES

- 1 The terms of reference ask the Commission to address issues relating to quality and fitness for purpose of data used in its assessments and to consider improving its quality assurance (QA) processes. This chapter sets out what we have achieved and our plans for continued improvements.
- 2 The Commission's QA processes aim to ensure:
 - assessment methods are:
 - conceptually sound;
 - based on robust data and consistently applied principles;
 - correctly implemented in the calculation of recommended relativities; and
 - stakeholders have a high level of confidence in our results.
- 3 The major strategies implemented during the 2010 Review are listed in Box 9-1.

Box 9-1 Quality assurance strategies for 2010 Review

- Introduce assessment guidelines to guide the Commission's decision making processes.
- Establish a data working party to monitor and improve the data used by the Commission.
- Develop a QA Strategic Plan to improve consistency in application of the Commission's decisions.
- Improve Commission work programs and work with States on consultative processes and new issues.
- Engage independent consultants to provide additional research or to quality assure methods and data used in major assessments.
- Engage external auditors to quality assure annual assessment calculations and staff compliance with QA processes.
- Establish a QA section to develop, implement and monitor QA processes.
- Improve documentation and reporting to enhance transparency.

QUALITY ASSURANCE STRATEGIC PLAN

- 4 During 2005, we engaged an external consultant to undertake a comprehensive examination of our workflow and quality assurance processes and identify gaps in the processes. That work showed our existing processes were sound and reasonably comprehensive.
- 5 Nevertheless, given the requirement of the terms of reference to undertake a program of continuous improvement of assessments and to consider improving quality assurance processes, we saw a need to formally address issues of quality assurance. We developed a Quality Assurance Strategic Plan and engaged independent experts to review it against best practice criteria. They found it ‘sets a high level quality approach that will provide an adequate level of assurance’. The plan was published on the Commission’s website in 2006.
- 6 The plan’s broad objective is to improve the consistency of our decision making and ensure our decisions are implemented in a reliable, accurate and transparent manner. It is based on five broad strategies involving:
 - improvements in data quality;
 - a greater use of external expertise;
 - an improved process for identifying issues — so States could better plan their workloads;
 - external audits of calculations and enhanced checking processes; and
 - improved documentation and reporting.

Improving data quality

- 7 The Commission’s calculations require large amounts of information on:
 - State revenues, expenses, capital expenditure and net lending;
 - revenue bases and tax policies for each State;
 - the use of services across Australia as a whole, sub-divided to show service use by certain groups in the population;
 - the Australian average cost of providing a unit of service to each population group; and
 - the circumstances of each State, especially details of the population and other potential service users¹, which should be consistent with data on service use.
- 8 Systematically and transparently ensuring data are of good quality and used appropriately is made difficult by the disparate sources of the data and their sheer volume. To help devise ways to improve the quality of data used in assessments, we established a data working party comprising representatives of State Treasuries, the ABS and Commission staff.
- 9 The working party recommended ways of improving data quality and reliability, including:

¹ There are also data on other variables that reflect the number of services provided, such as the number of primary industry businesses, road lengths, numbers of pensioners.

- introducing a protocol to help improve data provided by States; and
 - a schedule for examining specific datasets where there were concerns about their reliability.
- 10 We accepted the working party's recommendations, including the data request protocol. That protocol was implemented in the 2007 Update and modified for subsequent updates, following feedback from data providers and Commission staff.
- 11 Other steps taken to ensure data were of good quality and used consistently with that quality included:
- the development and application of guidelines for testing whether data were of suitable quality and were used appropriately;
 - examinations of the quality of datasets that have major effects on the GST distribution and which raised serious concerns for the States or the Commission; and
 - discounting disabilities that we were convinced should be assessed to achieve equalisation but where we had unresolved concerns about the quality of the data used to measure them — the greater our concerns the greater the discount applied.
- 12 More generally, data quality has been improved by the iterative procedures adopted for developing assessments. Under those processes, the States were given opportunities to consider and comment on all methods and data we considered using in our assessments.
- 13 An important part of ensuring data were reliable and comparable across States was to source them from national collections wherever possible because those collections were subject to their own quality assurance processes. Consequently, much of the data we used were obtained from the ABS, the Australian Institute of Health and Welfare, the National Centre for Vocational Education Research, Centrelink, and the Australian Prudential Regulation Authority.
- 14 *Data on State revenues, expenses, capital expenditure and net lending.* Data on State finances were obtained from the ABS GFS collection, except that data for 2008-09 were obtained from the States because the ABS could not provide them in time for inclusion in our analysis.
- 15 The ABS advised Heads of Treasuries that the quality of GFS data had improved since the introduction of accrual accounting and those data were generally fit for the Commission's purposes. However, it was concerned about the reliability of some of the detailed 4-digit Government Purpose Classification data used in the 2004 Review. The ABS has also advised us that the data used in the Infrastructure and Net lending assessments (expenditure on non-financial assets, net lending and relevant balance sheet items) are reliable and fit for our purposes.
- 16 Consistent with the requirement in the terms of reference to consider 'reducing the reliance on the use of 4-digit GFS data', our top down approach has produced broader, more aggregated categories of State services which has greatly reduced the need for those data. While some

adjustments to the GFS data are required to improve interstate comparability and to make the purpose classifications better align with our requirements², they are based on reliable data.

- 17 Overall, we are confident the financial data used in this review are fit for our purposes.
- 18 *Data on revenue bases and tax policies.* As far as possible, details of the revenue bases in each State have been obtained from national collections. For example: payroll tax bases were measured using ABS data on compensation of employees, private sector wages and salaries and public sector gross earnings; mining revenue bases were measured using ABS data on the value of mining production; and the insurance tax revenue base was measured using data on insurance premiums obtained from the Australian Prudential Regulation Authority.
- 19 However, for stamp duty on conveyances, land taxes and stamp duty on motor vehicle registrations and transfers we had to collect data from each State because they were not available from national collections. In these cases, we followed the data protocols agreed with the States. Data received from the States were subject to comparability checks and, if necessary, adjusted to improve comparability.
- 20 Together with the States, the ABS or external experts, we specifically examined the fitness for purpose and interstate comparability of data on:
- the value of mining production;
 - the value of conveyances in each State; and
 - the value of land in each State.
- 21 Each of those reviews concluded the data were fit for our purposes, collected using reasonable processes and sufficiently comparable across States and over time. However, it was noted land value data were allocated to value ranges on the basis of the value of individual parcels of land which did not reflect the way land tax was imposed. Alternative data were subsequently obtained from the States with value ranges based on the approach generally used in applying the tax — the value of a land owner's total holdings. However, we had concerns about the comparability of those data and discounted the disabilities derived from them by 50 per cent.
- 22 *Data on service use.* Estimating service use in each State on a policy neutral basis required information on the average use of services by people in relevant population groups across Australia and matching data on the population of each State. Every effort was made to obtain those data from national collections. For example:
- the AIHW's national hospital morbidity data base identifies the extent to which hospital expenses are affected by patient characteristics (such as age, Indigenous background, place of residence) and the treatment received;
 - the AIHW, Centrelink and other relevant Australian Government agencies together collect data on the users of the main types of welfare and housing services;
 - the ABS Schools collection provides data on school enrolments; and

² For example, we need to separate subsidies for urban bus services from road expenses.

