

Report on   
GST Revenue Sharing Relativities

2020 Review

Volume 2 — Methodology for measuring State fiscal capacities  
(Part A)



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# Purpose of this volume

|  |
| --- |
| On 28 November 2016, the Commission received terms of reference for a review of fiscal equalisation methodologies to inform the goods and services tax (GST) distribution from 2020‑21.  This volume of the report describes the processes, methods and data sources adopted by the Commission in arriving at its assessment of State relative fiscal capacities and hence its recommendations for the distribution of GST revenue in 2020-21. In particular, this volume:   * describes the context of the review, explains the requirements of the terms of reference and describes the approach taken by the Commission to the review, including the work program * discusses the major changes to the 2015 Review methodology, along with other areas the Commission considered extensively over the review, even where this has not resulted in changed assessments * summarises all changes to 2015 Review methods, as well as the Commission’s response to State proposals * discusses the equalisation objective and associated principle of horizontal fiscal equalisation (HFE), along with its supporting principles * describes how these principles have been implemented to determine the relative fiscal capacities of the States and hence prepare recommended relativities for the distribution of GST revenue in 2020-21 * outlines the Commission’s preliminary understanding of the requirements for its future work to implement the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018*, including an illustrative approach to how the Commission’s findings might be presented in the future * describes the assessments for each category, including data sources, as well as for each general disability that affects a number of category assessments (for example, wage costs) * describes how the relativities are calculated, how the Commission has used population data in the assessments and the adjusted budget that underpins the Commission’s work * looks ahead to possible approaches by governments and the Commission to considering method changes in the short to medium term. |

# List of acronyms

Volume 2

|  |  |
| --- | --- |
| ABF | Activity Based Funding |
| ABS | Australian Bureau of Statistics |
| ACARA | Australian Curriculum, Assessment and Reporting Authority |
| ACCHS | Aboriginal Community Controlled Health Services |
| ACEM | Australasian College for Emergency Medicine |
| ACTPS | ACT Public Service |
| AECC | Australian Emergency Care Classification |
| AEMC | Australian Energy Market Commission |
| AER | Australian Energy Regulator |
| AFP | Australian Federal Police |
| AGFS15 | Australian System of Government Finance Statistics 2015 |
| AGM-km | Average gross mass-kilometres |
| AIHW | Australian Institute of Health and Welfare |
| AP | Admitted patients |
| APC | Actual per capita |
| APRA | Australian Prudential Regulation Authority |
| APS | Australian Public Service |
| ARIA | Accessibility/Remoteness Index of Australia |
| ASGS | Australian Statistical Geography Standard |
| ATS | Australian Triage System |
| AWE | Average weekly earnings |
| BF | Block funded |
| BITRE | Bureau of Infrastructure, Transport and Regional Economics |
| BLADE | Business and Longitudinal Analysis Data Environment |
| CAEPR | Centre for Aboriginal Economic Policy Research |
| CALD | Cultural and linguistic diversity |
| CBD | Central Business District |
| CH | Community and public health |
| CoE | Compensation of Employees |
| CoES | Characteristics of Employment Survey |
| COFOG-A | Classification of the functions of government — Australia |
| COPEs | Commonwealth Own Purpose Expenses |
| CSS | Commonwealth Superannuation Scheme |
| CTP | Compulsory Third Party |
| CTWSSP | Country Towns Water Supply and Sewerage Program |
| DCM | Department of the Chief Minister |
| DRFA | Disaster Recovery Funding Arrangements |
| ED | Emergency Department |
| EMA | Emergency Management Australia |
| EPC | Equal per capita |
| ERP | Estimated Resident Population |
| ETF | Economic type framework |
| FESLs | Fire and emergency services levies |
| FHOG | First Home Owner Grant |
| FIFO | Fly in/fly out |
| FIRS | Federal Interstate Registration Scheme |
| FME | Feature Manipulation Engine |
| FOB | Free on board |
| FTE | Full time equivalent |
| GDH | Gove District Hospital |
| GFC | Global Financial Crisis |
| GFS | Government finance statistics |
| GG | General Government |
| GP | General Practitioner |
| GST | Goods and Services Tax |
| HACC | Home and Community Care |
| HAPHF | Heads of Agreement for Public Hospitals Funding |
| HCC | Health care card |
| HEI | Higher education institution |
| HFE | Horizontal fiscal equalisation |
| HILDA | Household, Income and Labour Dynamics in Australia |
| HoTs | Heads of Treasury |
| HPF | Health Performance Framework |
| IAHP | Indigenous Australians’ Health Program |
| ICH | Indigenous community housing |
| ICHO | Indigenous community housing organisation |
| ICSEA | Index of Community Socio-Educational Advantage |
| ICT | Information and communications technology |
| IGA | Intergovernmental Agreement on Federal Financial Relations |
| IHPA | Independent Hospital Pricing Authority |
| INST | Institutional sector classification |
| IRSD | Index of Relative Socio-Economic Disadvantage |
| IRSEO | Indigenous Relative Socio-economic Outcomes (index) |
| JUR | Jurisdiction classification |
| LBOTE | Language background other than English |
| LOG | Level of government classification |
| MBS | Medicare Benefits Schedule |
| MoU | Memorandum of Understanding |
| NAP | Non-admitted patients |
| NCA | National Capital Authority |
| NCCD | Nationally Consistent Collection of Data on School Students with Disability |
| NCP | National Capital Plan |
| NCVER | National Centre for Vocational Education Research |
| NDIA | National Disability Insurance Agency |
| NDIS | National Disability Insurance Scheme |
| NEC | National Efficient Cost |
| NEM | National Electricity Market |
| NEP | National Efficient Price |
| NERA | National Education Reform Agreement |
| NFW | Net financial worth |
| NHCDC | National Hospital Cost Data Collection |
| NHHA | National Housing and Homelessness Agreement |
| NHR | National Health Reform |
| NHRA | National Health Reform Agreement |
| NISEIFA | Non-Indigenous Socioeconomic Index for Areas |
| NNR | National network roads |
| NPPs | National partnership payments |
| NPRH | National Partnership on Remote Housing |
| NRN | National Rail Network |
| NSPPs | National Specific Purpose Payments |
| NSRA | National School Reform Agreement |
| NTC | National Transport Commission |
| NWAU | National Weighted Activity Unit |
| NWAUs | National Weighted Activity Units |
| NWIPP | National Water Initiative Pricing Principles |
| NWIS | North West Interconnected System |
| NWS | North West Shelf |
| OOHC | Out-of-home-care |
| PATS | Patient Assisted Travel/Transport Scheme |
| PC | Productivity Commission |
| PCC | Pensioner concession card |
| PFC | Public financial corporation |
| PH | Public Housing |
| PNFC | Public non-financial corporations |
| PNFS | Public non-financial sector |
| PoC | Point of consumption |
| PPPs | Public Private Partnerships |
| PRRT | Petroleum Resource Rent Tax |
| PSLA | Petroleum (Submerged Lands) Act |
| PSPs | Payments for specific purposes |
| PSS | Public Sector Superannuation scheme |
| PWD | Population-weighted density |
| RC | Regional costs |
| RCM | Reserve Capacity Mechanism |
| RoGS | Report on Government Services |
| RTOs | Registered training organisations |
| SA1 | Statistical Area Level 1 |
| SA2 | Statistical Area Level 2 |
| SAF | Skilling Australia Fund |
| SARIA | State Accessibility/Remoteness Index of Australia |
| SDC | Socio-demographic composition |
| SDS | Service delivery scale |
| SEIFA | Socio-economic indexes for areas |
| SES | Socio-economic status |
| SET | Survey of Education and Training |
| SLGFCE | State and local government final consumption expenditure |
| SMVU | ABS’ Survey of Motor Vehicle Usage |
| SOMIH | State owned and managed Indigenous housing |
| SPPs | Specific purpose payments |
| SRO | State Revenue Office |
| SRS | Schooling Resource Standard |
| SUA | Significant Urban Area |
| SWIS | South West Interconnected System |
| TAFE | Technical and further education |
| TALC | Type of asset and liability classification |
| TC | Taxes classification |
| ToR | Terms of reference |
| TOS Act | Traditional Owner Settlement Act 2010 |
| UCLs | Urban Centres and Localities |
| VDA | Value distribution adjustment |
| VET | Vocational Education and Training |
| VG | Valuer-General |
| VKT | Vehicle kilometres travelled |
| VLC | Veitch Lister Consulting |
| WEM | Wholesale electricity market |
| WPCLP | Western Parkland City Liveability Program |
| WSHP | Western Sydney Housing Package |

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# 1 Approach and main issues for the 2020 Review

1. On 28 November 2016, the Commission received terms of reference for a review of fiscal equalisation methodologies to inform the goods and services tax (GST) distribution from 2020‑21. This chapter:

* describes the context of the review
* explains the methodology related requirements of the terms of reference
* describes the approach taken by the Commission to the review, including the work program
* discusses the major changes to the 2015 Review methodology, along with other areas the Commission considered extensively over the review, even where this has not resulted in changed assessments
* summarises all changes to 2015 Review methods, as well as the Commission’s response to State proposals
* looks ahead to possible approaches by governments and the Commission to considering method changes in the short to medium term.

### Context of the review

1. Since 1976, fiscal equalisation has been an agreed Commonwealth and State policy, with the Commission being tasked with advising governments on how that could be achieved through the distribution of general revenue assistance from the Commonwealth to the States.
2. Intergovernmental agreements in 1999 and 2008 and, most recently, the Intergovernmental Agreement on Federal Financial Relations 2011 (the IGA), signed by the Commonwealth and all State governments, provide for the revenue collected from the GST to be paid to the States for them to use for any purpose. The agreements also said the GST revenue is to be distributed among the States in accordance with the principle of horizontal fiscal equalisation (HFE).
3. 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 the same standard of services to their residents.
4. Determining a distribution of the GST revenue that equalises State fiscal capacities involves a comprehensive examination of the impact of State social, physical and economic circumstances on the costs of providing the full range of State services and acquiring the associated infrastructure, and on the revenues they can raise. This approach ensures all fiscal advantages and disadvantages of the States are taken into account. To ensure the continuing relevance of the recommended distributions, the Commission has reviewed its methods at about five yearly intervals since 1981 and updated the distribution between reviews since 1989.
5. This review has taken the 2015 Review methodology as its starting point. To assist States, the main changes to this methodology are summarised in this chapter, and at the end of the chapters in this volume dealing with individual assessments.
6. Development of the methodology review benefited from substantial consultation with all States, including a program of visits by Commissioners to each State, along with detailed submissions from them. The Commission understands that the conduct of its reviews imposes a burden on States, and that the annual updates have a smaller, though not negligible, impact as well. It appreciates the efforts of States in hosting Commission visits and in responding to the Commission’s discussion papers in accordance with the work program.
7. The Commission has attempted to respond to the issues States have raised in sufficient detail to allow an understanding of its decision process. However, the report does not attempt to exhaustively document each and every State argument in detail. In this regard, State submissions are allowed to speak for themselves. They can be found on the Commission website (https://cgc.gov.au/), classified by the issue or discussion paper to which they are responding.
8. From 2021-22, legislated changes will see a graduated transition from the current arrangements for distributing GST revenue (based directly upon the Commission’s assessment of relative fiscal capacities), to new arrangements based upon a standard State, being the fiscally stronger of New South Wales and Victoria. This transition will be completed in 2026-27. The new arrangements are set out in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018,* which amends the *Commonwealth Grants Commission Act 1973* and the *Federal Financial Relations Act 2009*.
9. The Commission expects the methodologies determined in this review will continue to form the basis for relativity assessments under the new arrangements. Accordingly, whilst the legislated changes do not affect the work of the Commission until the update for 2021‑22, this report includes a description of the Commission’s understanding of how to give effect to the new legislation at that time, along with an illustrative example of how the Commission might present its findings during the change. The Commission welcomes State feedback on the illustrative approach.

### Methodology requirements of the terms of reference

1. The terms of reference ask the Commission to inquire into the methodological approach used to distribute the GST revenue among the States from 2020-21. They contain instructions and guidance on how the Commission should approach the task of developing this methodology. They ask the Commission to:

* take into account the Intergovernmental Agreement on Federal Financial Relations (as amended), which provides that the GST should be distributed among the States in accordance with the principle of horizontal fiscal equalisation (HFE)
* aim for assessments that are simple and consistent with the quality and fitness for purpose of the available data
* use the latest available data consistent with this
* ensure robust quality assurance procedures.[[1]](#footnote-2)

1. They also ask the Commission to consider whether the supporting principles it uses to guide its work remain appropriate, including whether different weights should apply to different supporting principles. In coming to a judgment, the terms of reference ask the Commission to seek State views on the supporting principles and the appropriate balance between them.[[2]](#footnote-3)
2. Specific guidance is provided in relation to the treatment of Commonwealth specific purpose payments (SPPs) and national partnership payments (NPPs), collectively referred to as payments for specific purposes (PSPs). The terms of reference require the Commission:

* to ensure some specified payments including reward NPPs (or some part of specified payments, usually 50%), have no impact on the GST distribution (collectively these payments are usually referred to as quarantined payments)
* to treat national SPPs, National Health Reform funding, Quality Schools funding (for government schools), national partnership project payments and general revenue assistance (GRA), other than the GST, so that they would affect GST shares, but treat facilitation NPPs so that they would not.[[3]](#footnote-4)

The terms of reference also give the Commission discretion to vary the treatment of the second group of payments where considered appropriate, ‘reflecting the nature of the payment and the role of State governments in providing services’.[[4]](#footnote-5)

1. Supplementary terms of reference directed the Commission not to change the mining revenue assessment methodology.
2. Table 1‑1 identifies the matters the terms of reference require the Commission to address and indicates where it has responded to them in this report.

Table 1‑1 Requirements of the terms of reference and the Commission’s response

| 2020 Review reference clause | Response |
| --- | --- |
| 1(b) per capita relativities for 2020‑21 | Volume 1 |
| 5 take into account the Intergovernmental Agreement on Federal Financial Relations … the principle of horizontal fiscal equalisation | Volume 2, Chapter 2 |
| 6 consider appropriate supporting principles and appropriate balance / weighting | Volume 2, Chapter 2 |
| 7(a) aim for assessments that are simple and consistent with the quality and fitness for purpose of the available data | Volume 2, Chapter 1 and chapters describing individual assessments |
| 7(c) ensure robust quality assurance procedures | The Quality Assurance Strategic Plan, which is available on the Commission website and Volume 1, Chapter 5 |
| 8 Treatment of Commonwealth payments | Volume 2, Chapter 5 Commonwealth payments |

### Approach to the review

1. The terms of reference asked the Commission to develop a work program for the review, in consultation with the Commonwealth and States.[[5]](#footnote-6) This is set out in Table 1‑2. Broadly, the work program included:

* in 2017, consultations with State Treasuries on the principles and methods which should be reviewed, followed by a Commission position paper on the principle of HFE and its implementation
* in 2018, Commission staff released discussion papers relating to each specific assessment, identifying material factors beyond the control of States affecting their revenue raising capacities and expenditure needs
* the Commission followed this with visits to each State, and subsequently received from States their detailed submissions on the discussion papers; further discussions have also taken place between State Treasuries and Commission staff, for example through the Officer Working Party forum.
* in 2019, provision of a draft report to the Commonwealth and States
* this was followed by discussions between Commission staff and State officials, consideration by the Commission of State submissions on the draft report, and informing States of any significant changes to the Commission’s views subsequent to the draft report[[6]](#footnote-7)
* in 2020, provision of the Commission’s final report, including the recommended per capita relativities to be used to distribute GST revenue among the States in 2020-21.[[7]](#footnote-8)

1. Commission papers, State submissions and consultations held as part of the review process are available on the [Commission website](file://cgcfs/I_drive/R2020/Report/Draft%20Report/Final%20Draft%20report%20papers/Commission website), (https://cgc.gov.au/).
2. In the 2015 Review, given its shorter timeframe, the Commission adopted an approach of focusing attention on areas where, in consultation with the States and consistent with the terms of reference, change was considered most warranted. While that resulted in significant changes in certain areas, it also showed that much of the existing methodology was robust.
3. Consequently, in this review, while changes to all aspects of the methodology were within the terms of reference, the Commission adopted the 2015 Review methodology as its starting point. Changes have been proposed where State circumstances have changed, better data have become available or where other evidence, including the work of consultants and in State submissions, has convinced the Commission to do so.

Table 1‑2 2020 Review program

|  |  |
| --- | --- |
| Date | Event |
| 2016 |  |
| 28 November | Terms of reference received. |
| 1 December | State views on work program processes sought. |
| 2017 |  |
| February-March | States and Commonwealth consulted and work program finalised. |
| April | Officer Working Party (OWP) of Commission and State officials commenced examination of specific assessment issues. Work program agreed and work started. |
| Mid May | Staff released a paper on approach to the review, HFE, supporting principles and their implementation, including assessment guidelines. Series of supporting research/background papers released. |
| End July | State submissions received on staff paper on approach to the review, HFE, supporting principles and their implementation, including assessment guidelines. |
| Late August/Sept | Bilateral discussions between the Commission and States on submissions. |
| End September | Commission paper sent to States on approach to the review, HFE, supporting principles and their implementation, including assessment guidelines. |
| October-November | Staff and Treasury officer initial discussions on assessment issues for the 2020 Review. |
| 2018 |  |
| End Feb | State submissions on approach to review, the objective(s), supporting principles and their implementation. |
| April | Preliminary staff papers released to States on the scope of HFE and assessment structure, treatment of Commonwealth payments, category and factor assessments. |
| June to September | Commission visits to States for discussions on assessment issues, including service delivery needs. Bilateral meetings with Treasurers/Heads of Treasuries to cover key issues, if required. |
| June to December | OWP meetings to discuss/report on specific issues. |
| End August | State submissions on scope and structure, treatment of Commonwealth payments, category and factor assessments. |
| 2019 |  |
| 25 June | Release of draft report to the Commonwealth. |
| 6 August | Release of draft report to the States. |
| Aug/Sept | Commission staff bilateral meetings with State officials to discuss the draft report. |
| 27 September | State submissions on draft report due. |
| 8 October | New issues paper issued by Commission staff. |
| 22 November | State submissions on new issues due. |
| 29 November | Commission paper on significant changes since the draft report, as required by the terms of reference. |
| 2020 |  |
| 3 January | Final State comments on significant changes to draft report due. |
| 28 February | Release of final report to the Commonwealth and States. |
| 16 March | Public release of final report. |

### Main assessment issues, method changes and responses to State proposals

1. In this review the Commission has developed new urban transport assessments, which are based on an econometric model developed with the help of transport consultants. The model better captures the effects of population density, passenger numbers and urban centre characteristics, on the cost of providing urban public transport.
2. Other assessment methodology changes that have had noteworthy effects on the GST distribution are largely evolutionary, as changes to the activity taxed by States, improved knowledge of service delivery approaches and better data have led to changes in how disabilities are measured. For example, recognising changes to the taxing of property transfer activity, the Commission has changed the scope of those revenues differentially assessed. Improved data for electricity and water subsidies and Indigenous community development expenses have affected assessments, as has a comprehensive review of the assessment of the minimum costs faced by States in preparing to deliver services.
3. In other changes, more detailed data from States on spending on police services, and greater utilisation of Independent Hospital Pricing Authority (IHPA) data on the costs of hospital services, have enabled better recognition of the effects of increasing remoteness on the costs of service delivery. More generally, the Commission has been able to measure directly the effects of remoteness across more categories in this review compared to the previous review. Feedback from States on the drivers of funding for schools has led to changes in the characteristics recognised as leading to differential costs in providing education services.
4. Following is a short discussion of each of the areas where there has been a major change from the approach adopted in the 2015 Review, along with instances where the Commission has considered an issue in some depth over the course of the review, even where the outcome has been not to change existing methods.

#### Elasticity adjustments to State tax bases

1. The Commission determines States’ capacities to raise revenue in each category by applying an average tax rate to each State’s assessed revenue base. The Commission currently measures State revenue bases using data that closely reflect the actual revenue bases accessed by States. Economic theory suggests that differences in State tax rates (and other tax policies) can affect the level of activity and, therefore, the observed revenue base. A State imposing an above average tax rate would have a smaller revenue base than if it were to impose the average rate, and vice versa. If differences in tax rates had material effects on observed revenue bases, incorporating elasticity adjustments would improve the policy neutrality of the Commission’s revenue assessments.
2. The Commission engaged consultants to provide, where possible, estimates of the size of elasticity effects for each revenue base. This would inform its decision on whether to make elasticity adjustments in the 2020 Review. The consultants’ report can be found on the [Commission website](https://cgc.gov.au/) (https://cgc.gov.au/). The consultants developed models to estimate elasticities for five revenue categories: Payroll tax, Land tax, Stamp duty on conveyances, Insurance tax and Motor taxes. Due to data limitations and methodological difficulties, the consultants concluded they could not estimate elasticities for mining royalties at this time.
3. Of the five elasticities modelled, four were found to be statistically significant. The consultants found no measurable behavioural effect of changes in payroll tax on labour market outcomes (wages and employment).
4. Elasticities were estimated using data from the Commission's assessments and, in two cases, data from other sources.[[8]](#footnote-9) The consultants’ findings are set out in Table 1‑3.

Table 1‑3 Estimated elasticities by revenue category

|  |  |  |
| --- | --- | --- |
| Revenue | Elasticity | Interpretation |
| Payroll tax | Statistically insignificant | Not applicable. |
| Land tax | -0.054 to -0.062 (CGC data) | A 10% increase in the tax rate will reduce the overall unimproved value of taxable properties by about 0.6%. |
| Stamp duty on conveyances | -0.29 to -0.43 (CGC data)  -0.01 to -0.37 (CoreLogic data) | A 10% increase in the tax rate reduces the overall value of sold properties by 3 to 4%. A 10% increase in the tax rate reduces the value of sold properties by 0.1 to 3.7%, depending on the specification chosen. |
| Insurance tax | -0.057 (CGC data) | A one percentage point increase in the tax rate (equivalent to about a 10% increase) reduces expenditure on total premiums by 0.6%. |
| Motor taxes | -0.056 (CGC data)  -0.035 (HILDA data) | A 10% increase in licence fees reduces vehicle ownership by 0.6%. A 10% increase in licence fees reduces car ownership by 0.35%. |
| Mining revenue | Could not be estimated | Not applicable. |

Note: The insurance tax elasticity was expressed as a percentage point change so that it could be more easily compared to the international literature.

Source: Tax and Transfer Policy Institute, *State Tax Elasticities of Revenue Bases*, page 4.

1. Of the six States that commented on whether the Commission should make elasticity adjustments, only two supported their introduction. New South Wales and the ACT argued that, where material, elasticity adjustments should be introduced to improve the policy neutrality of revenue assessments. The ACT said the methodology used by the consultants to estimate elasticities was thorough and comprehensive.
2. Three States questioned whether elasticity adjustments would be reliable or material. Victoria said there were uncertainties regarding the estimation of the elasticities. Western Australia did not have confidence in the size of the estimates or the data used. It said that elasticity adjustments would represent another micro adjustment to an already unreliable revenue approach and, instead, the Commission should move to broader measures of revenue capacity. South Australia questioned whether adjustments based on the consultants’ estimates would be material.
3. The Commission tested the materiality of elasticity adjustments and found that an elasticity adjustment would be material only for stamp duty on conveyances at the $10 per capita data adjustment materiality threshold.[[9]](#footnote-10)
4. The Commission has a number of concerns about making elasticity adjustments. The nature of internally generated elasticities is that they are highly sensitive to Commission decisions about what to include in the revenue assessments and associated revenue bases.[[10]](#footnote-11)
5. The introduction of an elasticity adjustment in the Stamp duty on conveyances assessment would require a series of judgments, such as:

* whether to use the estimate based on Commission data or CoreLogic data
* where within the elasticity ranges the Commission would set the adjustment
* whether the Commission should reconsider the composition of the category when determining effective and average rates of duty.

1. The practical implementation of an adjustment cannot be made without this series of judgments.
2. The Commission considers the consultants have produced a major analytical work that considerably improves knowledge of this issue in the Australian context. It considers that the consultants’ methodology is thorough and comprehensive and that elasticity adjustments would address some policy neutrality concerns. On the other hand, implementation issues within the HFE context include a degree of uncertainty about the magnitude of the adjustment (for example, the size of the elasticity effect based on the CoreLogic data is somewhat lower than that based on Commission data) and the sensitivity to the classification of revenues.
3. The Commission considers the consultants’ report and related staff analysis provide evidence that HFE is not being unduly compromised by elasticity effects, as these are very small for all but one tax base, stamp duties on conveyances, for which they are also not substantial. On this basis, and given its concerns about the practical implementation of making an adjustment, the Commission decided not to make any elasticity adjustments to revenue bases.

#### Stamp duty on conveyances

1. Changes to the property transfer activity taxed by States has changed the scope of those revenues differentially assessed. Fewer States taxing non‑real property transfers, but an increasing occurrence of taxing land rich transactions by listed companies, has led to changes in the scope of revenue differentially assessed by the Commission.
2. Only three States continue to impose duty on non-real property transactions. The Commission has ceased differentially assessing these duties in this review on practicality and simplicity grounds, given the non-real and real property tax bases are very different, making it difficult to reliably estimate a tax base for the majority of States that do not impose this duty.
3. Seven States impose duty on land rich transactions by listed companies and the Commission has differentially assessed these duties for the first time in this review. However, as a majority of States impose the duty at 10% of their general rates, only 10% of the value of these transactions are included in the category’s capacity measure. Chapter 8 Stamp duty on conveyances discusses these issues in more detail.

#### Mining revenue

1. The most contentious issue with the 2015 Review mining revenue assessment was the Commission’s approach to policy neutrality. Policy neutrality concerns arose because of the uneven distribution of mineral endowments across States. When one State dominates production of a mineral, its royalty rate determines the average royalty rate. This carries a risk to policy neutrality because changes to its rate could be influenced by expectations of resulting offsetting effects on GST shares. For this reason, the Commission initially consulted with the States on two possible adjustments to improve the policy neutrality of the mining assessment.

* A dominant State adjustment. No more than half of any change in revenue from a discretionary royalty rate change by a dominant State would be affected by the equalisation process.
* A banned minerals adjustment. Revenue from banned minerals, for example coal seam gas, would be assessed EPC.

1. In practice, the policy neutrality risk is significant only for Western Australia. The new equalisation arrangements enacted in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* substantively mitigate that risk such that, in practice, the Commission considers that there would be no need to proceed with either of the two adjustments referred to above.
2. In addition, the Treasurer has provided supplementary terms of reference to the Commission directing that ‘the Commission should not change the mining revenue assessment methodology’. Therefore, the Commission will continue the 2015 Review approach of assessing revenue capacity using a mineral by mineral approach.
3. While making no change to the assessment method, the Commission has considered its application in the 2020 Review. The 2015 Review methodology allows the composition of the category to respond to changes in the materiality of individual mineral assessments. In the context of the 2020 Review, this means nickel royalties will now be assessed alongside other minerals, and not be separately assessed as they were in the 2015 Review. Similarly, should it become material to separately assess a different mineral (for example, lithium), and the Commission takes the view its materiality would likely continue for the foreseeable future, the Commission considers a separate assessment of that mineral would be consistent with the 2015 Review methodology. There are no such cases at the time of this report.
4. After considering whether they should be treated like other Commonwealth payments, the Commission decided that shared royalty arrangements between the Commonwealth and Western Australia (and the Northern Territory), for example in relation to the North-west shelf, will continue to be assessed in this category. Chapter 11 Mining revenue discusses these issues in more detail.

#### Gambling

1. A criticism of the equalisation process made by some commentators relates to the Commission’s assessment of gambling taxes (that is, taxes on lotteries, electronic gaming machines, casinos, racing and sports betting). This criticism implies that the equalisation process somehow disadvantages Western Australia, because of its policy to restrict the availability of gaming machines. The Commission rejects this criticism as being based on a misconception of how the equalisation system operates. The Commission’s task in this area is to attempt to estimate the level of gambling revenue that Western Australia could raise if it followed the average State policy. It is not to make a judgment on the virtue or otherwise of State gambling policies and to move GST revenue accordingly. The Commission notes that the Western Australian Treasury has not joined in the criticism of the Commission’s gambling assessment.
2. In this review, the Commission again investigated whether it could develop a differential assessment of gambling taxes. None of the approaches it investigated proved satisfactory. The problem was that the pervasiveness of State policies, which materially affect the level of gambling activity (the tax base) in each jurisdiction, proved insurmountable. The Commission also investigated weighted socio-demographic models using gender, age and education level, but none of these models produced an assessment that was material. In addition, none of the approaches addressed the advent of online gambling which is making gambling activity more mobile. Taxation in one State might relate to the activities of residents from other States or overseas.
3. The Commission has decided to continue to assess gambling taxes on an EPC basis, meaning that these taxes do not affect any State’s relative fiscal capacity. In the absence of any robust alternative, most States supported this approach, including Western Australia. Chapter 12 Other revenue discusses these issues in more detail.

#### Schools

1. In this review, the Commission adopts a new model to estimate the drivers of differences in State expenses for government schools. The new model estimates the drivers to be the remoteness, socio-economic status (SES) and Indigenous status of school students. Most States supported the development of a new model.
2. The model directly measures the SES of students within each school, replacing the previous method that measured the SES of a school based on the school’s location.
3. The previous model measured Indigenous SES and non-Indigenous SES separately. The new model independently measures Indigenous status and SES status. This greatly simplifies the model and removes the need for assumptions about the internal distribution of school funding between Indigenous and non-Indigenous students, as well as being a better reflection of how States fund schools.
4. In addition, the new model estimates that there are no significant differences in expenses between some remoteness classifications. This has resulted in fewer remoteness classifications, with some remoteness areas being grouped together.
5. In this review, the Commission decided to assess student transport expenses in the Transport category. This reflects a view that the disabilities affecting the cost of transporting school children are likely to be more closely related to the disabilities affecting the cost of transporting other people, than to the disabilities affecting the cost of educating school children. Chapter 13 Schools discusses these issues in more detail.

#### Health

1. In this review, the Commission re-considered and confirmed its approach for recognising non-State sector influences on State health spending. Western Australia was critical of the Commission’s decision in the 2015 Review to adopt a more direct approach for assessing State health expenses. Although officer level discussions in this review initially focused on the choice of approach — a subtraction approach preferred by Western Australia, or the direct approach — it became apparent that the real issue under either approach was the extent to which non‑State sector services are substitutable for State services.[[11]](#footnote-12)
2. When Western Australia articulated the case for adopting a broad view of what constitutes substitutable services, it became clear that it was seeking an approach that would equalise most health expenditure in Australia, including services that are predominantly provided by the non-State sector (for example, primary care and benefit paid pharmaceuticals). It argued that in the long run, as the main provider of hospital services, States bear the costs of inadequate non-State sector activity. Therefore, the health assessment should recognise below average levels of non‑State sector activity on an annual basis if States are to be fully equalised in the long run.
3. The Commission acknowledges that States fill service gaps, but in limited circumstances. Furthermore, their capacity to meet all needs is constrained by State budgets. For example, a lack of general practitioners (GPs) in more remote areas means that States are often the main providers of primary health care services in these regions. The Commission’s direct assessment acknowledges that this is what States do by recognising the higher use and cost of hospital and community health services in remote areas.[[12]](#footnote-13) A non-State sector adjustment recognises that the availability of GPs in remote areas varies between States. Thus, a State with below average GP services in remote areas would receive the capacity to fund more State services.
4. The Commission considers that Western Australia’s proposition would effectively go beyond the scope of HFE by seeking to equalise the health outcomes of the community. The Commission prefers a more direct approach that focuses on what States collectively do while acknowledging the influence of the non‑State sector where it is relevant. This avoids States receiving GST to fund the provision of services they do not provide. The Commission observes there are not wide variations in what States do in the area of health. Thus, an approach that focuses on average State policy provides an appropriate equalisation outcome.
5. The other States supported the direct approach and were broadly supportive of the levels of substitutability adopted for each component. The Northern Territory raised some concerns about the implementation of the direct method in the community health assessment, which the Commission has sought to address. Chapter 15 Health discusses these issues in more detail.

#### Services to communities

1. In this review, the assessment of Services to communities changed mostly because of improved data for electricity and water subsidies and Indigenous community development expenses.
2. During the review, States provided water and electricity subsidy data that allowed the Commission to refine the definition of non-metropolitan communities receiving subsides under average policy. This led to separate assessments for water and electricity subsidies, as the disabilities affecting these subsidies are different. Previously, the assessment of these expenses used the population in remote and very remote communities sized between 50 and 1,000 people to assess State needs.

* Electricity subsidies for remote communities are now assessed using the population in remote and very remote communities. The definition of remote communities includes all communities of more than 50 people.
* Water subsidies for small communities are now assessed using the population in small communities outside major cities, and the definition of small communities has been broadened in this review to include communities of more than 50 but less than 3,000 people.

1. Assessed electricity subsidies for remote communities and water subsidies for small communities both have wage costs applied. The effects of regional costs, which have been derived using service specific State data, are also recognised. The split between electricity subsidies for remote communities and other electricity subsidies and the split between water subsidies for small communities and other water subsidies have been updated based on State data. The expense data will be updated on an annual basis.
2. Indigenous community development expenses are sourced from State data and include general grants to Indigenous local governments. The Commission considers that the expense data supplied by the States is more accurate than the 4-digit Government Finance Statistics (GFS) data that were used previously. State expense data are significantly lower than the GFS data.
3. The broadening of the definition of non-metropolitan communities receiving electricity and water subsidies, and reducing average State spending on Indigenous community development, reduced the influence of this assessment in this review. Chapter 18 Services to communities describes the changes to the assessment in more detail.

#### Justice

1. The judgment-based split in the 2015 Review methods between community policing (assessed on an EPC basis) and specialised policing (which was differentially assessed) has been criticised by several States, although they had conflicting opinions on what this split should be.
2. In response, in this review, the Commission has developed a more empirical-based method, using State provided data on spending by police districts, which removes the need for a judgment-based split. The new approach also implicitly captures regional costs and the very high cost of providing policing services in remote and very remote areas.
3. The Commission has also developed new methods for determining regional costs for courts and prisons, as the use of police regional costs as a proxy is no longer appropriate due to the changed nature of police data collected for this review. Chapter 19 Justice discusses these issues in more detail.

#### Transport

1. A priority for the Commission for the 2020 Review was to review the urban transport recurrent and infrastructure assessments. The assessments developed during the 2010 and 2015 Reviews used urban population as the main driver of urban transport expenditure.
2. Queensland, Western Australia, South Australia, Tasmania and the ACT expressed concerns with use of urban population as the sole driver of needs and did not support retaining the assessment for the 2020 Review. They noted that the assessment should recognise the influence of factors such as the presence of rail, population density and urban form/geography. States were also concerned about the theoretical foundation of the 2015 Review model.
3. To address these concerns and improve the urban transport assessments, the Commission engaged consultants to develop a model for assessing State urban transport recurrent and infrastructure expenditure requirements.[[13]](#footnote-14)
4. After consideration of the consultants’ recommended model and State feedback on the consultants’ report, and having engaged further with the consultants on various aspects of their report, the Commission decided to adopt an econometric model for urban transport recurrent expenses that recognises the following influences:

* population density
* numbers of public transport passengers (separately assessed for bus/light rail and heavy rail)
* the presence of ferry services[[14]](#footnote-15)
* distance to work
* topography.

1. The Commission decided to use the model developed for recurrent expenses to assess investment needs, as recommended by the consultants. The consultants concluded that the drivers of recurrent expenses were sufficiently similar to assess both using one model. They argued there were too few observations to estimate an investment-specific multi-variable model with confidence.
2. Further, to address concerns about the reliability of net urban transport expenses and the use of proxy variables to capture supply and demand, the Commission decided:

* for the urban transport expenses assessment — to blend the assessment based on the econometric model with a broad assessment based on the proportion of State populations living in urban centres
* for the transport infrastructure assessment — to blend the assessment based on the econometric model with an assessment based on the square of urban centre population.

1. In both assessments, the assessment based on the econometric model is given a weight of 75% and the population‑based assessments a weight of 25%.
2. States raised several issues with the outcomes of the transport consultancy including policy neutrality concerns, the definition of urban areas, the use of proxy variables and the decision to adopt blended assessments. Chapter 21 Transport discusses these issues in more detail and addresses State views.

#### Local government natural disaster expenses

1. State net expenses for natural disaster relief will continue to be assessed on an actual per capita (APC) basis but will include that part of local government expenses funded by States.
2. In the 2019 Update, the Commission decided to exclude local government net expenses, because at that time it was unclear whether States were the ultimate funders of these expenses. In the draft report, the Commission said it intended to retain this approach but asked States to provide information on their natural disaster funding arrangements.
3. In responding to the draft report, Queensland objected to the exclusion of local government expenses. It explained that local governments were fiscally unable to fund most natural disaster relief expenses, and that the State government contributed most of the funds for local government out of pocket expenses eligible for funding under the Disaster Recovery Funding Arrangements 2018 (DRFA). The Northern Territory also stated that local government lacked the financial capacity to self-fund most expenses, especially councils in remote areas.
4. After further investigation, the Commission concluded that States fund most local government natural disaster relief expenses under the DRFA, net of Commonwealth assistance. The Commission decided that State payments for local government expenses should remain in the assessment, as States fund most of these expenses and they represent an unavoidable cost for States.
5. Consistent with its decision to include local government net expenses going forward, the Commission decided to unwind fully in the 2020 Review the adjustment to the assessment in the 2019 Update to remove local government net expenses. For more information on this issue see Chapter 23 Other expenses.

#### Investment

1. The assessment of investment remains largely unchanged. However, in this review, the Commission has refined its methods to improve accuracy and to address concern that the investment assessment is too complex and difficult to interpret. Most States were generally supportive of the changes.
2. The Commission decided to assess investment separately in all service areas (not just roads and transport), to ensure actual investment levels are reflected and to make the assessment more transparent (by associating redistributive effects to each service area). Previously, the mechanism for combining investment resulted in the assumption that investment in each category is equal to its proportion of the capital stock, not actual investment, which could lead to revaluations having undue effects on the assessment.
3. Depreciation and net investment are now assessed together in an assessment of gross investment. The Commission considers this a simpler approach, because the same disabilities apply to both investment and depreciation and it removes the likelihood of any State being assessed as requiring negative investment in any particular service area that, while conceptually valid, was difficult to interpret.
4. While the assessment will continue to recognise the higher costs of construction faced in some States, where a State is assessed to require negative investment, it will no longer be assumed that higher costs of construction are mirrored by higher returns on asset sales. That is, costs of construction will not be additionally applied where a State’s investment requirement is assessed to be negative.
5. In addition, single year stock disabilities will be applied to stocks, improving the accuracy and transparency of the assessment. This removes the averaging of stock disabilities (over three years), which created a mismatch between growth in population and growth in stock disabilities, without unduly affecting the volatility of the assessment. Chapter 24 Investment discusses these issues in more detail.