- the NCVER collects data on the use of training services by people in the working age groups sub-divided by Indigenous status, English fluency and where they live.
- 23 In some cases where there were no comprehensive national data collections, the results of national surveys were used. For example, the overall use of non-admitted patient services was derived using data from the ABS National Health Survey.
- 24 In a few cases, such as custody data obtained from the Australian Institute of Criminology's National Police Custody Survey, we had concerns about whether they fully reflected the different levels of resources devoted to different groups of users, so we discounted the disabilities derived from them.
- 25 Given the open, iterative processes used in determining the indicators of service use, we are confident the ones we have used are fit for our purposes and measure the intended influences. We are also satisfied the data are reliable and of good quality.
- 26 *Data on service costs.* Details of the average costs of providing a given service to different groups of users were more difficult to obtain. Some, such as the details of hospital costs, were obtained from national data and were of high quality. In other cases, the data came from:
- the States, which provided data on matters such as;
 - the additional costs attributable to Indigenous, low SES and low English fluency students in schools;
 - the additional costs attributable to Indigenous, low English fluency students and students living in remote areas in post-secondary education facilities;
 - the cost to them of students in non-government schools compared to those in government schools;
 - the different levels of public transport subsidies paid in urban centres of various sizes; and
 - the costs associated with public housing occupied by Indigenous tenants;
 - the National Transport Commission, whose work identified the effects of road use on costs; and
 - the AIHW, whose collections contained details of extra expenses incurred in providing health services to Indigenous people and in remote areas.
- 27 While the States' financial processes often do not support a ready identification of the separate expenses required for precise cost weights or the expenses attributable to specific regions, they have made their best efforts to provide appropriate data but this often required judgment on their part. Nevertheless, given the materiality of the issues and the spread of States that provided data, we have accepted the data as the best available.
- 28 *Conclusion.* Overall, we are satisfied action taken during the review has resulted in the vast majority of assessments being based on data that are reliable and fit for the purpose. Where

we considered allowances were necessary to achieve equalisation but had concerns about the quality of the data, the results have been discounted consistently with our level of concern.

More rigorous assessment guidelines

- 29 The assessment guidelines developed for this review (see Chapters 3 and 5) were designed to help the pursuit of simplicity and to add rigour and consistency to our decision making processes. As such, they are a key part of the quality assurance process.

Greater use of external expertise

- 30 The Commission has engaged external expertise to improve the development of assessments and provide States with a level of assurance that those processes are rigorous and are implemented accurately. A list of the consultants engaged is in Chapter 2. The reports of the consultants, except for confidential material, are published on the Commission's web site.

A process for identifying issues

- 31 Some States argued earlier identification of issues would provide them with an opportunity to better plan their input and workloads.
- 32 Our open and iterative approach to the review was intended to ensure the States have timely opportunities to contribute to the development of the overall work plan and to individual assessments. Our approach has provided for consultation through written papers and submissions and meetings between the Commission and Heads of Treasuries, the Commission and officials in each State, and Commission staff and State officials. Commission papers and State submissions produced through this process are on the Commission's website.

External audits of calculations and compliance with quality assurance processes

- 33 To provide greater assurance about its calculations, we commenced an annual program of engaging external auditors to check samples of calculations and staff compliance with quality assurance checking processes. These audits were in addition to internal checking processes completed by Commission staff. External audits of calculations, covering about 20 per cent of assessments, have been undertaken each year since 2006. In 2009, former Commission staff were engaged to audit calculations of all revenue and expense assessments. Those auditors brought skills and techniques to the audit, which complemented earlier audits and strengthened quality assurance processes.
- 34 The audits found the quality assurance of the assessment system and work processes were at a high standard. Recommended improvements in work processes have been included in the 2010 Review work program. For example, Commission staff redesigned the internal checking processes to add extra checks, such as the re-creation of a sample of calculations each year to provide further verification of the results of the official calculations.

External audit of consistency in use of the assessment guidelines

- 35 To verify that we applied the assessment guidelines in reaching decisions on assessment methods and we did so consistently, we conducted a comprehensive internal review in late 2009. We also engaged a consultant to examine a sample of issues raised during the review and advise whether we had followed due process in reaching our decisions.
- 36 The consultant concluded the Commission has followed due process in relation to all of the decisions and assessments examined in this audit. His conclusions are summarised below and his report is available on our website.
- All relevant issues were addressed.
 - The assessment guidelines were used to inform Commission decisions. Materiality guidelines were followed.
 - Adequate research was undertaken.
 - Adequate expertise was used. In the areas he examined, the Commission used external consultants and/or expertise in Roads, Location, Urbanisation and Stamp duty on conveyances.
 - Methods have generally used reliable and accurate data sources. Where the data are less robust, the Commission has used discounting to reflect its perception of the degree of risk.
 - Methods were not overly complex, given what they have to achieve. There has been considerable simplification since the last review. The extent of the simplification is described in the documents he examined.
 - States were provided with many opportunities to present their views throughout the review process by means of working parties, discussions with Heads of Treasuries and submissions on staff and Commission papers. States were given an opportunity to influence the final decision of the Commission.
 - Documentation in the Commission papers provides a clear indication of Commission views and a justification of the decisions made.
- 37 However, the consultant suggested we better justify some decisions in the final report and raised some issues relating to specific assessments. We have attended to those matters. For example:
- *Discounting.* The consultant was concerned about the size and number of different discounts used. He also noted the need for clearer justification for discounting. We have addressed his concerns in Chapter 5 on Major assessment issues, and in the relevant chapters in Volume 2.
 - *Stamp duty on conveyances.* The consultant suggested we increase the disaggregation by value range used in the assessment. We have dissected data into value ranges of approximately \$100 000. Details are provided in the Stamp duty on conveyances chapter in Volume 2.

- *Welfare and housing.* While concluding that the assessment approach was conceptually rigorous and the Commission had used the data available consistent with their quality, the consultant was concerned about the lack of data available on the characteristics of State welfare users in some areas.

IT audits

- 38 In 2009 we conducted an internal audit of the Commission's assessment system, particularly the IT code used to generate the user interface and control the flow of data to and from the Commission's database. The audit confirmed the assessment system was a robust data manipulation application. Further work to improve the interface design was recommended.
- 39 We also conducted an external audit of the IT assessment system design, the control of the flow of data and the appropriateness of its interface features. The audit report confirmed the assessment system, measured against ten criteria, aligned with the objectives of the Commission.
- 40 Recommended improvements in the assessment system and procedures have been included in the staff work program.