#### Administrative scale

1. In this review, the Commission re‑estimated administrative scale costs using an approach similar to that adopted in earlier reviews. Administrative scale costs are expenses States incur in delivering services that are independent of the size of the service population.
2. The new estimates reflect a detailed examination of the services States provide and the organisational structures used to provide them. The new costings, using data for 2016-17, indicate that each State’s administrative scale expenses are $353 million. This is approximately 27% higher than the amount used in the 2019 Update, which was based on an estimate from the 2004 Review. The increased costs reflect increasing levels of collaboration between the Commonwealth and State governments in several spheres, greater legislative and reporting requirements, and changes in the nature and use of information and communications technology.
3. Chapter 26 Administrative scale describes the approach used in this review to re-estimate administrative scale expenses.

#### Geography

1. The distribution patterns of State populations play a significant role in the cost of delivering services. These distribution patterns vary considerably between States. In the 2015 Review, the Commission assessed the effect of geography in different ways. States have been critical of some of these approaches. In particular:

* the regional costs assessment relied on the experience of schools and police, and extrapolated the effect of remoteness on the services in those sectors to a wide range of other services
* the service delivery scale geographic classification was seen as complex and arbitrary
* the differences in non-wage costs between cities was assessed using Commission judgment.

1. The insight gained by the Commission over the course of the review, primarily through the State visits program, has assisted the development of its methods in this area. In this review, while there is still some extrapolation, the Commission has widened the range of services where regional cost and service delivery scale influences are measured directly, thereby improving the evidence base for the assessment. The Commission decided to discontinue the previous approach to determining areas affected by service delivery scale, and to classifying affected areas using the standard Australian Bureau of Statistics (ABS) remoteness areas.
2. The Commission considers there are differences between States in their interstate non-wage costs. However, the lack of data and the difficulty in determining the magnitude, or even (other than for Western Australia) the direction, of an appropriate adjustment has led the Commission to cease this assessment. Chapter 28 Geography discusses these issues in more detail.

#### Summary of changes to 2015 Review methodology

1. Table 1‑4 summarises the changes in this review – in each category and to each disability. Changes that are presentational in nature or are due to changes made by data suppliers have not necessarily been included.

Table 1‑4 2020 Review changes to 2015 Review methodology

|  |  |
| --- | --- |
| Category/disability | Main changes |
| Commonwealth payments | * Now has two components: impact payments and other Commonwealth transfers that have no impact on State fiscal capacities. |
|  | * Assessment method unchanged but the treatment of some payments changed because of changes to other category assessments. * The treatment of National Disability SPP changed from impact to equal per capita for all assessment years to reflect application year circumstances for SPP payment and disability services assessment. |
| Payroll tax | * The assessment method is unchanged. |
| Land tax | * Revenue from fire and emergency levies on property is now offset against Other expenses. * The other land based taxes have been moved to Other revenue. * The level of discount has been reduced from 25% to 12.5%. * The ACT adjustment has been increased from 2% to 6%, fixed for the review. * The NT adjustment has been increased from 0.6% to 0.8%, to be recalculated annually. |
| Stamp duty on conveyances | * Stamp duties on the transfer of motor vehicles have been moved to Other revenue. * No adjustment is made for concessional rates of duty relating to first home owners. * Land rich transactions by listed corporations are differentially assessed with other conveyance duties. Include 10% of the value of transactions in all States. * Non-real property transactions have been moved to Other revenue. * The off-the-plan and unit trusts adjustments have been discontinued. * Conveyance transactions that are not differentially assessed have been moved to Other revenue. |
| Insurance tax | * Revenue from fire and emergency levies on insurance products is now offset against Other expenses. * Revenue from workers’ compensation duty is now included in the category and assessed using the general insurance revenue base. * The capacity measure no longer includes premiums paid to public insurers or premiums paid to private insurers for CTP motor vehicle insurance. |
| Motor taxes | * The assessment method is unchanged. |
| Mining revenue | * The 215 Review methodology is unchanged, consistent with terms of reference. * Consistent with that methodology, nickel royalties are now assessed in the other minerals component. |
| Other revenue | * The assessment method (EPC) is unchanged. However, the composition of the category has changed. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑4 2020 Review changes to 2015 Review methodology (continued)

|  |  |
| --- | --- |
| Category/disability | Main changes |
| Schools | * The regression models used to estimate cost weights for Indigenous status, socio‑economic status (SES), service delivery scale (SDS), and remoteness have been respecified. * Commonwealth funded spending on non-government schools is now out of scope. * Expenses for transport of school children are now assessed in Transport. * Pre-year one student data are now incorporated in the assessment without being imputed from year one student data. |
| Post-secondary education | * Regional costs are now measured directly using State data. * The grouping of SES quintiles has been revised. |
| Health | * A remoteness adjustment is applied to the national weighted activity unit (NWAU) data for block funded hospitals in the admitted patients (AP) and emergency department (ED) assessments to ensure appropriate recognition of SDS costs. * The regional costs factor for the non-admitted patients (NAP) assessment is based on ED data. An SDS factor based on ED data has been included. * The regional and SDS cost adjustments for the community health (CH) assessment are based on the latest IHPA ED remoteness/SDS cost adjustment, respectively. * The 25% discount applied to the socio-demographic composition (SDC) assessment was reduced to 12.5%. The corresponding discount applied to the non-State sector adjustment for community health has been removed. * The SDC assessments for all components disaggregate remote and very remote populations. * The assessment of Indigenous grants uses AIHW data. A regional costs factor based on ED data is applied. * A cross-border capital stock factor has been included in the health infrastructure assessment. * The ACT’s cross-border allowance for community health has been revised. * A cross-border allowance for homelessness (Welfare) is included in the community health component. * Annual expenditure data for ED and NAP services from the National Hospital Cost Data Collection have been used to split outpatient expenses. * The non-State sector substitutability levels for NAP and community health are 30% and 60% respectively. * The non-State sector indicator for NAP is based on bulk-billed medical operations and specialist services. * Expenses for pharmaceuticals, medical aids and appliances and health administration not elsewhere classified are included in the admitted patients component. |
| Welfare | * Non-NDIS disability, aged care and National Redress Scheme for Institutional Child Sexual Abuse expenses are assessed EPC in a single component. * Other welfare expenses are assessed EPC but wage and regional cost disabilities are still applied. * A discounted (50%) combined general gradient has been used to recognise regional costs and service delivery scale effects. * The cross-border disability for welfare services only recognises the ACT’s higher homelessness expenses. For simplicity, the disability is recognised in the Health category. |
| Housing | * Concessional rates of conveyance duty for first home owners are assessed in the Stamp duty on conveyances category. * The Indigenous cost weight has been reduced from 1.3 to 1.2. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1-4 2020 Review changes to 2015 Review methodology (continued)

|  |  |
| --- | --- |
| Category/disability | Main changes |
| Services to communities | * Electricity subsidies and water subsidies are separately assessed. * For the electricity subsidies assessment: * the definition of remote communities includes communities in a remote or very remote area with a population of over 50 people and a population density of at least 60 persons per km2 * the regional costs assessment applies a cost weight to people in very remote communities, which is derived from regression analysis of State subsidy data * the proportion of remote community electricity subsidies and other electricity subsidies is updated annually using State data * wage costs are assessed. * For the water subsidies assessment: * the definition of small communities includes communities in an inner regional, outer regional, remote or very remote area with a population of over 50 but less than 3 000 people and a population density of at least 60 persons per km2 * the regional cost assessment applies a cost weights to people in small communities in outer regional, remote and very communities, which is derived from State subsidy data * the proportion of small community water subsidies and other water subsidies is updated annually using State data * wage costs are assessed. * Indigenous community development expenses are derived using State data and includes general revenue grants to Indigenous councils. * Changes to GFS classifications mean that national parks and wildlife expenses are now included in this category. |
| Justice | * The split between ‘specialised’ and ‘community’ expenses has been removed, including the discount previously applied to specialist policing expenses. * Police costs are assessed using cost weights by region and assessed offenders, derived from an econometric model using State provided data. * The courts component has been split into separate criminal courts and other legal services components. * For criminal courts, Indigenous status non-response has been allocated in relation to the ERP distribution, rather than responding criminal court defendants. * For courts and prisons, regional costs have been measured directly from State provided court and prison cost data. * The grouping of SES quintiles has been revised. * Non-zero use rates for the 0-14 and 65+ year age groups are now applied. |
| Roads | * Rural road length has been re-estimated. New road connections have been added to link significant areas, including mines, oil and gas basins, ports and national parks. The number of lanes on roads is also taken into account. The adjustment for unsealed roads has been removed. * Local roads expenses have been reallocated proportionately to the urban and rural road components. * Bridges and tunnels are now assessed using actual lengths of bridges and tunnels that are State managed, measured across comparable structures. * The number of heavy vehicle classes has been reduced from five to three. Light commercial vehicles are now classified with passenger vehicles. * Other services expenses have been reallocated proportionately across the rural roads, urban roads, and bridges and tunnels components. |
| Transport | * A new urban transport assessment is introduced. Instead of urban centre population alone, the new assessment also uses population density, passenger numbers by mode of transport, the presence of ferry services, distance to work and topography to measure State needs. The former assessment has a weight of 25% and the latter a weight of 75%. * All student transport expenses are now included in the urban transport component. * The transport infrastructure assessment uses the model developed for the expense assessment (75% weight) and the population-squared model from the 2015 Review assessment (25% weight). * Non-urban transport expenses are now assessed on an EPC basis. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑4 2020 Review changes to 2015 Review methodology (continued)

|  |  |
| --- | --- |
| Category/disability | Main changes |
| Services to industry | * Mining regulation expenses are assessed in a separate component. * Major project expenses are no longer assessed. * New State data have been used to weight regulation and business development expenses for each industry. * All user charges are deducted from regulation expenses for agriculture, mining and other industries. * A single broad indicator (sector size) is used to assess agriculture and mining regulation expenses. * Other industry regulation expenses have been assessed using sector size (75%) and population (25%). |
| Other expenses | * The natural disaster relief expense assessment includes net local government expenses that are funded by States, less an assessed local government contribution. * A cross-border disability is no longer assessed for recreation and culture expenses. * Capital grants to local government are no longer assessed. * The roads allowance in the national capital assessment has been discontinued and national capital planning allowances have been revised. * No adjustment has been made for interstate non-wage costs. * User charges, mainly fire and emergency services levies, are netted off expenses. * Pipeline expenses are now included in the Transport category. National parks and wildlife expenses are in the Services to communities category, reflecting new GFS functional classifications. |
| Investment | * Investment and depreciation expenses are assessed together. * Investment associated with each category is now measured directly. * 3 year averaging of stock disabilities has been removed. * Regional cost influences on the cost of construction is only measured using Rawlinsons, rather than an average of Rawlinsons and the general regional cost gradient. * Administrative scale is no longer assessed in the Investment assessment. |
| Net borrowing | * The 12.5% discount has been removed. |
| Administrative scale | * Administrative scale costs have been re-estimated for all expense categories. * The Northern Territory dual service delivery adjustment has been removed. However, an adjustment of $2.0 million in 2016-17 dollars for the Northern Territory is included. * The wage costs proportion of administrative scale expenses has been reduced from 80% to 60%. |
| Wage costs | * The assessment method is unchanged. |
| Geography | * Regional costs have been assessed directly in a broader range of categories. * The general gradient for regional costs, which is extrapolated to categories without other direct measures, is based on the average of the regional cost gradients measured in admitted patients and schools. A 25% discount is applied to the general gradient for regional costs. * Allowance has been made, where possible, for differences between where a service is delivered and where the recipients reside. * SDS is assessed using remoteness areas. * The interstate non-wage costs assessment has been discontinued and no adjustment is made to the Accessibility and Remoteness Index of Australia (ARIA) based remoteness area outcomes. |
| National capital | * Planning allowances have been revised. * Allowances for wider roads, above average urban space, above average urban/bush interface and bus subsidies are no longer assessed. |
| Cross-border | * The general method for estimating cross-border costs has been discontinued and a cross-border factor will no longer apply. * The remaining cross-border assessments are included in their relevant assessment categories. |
| Native title | * The native title and land rights expenses are assessed as a single component. * Land rights expenses are assessed for all States (not just the Northern Territory) using the APC method of assessment. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

#### Summary of responses to State proposals

1. During the review, States have argued for changes to the Commission’s assessments, ranging from requests to include new disabilities to changes in the way existing disabilities are measured. Western Australia in particular argued for major changes in the way equalisation is conceptualised, approached and implemented by the Commission. In general, the Commission has not acceded to these requests, considering they fail on at least one criterion of the assessment guidelines.
2. For a disability to be recognised, the Commission requires there to be a conceptual case, supporting evidence, reliable data and method for measuring the disability, and for the disability to be sufficiently large as to be worth including (that is, material. See Chapter 3, Volume 2 for discussion on materiality).[[15]](#footnote-16) Table 1‑5 describes for each category the major requests for change from States and the Commission’s response. Greater detail on each of these issues is in the relevant assessment chapters.

Table 1‑5 Commission responses to State proposals, 2020 Review

|  |  |  |  |
| --- | --- | --- | --- |
| Proposal | State | Adopted | Explanation |
| Commonwealth payments |  |  |  |
| Apply backcasting to all Commonwealth payments | ACT | No | Forward estimates published in Commonwealth budget papers are not reliable for this purpose. |
| Apply a standard 50% discount to all Commonwealth infrastructure payments | WA | No | This does not achieve equalisation. Payments for Infrastructure where the Commission assesses needs should affect the relativities. |
| Cease applying the 50% discount to National network roads and National rail network | Vic, WA, Tas, ACT | No | These projects have national objectives that are not captured in road and rail infrastructure assessments. 50% discount achieves the appropriate balance between equalising State fiscal capacities and meeting national objectives. |
| Assess capital funding and related expenditure over time | Tas | No | Agree in principle but collecting information on expenditure for each infrastructure payment is problematic. |
| Re-stated the Commission should use its discretion under clause 8(d) of ToR and treat the $37m NSW received in 2017‑18 for signing the Skilling Australians Fund NP before a specific date as a 'no impact' reward payment. | NSW | No | The Commission does not consider it should exercise discretion as to whether a payment is a reward payment or not. It relies on information from the Australian Treasury on these payments and this payment is not listed as a reward payment. |
| Payroll tax |  |  |  |
| Remove remuneration paid by non-profit organisations | ACT | No | No reliable data source of non-profit remuneration by State. |
| Change data source of the assessment | ACT | No | Current data set is best available at this time. |
| Land tax |  |  |  |
| Broader revenue assessment | WA | No | Does not produce a more reliable indicator of States’ capacity to raise revenue. |
| Remove revenue base adjustments | WA | No | They reflect what States do and are material. |
| Adjustment for annual land valuations | Vic | No | All States try to keep their land valuations contemporary through valuations or benchmarking. |
| Different disability for other land based taxes | WA | No | Not material to separately assess. |
| Size of CBD for parking space levies | ACT | No | Not material to separately assess. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑5 Commission responses to State proposals, 2020 Review (continued)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Proposal | State | Adopted | Explanation | |
| Land tax (continued) |  |  |  | |
| Not use land values | WA | No | | No evidence that State policy differences are having a material effect on land values. | |
| Assess all land revenue together | ACT | No | States impose land tax differently to other land based taxes. The difference is material. | | |
| Reduce discount | 6 States | Yes | There appears to have been some improvement in comparability of SRO data in the last decade. | | |
| Base ACT adjustment on other State’s data | NSW, WA | No | Adjustment based on data provided by the ACT. | |
| Update NT adjustment annually | NT | Yes | Annual data are available to update adjustment. | |
| Expand value ranges | ACT | Yes | States provided the data to support the expanded number of ranges. | |
| Stamp duty on conveyances |  |  |  | |
| Broader revenue assessment | WA | No | Does not produce a more reliable indicator of States’ capacity to raise revenue. | |
| Remove revenue base adjustments | WA | No | They reflect what States do and are material. | |
| Adjustment because Victoria records its off‑the‑plan transactions according to dutiable value rather than purchase price | NSW | No | Victoria has provided transactions data by purchase price rather than dutiable value so an adjustment is not required. | |
| Assess all concessional rates of duty as grants | WA, ACT | No | The Commission does not intend to treat concessional rates of duty as an expense. | |
| Assess duty on sale of major State assets APC | Vic | No | Duties from the sale of major State assets arise because of policy choice. | |
| Differentially assess duty on windfall gains from State asset sales | ACT | No | Duties from the sale of major State assets arise because of policy choice. | |
| Assess non‑real property transactions APC | Vic | No | An APC assessment is not appropriate as the Intergovernmental Agreement is not binding. | |
| Assess land rich transactions by listed corporations EPC | WA | No | Seven States impose these duties and their capacities differ. | |
| Remove unit trusts adjustment | NSW, WA | Yes | Changes in State legislation mean any differences are no longer material. | |
| Only include 10% of the value of land rich transactions by listed companies | NSW | Yes | The majority of States apply duty at 10% of the general rate. | |
| Expand value ranges | ACT | Yes | States provided the data to support the expanded number of ranges. | |
| Introduce an elasticity adjustment | NSW, ACT | No | HFE is not being unduly affected by elasticity effects and concerns about the practical implementation of the adjustment. | |
| Insurance tax |  |  |  | |
| Remove CTP premiums from measure of the revenue base | NSW | Yes | Removed due to CTP premiums being influenced by individual State policies. | |
| Assess CTP duty EPC | NSW | No | Practicality grounds. Revenue cannot be reliably identified and unlikely to be material. | |
| Remove workers’ compensation insurance and CTP revenue | NSW, Qld, SA | No | Practicality grounds. A separate assessment of workers’ compensation is not material. Not including the associated premiums in the revenue base avoids policy neutrality concerns. | |
| Motor taxes |  |  |  | |
| Broader revenue assessment | WA | No | Does not produce a more reliable indicator of States’ capacity to raise revenue. | |
| Remove revenue base adjustments | WA | No | They reflect what States do and are material. | |
| Make an adjustment for the progressive rates of duty on passenger vehicles | 5 States | No | Adjustment is not material. | |
| Assess all concessional rates of duty as grants | ACT | No | The Commission does not intend to treat concessional rates of duty as an expense. | |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑5 Commission responses to State proposals, 2020 Review (continued)

|  |  |  |  |
| --- | --- | --- | --- |
| Proposal | State | Adopted | Explanation |
| Mining revenue |  |  |  |
| Discount the mining assessment | Qld, WA | No | Not possible to identify how much of the revenue might be attributable to above average revenue effort. |
| Discount the North West Shelf payment | WA | No | Not possible to identify how much of the payment might be attributable to above average revenue effort. |
| Adjustment for differences in development efforts | WA | No | Not possible to identify how much of any expanded revenue base might be attributable to above average revenue effort. |
| Adjustment for differences in compliance efforts | WA | No | More likely that diminishing tax receipts have a larger effect on compliance policy than GST effects. |
| Differences in the cost of production and profitability | Tas | No | The profitability of Tasmania’s mining sector does not appear to differ from other States. |
| A global revenue assessment | WA | No | Does not produce a more reliable indicator of State revenue raising capacity. |
| A uniform fixed standard royalty rate | WA | No | Does not produce a more reliable indicator of State revenue raising capacity. |
| A policy neutral capacity measure (land area) | WA | No | Does not produce a more reliable indicator of State revenue raising capacity. |
| Blend value of production data with land area | WA | No | Does not produce a more reliable indicator of State revenue raising capacity. |
| A rotating standard | WA | No | A rotating standard would add unnecessary complexity to the task of assessing capacity. |
| Assess grants in lieu of royalties in the category. | WA | Yes | Consistent with terms of reference direction not to change assessment method. |
| Back royalties should be assessed EPC | WA | Partial | Back royalties relating to the assessment years are assessed with iron ore royalties; back royalties relating to non-assessment years assessed EPC. |
| Other revenue |  |  |  | |
| Differentially assess gambling taxes | SA, ACT | No | A reliable capacity measure could not be found. | |
| Assess Other revenue EPC | WA | Yes | Other revenue assessed EPC. | |
| Schools |  |  |  | |
| Assess early childhood education | Vic | No | Unlikely to be material. | |
| Apply school disabilities to centrally managed costs | NSW, NT | No | ACARA data appropriately allocates centrally managed costs across schools. | |
| CALD disability | NSW, Vic | No | Not material. | |
| Include spending from Commonwealth funding in regression | WA | No | Aim of model is to identify cost drivers for State funded spending. | |
| Include Indigenous cost weight in non‑government schools, even though it is negative | WA | No | Cost weight as measured not supported by conceptual case and appears unreliable. | |
| Use quadratic equation to measure effect of school size on spending on schools | Vic | No | This approach would add complexity, introduce policy neutrality concerns and would prevent a reliable measure of other disabilities. | |
| Measure spending on 2nd quartile SES students | SA | No | Cost weight as measured not supported by conceptual case and appears unreliable. | |
| Students with disabilities | NSW, Qld, NT | No | Unable to find reliable data to support this disability. | |
| Recognise higher concentrations of low SES students | Tas | No | This cannot be done reliably, and any adjustment is unlikely to be material. | |
| Post-secondary education |  |  |  | |
| Assess a course mix disability | SA, Vic | No | Unlikely to be material, and concerns over policy neutrality. | |
| Recognise qualification level costs | 5 States | No | Unlikely to be material, and unable to find reliable data to support this disability. | |
| Recognise differential public/private provision | Vic | No | Unlikely to be material, and concerns over policy neutrality. | |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑5 Commission responses to State proposals, 2020 Review (continued)

|  |  |  |  |
| --- | --- | --- | --- |
| Proposal | State | Adopted | Explanation |
| Health |  |  |  |
| Revert to the subtraction approach | WA | No | Not consistent with what States do or the scope of fiscal equalisation. |
| Consider subtraction approach for the community health assessment | NT | No | Main concerns relate to implementation issues with the 2015 Review direct approach that have been addressed. |
| Include adjustment for CALD patients | NSW, Vic | No | IHPA costing study indicates a CALD patient adjustment would not be material. |
| Ensure all remoteness and SDS costs are recognised | Qld, WA, Tas, NT | Yes | An SDS adjustment is applied to block funded hospital NWAU data to better recognise SDS costs. Additional regional/ SDS cost adjustments based on the ED combined general gradient are applied in the NAP SDC assessment. For CH, the regional and SDS cost adjustments will be based on the latest year's data to ensure all remoteness costs are recognised and eliminate double counting. |
| Split the 75+ age group if material | Vic, SA, Tas, ACT | No | Tested but not material. The small number of people aged over 85 offsets their higher cost. |
| Assess NAP and community health together | NSW, Tas | No | Keeping NAP and community health separate aligns with funding arrangements/associated IHPA data. |
| Reinstate the 25% discounts applied to the CH SDC and non-State sector adjustment | NSW, Vic, ACT | No | The adjusted ED 4 and 5 NWAU data are the best available indicator for community health services. The analysis of NSW and Vic community health data confirms that the direction and scale of SDC influences are similar to their influence on ED services. However, because the assessment continues to use a proxy indicator, a 12.5% discount is applied. |
| AP substitutability – consider if this can be based on NWAU for the private sector | Vic | No | NWAU data are not available for private hospital services. |
| Lower substitutability level for ED services | NSW | No | Evidence does not support proposition that time of day affects presentation of GP-type patients at ED. |
| Low level substitutability (15%) for NAP allied health services | Tas | No | Access to NAP allied health services must be linked to a hospital admission. Presence of private allied health services unlikely to affect level of State provision. |
| Reduce NAP substitutability level | NSW, Vic, Qld | Yes | Level has been reduced from 40% to 30%. |
| Review why bulk billed services (rather than total MBS) used to measure non‑State sector | NT | No | Bulk billed services are more similar to State provided services as the cost constraint is removed. |
| Review Indigenous grants non‑State sector adjustment | NT | Yes | AIHW data are used to assess the use of Indigenous health services instead of ED data. |
| Reduce substitutability level of community health | Vic | Yes | Level has been reduced from 70% to 60%. |
| Substitutability level for community health is higher in remote areas | Qld | Yes | Already recognised. Substitutability levels are an average level and already account for regional differences of service availability. This is also recognised through the high use of State services in remote regions. |
| Bulk billed GP data should not include services eligible for the Section 19(2) Exemption Initiative | NT | No | Concern related to double counting. It does not occur because the MBS refunds are not deducted from State spending. In addition, participating States spend less on GP services as eligible costs are covered by the Commonwealth through Medicare. |
| Consider capital cost associated with providing cross-border hospital services | ACT | Yes | A cross-border capital stock factor has been introduced. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑5 Commission responses to State proposals, 2020 Review (continued)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Proposal | State | Adopted | Explanation | |
| Health (continued) |  |  |  | |
| Include Gove and other standalone hospitals when calculating the SDS adjustment for block funded hospitals | NT | No | Gove and other standalone hospitals are extreme outliers. Including them would distort the assessment of remote costs under average policy. | |
| Non-hospital patient transport understates remote costs | NT | Yes | Three remoteness areas included in the assessment instead of two. | |
| The assessment does not consider regional hospitals treating fly-in fly-out workers and tourists | WA | No | There are no service use data for FIFO workers nor information about their SES status. An assessment would require significant judgment. | |
| Welfare |  |  |  | |
| Include a CALD cost weight | NSW, NT | No | No data to reliably calculate cost weight. | |
| Include a Indigenous cost weight | NT | No | No data to reliably calculate cost weight. | |
| Combine New South Wales child protection data with AIHW data for the other States | NSW | No | New South Wales has been requested to provide the data to AIHW to ensure it is compiled on a consistent basis for all States. | |
| Apply SDS disability to child protection and family services | Qld, WA, Tas, NT | Yes | The combined general gradient, discounted 25%, is used to recognise both SDS and regional costs. | |
| New measure for the SES assessment of the other welfare component | NSW | No | Insufficient evidence to support an SES disability. | |
| Apply a low SES measure for other welfare | Qld, Tas, NT | No | Insufficient evidence to support an SES disability. | |
| Assess non-NDIS expenses using low SES | SA, Tas, NT | No | Insufficient evidence to support an SES disability. | |
| Assess homelessness and other welfare costs on an EPC basis | WA | Yes | EPC assessment has been applied due to insufficient evidence to support an SES disability. | |
| Apply a cross-border disability to category expenses | ACT | No | Insufficient evidence to support a disability. | |
| Apply a cross-border disability to homelessness expenses | ACT | Yes | There is a small cross-border effect for homelessness services. | |
| Housing |  |  |  |
| Recognise higher costs associated with higher land prices | NSW, Vic | No | There is little evidence linking land prices to social housing costs. |
| Include a CALD cost weight | NSW | No | A CALD cost weight based on language proficiency is not material. |
| Indigenous adjustment to rental revenue | Qld | No | An assessment of the cost of differential rental arrears rates between Indigenous and non‑Indigenous households would not be material. |
| Recognition of clients with a disability | Qld, Tas | No | No data to reliably calculate cost weight. |
| Update Indigenous and maintenance cost weights | WA, NT | Yes | The data collected from the States suggested that the 2015 Review Indigenous cost weight should be reduced and the maintenance cost weight retained. |
| Services to communities |  |  |  |
| Continue applying a regional cost weight and SDS to electricity subsidies | NT | Yes | The remoteness cost weights in the new method capture regional and SDS costs. |
| Differentially assess electricity subsidies for large remote and very remote communities | WA | Yes | Data show that these communities receive subsidies to offset higher costs. |
| Recognise an implicit electricity subsidy for the South West Interconnected System in Western Australia | WA | No | This network is not subsidised, and if it were, it would be considered largely the result of State policies. |
| Recognise higher electricity consumption in Darwin | NT | No | NT consumption is comparable to colder southern States. |
| Assess a water quality | SA | No | Unable to find data to support an assessment of this disability. |
| APC assessment of water subsidies, net of average revenue, discounted | WA | No | Policy influences actual subsidy levels. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑5 Commission responses to State proposals, 2020 Review (continued)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Proposal | | State | Adopted | | | Explanation |
| Services to communities (continued) | | | | |  |  |
| Assess a pipeline disability for water subsidies | | WA | | | No | No evidence of a consistent relationship between distance from the nearest surface water source and costs. |
| Differentially assess water subsidies for large remote and very remote communities | | WA | | | No | On average, States do not subsidise large communities; however, the small community population threshold increased from 1,000 to 3,000. |
| Include a land area disability for land management expenses and related services to industry, national parks and environmental protection expenses | | WA | | | No | Land area is not the only driver for these expenses and data are not readily available to identify these expenses. |
| Exclude common tariff costs for electricity subsidies in remote areas | | NSW | | | No | These costs are not material and removing them would overly complicate the assessment. |
| Reassess the community size cut-off for electricity subsidies | | NSW | | | Yes | Data are available to reassess the size limits. |
| Apply different population groupings to electricity subsidies | | NT | | | No | Community size (SDS) captured through the remoteness cost weight. |
| Apply different population groupings to water subsidies | | NT | | | No | Data support a community size of less than 3 000 people. SDS captured by the regional cost weight. |
| Reassess the split between small community and other water subsidies | | WA | | | Yes | Data are available to determine the split. |
| Discount the Indigenous community development assessment if using GFS data | | NSW | | | No | Assessment uses State expense data which is considered more comparable, and the disability is considered reliable. A discount is not warranted. |
| Exclude general grants to Indigenous councils | | Vic | | | No | The Indigenous community development disability is the most appropriate driver for these expenses, which cannot be functionalised. |
| Do not apply regional costs to Indigenous community development | | NSW | | | No | Regional costs are relevant as the Indigenous community development expenses are mostly incurred on site in communities. |
| Do not apply regional costs to environmental protection, excepting national parks and wildlife | | SA | | | Yes | There is insufficient evidence to support applying regional costs to these expenses. |
| Apply regional costs to all environmental protection expenses | | NT | | | No | Many expenses may be incurred centrally or in urban areas, such as research and development or pollution abatement. |
| Net off user charges | | SA, ACT | | | No | Disabilities for user charges are unlikely to be the same as those for expenses. |
| Justice |  | | |  | |  |
| Major city effects, including terrorism & complex crime | NSW | | | No | | No reliable assessment can be made and other indicators suggest it would not be material. |
| Recognise border patrol costs | Qld | | | No | | Data indicate any potential costs are not material and costs of remote policing are considered. Neither are reliable data available to indicate a disability compared to other States. |
| Recognise cross-border costs | ACT | | | No | | Data determine no cross-border case for Justice. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑5 Commission responses to State proposals, 2020 Review (continued)

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Proposal | | State | | Adopted | | | Explanation | |
| Justice (continued) |  | |  | |  | | | |
| Separate SDC assessments of higher and lower courts | Vic | | No | | Separate assessment of courts is not material given the way Indigenous status non-response is distributed on an ERP basis. | | | |
| Cost weights associated with culturally and linguistically diverse population | NSW | | No | | Data are not available to make a reliable assessment. Data also suggest any potential higher costs weight would be offset by lower use rate. | | | |
| Separate SDC assessment of custodial and non-custodial corrective services | Vic, Qld | | No | | Separate assessment is not material. | | | |
| Use State budget data to determine SDC/EPC split of courts | | Vic, ACT | | Yes | | Data provided directly from States are more accurate. | | |
| Discount SES data by 25% for prisons | | ACT | | No | | Data and conceptual case suggest a mark-up, rather than discount, is warranted. However, it cannot be reliably measured and is unlikely to be material. | | |
| Assess community drug consumption | | WA | | No | | No reliable assessment can be made. | | |
| Administrative scale for circuit courts | | NT | | No | | The administrative scale assessment gives States the capacity for minimum size of magistrates’ courts. It is double counting to also provide a separate amount for the same service in a different model. | | |
| Assess user charges within Justice assessment | | ACT | | No | | It is simpler to assess user charges in the other revenue category given that it is not differentially assessed. | | |
| Incorporate regional costs of offenders in police model | | NSW | | No | | Such a model is confounded by remoteness of offender and remoteness of offence and produces counter‑intuitive patterns. | | |
| Regional costs for prisons and/or courts should be based on gradient/not included at all | | NSW, Vic, WA, NT | | Partial | | There is a conceptual case for regional costs though evidence suggests this is lower than the general gradient. The regional costs gradient has been based on the best available data. | | |
| Include remoteness in the SDC assessment of defendants (courts) | | WA, NT | | No | | After controlling for SES, Indigenous status and age, there is no consistent relationship between remoteness and the defendant rate. | | |
| Roads | |  | |  | | |  | |
| Assess a physical environment disability | | Qld, Tas, NT | | No | | | Cannot capture all relevant influences; further attempts at measuring the impact are not likely to deliver an improved outcome. | |
| Disaggregate articulated trucks into at least two categories | | WA | | No | | | Data are not available, and disability would be policy influenced. | |
| Assess a congestion disability | | NSW | | No | | | Traffic volume and heavy vehicle use would capture a large proportion, if not all, of the effect of congestion. |
| Assess an urban density disability | | ACT | | No | | | A conceptual case has not been established. |
| Include roads to oil and gas mining, hydro power stations, wind farms, grain bins, mining exploration, mines of lesser significance in the measurement of rural road length | | WA, SA, Tas | | Partially | | | Roads to gas processing plants have been included as a proxy for roads to oil and gas mining. Other adjustments could not be made because of data limitations. |
| Include an adjustment for unsealed road length | | Vic | | No | | | No reliable cost or road length data to make an assessment. |
| Assess more connections to urban centres of less than 1 000 people | | WA, ACT | | No | | | Two connections reflect what States do on average and incorporating additional connections tended to result in over-counts of road length for most States. |
| Cease applying the regional costs gradient to rural road length | | NSW | | No | | | The general cost gradient is applied to rural road length, and reduced by 25% to recognise that this gradient is less applicable to road maintenance expenses than to other categories. |
| Retain local road assessment | | WA | | No | | | State spending on local roads is policy influenced. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑5 Commission responses to State proposals, 2020 Review (continued)

|  |  |  |  |
| --- | --- | --- | --- |
| Proposal | State | Adopted | Explanation |
| Roads (continued) |  |  |  |
| Recognise the differential cost of floodways | WA | No | The Commission did not have information on the number and length of floodways. |
| Retain EPC treatment of other expenses | NSW, Vic, ACT | No | Expenses on corporate services and regulation are influenced by the same disabilities as those that affect service delivery expenses. |
| Use only the NTC urban/rural split for roads investment | NSW | No | NTC data has continued to be blended with the split in State provided data to provide better alignment with stock data. This is an area of focus for the next review. |
| Transport |  |  |  |
| States requested that the urban transport assessment be expanded to capture additional disabilities, such as urban form and topography | Most States | Partially | Some disabilities requested were not included because either no data were available (for example, international students) or their inclusion did not improve the model (for example, waterways). |
| States requested that the non‑urban transport assessment be reviewed to ensure that all material drivers are captured | Vic, Qld, ACT | Yes | No material drivers could be identified. |
| Change the definition of urban centre and/or include satellite cities as part of capital city | Qld | No | The analysis by the consultants did not support this change. |
| Assess urban transport expenses EPC | WA | No | Evidence shows that there are significant non‑policy differences between States in the cost of providing urban transport services. |
| Assess non-urban transport expenses EPC | WA | Yes | No material drivers could be identified. |
| Remove blending | NSW | No | There are concerns about the reliability of the data. |
| Discount instead of blending | Tas, ACT | No | The Commission does not consider that discounting would provide a better outcome. |
| Services to industry |  |  |  |
| Consider the impact of Commonwealth assistance to industry on State business development spending | ACT | No | The interstate distribution of these payments is unknown and it would be difficult to determine how these affect State fiscal capacities. |
| Restrict the EPC assessment to expenses that develop new industries — for existing industries, use industry activity measures to assess needs | WA | No | States have considerable discretion over the amount and types of programs that receive funding. Population remains the appropriate driver of business development expenses. |
| The absence of a well-established private sector is a driver of State spending on business development | NT | No | As above. |
| Include business counts in the agriculture and mining regulation assessments | NSW, Vic, SA | No | The disability is not material. |
| A regional costs factor should be applied to business development expenses | WA | No | A significant proportion of business development expenses are incurred in capital cities or provided as grants, which are set amounts with no provision for regional or other costs |
| Use a regression approach to determine disability weights | WA | No | There is significant policy influence on the expense data, and volatility in the annual value of agricultural production. |
| Major projects disability should include Commonwealth non-dwelling construction, rather than just private non-dwelling construction | ACT | No | Including this indicator is appropriate and is material for the ACT. However, major project expenses will no longer be assessed. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑5 Commission responses to State proposals, 2020 Review (continued)

|  |  |  |  |
| --- | --- | --- | --- |
| Proposal | State | Adopted | Explanation |
| Other expenses |  |  |  |
| Assess natural disaster mitigation expenses APC | ACT | No | Unable to isolate expenses and identify an appropriate disability. |
| Assess natural disaster mitigation expenses APC, with 50% discount | NSW | No | As above. |
| Apply a cross-border disability to recreation and culture expenses | ACT | No | Insufficient evidence to support a disability. |
| Include State payments for local government net expenses for natural disaster recovery | Qld | Yes | All States provide financial support to local government for natural disaster recovery and local government are fiscally unable to fully self-fund disaster relief. |
| Unwind the 2019 natural disaster relief assessment and adjustment | Qld | Yes | The Commission would have assessed 2019 Update expenses differently if complete funding information had been provided. |
| Assess natural disaster relief expenses EPC | Vic | No | Insurance and mitigation measures considered to be sufficiently consistent between States for an APC assessment due to the common national framework. |
| Investment |  |  |  |
| Assess a physical environment disability | NT | No | Current capital cost measure captures some influences. It is not possible, with the data available, to further refine the assessment. |
| Recognise volatility of population growth | WA | No | The conceptual case is weak, a reliable assessment cannot be produced. Any assessment is likely to be immaterial. |
| Recognise the costs of construction on Indigenous owned/managed land | NT | No | Data are not available. |
| Recognise differential ability to attract PPPs | TAS, ACT | No | Unlikely to be material. |
| Recognise higher land costs in urban areas | NSW, Vic | No | Unlikely to be material. |
| Retain a separate depreciation assessment | WA, TAS, NT | No | More transparent to assess depreciation with investment in a gross assessment. |
| Alter assessment for timing mismatches | WA | No | The Commission considers that the assessment captures pressures on State budgets as accurately and consistently as possible. |
| Not include wage costs in the blended construction cost factor | WA | No | Rawlinsons’ does not recognise all public sector road and transport type costs. |
| Not assess negative investment | NT | Partially | Assessed negative investment reflects pressures on State governments with slow population growth and relatively low investment. The construction cost weight on such investment has been removed. |
| Not include intercensal discrepancy as population growth | WA, NT | No | Western Australia does not consider the Commission should bind future Commissions to a treatment of intercensal discrepancy. The Commission is describing its method for updating assessments. If unforeseen circumstances demand a departure from this method, that would be considered in the appropriate update. |
| Net borrowing |  |  |  |
| EPC assessment | Vic | No | States hold net financial assets on average and faster growing States have higher GST requirements. |
| Administrative scale |  |  |  |
| Review the administrative scale cost estimates | All States | Yes | The cost estimates had not been reviewed since the 2004 Review. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