Improved documentation and reporting

- 41 We have also sought to improve documentation to make methods and decision making processes more transparent and to provide a simpler explanation of outcomes.

A CASE STUDY ON QUALITY ASSURANCE IMPROVEMENTS

- 42 Box 9-2 provides an example of the practical outcomes of QA improvements made in the Stamp duty on conveyances assessment.

CONCLUSIONS

- 43 In this review, we have sought to produce fewer, simpler assessments that are consistent with the principle of fiscal equalisation.
- 44 We have sought to do that through quality assured processes at all levels of our operation with the aims of improving the transparency of our work processes, decisions, judgments and reporting, and providing a greater assurance to the Australian and State Governments that:
- our methods and calculation of relativities are robust;
 - the assessment system and calculations are accurate and produce the intended results;
 - data are used appropriately; and
 - the assessment guidelines have been adhered to, resulting in improved transparency in decision making and consistency in the use of judgment.

Box 9-2 QA improvements made to the Stamp duty on conveyances assessment

STAMP DUTY ON CONVEYANCES

Exempt transactions

During 2006, the Commission examined the comparability of the State-provided data used in the assessment.

The revenue base is measured using data provided by each State on the value of transactions that are liable for stamp duty, with those data sub-divided into a number of value ranges. For each value range, States provided data on the number and total value of transactions and the revenue collected.

A number of quality checks were applied to the data, such as testing whether the average duty raised per transaction in each value range was consistent with that implied by the legislated tax rates. In some cases, the duty raised was much less than expected, which implied data on the value or number transactions may be unreliable.

Those concerns were raised with the States. That process generally resolved the concerns, but it also identified the treatment of exempt transactions as an area requiring more attention.

Prior to the 2007 Update, the Commission's practice had been to ask the States to *include* all exempt transactions in their data. However, the work during 2006 indicated that some States could not provide data on exempt transactions and the quality of the data provided by the others was questionable.

A further survey indicated that the States generally had a common set of exemptions. The Commission concluded the data would be more reliable if transactions generally exempted by the States were excluded. As a result, since the 2007 Update, States have been asked to remove details of the number and value of exempt transactions from the data they supply to the Commission. All States supported this approach.

Comparability of States' duty legislation

Since the data on the value of transactions in each State are obtained from their tax collection processes, they reflect each State's legislation. While the States have a common approach to most transactions taxed as conveyances, there are differences in some matters, especially the approach to anti-avoidance measures, which can result in material differences in the range of properties subject to duty. Under the 2004 Review method, the Commission adjusted the data of various States to improve the comparability of the data.

Since the 2004 Review, a number of States have amended their legislation. The Commission engaged a consultant to identify material differences between States in the type of property subject to duty and that advice was given to States for their comment.

The consultant identified seven potential areas of differences in States' legislation. The Commission considered that five of these differences could be material. Details of why the five adjustments were accepted and the others rejected are in the Stamp duty on conveyances chapter in Volume 2. The consultant's report is available on the Commission's web site.

In both cases, quality assurance testing, together with input from the States and external experts have resulted in improved interstate comparability of the data and more reliable and robust assessments.

ATTACHMENT A

ASSESSMENT GUIDELINES

INTRODUCTION

- 1 In response to calls to clarify and strengthen the Commission's decision making process in this review, we developed interim assessment guidelines. We developed them in consultation with the Australian and State Treasuries and they were first published in the *Progress Report to Ministerial Council for Commonwealth-State Financial Relations, 2006*. Since then, a number of additions and amendments have been made.
- 2 The guidelines are forward looking and have provided structure, rigor and transparency to the process of making assessments. They did this by:
 - defining the sequence of decisions;
 - specifying what information is needed at each step;
 - establishing the quality of the information the Commission requires; and
 - providing guidance on how to modify assessments, depending on the quality of the information on which they are based.
- 3 We consider that the guidelines have assisted in:
 - achieving consistent and appropriate standards in the assessment of disabilities and the development of categories, consistent with the principles of fiscal equalisation; and
 - doing this in the simplest, most transparent way possible, leading to assessments with fewer moving parts.
- 4 In operation, the guidelines set a clear hurdle for both individual disability assessments and expense or revenue category assessments to pass before they are included in the calculation of relativities. We decided not to index the materiality thresholds set at the start of this review, although they could be indexed in the future, if required.
- 5 The guidelines have also formed a key part of the quality assurance process. They have allowed us to be confident that all relevant information has been used in making decisions.

They have also allowed external parties to follow the decision processes used by the Commission and to form conclusions about whether due process has been observed.

- 6 We planned to follow an iterative process in building and finalising our assessments. We planned:
 - to apply prospective materiality thresholds to make preliminary decisions about category structures and disabilities using historical information;
 - to build the assessments using data relating to the assessment period for the review;
 - to confirm the reliability of methods, including through the use of external reviews of important assessments; and
 - to confirm the materiality of all its category and disabilities assessments at the conclusion.
- 7 The final assessment guidelines we used to decide on the category structure for the assessments and how each assessment would be made for this review are set out in Box A-1.

Box A-1 Assessment guidelines for 2010 Review

STRUCTURE GUIDELINES

- 1 The Commission proposes to structure expense and revenue categories starting with large aggregates and disaggregating only where that is expected to improve the equalisation outcome.
- 2 A function (expense or revenue item) will be considered for separate category assessment, if:
 - the service provided or revenue source is clearly a major State service or revenue source distinct from others;
 - it is affected by disabilities that are markedly different from those of other categories;
 - data used to estimate the average expense or revenue are satisfactory;
 - it is expected that satisfactory assessments of disabilities can be made; and
 - the category is expected to be material, which is defined as:
 - the average expense or revenue is greater than \$50 per capita; or
 - the assessment is likely to redistribute more than \$30 per capita for any State.

ASSESSMENT GUIDELINES

- 3 The Commission organises its work by making assessments for individual categories.
- 4 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); and
 - 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; and
 - of suitable quality — the collection process and sampling techniques are appropriate, the data are consistent across the States and over time and are not subject to large revisions.
 - Data will be adjusted where necessary to improve interstate comparability. The Commission will not make data adjustments unless they redistribute more than \$3 per capita for any State.
 - Where a case for including a disability in a category is established but the Commission is unable to make a suitable assessment of its impact, the options are:
 - to discount the impact that has been determined; or
 - to make no assessment.

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; and
- consistency with State circumstances.

When the assessment is to be discounted, a uniform set of discounts is used, with higher discounts being applied when there is less confidence in the outcome of the assessment or more uncertainty attaches to the information. The discounts are:

- 12.5 per cent, if there is not full confidence about the size of an effect because of a low level of uncertainty around the information on which it is based;
- 25 per cent, if there is a medium level of confidence about the size of an effect or a medium level of uncertainty about the information;
- 50 per cent, if an effect on States is known to be large and there is confidence about its direction and but there is limited confidence in the measurement of its size due to a high level of uncertainty in the information; and
- if there is little confidence in the direction of an effect or its size, no differential assessment would be made.