Table 1‑5 Commission responses to State proposals, 2020 Review (continued)

|  |  |  |  |
| --- | --- | --- | --- |
| Proposal | State | Adopted | Explanation |
| Wage costs |  |  |  |
| Recognise a national labour market | Vic, SA | No | No evidence for large impact of national market over and above impact of competition for labour from other sectors within a State. |
| Productivity adjustment | SA | Partially | Comparison with HILDA model does not indicate bias, but contributing factor to retention of discount. |
| PSS adjustment | ACT | No | Not material under specified conditions. |
| Health wage costs adjustment | WA | No | Would introduce policy choice concerns and increase the requirement for Commission judgement in the assessment. |
| Tasmania specific adjustment | Tas | No | Most recent model results for Tasmania lay within reasonable bounds, reducing the concerns. |
| Not use private sector wages | Qld, SA | No | Consultants found that public sector wages respond to the same pressures as private sector wages. |
| Revise model specifications | Vic | No | There is a strong conceptual case for the existing model. |
| Remove the discount | WA, Tas, ACT | No | There are still low levels of concerns over how well private sector wages may proxy government sector wages and how well the model controls for productivity. |
| Reduce model volatility | WA | No | The current three-year averaging process sufficiently reduces the volatility in the single year estimates. |
| Change model and data source | WA | No | The Commission considers the current method and data source are the most appropriate way to estimate differences in relative wage costs. |
| Geography |  |  |  |
| Recognise differences between place of residence and place of receiving services | NSW, Vic | Yes | A strong conceptual case for these allowances. |
| Allow increasing distance to increase remoteness without limit | WA | No | This does not reflect the real world phenomenon being measured. |
| Apply a continuous remoteness score rather than remoteness categories | WA | No | There is no evidence that the relationship between ARIA scores and cost is linear, and attempting to measure such a relationship is likely to be difficult, incomplete and misleading. |
| Further differentiation of very remote areas | WA, NT | No | No practical way of doing so, and not clear what basis upon which to do it. |
| Distinguish between remote and very remote areas even when data does not support such a distinction. | WA | No | In the absence of data on the nature of the cost difference, this adjustment cannot be reliably made. |
| Retain interstate non-wage cost assessment | WA | No | Conceptual case but no evidence that a disability would be material. |
| Cease interstate non-wage cost assessment | NSW, Vic, NT | Yes | Convinced by State arguments that assessment is unreliable. |
| Cost of construction in brownfield areas | VIC | No | Not material. |
| Incorporate housing costs into measure of SES | NSW | No | Not material, but intend to follow Australian Bureau of Statistics (ABS) if ABS adopts this approach. |
| Use remoteness areas to measure SDS | ACT | Yes | This represents a simplification of the assessment. |
| Adopt State specific regional cost assessment | WA | No | It is not clear how this could be assessed without introducing major opportunities and incentives for States to game the system. It is not clear that any material disabilities are not currently being captured. |
| Use category specific data to measure regional costs where possible | NSW, Vic, Qld | Yes | This improves the reliability of the assessment. |
| Exclude hospitals from general gradient | WA | No | The Commission considers that using a combination of accurate and diverse services as a proxy is appropriate when direct information is available. |
| Include patient remoteness within general gradient | WA | No | The conceptual basis that place of residence has an effect on cost of services has been established for hospitals, but there is no evidence that such effects can be extrapolated to other services. |

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Source: Commission decisions.

Table 1‑5 Commission responses to State proposals, 2020 Review (continued)

|  |  |  |  |
| --- | --- | --- | --- |
| Proposal | State | Adopted | Explanation |
| National Capital |  |  |  |
| National Capital Plan on planning and development activities | ACT | Yes | A strong conceptual case for these allowances. |
| National Capital Plan on the ACT's capital works program | ACT | Partially | An allowance for the administration costs related to capital works is accepted but the capital costs are not. |
| National Capital Plan on the ACT's light rail project | ACT | Partially | An allowance for the administration costs related to light rail works is accepted but the capital costs are not. |
| National Capital Plan costs incurred due to leasehold system | ACT | Yes | The ACT does not have an option to end the leasehold system and move to a freehold system. |
| The additional costs of maintaining above average urban space | ACT | No | Insufficient evidence ACT faces above average costs beyond its control. |
| Additional ACTION costs | ACT | No | Considered in Transport assessment. |
| Above average urban/bush interface | ACT | No | Insufficient evidence ACT faces above average costs beyond its control. |
| Additional services provided to the Commonwealth - suspicious packages | ACT | No | Relates to a federal agreement between States and is outside the scope of this assessment. |
| Wider arterial roads | ACT | No | Sufficient time has passed for the road network to be restructured and no longer impose additional costs. |
| Native title and land rights |  |  |  |
| Consider alternative indicators for a differential assessment, rather than APC assessment | NSW, ACT | No | States tend to provide these services in cost effective ways and any differences in the level of expenses reflect their circumstances. |

Note: Acronyms used in this table are spelt out in the list of acronyms at the beginning of this volume.

Source: Commission decisions.

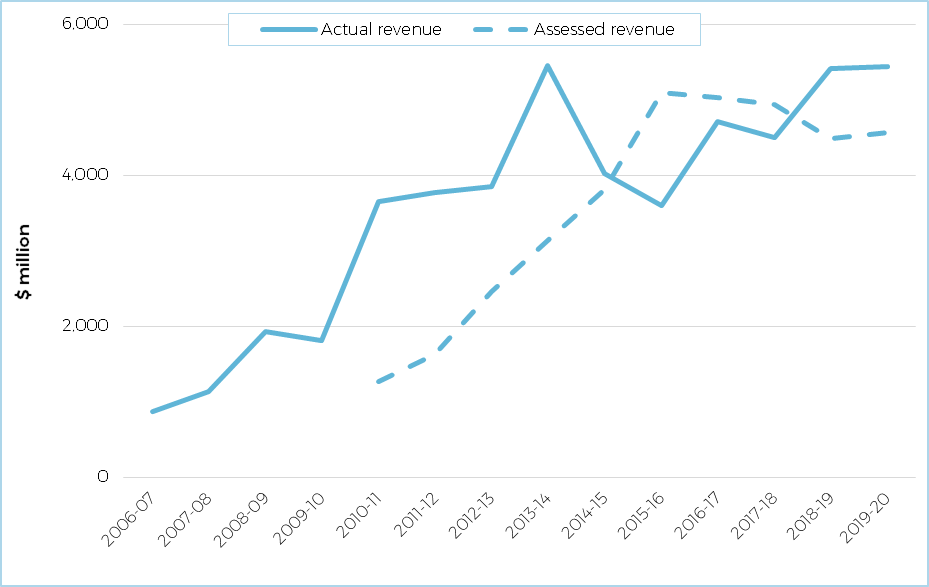
##### General State concerns — simplification and State-specific circumstances

1. More broadly, Table 1‑5 shows that most State proposals, if adopted, would result in increased complexity in the Commission’s methods. These proposals include, for example, even finer disaggregation of remoteness areas or SES cohorts, and the introduction of non‑linear relationships for measuring SDS effects. In some cases, application of the proposals put forward by States are not practical. For example, seeking to have differential Indigenous or low SES cost weights, depending upon the proportion of each of these types of students in a school, presupposes that the Commission could, on an average policy basis, assess the number of schools (including their student mixes) that each State would have.
2. The Commission has generally resisted this push by States for ever increasing complexity. Consistent with the direction in its terms of reference for the 2010 Review to simplify its assessments (progressing earlier work undertaken by Heads of Treasury), the Commission has aimed for methods that are no more complex than required to determine relative fiscal capacity, recognising the inherent complexity in the range of activities undertaken by State governments.
3. To those States that consider its methods do not sufficiently reflect the nuances of their specific service delivery circumstances, the Commission would respond that its role is to measure, on a comparable basis across States, the effects of the major drivers of service delivery cost differences. The heterogeneity of individual State service delivery circumstances means that it would be unlikely, no matter how complex a method might be developed, for that method to be able to address each and every individual State circumstance. Proceeding down such a path would inevitably lead to nothing more than an assessment reflecting actual State spending which, consistent with the policy neutrality supporting principle, would not accurately reflect underlying differences in State fiscal capacity.

##### Western Australia’s concerns

1. The Commission would also like to specifically address concerns raised by Western Australia. Western Australia has argued for major changes in the way equalisation is conceptualised, approached and implemented by the Commission. While most States have some issues in the detail of the Commission’s assessments, in the Commission’s view Western Australia stands alone among the States in its fundamental opposition to the approaches to measuring relative fiscal capacity, first adopted with the introduction of all State equalisation in the early 1980s.
2. The Commission rejects the assertion by Western Australia that recent legislated reforms to the GST distribution reflect serious concerns with the Commission’s approach to measuring State relative fiscal capacities. On the contrary, past and present Commissions have been consistent in their approach, and argued the form of equalisation used to distribute GST revenue is properly a matter for governments.[[16]](#footnote-17)
3. The recent reforms enshrine the approaches adopted by the Commission, which form the basis for identifying the fiscally stronger of New South Wales and Victoria. The reforms make clear the transition path from the previous arrangements (based on State relative fiscal capacities as measured by the Commission), to new arrangements (equalising to a standard State, being the fiscally stronger of New South Wales and Victoria) for the distribution of general revenue assistance to the States.
4. The Commission considers calls by Western Australia for changes to its approach to be inconsistent and contradictory. For example, Western Australia has argued for more broadly based tax assessments (which would ignore material differences in State revenue raising capacity due to progressivity of tax rates across thresholds and suchlike) on the one hand, while conversely also arguing the Commission overlooks ‘extreme’ expense disabilities affecting only outlier States on the other.
5. The Commission’s Representative Tax System (RTS) approach to measuring revenue raising capacity is consistent with world practice, for example that being used in Canada’s equalisation system.[[17]](#footnote-18) Past and present Commissions have consistently observed the bases States actually tax. Most often this is the legislative base, with adjustments to derive average exemptions and thresholds because this is what States collectively tax. No Commission has ever considered that global measures (such as household disposable income or adjusted gross State product), or broader measures of potential tax bases (unadjusted for differences in tax-free thresholds, progressive rates of tax or other exemptions), approaches favoured by Western Australia, are good indicators of the revenue States can raise.
6. On the expenditure side, the Commission rejects Western Australia’s assertion that it only includes disabilities for which data exist. In the 2015 Review, reliable data on a regional cost gradient were only available for schools, and to a slightly lesser extent for police. However, the Commission’s view was that the conceptual case that regional cost effects would also apply across other service delivery areas was sufficiently strong that an improved HFE outcome would result from it making an assessment. To that end, the Commission constructed a ‘general gradient’, which it applied to other service areas.
7. While a particular focus of the 2020 Review has been on trying to better measure the regional cost gradients across different service areas, the Commission continues to apply a ‘general gradient’ where reliable data are not available but the conceptual case is strong. The interstate non-wage adjustments applied in the 2015 Review (to the benefit of Western Australia) were a clear case of the Commission being prepared to make a judgment call in the absence of data. While the conceptual case for an adjustment remains strong (in the case of Western Australia), the Commission has been unable to find supporting evidence for the effects, or a data source to confirm the relative size of the effect. Due to this unreliability in the assessment, it has been discontinued in this review.
8. More broadly, the Commission considers that the exercise of judgment is an integral part of its role. In some areas of State activity, data that reflect the particular interests of the Commission are only partial, or absent. In these cases, the Commission makes a judgment call, following the processes outlined in its ‘Assessment guidelines’, as to an approach that will result in an improved measure of State relative fiscal capacities.
9. Putting aside the direction in the terms of reference for the Commission not to change its 2015 Mining revenue assessment methodology, Western Australia has criticised the Commission’s use of State value of production data (and State tax base data more generally). Western Australia said that these data reflect individual State policy positions and are hence not policy neutral, and consequently, as they do not reflect average policy positions, are not fit for purpose.
10. The assessment of revenue arising from mineral deposits has consistently presented issues for equalisation systems around the world. In Australia, the approach to assessing mining revenue has been considered in some detail by others apart from the Commission, most recently by the Productivity Commission.[[18]](#footnote-19) Indeed, the assessment of mining revenue is one area where successive Commissions have found it difficult to settle on an approach. While the Commission does acknowledge that State policies can affect value of production data, its view is that these effects cannot be disentangled from other non-policy influenced effects and, in any case, are subsidiary to these other non-policy effects. Mining is not undertaken by State governments, but by private companies. It is considerably more likely that the world demand for a particular mineral commodity, as reflected in current and prospective prices, is a much greater driver for these companies in making investment decisions, than State policies such as on planning approvals and royalty regimes (not to say that these policies have no bearing on investment decisions).
11. The boom in iron ore volumes and prices has resulted in a structural change in Western Australia's economy, and as a consequence, the national economy. As a result, although actual values of mining production data are used by the Commission, the three year lag in the assessment methodology has meant that Western Australia's actual mining revenue has generally exceeded its assessed mining revenue. This means that Western Australia has received substantially more GST revenue than it would have got under a fully contemporaneous approach. Put another way, Western Australia has received more GST revenue than required for horizontal fiscal equalisation purposes
12. Figure 1-1 shows that this has been the case over the decade from 2010-11 to 2019-20, with the exception of only three years from 2015-16 to 2017-18. A consequence of the legislated changes to the GST distribution (see Chapter 4 of this Volume for details) is that Western Australia will retain most of this benefit even if a structural downgrade in iron ore volumes and/or prices occurs in future years.

Figure 1-1 Iron ore royalties, assessed and actual, 2010-11 to 2019-20



Source: Commission calculations, Western Australia Budget Paper 3 — Economic and fiscal outlook, various years.

### Looking ahead

1. The completion of the 2020 methodology review marks the fourth method review completed by Commissions since the introduction of the GST.[[19]](#footnote-20) These roughly five yearly reviews have enabled the entire suite of assessments to be considered and weighed by each Commission, before all method changes to its assessments are introduced concurrently. Each successive review has produced a coherent measure of State relative fiscal capacities, but there has inevitably been a step change in GST shares from the preceding update inquiry, based on the previous review methods. The Commission understands that these step changes have implications for the stability and predictability of GST shares, which States value for their budget management purposes.
2. In 1993, the Commission said that the workload variations over the course of a five‑yearly review present challenges to the Commission (as well as presumably to States) in efficient and effective staff resourcing.[[20]](#footnote-21) In its submission on the draft report, the ACT argued that ‘the major peaks and troughs created by the five-year review cycle make it more difficult to maintain the detailed technical expertise necessary to participate in the reviews, and this could be improved by a better distribution of the workload over that period.’
3. The ACT said that one of the key disadvantages of the five-yearly review cycle is the large variations in workload during the inter-review period. It said the resources required for the two final years of each inter-review period significantly exceed those for the updates for the first three years of the period.
4. Additionally, the ACT has argued that today’s public sector is significantly different to that which existed in 1993, with a focus on staff agility, flexibility and multi-tasking. It said this approach has resulted in staff, particularly at the management and executive levels, getting a broader experience across a range of issues, rather than necessarily developing deep expertise in individual areas. In the ACT’s view, the major peaks and troughs created by the five-year review cycle make it more difficult to maintain the detailed technical expertise necessary to participate in the reviews.
5. The ACT argues for a rolling review. It said that while this would represent a significant shift in how the GST distribution methodology is determined, the approach would significantly smooth the workload of reviewing the GST distribution methodology, while making the process more responsive to changes in Commonwealth and State policy.
6. The work of the Commission is determined by the terms of reference which it receives. For many years, the terms of reference have specified comprehensive methodology reviews every five years or so, and annual updates of relativities using new data under established methods. The reviews and updates then formally enter into an established process of ministerial consideration including consultation between the Commonwealth and the States.
7. The approach suggested by the ACT would require a quite different approach to terms of reference and these processes. It is not open to the Commission to make decisions on these matters. Rather, they are matters for the Commonwealth and the States to consider, and to decide the direction they wish to pursue.
8. There is, however, one way that the Commission, in consultation with the Commonwealth and the States, could seek to improve work flows in future, and that is in its work program for the methodology reviews. The past pattern has been to concentrate initially on principles and guidelines and then to follow up later with specific assessments, all at the same time. Future work plans (if terms of reference allow and if they are received sufficiently early in the cycle) could instead nominate a sequence of assessment reviews — some starting immediately with others spaced over the available time.
9. The Commission considers that the Commonwealth and the States, through Heads of Treasury, could give consideration to the ACT suggestions insofar as they may affect future terms of reference and other processes. Separately, the Commission proposes, if governments agree and in consultation with them, to develop an early indicative work program for the next methodology review period that includes a sequential approach to the review of priority specific assessments. The Commission would see advantage in pursuing these considerations in 2020, even in advance of receiving new terms of reference.
10. Examples of assessments that could be progressed on a priority basis, particularly relating to outstanding data related issues, include:

* the allocation of roads expenditure between urban and rural roads using NTC and State data
* investigating the interaction between remoteness and Indigeneity costs for social housing
* fitness for purpose of IHPA non-admitted patient NWAU data
* responsiveness of State spending to changes in non-State health services
* suitability of the BLADE dataset to underlie the payroll tax assessment, once these data become available.

# 2 Measuring relative fiscal capacity

1. This chapter sets out the principles and guidelines the Commission has applied in developing the methodology for measuring State fiscal capacities. The Commission has had regard to State views in response to the draft report and earlier consultation papers.

### The Commission’s task

1. On 28 November 2016, the Treasurer gave the Commission terms of reference for a review of the methodology for calculating the GST relativities from 2020-21. A copy of those terms of reference is in Volume 1 and is available on the [Commission website](https://cgc.gov.au/) (https://cgc.gov.au/).
2. The 2020 Review methodology will provide the basis for measuring State relative fiscal capacities under the current and new arrangements for determining the GST distribution from 2020-21.[[21]](#footnote-22)

#### The terms of reference and the principle of HFE

1. Chapter 1 of Volume 2 set out the requirements of the terms of reference for this review. The terms of reference require the Commission to base its methodology for measuring State fiscal capacities on the principle of HFE. In the 2015 Review, the Commission articulated the HFE principle for determining the distribution of GST revenue as follows:

State governments should receive funding from the pool of GST 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.

1. This definition reflects the Commission’s approach to measuring the relative fiscal capacities of the States. Figure 2‑1 illustrates the approach.

Figure 2‑1 Equalisation requirement, 2020-21

(a) Includes expenses and investment.

Note: These are assessed expenditures, own-source revenue, net borrowing, Commonwealth payments and GST.

Source: Commission calculation.

1. A State’s equalisation requirement is the difference between the sum of its assessed expenses and assessed investment, and the sum of its assessed own-source revenue, assessed net borrowing and Commonwealth payments for specific purposes (PSPs). That is:

* a State’s assessed expenses are the expenses it 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[[22]](#footnote-23)
* a State’s assessed investment is the expenditure on infrastructure it 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
* a State’s assessed revenue is the revenue it would raise if it were to apply the average policies to its revenue base, and raise revenue at the average level of efficiency
* a State’s assessed net borrowing is the amount a State would require to achieve the average net financial worth at the end of each year
* a State’s assessed Commonwealth payments is the amount of PSPs it receives from the Commonwealth.[[23]](#footnote-24)

1. The equalisation requirement is the Commission’s estimate of the funding each State requires to have the financial capacity to provide the average (or same) standard of services. This level of funding also ensures that each State has the financial capacity to finish the year with the average (or same) net financial worth (NFW) per capita. In other words, NFW is equalised.
2. Under the current arrangements, the Commission is required to produce per capita relativities for distributing GST revenue in accordance with the above principle of HFE.[[24]](#footnote-25) These relativities reflect each State’s equalisation requirement. Under the new arrangements for distributing the GST that take effect from 2021-22, the Commission’s measures of relative fiscal capacity will no longer be the sole basis for determining the recommended GST distribution. The Commonwealth government has adopted a new equalisation standard under which State governments will receive funding from the GST pool such that each has the capacity to provide services at the standard of New South Wales or Victoria, whichever is higher.[[25]](#footnote-26)
3. The new arrangements will require the Commission to measure the relative fiscal capacity of all States as a step towards recommending GST revenue sharing relativities consistent with the legislated transition to ‘reasonable equalisation’ in 2026-27. Throughout this transition, the Commission will continue to base its measures of relative fiscal capacity on the same HFE definition that applied previously, but it will be expressed in a way that has regard to the changes to the arrangements for determining GST payments to the States. For the 2020 Review, the principle of HFE has been articulated as follows:

The assessment of State relative fiscal capacities, for informing the GST distribution, will be determined for each State 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.

1. The definition continues to focus on the main task of the Commission: to identify factors, or ‘disabilities’, affecting State finances.
2. Disabilities are influences that are beyond the direct control of States that cause their fiscal capacities to diverge. By assessing these factors, the Commission is able to determine the level of funding each State would need to provide the average level of services. The reference to material factors in the definition makes it clear that the Commission only measures those disabilities that have a relatively significant effect on State expenditure needs or revenue raising capacity.
3. Specifically, material factors affecting revenue and expenditures mean differences in State circumstances outside their direct control that:

* give rise to differences in the capacities of States to raise revenue or differences in the cost of providing services or infrastructure, other than those that result from the policy choices of individual States
* can be measured or estimated reliably
* cause their assessed expenditure or revenue to differ from an equal per capita (EPC) assessment by more than the materiality thresholds.[[26]](#footnote-27),[[27]](#footnote-28)

1. In 2020-21, the Commission’s assessment of State relative fiscal capacities will provide the recommended GST revenue sharing relativities as in previous years. From 2021-22, the Commission’s assessments will allow it to assist the government to implement the legislated changes by:

* identifying the stronger of New South Wales and Victoria for the purpose of producing reasonable equalisation relativities
* facilitating the legislated calculation of a set of blended relativities for distributing GST revenue during the transition years
* providing information to allow the Treasurer to determine if any State is worse off under the new arrangements during the transition years.

1. Chapter 4 of Volume 2 discusses the new arrangements in detail.
2. Having regard to the terms of reference and the amendments to the *Commonwealth Grants Commission Act 1973* and *Federal Financial Relations Act 2009*, it will be necessary for the Commission to continue to assess State relative fiscal capacities in accordance with the principle of HFE applying before the HFE reforms were legislated. Consistent with this, the Commission considers that it must continue to estimate the amount required by each State under the current ‘full equalisation’ standard.
3. Victoria said the Commission’s HFE definition should refer to the new equalisation standard in the amended legislation. The Commission considers it unnecessary to alter its definition in the way Victoria proposes. The Commission prefers a definition that articulates its main task, which is to measure relative fiscal capacity of the States for the purpose of informing the GST distribution.
4. New South Wales said it supports HFE that, in its view, an EPC distribution would achieve. The Commission does not agree that an EPC distribution is consistent with achieving HFE. Furthermore, it would be inconsistent with the Commonwealth’s fiscal equalisation policy.
5. Queensland said it strongly supported HFE but the definition should change to reflect better that in practice the outcomes deliver similar rather than the same fiscal capacities. The Commission considers that the references to ‘same standard’ and ‘same effort’ in the definition reflects what the Commission aims to achieve, which is illustrated in Figure 2‑1. Furthermore, changes to the terminology would not improve understanding of the Commission’s task.
6. Other States supported or did not comment on the definition of HFE. However, Western Australia said that although it was comfortable with the definition, not even proximate HFE is achieved under current implementation and methods. Western Australia’s criticisms of the Commission’s approach to implementing HFE are discussed in the following sections of this chapter, and in Chapter 1 of Volume 2.
7. An understanding of what HFE is, and its purpose in Australia’s fiscal federalism arrangements, provides useful context when considering the Commission’s approach to its task. Box 2-1 discusses these arrangements in the Australian federation.

|  |
| --- |
| Box 2-1 Horizontal Fiscal Equalisation in the Australian Federation |
| The principle of HFE underlies the fiscal equalisation arrangements of all federations. Broadly, fiscal equalisation seeks to reduce fiscal disparities between sub‑central governments. Each federation decides how to give effect to the principle and no two federations have the same arrangements. In Australia, the Commonwealth government, in consultation with the States, is responsible for deciding the form of equalisation. The Commonwealth Grants Commission is the body responsible for measuring the relative fiscal capacities of the States and recommending the distribution of GST revenue in accordance with the government’s fiscal equalisation policy.  Under HFE arrangements in Australia since the 1980s, equalisation has sought to ensure that each State has the same fiscal capacity to deliver services. Each State may pursue its own policies and priorities, but its fiscal capacity to do so is equalised, taking account of the differences between jurisdictions in their tax bases and their service delivery needs or costs. In practice most of the spending by the States delivers a broadly similar set of services across Australia, and HFE makes this possible.  The Commonwealth and State governments have responsibility for delivering major public services to Australians. The Commonwealth collects most of the tax revenue for both levels of government. In addition to defence and other national functions, the Commonwealth also delivers most of the social assistance transfers (pensions, family allowances, Medicare payments and pharmaceutical benefits) and plays the major role in funding many service areas such as universities, childcare and aged care.  Commonwealth funding policies generally apply on a common basis in all States, so that in these areas there is effective equalisation operating throughout the Commonwealth. The Commonwealth collects more revenue from taxpayers in States with stronger tax bases, and more Commonwealth spending occurs in States with higher needs, simply because the same Commonwealth policies (obligations and entitlements) apply across all States.  Over 80% of State spending relates to programs in several broad areas — health (mainly public hospitals), education (mainly public schools), justice, roads, public transport and some remaining welfare and social housing services. While the Commonwealth has been playing an ever-increasing role in most of these areas, the States retain major roles, including responsibility for service delivery. HFE makes it possible for every State to have the financial resources to provide the same standards of services in these and other areas for which they are responsible.  Thus, HFE seeks to achieve the benefits of equalisation that would otherwise require transfers of functions to the Commonwealth, without losing the benefits of decentralised governance and administration provided by sub-national jurisdictions. The payment of HFE grants as general revenue assistance allows State governments to deliver services according to State specific needs and circumstances. The combination of fiscal equalisation with decentralised governance is a longstanding feature of the Australian federation. |

### Supporting principles

1. In making and explaining decisions on the development of its methodology in accordance with HFE, the Commission has adopted certain supporting principles. They capture the main influences that experience suggests the Commission has to consider in evaluating the different aspects of the methodology for assessing State fiscal capacities. These principles also provide guidance to the States in preparing their submissions through the consultation process.
2. The four supporting principles developed over time are:

* what States do
* policy neutrality
* practicality
* contemporaneity.

1. The supporting principles inform decisions on the structural elements of the Commission’s methodology:

* scope — identifying which revenues and expenditures to assess and how to categorise them
* disabilities — identifying the conceptual case supporting the existence of a disability[[28]](#footnote-29)
* assessment methods — how to give effect to, and measure, the disabilities.

1. Clause 6 of the terms of reference asked the Commission to consider whether the supporting principles it uses remain appropriate, including whether different weights should apply to different supporting principles.
2. The supporting principles are guiding considerations for the Commission in determining its methodologies. They are neither separate objectives nor pre‑conditions for methodological choices. In most cases, all or most of the supporting principles apply concurrently and so each is constrained by the others. Their relevance and role inevitably vary according to the issues and circumstances under consideration.
3. The interaction and subsequent constraints between the supporting principles requires a balancing of competing considerations when choosing methods. The need to balance competing considerations reflects the complex issues the Commission must consider when undertaking its task, which in turn reflects the complexity and variety of State government activities. As required, the Commission uses its judgment to devise the best overall result consistent with the definition of HFE.
4. For the 2020 Review, the four existing supporting principles have been maintained, but with some further clarification of their purpose and scope. The Commission has not established any prior ranking or weighting of them. The balance of considerations may differ with the varying structural elements of the Commission’s methodology and with varying underlying circumstances in each assessment area. The Commission considers that wherever possible, methods should have regard to all of the supporting principles.
5. All States except New South Wales and Western Australia expressed support for retaining the supporting principles from the 2015 Review. In addition, Victoria, South Australia, Tasmania and the Northern Territory did not support a hierarchy of principles and argued the Commission should retain flexibility to use its judgment to determine the relative priority of the principles on a case-by-case basis. These States considered the supporting principles assist the Commission to implement HFE in a consistent and coherent way, and ensure HFE remains the priority. In addition, they did not suggest any new principles, noting that the four current principles are appropriate and sufficient.
6. The ACT considered that there is already an implicit weighting built into the current listing of the principles and that ‘what States do’ and ‘policy neutrality’ are the most important. It said that any trade-offs should ensure HFE remains the priority. The ACT said that one of the positive aspects of the HFE arrangements is that the Commission can exercise judgment if its best endeavours to build a reliable assessment do not lead to an outcome consistent with its observations of State circumstances.
7. Queensland also viewed HFE as the priority, with the supporting principles assisting the Commission to achieve HFE. Queensland emphasised the importance of:

* practicality, particularly simplicity, which helps to build the credibility and robustness of the HFE system
* ‘what States do’, which is critical in determining the scope of HFE and the factors affecting State finances
* policy neutrality, because the HFE process should not be allowed to be a significant consideration for policy makers.

1. Queensland suggested the Commission specify a hierarchy for the supporting principles but did not suggest how a hierarchy might be developed or used.
2. Western Australia argued for a new set of principles and raised concerns about the current principles.
3. Western Australia’s main concerns were:

* HFE cannot be achieved without policy neutrality, because it is integral to ensuring that the outcomes reflect States applying the same effort and HFE does not distort their policy decisions
* the Commission’s use of the ‘what States do’ principle leads to a micro approach which fails to uncover the essence of what States do and ignores intertemporal aspects of what States do
* the practicality principle is really an operational consideration, not a core principle, and it is inherently ambiguous
* contemporaneity is also an operational consideration rather than a defining principle, which the Commission acknowledges is not achieved due to the use of average historical assessments; this causes significant budget management difficulties and volatility for an outlier State.

1. Western Australia distinguished between fundamental principles and operational principles. It proposed the following fundamental principles to support HFE.

* Policy neutrality — proposing that broader indicators should be used so that GST grants are unaffected by revenue or spending mixes or differences in policies that affect revenue bases and spending needs. Western Australia’s arguments focused on revenue assessments.
* Equity — so that underlying disabilities are recognised (rather than their detailed manifestations), consistent with policy neutrality, broadly reflecting State policies.

1. Western Australia proposed the following operational principles to guide implementation.

* Contemporaneity — by using forward estimates volatility would be recognised as it occurs (using budget estimates and later corrections), or long run capacity should be recognised, avoiding the influence of cyclical factors.
* Conservatism — a State’s fiscal capacity should be presumed to fully or partly reflect its own effort if there is no, or only partial, evidence to the contrary, so that the Commission should use caution in redistributing away from EPC.
* Accountability, simplicity and transparency.
* High-level implementation decisions should reflect a consensus view of governments or decisions of the Commonwealth Treasurer (where there is no consensus). The Commission should be responsible for implementation, not policy.
* The Commission’s methods should undergo regular peer review by independent experts commissioned to conduct reviews.
* There needs to be full documentation of data and evidence used by the Commission in reaching decisions.
* Methods should be clearly described and simple.

1. New South Wales did not discuss the current supporting principles. Instead, it proposed a new set of principles to guide an appropriate distribution of the GST.
2. New South Wales argued that a well-designed and carefully targeted system of HFE, which it considers could be achieved by an EPC distribution, must be consistent with the following principles.

* Fairness — the distribution of GST revenue should be fair in the eyes of Australians. The system should provide sufficient revenue for States to provide minimum levels of selected critical services — health, education, law and order and infrastructure. No single State should bear an unreasonable burden that would detract from their responsibilities towards their own constituents.
* Efficiency — the distribution of GST should not create disincentives for economic adjustment and reform relating to expenditures or taxes. The benefits of pursuing equity should be greater than the efficiency cost.
* Simplicity — the mechanism should be simple to understand and administer, and easy to replicate.
* Accountability — this should apply to both the body making the calculations of GST distribution and to the Commonwealth and State governments who must be responsible to their citizens for the spending and revenue choices they make.
* Stability — GST revenue distribution needs to be more predictable so that State governments can confidently budget to provide essential services.

1. New South Wales acknowledged these principles are similar to the current principles the Commission uses. It argued that they are essential to HFE and not subsidiary to the overarching equity principle.
2. The Commission noted a significant overlap between the supporting principles proposed by New South Wales and Western Australia and the Commission’s current principles. The Commission considered that the proposals put forward by New South Wales and Western Australia stem from concerns with the Commission’s emphasis on HFE and relate to how it applies the supporting principles to its work. For example, both States support a policy neutrality principle. However, their judgments on how to apply the principles in deciding questions of scope, disabilities and methods would be different to the Commission’s judgments.
3. The main area of difference between the Commission’s principles and those proposed by New South Wales and Western Australia relates to their views on HFE. Western Australia supports an equity principle that takes a broad view of what States do and a broader approach to measuring fiscal capacity (especially on the revenue side of the budget). New South Wales prefers a fairness principle that provides capacity for a minimum standard of core services. It also supports broader assessments, which it considers could be achieved by increasing the materiality threshold for a disability.
4. New South Wales and Western Australia also emphasised accountability and transparency as supporting principles. The Commission agreed these are important matters but considered them governance issues that do not change, in themselves, the task of measuring fiscal capacities. The Commission noted that simplicity, which is an aspect of the practicality principle, supports transparency.
5. Having considered the proposals of New South Wales and Western Australia, the Commission took the view that the current supporting principles remain relevant and appropriate for supporting its work in assessing State fiscal capacities. The Commission considered that there would be no advantage in weighting the supporting principles or distinguishing between fundamental and operational principles as suggested by Western Australia. The task of the Commission, articulated in the terms of reference, is to measure the fiscal capacities of the States in accordance with the principle of HFE. The Commission considered that proposals presented by New South Wales and Western Australia would have the effect of limiting the Commission’s ability to achieve its mandated task.

#### ‘What States do’

1. This supporting principle ensures that the Commission’s assessments reflect the full range of State expenditures and revenues. It applies mainly to deciding the scope of assessments and to identifying disabilities. It refers to what States collectively do (rather than what each does individually) because the assessment of fiscal capacity is based on determining what State revenues and expenditures would be under a common (or average) policy. Importantly, this principle reflects the long‑standing empirical nature of the Commission’s way of working to equalise State budgets, as opposed to a normative approach whereby the Commission would substitute its own view of ‘what States should do’ or ‘what States could do’.
2. Following the ‘what States do’ supporting principle means that the common policy assessed by the Commission generally is the (weighted) average policy of all States combined. ‘What States do’ sets the average expenditure and revenue,[[29]](#footnote-30) rather than requiring judgment of what States should, or could, do. As the roles, functions, priorities and circumstances of the States change, so does the assessment of their fiscal capacities.
3. More specifically, as a result of following this supporting principle:

* the scope of the assessments reflects the average range of services provided collectively by States and the average range of taxes and other revenues to fund them
* the level of services and associated infrastructure States are funded to provide, and the revenue raising efforts they are presumed to make, are an average of those actually provided or made
* the range of disabilities assessed reflects the material factors beyond a State’s control actually affecting the cost of delivering State services and the capacity to raise State taxes.[[30]](#footnote-31)

1. Victoria, Queensland, South Australia, Tasmania, ACT and the Northern Territory supported the ‘what States do’ principle and its implications for the scope of equalisation, choice of standards and disability measurement. New South Wales did not comment.
2. Western Australia agrees with the use of internal standards and that assessments should be based on ‘what States do’.[[31]](#footnote-32) However, it argued that the ‘what States do’ principle leads to the recognition of disabilities generated by policy instead of underlying disabilities. Western Australia suggested the Commission should ‘try to uncover the essence of what States do’, rather than focusing on the detailed manifestations of ‘what States do’. To illustrate its point, Western Australia said the Commission should consider how States establish their tax thresholds, presumably instead of simply observing that this is ‘what States do’ when developing an assessment that reflects average State policies.[[32]](#footnote-33) Western Australia appears to be making the case for broader assessments. In recent reviews, the Commission has considered adopting broader assessments, particularly for revenue.
3. The Commission acknowledges that there are advantages and disadvantages with the current tax approach for assessing revenue capacity compared with broader revenue assessments. However, the Commission has consistently concluded that moving to broader revenue assessments would not result in a better HFE outcome because it has not been able to identify broader indicators, or global measures, that reliably measure State capacity to raise revenue. The Commission has considered options for assessing service delivery costs using broader indicators but it has been unable to identify a way forward that would be consistent with achieving equalisation. No State has suggested alternative approaches, other than increasing materiality thresholds.
4. As well as a concern that broader assessment approaches would compromise the achievement of HFE, the Commission also noted that adopting Western Australia’s suggestion would involve a fundamental departure from the Commission’s practices since its establishment in 1933. It runs the risk of creating a ‘castle in the air’ of what States might, in a theoretical sense, be able to do if freed from real world constraints.