5 The Commission will include the disability in its final assessments if it is material.

- A disability assessment must redistribute more than \$10 per capita for any State in the reference period to be included in the calculation of relativities.
- Where a disability influences more than one revenue or expense category, the materiality test will be applied to the total impact it has on the redistribution of funds.
- The disability may not be assessed in a category, if the amount redistributed in that category is small.

6 A category assessment will be included in the final assessment if:

- the assessment cannot be made simpler without reducing its conceptual rigor and reliability;
- the Commission considers the methods are reliable and has confidence in the results;
- the results are consistent with the real world;
- where used, external review highlights that the approach is reasonable;
- the assessment is robust, that is, it is not unduly sensitive to the change in inputs;
- the average expense or revenue is greater than \$50 per capita or the category redistributes more than \$30 per capita for any State. Categories that do not meet one of these thresholds will either remain part of an aggregated category that has similar, often broader, disabilities or be treated EPC; and
- the effect on the distribution of the GST pool resulting from the use of disaggregated assessments instead of an aggregated assessment exceeds \$30 per capita for any one State. If the combined distributions of disaggregated assessments do not redistribute \$30 per capita more than the aggregated assessment, then the aggregated assessment will be used.

ATTACHMENT B

CALCULATION OF RELATIVITIES

- 1 This attachment shows the calculation of the recommended per capita GST relativities.
- 2 Table B-1, Table B-4 and Table B-7 use accounting identities to show the net lending each State would require in each year if it were to finish the year with the average per capita net financial worth¹, given its starting position. Table B-2, Table B-5 and Table B-8 then show the GST each State would require in the year to achieve that net lending outcome by *adding*:
 - the per capita saving the State would make to give it the average per capita stock of financial assets at the end of the year, assuming it began the year with the then average per capita stock of financial assets (its assessed net lending);
 - the per capita expenses the State would incur if it provided the Australian average level of services given its disabilities (its assessed expenses); and
 - the per capita investment in new infrastructure the State would make if it maintained the average level of infrastructure required to provide the average services given its disabilities that affect capital (its assessed investment);*and subtracting*:
 - the per capita revenues it would raise if it applied the average revenue raising policies to its revenue bases (its assessed revenues); and
 - its per capita revenues from Commonwealth payments.
- 3 The annual relativities are calculated by expressing the per capita GST revenue required by each State to achieve equalisation² (its equalising requirement) as a ratio of the average per capita GST for that year.

¹ After applying the discount.

² This is the amount of the GST that would allow each State to have the average net financial worth per capita, if it provided the average level of services, made the average additions to its stock of associated infrastructure and made the average effort to raise revenue.

- 4 The recommended relativities (the average relativities) are calculated as an average of the three annual relativities (see Table B-10).
- 5 Table B-3, Table B-6 and Table B-9 show an alternative presentation of the derivation of each State's equalising requirement. In these tables, the equalising requirements are calculated as the average per capita GST paid during each year plus the State's:
- per capita expense assessed difference (the State's per capita assessed expenses less the average State per capita expenses);
 - per capita investment assessed difference (the State's per capita assessed investment less the average State per capita investment);
 - per capita net lending assessed difference (the State's per capita assessed net lending less the average State per capita net lending);
 - per capita revenue assessed difference (the average State per capita revenue less the State's per capita assessed revenue); and
 - per capita assessed difference for Commonwealth payments (the average State per capita Commonwealth payments less the State's per capita Commonwealth payments).
- 6 A full description of the distribution model the Commission uses in deriving the relativities is provided in Chapter 29 of Volume 2.

Table B-1 Assessed Net lending, 2006-07

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Net financial worth at end of year (\$pc)									6 030
Net financial worth at end of year (\$m)	41 358	31 179	24 963	12 571	9 506	2 966	2 033	1 280	125 856
<i>less:</i> Net financial worth at start of year (\$m) (a)	41 172	30 852	24 533	12 360	9 460	2 964	2 016	1 264	124 621
Undiscounted net lending (\$m)	186	327	430	212	46	2	16	16	1 235
Net lending (\$m)	241	322	384	190	58	9	17	15	1 235
Net lending (\$pc)	35	62	93	91	37	18	51	71	59

(a) Net financial worth at the start of the year assumes each State had the Australian average per capita net financial worth at that time.

Table B-2 Per capita relativities, 2006-07

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Assessed net lending	35.16	62.22	92.69	90.90	36.73	17.74	50.72	71.49	59.17
<i>plus:</i>									
Assessed expenses	6 894.17	6 585.05	7 084.38	7 381.58	7 117.11	7 579.28	6 886.71	14 324.95	7 012.46
Assessed investment	272.25	289.58	396.04	397.92	238.83	222.80	242.89	628.63	313.11
	7 201.59	6 936.84	7 573.11	7 870.40	7 392.66	7 819.82	7 180.32	15 025.08	7 384.74
<i>less:</i>									
Assessed revenue	4 134.73	3 816.80	4 396.12	5 200.37	3 520.19	3 359.94	3 676.36	3 926.52	4 140.06
Total requirement for assistance	3 066.86	3 120.04	3 176.99	2 670.03	3 872.48	4 459.87	3 503.96	11 098.55	3 244.69
<i>less:</i>									
Revenue assistance from Commonwealth payments	1 350.52	1 309.20	1 352.39	1 345.08	1 425.81	1 322.43	1 236.18	1 975.88	1 349.65
GST requirement	1 716.34	1 810.84	1 824.60	1 324.95	2 446.67	3 137.44	2 267.77	9 122.68	1 895.03
Per capita relativity (a)	0.90571	0.95557	0.96283	0.69917	1.29110	1.65561	1.19669	4.81399	1.00000

Note: Calculated as the per capita amount of net lending each State would require to maintain the average net financial worth in the year, taking account of its relative population growth.

(a) Per capita relativities are equal to each State's GST requirement divided by the average GST.

Table B-3 Per capita relativities, alternative presentation, 2006-07

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Average GST	1 895.03	1 895.03	1 895.03	1 895.03	1 895.03	1 895.03	1 895.03	1 895.03	1 895.03
<i>plus:</i>									
Assessed differences									
Expenses	-118.29	-427.41	71.92	369.12	104.65	566.82	-125.75	7 312.49	0.00
Investment	-40.86	-23.53	82.93	84.81	-74.28	-90.31	-70.22	315.52	0.00
Net lending	-24.01	3.04	33.52	31.73	-22.45	-41.43	-8.45	12.32	0.00
Revenue	5.33	323.26	-256.06	-1 060.31	619.87	780.11	463.69	213.53	0.00
Commonwealth payments	-0.86	40.45	-2.74	4.57	-76.16	27.22	113.47	-626.23	0.00
Total assessed differences	-178.69	-84.20	-70.43	-570.08	551.64	1 242.41	372.74	7 227.64	0.00
GST requirement	1 716.34	1 810.84	1 824.60	1 324.95	2 446.67	3 137.44	2 267.77	9 122.68	1 895.03
Per capita relativity (a)	0.90571	0.95557	0.96283	0.69917	1.29110	1.65561	1.19669	4.81399	1.00000

(a) Per capita relativities are equal to each State's GST requirement divided by the average GST.

Table B-4 Assessed Net lending, 2007-08

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Net financial worth at end of year (\$pc)									6 202
Net financial worth at end of year (\$m)	43 063	32 635	26 312	13 259	9 882	3 072	2 121	1 348	131 694
<i>less:</i> Net financial worth at start of year (\$m) (a)	44 693	33 694	26 976	13 585	10 273	3 205	2 197	1 384	136 005
Undiscounted net lending (\$m)	-1 630	-1 058	-664	-326	-391	-133	-75	-35	-4 311
Net lending (\$m)	-1 575	-1 061	-713	-353	-374	-125	-74	-37	-4 311
Net lending (\$pc)	-227	-202	-168	-165	-235	-251	-215	-172	-203

(a) Net financial worth at the start of the year assumes each State had the Australian average per capita net financial worth at that time.

Table B-5 Per capita relativities, 2007-08

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Assessed net lending	-226.78	-201.60	-168.07	-164.93	-234.69	-251.38	-215.44	-172.20	-203.01
<i>plus:</i>									
Assessed expenses	7276.99	6937.64	7470.27	7908.50	7574.10	8004.66	7183.39	15652.28	7418.61
Assessed investment	336.06	338.38	506.19	528.62	303.16	257.46	226.97	1037.63	391.14
	7386.27	7074.42	7808.39	8272.19	7642.58	8010.74	7194.92	16517.71	7606.74
<i>less:</i>									
Assessed revenue	3994.99	3857.74	4386.68	5378.66	3543.11	3398.39	3724.65	3870.86	4125.10
Total requirement for assistance	3391.27	3216.67	3421.72	2893.52	4099.47	4612.35	3470.27	12646.84	3481.64
<i>less:</i> Revenue assistance from Commonwealth payments	1469.51	1418.95	1532.24	1501.56	1555.19	1527.58	1357.11	2404.26	1488.29
GST requirement	1921.76	1797.72	1889.47	1391.96	2544.27	3084.77	2113.16	10242.59	1993.35
Per capita relativity (a)	0.96409	0.90186	0.94789	0.69830	1.27638	1.54753	1.06010	5.13837	1.00000

Note: Calculated as the per capita amount of net lending each State would require to maintain the average net financial worth in the year, taking account of its relative population growth.

(a) Per capita relativities are equal to each State's GST requirement divided by the average GST.

Table B-6 Per capita relativities, alternative presentation, 2007-08

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Average GST	1993.35	1993.35	1993.35	1993.35	1993.35	1993.35	1993.35	1993.35	1993.35
<i>plus:</i>									
Assessed differences									
Expenses	-141.62	-480.97	51.66	489.89	155.49	586.05	-235.22	8233.66	0.00
Investment	-55.08	-52.76	115.06	137.48	-87.97	-133.68	-164.16	646.50	0.00
Net lending	-23.77	1.40	34.94	38.08	-31.68	-48.37	-12.43	30.81	0.00
Revenue	130.11	267.36	-261.58	-1253.57	581.99	726.71	400.45	254.24	0.00
Commonwealth payments	18.78	69.33	-43.96	-13.27	-66.91	-39.30	131.18	-915.97	0.00
Total assessed differences	-71.59	-195.64	-103.88	-601.39	550.92	1091.41	119.80	8249.23	0.00
GST requirement	1921.76	1797.72	1889.47	1391.96	2544.27	3084.77	2113.16	10242.59	1993.35
Per capita relativity (a)	0.96409	0.90186	0.94789	0.69830	1.27638	1.54753	1.06010	5.13837	1.00000

(a) Per capita relativities are equal to each State's GST requirement divided by the average GST.

Table B-7 Assessed Net lending, 2008-09

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Net financial worth at end of year (\$pc)									5 447.20
Net financial worth at end of year (\$m)	38 355.9	29 223.1	23 692.7	12 005.8	8 780.9	2 725.1	1 894.8	1 207.5	117 885.9
<i>less:</i> Net financial worth at start of year (\$m) (a)	41 969	31 806	25 644	12 923	9 631	2 994	2 068	1 314	128 349
Undiscounted net lending (\$m)	-3 613.6	-2 583.2	-1 951.0	-916.8	-850.3	-269.0	-172.8	-106.6	-10 463.3
Net lending (\$m)	-3 561.3	-2 585.9	-1 989.0	-954.0	-832.6	-262.2	-171.6	-106.8	-10 463.3
Net lending (\$pc)	-505.76	-482.01	-457.29	-432.84	-516.49	-524.13	-493.35	-481.69	-483.48

(a) Net financial worth at the start of the year assumes each State had the Australian average per capita net financial worth at that time.

Table B-8 Per capita relativities, 2008-09

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Assessed net lending	-505.76	-482.01	-457.29	-432.84	-516.49	-524.13	-493.35	-481.69	-483.48
<i>plus:</i>									
Assessed expenses	7737.16	7398.19	7968.74	8405.27	8048.31	8500.57	7670.26	17249.68	7904.91
Assessed investment	461.34	401.90	633.82	608.59	382.43	352.12	310.81	753.90	488.44
	7692.74	7318.08	8145.26	8581.02	7914.26	8328.57	7487.72	17521.89	7909.86
<i>less:</i>									
Assessed revenue	3843.79	3670.51	4432.89	5437.14	3377.79	3189.23	3522.82	3997.23	4028.07
Total requirement for assistance	3848.95	3647.57	3712.37	3143.88	4536.47	5139.35	3964.90	13524.66	3881.79
<i>less:</i> Revenue assistance from Commonwealth payments	1971.69	1815.86	2134.71	1903.96	2086.16	1980.74	1677.08	3496.22	1978.54
GST requirement	1877.26	1831.71	1577.66	1239.92	2450.30	3158.61	2287.82	10028.44	1903.25
Per capita relativity (a)	0.98635	0.96242	0.82893	0.65148	1.28743	1.65959	1.20206	5.26913	1.00000

Note: Calculated as the per capita amount of net lending each State would require to maintain the average net financial worth in the year, taking account of its relative population growth.

(a) Per capita relativities are equal to each State's GST requirement divided by the average GST.