##### Scope of equalisation

1. The Commission retained the 2015 Review scope of equalisation, which includes the State general government sector, plus urban transport and social housing public non‑financial corporations (PNFCs) and excluding local government (except for the interactions between it and the State sector).
2. The Commission considered that neither the intergovernmental agreement (IGA), nor successive terms of reference from the Treasurer, provided a basis for discriminating between services or revenues. Therefore, it considered there to be no logical basis for excluding particular activities as proposed by New South Wales and Queensland. A comprehensive coverage is consistent with an aim of measuring (to the extent possible) the capacities of States to provide services at the average standard. Omitting major revenues, expenditure or disabilities would not be consistent with equalising fiscal capacities. A comprehensive scope does not mean that all functions can or need to be differentially assessed or that spending and revenue needs to be examined in detail. Most States supported a comprehensive coverage of State activities, although Western Australia said it preferred to take a broader view of State activities. It suggested options for broader revenue assessments but not for expenditure.
3. A comprehensive scope is also fully consistent with a policy framework that encourages innovation in service delivery or revenue raising. It would make no sense, for example, for the Commission to consider only service delivery spending in the general government sector when some services, in some States, are delivered through PNFCs. A comprehensive scope limits the risk of inadvertently favouring or prejudicing certain ways of delivery services through the creation of artificial distinctions. It leaves States with flexibility on how they manage the business of government.
4. The Commission will continue to equalise the fiscal capacity of States so that they have the same average per capita NFW. That is, as in the 2015 Review, the Commission will implement the HFE principle as follows:

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

1. This approach explicitly states that equalising net financial worth means that income from general government holdings of NFW is equalised. There is a simplifying assumption underlying the equalisation of NFW, that States hold the average mix of financial assets and have the same capacity to earn income from those assets.
2. Victoria, South Australia, the ACT and the Northern Territory said they supported, or were comfortable with, the current approach to implementing HFE, which culminates in the equalisation of NFW. South Australia noted it continues to see merit in the 2012 GST Distribution Review’s recommendation of a simplified and integrated assessment framework.[[33]](#footnote-34) Tasmania said it continued to have concerns with the assumptions underlying the net borrowing assessment that ensures NFW is equalised. It acknowledged the effects of population growth on NFW but considered there are other offsetting effects that the assessment should recognise. Tasmania has not presented any new analysis of the issue, which the Commission considered in some detail in the 2010 and 2015 Reviews. In addition, the expanded scope of the adjusted budget from the 2015 Review, to include certain PNFCs, has seen a reduction in materiality of the net borrowing assessment. As a result, an assessment to recognise the influences Tasmania described would be immaterial. New South Wales, Queensland and Western Australia did not comment. In the absence of any new analysis to support a change to the assessment, the Commission will continue to implement the HFE principle so that States have the capacity to hold the same average per capita NFW.
3. Regarding local government, all States that commented on this issue supported the exclusion of local government.[[34]](#footnote-35) New South Wales and Western Australia did not comment.
4. No State objected to including urban transport and social housing PNFCs; however, Tasmania noted the implications for the Investment assessment. Tasmania’s concerns related to the Commission’s approach to assessing capital rather than including PNFCs.

##### Internal standards

1. The Commission continues to have a strong preference for internal standards (that is, basing equalisation on what States do) because it avoids the need for normative judgments about appropriate external standards. However, in circumstances of extreme policy non-neutrality, where it is difficult to determine what average policy would be, the Commission could consider the use of external standards, if another suitable resolution is not available. In this review, the Commission has not identified any situations necessitating an external standard.
2. Average State expenses, investment and revenues per capita are derived generally by dividing the total State expenses, investment and revenues by total State population. Average revenue raising efforts generally are derived by dividing the total State revenue by the total State tax bases. Therefore, these averages are influenced by what States do, to the extent each State undertakes the activity.
3. In relation to service delivery, the Commission observes what the data reveal about the different spending patterns States collectively adopt for different groups in their populations — differentiated by characteristics such as age, SES and location. In this way, the Commission will recognise what each State would need to spend if it spent these average amounts on its own population groups.
4. The Commission does not discount or otherwise adjust standards as a means of more actively encouraging efficiency. This would distort the observed relationships. The Commission will equalise States to the average cost of service delivery that incorporates the average level of technical efficiency. If a State is more efficient than average, its own budget benefits. If a State is less efficient than average, it must finance this above average inefficiency itself.
5. The Commission observes that different tax bases in States attract different (sometimes nil) rates of tax. These differences reflect constitutional, historical and economic conditions over the course of the development of States. In the same way, settlement patterns (including urban form) reflect a range of geographic, historical and economic conditions. The Commission’s view is that measuring State fiscal capacities must take account of these differences.
6. The Commission acknowledges that data quality and policy neutrality challenges associated with more detailed approaches could potentially be solved or reduced with the use of a broad indicator. However, the Commission would only consider adopting a broader indicator if it were a more reliable indicator of State capacity to raise revenue or service delivery costs than any alternative approach. As already noted, Western Australia said the Commission should not focus on what States do in detail but try to uncover the essence of what States do. This appears to be a reference to adopting broader assessment approaches. Western Australia has described what this entails for revenue assessments but not how the Commission would uncover the essence of what States do for service delivery, or how it would implement an assessment or assessments recognising the essence of what States do.
7. Victoria, Queensland, Western Australia, South Australia, Tasmania, the ACT and the Northern Territory supported the use of internal standards and considered any departure from an internal standard to overcome policy neutrality concerns should be in extraordinary cases only. South Australia doubted there are any current circumstances that would warrant the use of external standards. Queensland, Tasmania and the Northern Territory commented that an external standard would impinge on State autonomy. The Northern Territory noted that the most populous States dominate an internal standard, which embeds a level of efficiency into the national average cost, based on the largest States being able to achieve economies of scale. New South Wales did not comment specifically on the issue.

##### Weighted averages and average policy

1. Where States follow different policies, the Commission needs to determine the average policy to be used as a benchmark for its assessments. If the Commission observes that a tax or service is part of what States do, it considers whether there are material differences in underlying capacities to raise the tax or deliver the service.
2. In adopting internal standards, States with a larger share of a revenue base or service population will have a larger impact on the average policy. The more populous States, New South Wales and Victoria, generally have the largest effect on standards, but this is not always the case. A State with more of a revenue base (for example, Western Australia in regard to iron ore and Queensland in regard to coal) will have a larger effect on the average tax rate used to calculate the relevant revenue raising capacity if these minerals are assessed separately. Similarly, States with the greatest number of Indigenous people (New South Wales and Queensland) will have a larger effect on the average State spending on services to Indigenous people.
3. In the 2015 Review, the Commission extended its approach to determining average standards to also determining average policy. It said the aim was to use what the data told it about what States do to decide the scope of the assessments. The Commission decided to retain this ‘weighted average’ method as its general approach, where average policy reflects the average of what all States do, recognising that some States may make a zero effort.
4. Under this approach to average policy, if even one State raises a revenue or provides a service, the revenue raised or spent becomes part of what States do collectively. However, the Commission would only have a differential (non-EPC) assessment if the conceptual case for a disability is established, there is a reliable and policy neutral method for measuring the disability and it is material. In this way, average policy is not a switch, where States collectively either do, or do not do, an activity; rather it is a continuum, where:

* the average effective tax rate on a base is a reflection of the share of the tax base taxed by States[[35]](#footnote-36)
* the average per capita spending on a service will depend on the total amount of money spent on that service, regardless of in which States that money is spent.

1. Hence, the more States there are taxing a base, the higher the average effective rate will be; the more States providing a service, the higher the average per capita spending on the service will be. The Commission then determines if a differential assessment is to be made on the basis that it can be done reliably and would be materially different from an EPC assessment.
2. The Commission observes that, where only one State raises a tax or provides a service, the average effective tax rate or national per capita spending is most likely to be very low and a differential assessment is unlikely to be material. Thus, the materiality threshold guards against a proliferation of assessments under its average policy approach. However, if one State raises a tax on a large tax base or spends a large amount on a service, a differential assessment could be material, in which case the impact on State fiscal capacities should be recognised.
3. The Commission notes that applying this approach to determining average policy, at times, may need to be modified due to practical considerations; for example, where reliable assessments cannot be made. Data limitations can mean the approach may not always be practical. In these cases, the Commission uses its discretion in deciding the methods to adopt.
4. Victoria, Queensland, Western Australia and the Northern Territory commented on the Commission’s approach to average policy. Victoria said it could not determine if the 2015 Review approach would produce different outcomes and therefore it was indifferent to which approach the Commission uses. Queensland and the Northern Territory said there are policy neutrality concerns with the 2015 Review approach. They were concerned that one or two States could potentially set average policy and directly influence outcomes. Queensland cited the commodity based Mining assessment as an example. Western Australia raised concerns about the lack of policy neutrality arising from a detailed view of what States do. It considered that the Commission’s approach to average policy promotes a view that disabilities are generated by policy. The other States supported the Commission’s approach to average policy or did not comment.
5. The Commission notes that the change in its approach to average policy has not increased the number of disability assessments in the 2015 or 2020 Review. This is largely due to the materiality threshold applying to a disability or absence of data to support a reliable assessment of a tax or service that is not common to most States. The advantage of the 2015 Review approach is that it reduces the need for judgment about when a tax or service is part of average policy. In addition, the Commission notes that, although all State spending and revenue contribute to average policy, not all spending and revenue is subject to a differential assessment. By applying its assessment guidelines, the Commission avoids the potential for policy‑generated disabilities, a concern raised by Western Australia.

##### Disability measurement

1. In this review, the Commission continued to use the general approaches it has used in the past and for its assessments to reflect ‘what States do’ on average. For revenue assessments, it can often do this in a straightforward manner. For example, in the case where a revenue assessment uses the base that States actually tax, actual (national average) tax rates can be applied to that base.
2. For expense assessments, the Commission observes State service delivery policies and collects administrative data that reveal what States do. The data reveal the populations to whom States provide services. What States spend on different population groups, such as Indigenous and non-Indigenous, different age groups, people living in different SES areas or different remoteness regions, is calculated. The Commission then takes total spending by States on each population group and divides that by the national number of people in each of those groups. The resulting expense per person for each group is applied to the actual numbers of people in the group in each State to calculate what each State needs to spend if it applied the average policy (if it spent the average amount per person in each group).
3. While States may not develop or implement their policies by deciding how much to spend per person in different groups, the data capture the result of how States have implemented their policies. Therefore, to that extent, the Commission measures what States do. For example, the Commission observes that for admitted patient hospital services, States spend twice as much per capita on Indigenous people as non‑Indigenous people, and nearly six times as much on people aged 75 years and over as those under 15 years, based upon clinical need rather than explicit client group policy goals. The Commission’s assessments reflect these observations.
4. Western Australia said that this approach to assessing expenses relies on observing the manifestations of State policies rather than on a legal incidence basis, which differs from the approach for assessing revenues. The Commission agreed that its approaches to assessing revenue and expenses are different. The differences reflect how States legislate and administer these activities. For example, States do not legislate the proportion of the State hospital budget allocated to the elderly. The Commission considers the different assessment approaches for revenues and expenses are consistent with ‘what States do’.
5. There are population groups that the Commission may not include in any differential assessment, for a variety of reasons.

* Some groups may have a higher cost per episode of service delivery, but lower use of services, so that overall the cost of servicing these population groups is not materially different to other population groups. There is some evidence that overseas born populations fall into this category.
* Some groups may be high cost, but the numbers of them are not large, or the interstate distribution is not sufficiently different from EPC to make a material impact. There is some evidence that the population of recent refugees falls into this category.
* Some groups may be high cost, but the Commission does not have reliable data on their interstate distribution. The population of students with disabilities currently falls into this category.

1. There are some assessments where the relationship between what States do and how the Commission assesses State needs is less direct. For example:

* bulk‑billed Medicare services are a proxy for non-State provided health services
* private sector wage levels for comparable employees are a proxy for the pressure on public sector wage levels
* annual growth in service populations are proxies for the pressures States face in their capital requirements.

1. In each of these cases, the Commission’s measurement is not directly tied to what States actually do, but reflects real disabilities and differences between States in the most reliable way it can measure them.
2. Victoria, South Australia, Tasmania, the ACT and the Northern Territory supported the Commission’s approach to disability measurement. Victoria noted that disability measures must minimise double counting, be supported by reliable evidence, and balance the risk of under and over-compensating for a disability.
3. In relation to Victoria’s concern about double counting, the Commission is aware of the potential for double counting some disabilities, for example, the potential to double counting the high costs associated with providing services to Indigenous people and remoteness costs. The Commission takes care in the design of assessment methods to avoid double counting.
4. Similarly, in designing methods, the Commission is careful to capture disabilities appropriately. One step the Commission takes to check that disabilities are not under- or overstated is to compare actual and assessed expenses and revenue. If there are deviations between actual and assessed that State policies cannot explain, then the Commission re‑examines the assessment method.
5. Western Australia considered that the Commission’s ‘national-centric approach’ to identifying and measuring disabilities is one of the factors undermining confidence in HFE. The difficulty with moving away from measuring disabilities based on ‘what States do’ on average is that it runs the risk of including assessments that are not policy neutral. Western Australia has consistently argued that the Commission’s assessments are not sufficiently policy neutral. The Commission considers that its approach to measuring disabilities leads to assessments that are policy neutral while giving appropriate recognition to material disabilities affecting State revenue raising capacity and expenditure needs.
6. Western Australia also argued that the Commission’s approach to implementing what States do leads to detailed data-driven assessments that are too reliant on standard national classifications (for example, the Accessibility and Remoteness Index of Australia (ARIA) and indexes of socio-economic disadvantage). It argued that this fails to capture underlying drivers of need. The Commission prefers methods that are evidence-based and use standard classifications. This reduces the need for judgment — of which, in other contexts, Western Australia is also wary. Many administrative datasets used in the expense assessments utilise standard classifications that are familiar to data providers and analysts. Adopting bespoke classifications would reduce transparency and unwind some of the simplification achieved in the 2010 and 2015 Reviews. It also appears inconsistent with other proposals put forward by Western Australia including on policy neutrality, conservatism and simplicity.
7. The Commission does not agree with Western Australia that the disability assessments were data-driven, or that the Commission engaged in ‘data mining’. The Commission’s process for including a disability is set out in the assessment guidelines. The first step is to establish the conceptual case for a disability. In establishing the conceptual case, the Commission observes what States do. State visits and submissions are an important part of developing an understanding of the factors that affect service delivery costs and revenue raising capacity. Then the Commission looks for national datasets, or comparable State data, that show what States spend on different population groups or the size of each State’s tax base. Without data, it is difficult for the Commission to confirm the presence of a disability or measure its effect on State finances. This is how the Commission prefers to approach its task.
8. In submissions, States identified additional disabilities they wanted the Commission to assess. A summary of the specific disabilities States requested and the Commission’s responses are in Table 1‑4 in Chapter 1, Volume 2.

#### Policy neutrality

1. This supporting principle aims to ensure that State policy choices have minimal direct influence on HFE assessments and, conversely, that HFE has minimal direct influence on State policy choices.
2. Equalisation has the potential to interact with policy choices, at least indirectly. However, through assessing fiscal capacity using the weighted average of the revenue and expenditure policies of the States, it is possible to minimise direct effects of policy in most cases. Arguably, adopting a rotating standard approach might improve policy neutrality. However, the Commission did not consider these improvements would offset the increase in complexity that would flow from operationalising such an approach. No State supported a rotating standard, although Western Australia viewed it as a second best option to its broader revenue approach.[[36]](#footnote-37)
3. The Commission’s assessments continue to be based on average policies, so that a State’s incentive to change its own policies in the expectation of increasing its grant share (that is, engage in grant seeking behaviour) is limited to the effect of its policies on the average. Under the Commission’s approach, there are no allowances for differences between the average policy and a State’s own policy. To the extent that those differences lead to increased costs, States are responsible for funding those additional costs. If those differences lead to reduced costs, States retain the benefit of the cost savings.
4. Western Australia said it accepted that complete policy neutrality is not feasible, but considered that policy neutrality needed greater emphasis. It highlighted policy neutrality concerns with the Mining assessment. Western Australia said the Commission’s over reliance on a narrow interpretation of the ‘what States do’ principle undermines policy neutrality, which could be improved by adopting global revenue indicators.[[37]](#footnote-38) Queensland suggested addressing policy neutrality concerns with the mining assessment through an aggregated Mining assessment or discounting. Nevertheless, Queensland stated that it is not aware of hard evidence that the current system creates disincentives for States to pursue economic reforms or engage in economic development.
5. Most States considered the Commission’s current approach to achieving policy neutrality is effective. South Australia considered that the motive behind proposals to address policy neutrality concerns through broader assessments appears to be a desire to increase grant shares for States with strong fiscal capacities. South Australia is opposed to broad indicators to measure revenue capacity because this would result in arbitrary winners and losers, is unlikely to achieve significant simplification and would result in a less equitable and efficient HFE outcome. Tasmania said that legislated changes to the HFE system obviate the need to adjust the Mining assessment to address policy neutrality. It also said the Commission’s proposal to limit the extent that tax and royalty changes constrained the operation of HFE, is impractical and may be unnecessary under new HFE arrangements.[[38]](#footnote-39)
6. Victoria said that the current HFE system results in some minor incentives that could, conceptually, affect State policymaking. However, it said that in practice there appears to be no significant impact on policy. Victoria cited a number of examples of States undertaking reform in the presence of HFE. It also noted the view of the 2012 GST Distribution Review Panel, which doubted ‘that GST share effects are a very powerful factor when States are considering tax reform’. The Northern Territory agreed that grant distribution effects are not a determinant of whether States pursue reforms.
7. The ACT supported the Commission’s efforts to further strengthen policy neutrality through the proposal to limit the extent to which any discretionary change in mineral royalty rates flows through to assessed revenue capacities, ensuring States placing bans on minerals and energy development are not unduly rewarded and accounting for the influence of tax elasticities. New South Wales, Queensland and the Northern Territory also supported the Commission undertaking additional work to consider the influence of tax elasticities.
8. Most State comments focused on policy neutrality and the revenue assessments, which the following sections discuss.

##### Dealing with policy neutrality of State revenue raising capacity

1. The Commission accepted that adoption of broader indicators, particularly for revenue assessments, may improve policy neutrality, but it does not agree that this would necessarily result in an improved HFE outcome when having appropriate regard to all supporting principles. The Commission did not agree with the view that HFE can only be achieved with complete policy neutrality, and that policy neutrality could only be achieved with a ‘long term view’ of what States do, as argued by Western Australia.[[39]](#footnote-40)
2. Western Australia again raised the issue of differences in State development efforts. It said its above average development effort represented a policy influence on its mineral production that the Mining assessment should recognise.[[40]](#footnote-41) However, the Commission has not been able to determine how much of Western Australia’s royalty revenue can be attributed to its development effort or how much of its effort was above the average effort. Similarly, it is not possible to identify any additional revenue that may be attributable to various economic development projects (reflecting above average effort) in other States.
3. In the absence of evidence that certain States have invested more, or invested more effectively, in the development of their State’s economic base (leading directly to enhanced State revenue bases), the Commission cannot separately identify revenue raised due to the effects of above average effort on the revenue base. There is no reason to assume that a discount (as proposed by some States) would produce a more reliable HFE measure. This would assume that in all cases, States with higher than average revenue raising capacity are in this position because of greater, or more effective, historical State development policies. Similarly, a discount would assume that States with lower than average revenue raising capacity have attained their positions due to lesser, or less effective, historical State development policies.
4. The legislative incidence of State revenue raising policies affects rates of tax, as well as the tax base to which those rates are applied. In applying a common policy to determine State revenue raising capacities, the Commission adopts different approaches depending upon the circumstances.
5. There are a number of circumstances where the Commission has had to address policy neutrality concerns relating to the comparability of State revenue rates and bases.
6. Western Australia also argued that the current approach could result in a high loss of equalisation grants from increased tax compliance. This is because increasing compliance will increase the size of a State’s tax base, increasing its relative revenue raising capacity for that tax. The Commission acknowledges that under exceptional circumstances it is possible for grant losses to more than offset gains from increased compliance effort. This could occur if a State’s compliance effort caused its share of the tax base to deviate significantly from its population share. In reality, given the state of the current State tax bases, the Commission considers that HFE does not remove the incentive for States to maintain at least the average compliance effort and that there are sufficient incentives applying to States unrelated to the HFE system for them to maintain compliance activities.

##### Dealing with policy neutrality concerns relating to revenue rates

1. In most cases, each State has only a limited influence on the average rate policy. However, exceptions can arise, and over the past decade, these have become potentially significant in the case of State mining revenues. When a tax base is concentrated in one or two States (such as iron ore in Western Australia and coal in Queensland), the policies of those States can have a dominant role in determining average rate policy, particularly where minerals are assessed separately.
2. The Commission determined that its current assessment of mining revenues appropriately supports the measurement of State fiscal capacities, observing that the Commonwealth’s recent changes to the form of equalisation insulate Western Australia from the distributional effects related to its dominant producer position. See Box 2-2 for a discussion of the unique aspects of the mining assessment and Chapter 11 Mining revenue for further detail on the policy neutrality aspects of the Mining assessment.