Table B-9 Per capita relativities, alternative presentation, 2008-09

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Average GST	1903.25	1903.25	1903.25	1903.25	1903.25	1903.25	1903.25	1903.25	1903.25
<i>plus:</i>									
Assessed differences									
Expenses	-167.74	-506.72	63.83	500.37	143.41	595.67	-234.64	9344.78	0.00
Investment	-27.10	-86.54	145.38	120.15	-106.01	-136.32	-177.63	265.46	0.00
Net lending	-22.28	1.48	26.19	50.64	-33.01	-40.64	-9.87	1.79	0.00
Revenue	184.29	357.57	-404.82	-1409.07	650.28	838.85	505.25	30.84	0.00
Commonwealth payments	6.86	162.68	-156.17	74.59	-107.62	-2.20	301.47	-1517.68	0.00
Total assessed differences	-25.98	-71.53	-325.59	-663.33	547.06	1255.36	384.58	8125.19	0.00
GST requirement	1877.26	1831.71	1577.66	1239.92	2450.30	3158.61	2287.82	10028.44	1903.25
Per capita relativity (a)	0.98635	0.96242	0.82893	0.65148	1.28743	1.65959	1.20206	5.26913	1.00000

(a) Per capita relativities are equal to each State's GST requirement divided by the average GST.

Table B-10 Assessed relativities, 2006-07 to 2008-09

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
Per capita relativities									
2006-07	0.90571	0.95557	0.96283	0.69917	1.29110	1.65561	1.19669	4.81399	1.00000
2007-08	0.96409	0.90186	0.94789	0.69830	1.27638	1.54753	1.06010	5.13837	1.00000
2008-09	0.98635	0.96242	0.82893	0.65148	1.28743	1.65959	1.20206	5.26913	1.00000
Assessed relativities (a)	0.95205	0.93995	0.91322	0.68298	1.28497	1.62091	1.15295	5.07383	1.00000

(a) The average of the relativities for each assessment year.

ATTACHMENT C

ILLUSTRATIVE POPULATIONS

- 1 Table C-1 shows the projected State populations as at December 2009 and December 2010 prepared by the ABS. These populations are used in our calculations of the distribution of the GST.

Table C-1 Estimated resident populations, December 2009 and 2010

	31 December 2009		31 December 2010	
	'000	%	'000	%
New South Wales	7 131	32.38	7 215	32.23
Victoria	5 460	24.80	5 551	24.80
Queensland	4 454	20.22	4 555	20.35
Western Australia	2 262	10.27	2 317	10.35
South Australia	1 630	7.40	1 647	7.36
Tasmania	505	2.29	509	2.28
Australian Capital Territory	353	1.60	358	1.60
Northern Territory	226	1.03	231	1.03
Total	22 022	100.00	22 384	100.00

Source: Data used in the Commonwealth of Australia *Mid-Year Economic and Fiscal Outlook 2009-10*..

COMMISSION TERMINOLOGY

- 1 The Commission aims to keep the language it uses as simple as possible to make its reports and other documents more accessible. That said, there will always be a need for special terms to describe some concepts. This attachment provides a list of the main terms that have a meaning that is unique to the Commission.
- 2 Note, the term ‘State(s)’ includes the Australian Capital Territory and the Northern Territory. The term ‘average’ refers to the average of all the States as defined. Where a defined term is used in a definition of another term, it is shown in italics.

TERMS

actual per capita assessment method (APC)

The *assessed expense or revenue* for each *State* is set equal to its actual expense or revenue. It is used when, in the Commission’s judgment, the policies of all *States* are the same and any differences in expenses or revenue per capita are due to differences in *State* circumstances.

adjusted budget

A representation of *State* budgets used by the Commission to calculate the *average* per capita revenue and expenses. The scope of the adjusted budget covers all *State* general government transactions that contribute to the *net lending/borrowing* recorded in the *GFS* operating statement. It excludes direct spending or revenue raised by the Australian Government, local government, State PTEs and non-government bodies. The adjusted budget is dissected into revenue and expense categories. The Australian Bureau of Statistics (ABS) Government Finance Statistics (GFS), supplemented by information collected from the States and other sources, are used to compile the budget.

administrative scale disability

A *disability* that measures differences in costs which *States* incur in providing the minimum level of administration and policy development required to deliver services. It relates to core head office functions and to specialised *State*-wide services provided centrally.

assessed capital requirements ratio

A ratio of a *State's* assessed *capital requirements* per capita to the *Australian average* capital requirement per capita. The assessed capital requirements are what a *State* would have needed to invest or lend/borrow (net) to have the *Australian average* level of capital.

assessed differences (also known as needs)

The financial impact on a *State's* budget of its *disabilities*. They are measured, for example, as the difference between *assessed expenses* and *average expenses*, *average revenue* and *assessed revenue*. Assessed differences can be either positive or negative.

assessed expenses

The expenses a *State* would incur if it were to follow *average* expense policies, allowing for the *disabilities* it faces in providing services, and assuming it provides services at the average level of efficiency. Assessed expenses equal *assessed service use* multiplied by *assessed unit cost*. Assessed expenses exclude differences from the average due to policy choices under the control of a *State*.

assessed GST requirement, or share

A *State's* requirement for funds from *GST revenue*. It is measured as its *assessed expenses*, less its *assessed revenue*, less assessed *Commonwealth payments* plus its *assessed investment* plus *assessed net lending*.

assessed investment

The expenditure on new infrastructure a *State* would incur if it were to follow *average* policies, allowing for disabilities it faces in providing infrastructure, and assuming it requires the average level of infrastructure to deliver the average level of services. Assessed investment excludes differences from the average due to policy choices under the control of that *State*.

assessed net lending

The transaction-based change in net financial worth that a *State* would require to achieve the *average* net financial worth at the end of a year.

assessed revenue

The revenue a *State* would raise if it were to apply the *average* policies to its revenue base, and raised revenue at the average level of efficiency. Assessed revenue excludes differences from the average due to policy choices under the control of that *State*, for example a higher or lower tax rate applied by a *State* compared to the *average*.

assessed service use

The use assessed by the Commission for a *State* to achieve *average* service delivery to its population. Assessed service use can be influenced by many things especially the demographics of the *State's* population (for example, percentage of low income people, percentage in remote communities) and geography (which influences, for example, length of roads).

assessed unit cost (of a service)

The cost per unit of service assessed by the Commission for a *State* to deliver a particular service to a particular segment of the population at the *average* standard (for example, cost per student of *State* primary education). The assessed unit cost can differ for different population groups.

assessment years (period)

The financial years used in a *review* or an *update* to determine *relativities*. The Commission uses data for three financial years. For example, the *2010 Review* recommends the distribution of the *GST* in 2010-11. It uses the average of three annual *relativities* calculated for the most recent completed financial years at the time the *relativities* are released (2006-07 to 2008-09).

average (or Australian average)

The benchmark against which the performance or characteristics of a *State* are assessed. It is an average derived from the policies or financial data of all *States*, and hence may be a financial average or a policy average.

average expenses

The *average* per capita expense, in a *category*, a group of *categories* or in total. It is calculated as the sum of expenses of all *States*, divided by the Australian population.

average revenue

The *average* per capita revenue, in a *category*, a group of *categories* or in total. It is calculated as the sum of *State* revenues, divided by the Australian population.

backcasting

Changes made to figures for past financial years in an *assessment period* to reflect current or future Commonwealth or *State* policies. *Backcasting* is mainly used to reflect major changes in federal financial arrangements. Where required by the Commission's terms of reference, it has also been used to reflect other changes, such as the replacement of one tax with another tax or the abolition of a tax. In effect, backcasting produces notional financial data that simulate a changed distribution of a Commonwealth payment or *State* revenue collection before they may have actually changed. Actual figures for the *assessment period* are adjusted to reflect what is known to be happening in the *application year*.

capital assessments, ratios, or requirements

In this report, the term *capital* refers to the Investment and Net lending assessments.

category

A classification of *State* general government transactions relating to distinct services or revenue sources, used for analytical purposes. In this review, the adjusted budget is divided into Commonwealth payments, six specific revenue categories, thirteen specific expenditure categories and two residual (or other) categories — one for revenue and one for expenditure.

category factor

The combined result of all the *disability factors* in a *category*, or where the *category* is made up of multiple *components*, the combined *disability factors* for all of those *components*.

Commonwealth own-purpose expenses (COPEs)

Commonwealth payments paid to *States* and non-government organisations for the services they supply.

Commonwealth payments

Payments to *States* made by the Australian Government, including general revenue grants, *National specific purpose payments* (SPPs), *National partnership payments* (NPPs) and *Commonwealth own-purpose expenses* (COPEs). The Commission examines the purpose of each payment using established guidelines to decide whether the payment has an impact on *State fiscal capacities*.

component

A part of an expense or revenue *category* that is separated from others in the *category* because different *disability factors* apply to it.

cost of service ratio

A *State's* per capita cost of providing services at *average* standards, relative to the *average* per capita cost. It is calculated by dividing per capita *assessed expenses* by per capita *average* expenses.

cross-border factor

A *disability factor* that measures the net effects on a *State's* costs of the use of its services by residents of other *States* and vice versa.

disability

An influence beyond a *State's* control that requires it:

- to spend more (or less) per capita than the *average* to provide the average level of service; or
- to make a greater (or lesser) effort than the *average* to raise the average amount of revenue per capita.

disability factor

A measure of a *State's* use, cost or revenue raising *disability*, expressed as a ratio of the *State's* use, *assessed cost* or *assessed revenue* over the corresponding *average* figure. Policy differences between *States* are specifically excluded when calculating disability factors. The population weighted average of a disability factor is 1.0.

discounting

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, due to data quality or other difficulties, the Commission may discount the impact by 12.5 percent, 25 per cent or 50 per cent, proportional to the level of uncertainty held.

distribution

State shares of GST as determined by the *relativities*.

distribution model

A formulation, mathematical or otherwise, of the way in which *relativities* are calculated.

equal per capita assessment method (EPC)

Each *State's assessed expense* or *assessed revenue* in a category is set equal to the *Australian average* per capita amount. It is typically used when there are judged to be no material *disabilities* between the *States* and any differences between the *States* in the cost of providing services or raising revenue reflect differences in *State* policies, or no reliable assessments could be developed due to data or other limitations. Such an assessment means that no needs are assessed for any *State* and that there is no impact on the *relativities*.

equalisation

See *horizontal fiscal equalisation*.

expenditure

This term is used to refer to expenses and capital expenditure.

expenses

Operating outlays under an accrual budgeting framework.

expense assessment framework

The general approach used to assess expenses. Under the current framework, an expense *category* is divided into *components*, separate *disability factors* are applied to each *component* and the final *category* assessment is achieved by summing the *component* assessments.

financial averages

The *weighted average* per capita expenses and revenues for each *category* in the *adjusted budget*.

fiscal capacity

The fiscal capacity of a State is a measure of its ability to provide *average* services, including infrastructure, to its population if it raised revenue from its own revenue bases at *average* rates and received its actual *Commonwealth payments*, excluding the GST. Once the GST has been distributed using the Commission's *relativities*, State fiscal capacities should be equal.

The relative capacity of each *State* is a comparison of its fiscal capacity with the *average* capacity. In this review, the Commission has chosen to equalise the *net financial worth* position of *States* in deciding the distribution of the GST.

Goods and Services Tax (GST) revenue / GST pool

The funds made available by the Australian Government for transfer to the *States* as untied financial assistance.

grant design inefficiency

A flaw in a method of assessment which would allow a *State* to influence its *relativity* by changing its expense or revenue policies (apart from any effect of these policies on the *average*).

horizontal fiscal equalisation (equalisation)

A distribution of *GST revenue* to *State* governments such that, after allowing for material factors affecting revenues and expenditures, each would have the *fiscal capacity* to provide services and their associated *infrastructure* at the same standard, if each made the same effort to raise revenue from its own sources, operated at the same level of efficiency and maintained the *average per capita net financial worth*.

impact on relativities (see also *no impact on relativities*)

Treatment applied to a *Commonwealth payment* that provides budget support for *State* services and affects *State fiscal capacity*. The expenses are assessed differentially in relevant *categories* and the revenue is assessed on an *actual per capita (APC)* basis.

infrastructure

Infrastructure refers to the stock of physical assets owned by a *State's* general government sector for the purpose of delivering services. It includes buildings, non-building construction (such as roads) and plant and equipment for economic and social purposes.

investment

Investment refers to acquisition of new *infrastructure*. It is the equivalent to 'net acquisition of non-financial assets' that appears in the Australian Bureau of Statistics Government Finance Statistics (GFS) State operating statement.

interstate location disability

A *disability* that measures the differences between the *States* in the costs per unit of labour and other inputs to services.

joint factor

A *disability factor* in which more than one basis of *disability* is calculated simultaneously. The joint factor approach is most frequently used for the calculation of socio-demographic composition disability factors.

level of capital provision ratio

A ratio that reflects how a *State's* policies on the level of *capital* provided varies from the *average* policies. It is measured by dividing actual per capita expense by *assessed expense* per capita.

level of service ratio

A ratio that reflects how a *State's* policies on the level of services provided and the relative efficiency with which they are provided vary from the *average* policies. It is measured by dividing actual per capita expense by *assessed expense* per capita.

material, materiality test, materiality threshold (see the Assessment Guidelines, Attachment A of Volume 1)

A test used to assist decisions on when a separate *category* of *State* activity or *disability* should be assessed or when data should be adjusted. The materiality levels are defined in terms of the amount of GST redistributed per capita for any *State*. Different thresholds are used for each. An assessment or adjustment is said to be material if it exceeds the threshold set for it.

model

See *distribution model*.

national capital disability

A *disability* that measures the additional costs that the ACT incurs because of Canberra's status as the national capital.

National partnership payments (NPPs)

Commonwealth payments to *States* that support the delivery of specified projects, facilitate reforms, or reward those jurisdictions that deliver on nationally-significant reforms. Some *Specific purpose payments* under the previous federal financial arrangements have become National partnership payments.

native title and land rights disability

A *disability* that measures differences in costs that *States* incur because of the operation of the Australian Government's Native Title Act 1993 or the additional and unique costs that the Northern Territory incurs because of the operation of the Australian Government's *Aboriginal Land Rights (Northern Territory) Act 1976*.

needs

See *assessed differences*.

net financial worth

Net financial worth is the sum of financial assets minus the sum of liabilities.

net lending

The outcome of an operating budget calculated as expenses and expenditure on non-financial assets, change in inventories, etc less *State* own source revenues and revenues received from the Australian Government.

no impact on relativities (previously called exclusion or out of scope)

Treatment applied to a *Commonwealth payment* that does not provide budget support for *State* services. Both the payment and the expenses relating to it have no impact on a *State's fiscal capacity*.

policy neutral assessment

An assessment in which the *policy average* is applied to every *State*. The resultant assessment is therefore unaffected by the policies of individual *States*, other than through the influence of those policies on the *averages*.

policy averages

The *average* policies as reflected in the practices of the *States* in the collection of revenue and the provision of services. These averages are usually weighted according to the size of the user or revenue bases in each *State*.

quarantine

The treatment of a *Commonwealth payment*, and where possible the expense for which it is used, in such a way as to have *no impact on the relativities*. Quarantining always results from instructions given directly to the Commission in its terms of reference and the term is used only in this context.

redistribution

The difference between an *EPC* share of the *GST* and the *distribution* determined by the *relativities*.

regional location disability

A *disability* that measures cost differences within a *State* due to differences in the wages paid and in the price and quantity of other inputs to *State* services.

relativity

A per capita weight assessed by the Commission for use by Treasury in calculating the share of the *GST revenue* a *State* requires to achieve *horizontal fiscal equalisation*.

revenue base

A measure of the transactions, activities, or assets that are taxed by the *States*. Differences between the revenue bases of each *State* are used by the Commission to determine the relative capacities of each to raise a particular type of revenue.

revenue effort

The intensity of use of a revenue base (the implied tax rate) measured as actual revenue divided by the *assessed revenue*. It is influenced by the rate of tax or charge, the exemptions, and concessions provided, actual scope of the revenue base in a *State*, and the effort put into ensuring compliance.

revenue raising capacity ratio

A ratio which indicates the capacity of a *State* to raise revenue relative to the *average*. It reflects the size of a *State's revenue base* per capita relative to the *average* and is measured by dividing *assessed revenue* per capita by *average revenue* per capita.

revenue raising effort ratio

A ratio which indicates the actual effort made by a *State* to raise revenue relative to the *average* effort. It is primarily a measure of the deviation of a *State's* tax rates and efficiency in ensuring compliance from the *average* rates and compliance efficiency. It is measured by dividing actual *per capita* revenue by *assessed revenue* per capita.

review

The process in which the Commission reconsiders the methods used to calculate *State relativities*, according to terms of reference given to it. From 1988 onwards, reviews have usually been done

every five years. By contrast, an *update* is conducted every year other than a review year and updates the *relativities* using the methods determined in the last review and the latest financial data.

service delivery scale

A *disability* that measures the additional costs of providing a service where it needs to be delivered but where the delivery is of less than economic size because the population served is small and remote from other points of service delivery.

socio-demographic composition disability

A *disability* that measures the budgetary impact, due to differences in both demand for and cost of providing services, that results from differences between *States* in the relative size of socio-demographic groups. It can reflect differences between *States* in some or all population characteristics such as age-sex structure, socio-economic status, Indigeneity, cultural and linguistic background, and location of residence.

Specific purpose payments (SPPs)

Commonwealth payments to *States* for specific purposes which enable national policy objectives to be achieved in areas that may be administered by *States*.

State(s)

Unless the context indicates otherwise, the term ‘*State(s)*’ includes the Australian Capital Territory and the Northern Territory.

tax base

See *revenue base*.

update

The annual assessment of *State relativities* undertaken by the Commission between *reviews*. Update assessments incorporate new budgetary developments and the most recent available data. In general, the methods used to calculate the *relativities* are those adopted in the most recent *review*.

user charges

Fees and charges raised by *States* through the provision of goods or services. In the *adjusted budget*, user charges for admitted patients, welfare housing, electricity, water and sanitation, and public transport are deducted from related expenses, and other user charges are included as other revenue.

year of application

The year in which the *relativities* assessed are to be used to distribute the *GST revenue*. In this review, the year of application is 2010-11.

years of assessment

See *assessment period*.

ACRONYMS

ABS	Australian Bureau of Statistics
AIHW	Australian Institute of Health and Welfare
EPC	Equal per capita
GFS	Government Finance Statistics
GST	Goods and Services Tax
IGA	Intergovernmental Agreement on Federal Financial Relations, 2008
NPP	National partnership payment
PTE	Public trading enterprise
SARIA	State-based Accessibility/Remoteness Index of Australia
SES	Socio-economic status
SET	Survey of education and training
SPP	Specific purpose payment

INDEX

2010 Review, consultants engaged	28
2010 Review, findings.....	19
2010 Review, key issues	6
2010 Review, quality assurance of.....	133
2010 Review, report structure	20
2010 Review, responding to the reference	22
2010 Review, the work program	26
Acronyms	163
Assessment guidelines.....	38, 142
Assessments, approach.....	41
Assessments, categories	43
Assessments, major issues.....	53
Commission terminology	154
Commonwealth payments, treatment of.....	77
Contemporaneity	6, 37, 53
Cultural diversity, effect on expenses	73
Discounting, use of.....	82
Equalisation, definition of.....	34
Equalisation, implementing.....	40
Equalisation, principle of	29
Equalisation, supporting principles	35
GST distribution, effects of main taxes and services	112
GST distribution, why it has changed	120
Indigenous status, effect on expenses.....	73
Infrastructure, investment.....	6, 55
Judgment, use of.....	82

Location, effects on State expenses.....	63
Methods, changes.....	122
Methods, our approach.....	5
Methods, simplification of.....	8, 85
Methods, simplification of.....	8
Net lending.....	7, 59
Overview.....	1
Population data used.....	153
Public trading enterprises, capital grants treatment.....	62
Quality assurance strategic plan.....	134
Relativities, Australian Capital Territory.....	16
Relativities, calculation of.....	146
Relativities, differences from 2009-10.....	3
Relativities, for 2010-11.....	2
Relativities, New South Wales.....	10
Relativities, Northern Territory.....	17
Relativities, Queensland.....	12
Relativities, South Australia.....	14
Relativities, Tasmania.....	15
Relativities, Victoria.....	11
Relativities, Western Australia.....	13
Revenue bases.....	48
Services, specific disabilities.....	51
Simplification.....	8
State fiscal capacities, changes in.....	127
State fiscal capacities, costs of providing services, investment and net lending.....	102
State fiscal capacities, diseconomies of scale.....	111
State fiscal capacities, other Commonwealth revenues.....	111
State fiscal capacities, revenue raising.....	97
State fiscal capacities, why they differ.....	95
Terms of reference.....	v