##### Dealing with States applying a nil rate to a revenue base

1. A State may apply a nil rate to a revenue base in circumstances where reliable data are available to estimate the revenue base for that State. This occurs in the case of land tax, where the Northern Territory does not raise this tax. The Commission imputes a land tax base for the Northern Territory for assessing its capacity to raise land tax, if it followed average policy.

##### Dealing with uncertain distributions of State revenue bases

1. Revenue may be raised from a revenue base in circumstances where the distribution of that revenue base across States is unclear because specific policies relating to that activity are highly variable among the States. Gambling revenue is an example of this, where the legal framework for gaming varies considerably across the States, on the numbers and placement of gaming machines in particular. In the case of gambling revenue, since the 2010 Review the Commission has taken the view that, because it cannot identify comparable revenue bases across States, it cannot construct a reliable and material differential assessment. Therefore, it makes an EPC assessment of gambling revenue. This approach means that gambling revenues do not affect the measurement of State fiscal capacities.

##### Dealing with tax rate effects on a revenue base

1. The Commission engaged consultants to produce elasticity estimates that would inform its decision whether to adjust its assessed revenue bases for elasticity effects. The aim was to minimise, to the extent practicable, tax reform disincentives arising from the direct effects on tax bases (elasticity effects) of tax policy choices.
2. The consultants calculated elasticity estimates for four revenue assessments: insurance taxes, conveyance duties, motor taxes and land tax. After considering the consultants’ work and State views, the Commission concluded that elasticity effects are not unduly affecting HFE, as the effects are very small for all but one tax base, stamp duties on conveyances, for which they are also not substantial. On this basis, and given its concerns about the practical implementation of making an adjustment, the Commission decided not to make any elasticity adjustments to revenue bases. This issue is discussed in Chapter 1 of Volume 2.

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| Box 2-2 HFE and mining revenue policy The changing fiscal role of mining revenue Over the past decade, the role of mining revenues in fiscal equalisation has significantly increased. State mining revenues, mainly from iron ore and coal, have increased more than four-fold since the early 2000s. The expansion of mining has had major implications for the structure of Australia’s economic development. It has also resulted in some divergence and greater volatility in the fiscal capacities of the States.  The continuing emergence of China and other Asian countries as leading growth engines of the world economy has driven the expansion of Australia’s mineral and energy industries. Australia’s endowments are key inputs to the rapidly expanding Asian supply chain.  While there has been some cyclical element in the price of commodities, the mining expansion is largely long term and structural. It has transformed the fiscal capacity of Western Australia, the main mining State. Throughout most of the 20th century, Western Australia received above average per capita Commonwealth funding under fiscal equalisation arrangements. However, it now requires much less than average funding under the same arrangements, due overwhelmingly to its high share of State mining revenues, which have greatly increased its fiscal capacity. Applying the HFE supporting principles to mining revenues Mining differs from most other State tax bases for the following reasons.   * The distribution of mineral resources is highly unequal across the States. * Each mineral product has a different effective tax (royalty) rate. * The conceptual driver of the tax base is unclear — royalties appear to be related to the underlying profitability of mining activities, but the royalty base itself is generally the gross value of production rather than profit. States have adjusted some royalty rates in recent years to reflect the higher profitability of certain major mining developments, but royalty rates otherwise have tended to be relatively stable over time.   The unusual features of the mining revenue base in Australia present unique challenges in applying, and appropriately balancing, the supporting principles for HFE. In general, the ‘what States do’ and practicality principles have been applied reliably to mining revenues in much the same way as to other assessments. The issues raised by some States due to the interaction of the contemporaneity supporting principle with budget management processes are well-known (and addressed separately in the contemporaneity section of this chapter). However, the assessment approach has also generated policy neutrality concerns in some circumstances. Nonetheless, through supplementary terms of reference the Commission has been instructed not to change the approach to assessing mining revenues it developed in the 2015 Review. Chapter 11 Mining revenue, in Volume 2 of this report, discusses these issues in detail. |

#### Practicality

1. This supporting principle means that assessments should be based on sound and reliable data and methods and be as simple as possible, while also reflecting the major influences on State expenses and revenues.
2. Practicality is an umbrella principle that covers the following concepts.

* Simplicity — assessments should be as simple as possible while being conceptually sound and reflecting the major influences on State expenses and revenues.
* Reliability — the methods for making assessments should use reliable data, including the use of discounting where there are specific concerns about the degree to which data are fit for purpose.
* Materiality — the Commission will make assessments only where they have a sufficiently large impact on assessed revenue and expenditure.
* Quality assurance — processes are in place to ensure data are accurate and fit for purpose, and methods are sound and delivering outcomes in accordance with HFE and the supporting principles.
* Fitness for purpose — the Commission’s relativities are practically useful for States to incorporate into their budgets.

1. The terms of reference (clause 7) ask the Commission to aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data and to ensure robust quality assurance processes. The practicality principle assists the Commission in ensuring it is meeting this requirement of the terms of reference.
2. This principle originated from the emphasis in the 2010 Review terms of reference on simplification, reliability, materiality and quality assurance. The practicality principle is put into practice in the Commission’s assessment guidelines (including a discounting framework and determination of materiality thresholds) and quality assurance plan, which are discussed in the section on implementation issues. (See Chapter 3, Volume 2.)
3. Practicality recognises that, while a wide variety of factors affect State fiscal capacities, an improved HFE outcome may not be achieved by including factors when sufficient data are not available to measure their effects or where effects are small. This effectively limits the extent to which the Commission can achieve full fiscal equalisation.
4. The Commission considers that the practicality principle applies in all stages of the development of assessments, including:

* the scope of the revenue and expenditure that should be part of fiscal equalisation and how they are grouped into categories and components
* the disabilities that should be assessed — this covers the conceptual case and the assessment of disabilities.

1. Following consultations with States, the Commission further developed its view on the practicality principle, to make explicit the need for recommendations to be formulated and delivered in a way that is ‘fit for purpose’ for State budget processes.
2. All States identified the Commission’s recommended relativities as being a key component in the preparation of their budgets, including across the forward estimates. All States except Western Australia have said that they prefer fixed relativities that are:

* available in February, prior to the presentation of State budgets (for the following financial year)
* to the extent possible, predictable and reasonably stable over the period of the forward estimates.

1. These States seek to minimise forecasting errors across the forward years, which could be greater if relativities are based on a narrower assessment window,[[41]](#footnote-42) or are based upon forecasts and estimates which are subject to correction. While the Commission does not consider that stability or predictability are necessarily essential to achieving HFE, it recognises these considerations are of some practical relevance in its choice of methods, through their effect on State budget processes.
2. In contrast, as a State subject to considerable volatility in own-source revenue (which in turn affects its fiscal capacity), Western Australia would prefer GST revenue outcomes that are much more contemporaneous, to offset movements in its own-source revenues, leading to greater stability in its overall revenues. It regards the lag arising from the historical assessment window as creating difficulty for its budget processes.[[42]](#footnote-43) Western Australia supported the use of forecasts followed by a correction in the following year to reflect outcomes. In setting out this view, Western Australia has advocated a radical change to current assessment methods more generally. The following section on contemporaneity addresses these issues. Alternatively, Western Australia proposed adopting capacity measures that are unaffected by cyclical or transient factors. This appears to be a reference to using broader indicators. As noted previously, the Commission would only consider adopting broader indicators if they were a more reliable indicator of State capacity to raise revenue or service delivery costs than any alternative approach.
3. The Commission provides detailed reports during a review that explain reasons for decisions, assessment approaches and outcomes. The update reports explain the main sources of change each year in State fiscal capacities and decisions on new issues following State consultation. All this information is publicly available on the [Commission website](https://cgc.gov.au/) (https://cgc.gov.au/). The Commission and its staff continue to work with stakeholders to increase accessibility and understanding.
4. Most States support the Commission’s practicality principle.

#### Contemporaneity

1. The terms of reference ask the Commission to provide relativities for distributing GST revenue in an application year (the year in which its recommended relativities are applied).[[43]](#footnote-44) The Commission interprets this to mean recommending relativities appropriate to equalising State fiscal capacities in the application year.
2. Currently, the Commission expresses its recommendations in the form of relativities. The new legislation requires the Commission to continue to present the outcomes of its work in this way. The effect of applying relativities (based upon the assessment window) to the application year is that State GST requirements are inflated by the growth in GST revenue between the assessment window and the application year.
3. A fully contemporaneous approach would equalise State fiscal capacities in the application year. However, implementing this approach would require application year data, which are not available in a robust, tested way until the application year has passed.[[44]](#footnote-45) In the absence of such data, past Commissions have based recommendations on historical data. This provides a result that is reasonably appropriate for the application year, notwithstanding that it entails a lagged recognition of changes in State circumstances.
4. Since the 2010 Review, the assessment window has been the most recent three years for which reliable data are available. In this review, the Commission considered a range of alternative approaches. These have ranged from continuing to use historical data while reducing the gap between assessment and application years (by narrowing the assessment window from three years to one or two years), to treating volatile revenues by absorption, or by using forecasts of conditions in the application year.[[45]](#footnote-46),[[46]](#footnote-47)
5. The Commission prefers not to use estimates or forecasts of revenues and expenditure in the application year because they are not sufficiently reliable. Historically, errors in forecasts have at times been large, particularly for volatile revenues. The Commission’s view is that an approach using such unreliable data raises a range of issues, including that it would almost certainly require consequent GST adjustments in future to compensate for errors. This ex‑post correction could, of itself, undermine the contemporaneity of GST distributions in future years. Most States expressed concerns that the use of forecasts would merely introduce unwarranted complexity, uncertainty and volatility. The Commission noted an approach using forecasts with subsequent adjustments would add to the complexity of the new arrangements.
6. All States that commented on this issue, except Western Australia, said they supported the Commission’s current approach to contemporaneity. Western Australia supported a distribution more reflective of current budget circumstances to improve public transparency, aid budget management and mitigate the risks from volatility for an outlier State. It said the Commission could achieve contemporaneity, without volatility, by adopting policy neutral indicators of long-term revenue capacity. As a second best option, for achieving contemporaneity and stability for an outlier State, Western Australia supported the use of forecasts with ex-post corrections.
7. The Commission’s view is that for this review it will continue to maintain the established approach, which uses the most recent three years for which reliable data are available, with each year receiving an equal weighting. The Commission acknowledges that it is possible to achieve HFE with a narrower assessment window; however, the current approach provides an appropriate balance between contemporaneity, stability and predictability. The Commission understands that stability of the GST distribution was a consideration in the design of the new HFE system.
8. Western Australia said the Commission should quantify the differences arising from the use of lagged data. The Commission addressed this matter during the 2015 Review in response to a special request from the Treasurer.[[47]](#footnote-48) At that time, the Commission estimated that, compared with using lagged data, Western Australia had received most likely about $7 billion more over a six year period than under a fully contemporaneous approach. Updated data relating to this point are presented in Chapter 1, Volume 2. Staff discussion paper CGC‑2017‑05‑S also provides information about the scale of discrepancies, or ‘gaps’, arising from the lack of contemporaneity.[[48]](#footnote-49)

##### Backcasting

1. If there are major changes in federal financial relations between the assessment years and the application year, the Commission ‘backcasts’ the new arrangements, unless the terms of reference direct the Commission not to or it cannot be done reliably. This 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.
2. Most States supported backcasting major changes in federal financial relations, but only if the information and data used for backcasting are reliable. The ACT suggested the Commission backcast all Commonwealth payments to improve contemporaneity.
3. The Commission does not support backcasting all Commonwealth payments. The estimated amounts for forward years published in the Commonwealth’s budget papers are not certain to eventuate and sometimes not available when a new agreement is under negotiation.
4. The Commission will continue to backcast payments that are major changes in federal financial relations, only if the information and data available for backcasting are reliable. The Commission is currently backcasting State shares of spending on the NDIS and other disability services, and the National Disability SPP.

#### Applying the supporting principles

1. In general, wherever data are adequate, the Commission adopts methods that are readily understood and reproducible. However, the areas of difference between the States are not always sufficiently clear-cut and the data to measure these differences not always sufficiently reliable. This means that judgments on what constitutes the best equalisation outcome continue to be necessary. The Commission seeks to make its judgments as consistent and understandable as possible, and rejects suggestions that its judgments are arbitrary or inexplicable. Such complaints often reflect that the critic would prefer a different outcome to that reached by the Commission.
2. Ideally, all methods would embody the attributes of all the supporting principles. In practice, the Commission often has to evaluate alternative methods that embody mixtures of these principles and has to decide trade-offs between them — for example, between methods that capture what States do and methods that are policy neutral.
3. As in past reviews, as circumstances require, the Commission has no practical alternative but to reserve the right to exercise its own judgment on how best to measure State fiscal capacities based upon the principle of HFE. The Commission does not think that the impracticality of giving full weight to all supporting principles in every situation is an argument, as some States suggested, for diverging from HFE.
4. The Commission’s approach is to develop methods that achieve HFE, balancing the principles to guide it among alternative methods. For example, the weighted average approach to determining revenue and expenditure standards incorporates aspects of all the supporting principles:

* what States do — the standards reflect the actual revenue raising or spending practices collectively of the States, with each State contributing on the basis of its weight in the tax or spending base
* policy neutrality — the averaging process means that (in the vast majority of cases) no one State’s policy decisions directly drive the average revenue or expenses
* practicality — reliable and comparable data on State revenue raising and spending practices are readily available when assessments are based on what States do
* contemporaneity — the actual revenue and spending as revealed in the assessment window, and data for measuring disabilities, are those upon which assessments are based, and are updated each year.

1. The Commission considers that the current supporting principles, together with the HFE objective itself, are sufficient to guide consideration of all relevant methodological issues and that the addition of further supporting principles, including those suggested by Western Australia, would not be operationally useful. Particular issues are as follows.

* An equity principle incorporates elements of other existing supporting principles, such as policy neutrality, while a principle of conservatism appears likely to be interpreted as leading to partial equalisation. In both cases the Commission’s assessment guidelines (Chapter 3, Volume 2) act to ensure that disabilities are only recognised where a conceptual case exists and the effects of the disability can be measured using sufficiently reliable data.
* Suggested accountability and transparency principles appear to relate more to processes or governance of the arrangements (of the Commission or of other bodies) rather than to guiding assessment methodologies to achieve HFE. As distinct issues, insofar as they relate to the Commission’s task, they are covered separately in the terms of reference. For example, in accordance with clause 3 of the terms of reference, the Commission regularly consults the Commonwealth and the States on its methods. Clause 7 directs the Commission to aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data, to use the latest available data consistent with this and to ensure robust quality assurance processes. Some matters (such as simplicity) referred to by Western Australia in suggesting these further principles may relate in part to assessment methods, but are already covered in the existing practicality principle.

1. In the case of an EPC distribution, as proposed by New South Wales, the supporting principles are largely superfluous (perhaps other than contemporaneity). However, such a distribution does not meet HFE and so is not consistent with the Commission’s terms of reference, or the IGA.[[49]](#footnote-50)
2. Finally, a number of States raised issues relating to administrative arrangements or the Commission’s communication processes. These are not relevant to the supporting principles for interpreting HFE. The work of improving communication and accessibility is ongoing.
3. The following chapter addresses specific implementation issues.

# 3 Implementation issues and assessment guidelines

1. Since the 2010 Review, the Commission has used guidelines to assist in the implementation of HFE. The guidelines allow the Commission to give effect to the HFE objective having regard to the supporting principles. The Commission decided in this review to retain the assessment guidelines developed in the 2015 Review with some amendments to explain more clearly the Commission’s approach to discounting. The assessment guidelines for the 2020 Review are included in Box 3-1.
2. The guidelines also form a key part of the quality assurance (QA) process. They allow the Commission to be confident that all relevant steps in the decision-making process have been followed. They allow external parties to follow the Commission’s decision processes and to form conclusions about whether due process has been observed. This is important for ensuring transparency.
3. The guidelines cover the following implementation processes:

* the steps for establishing and measuring disabilities
* when and how discounting decisions are made and applied
* the materiality threshold for recognising a disability and making a data adjustment.

1. The guidelines inform the Commission’s decision-making processes. However, it retains the right to exercise judgment if its best endeavours to build a reliable assessment do not lead to an outcome consistent with its observations and understanding of State circumstances. Where the Commission deviates from the guidelines, it will aim to explain clearly its reasoning. The Commission notes the views expressed by some States that it could improve the way it documents its deliberations and decisions by providing additional information on how it applies the supporting principles to reach conclusions for individual assessments including discounting decisions. The Commission consistently endeavours to provide clear documentation of its decision-making processes.
2. The following sections elaborate on how the Commission approaches discounting and materiality. States frequently comment on these aspects of the assessment guidelines.

#### Discounting assessments

1. The Commission is often in the position where it considers there is a conceptual case for including a particular influence (disability) beyond State control that would materially affect State fiscal capacities. The Commission has a choice of either letting the data influence the assessments in proportion to their quality or ignoring the data and the particular influence completely.
2. Measurement of the effect of a disability can be affected when the associated data are incomplete, dated, unreliable, not fully fit for purpose or a combination of all these factors. In these cases, the Commission has to exercise judgment about whether to recognise the disability or not. The quality of the available data is a key consideration guiding the Commission’s judgment.

|  |
| --- |
| Box 3-1 Assessment guidelines for the 2020 Review  The Commission organises its work by making assessments for individual categories. Separate assessments will be made when they are materially different from other assessments or if the assessment is easier to understand if undertaken in a separate category.  The Commission will include a disability in a category when:   * a case for the disability is established, namely: * a sound conceptual basis for these differences exists * there is sufficient empirical evidence that material differences exist between States in the levels of use or unit costs, or both, in providing services or in their capacities to raise revenues * a reliable method has been devised that is: * conceptually rigorous (for example, it measures what is intended to be measured, is based on internal standards and is policy neutral) * implementable (the disability can be measured satisfactorily) * where used, consistent with external review outcomes. * data are available that are: * fit for purpose — they capture the influence the Commission is trying to measure and provide a valid measure of State circumstances * of suitable quality — the collection process and sampling techniques are appropriate, the data are consistent across the States and over time and are not subject to large revisions.   The Commission will adjust data where necessary to improve interstate comparability. However, the Commission will only make data adjustments if they redistribute more than $10 per capita for any State in the assessment period.  The Commission will include a disability in its final assessments if:   * it redistributes more than $35 per capita for any State in the assessment period (the materiality test will be applied to the total effect the disability has on the redistribution from an EPC assessment of revenue or expenditure, averaged over the three assessment years) * removing the disability has a significant effect on the conceptual rigor and reliability of assessments.   Where a case for assessing a disability in a category is established, but the Commission has concerns with the underlying data or assessment method, a uniform set of discounts will be used — low (12.5%), medium (25%), high (50%) or no assessment (100%). The Commission will use higher discounts when the Commission has greater concerns with the underlying data or assessment method. |

1. Discounting allows the Commission to partially recognise a disability when the presumptive case for the disability is established but there are concerns with its measurement. In other words, discounting allows the Commission to achieve the HFE objective while taking account of practical issues that affect the measurement of disabilities. The Commission considers a better HFE outcome is achieved if discounting targets the data or methods of concern, rather than applying a global discount, which would guarantee partial equalisation at best.
2. The Commission has retained the 2015 Review discounting framework. This framework consists of four levels of discounting — low (12.5%), medium (25%), high (50%) and no assessment (100%) — depending on the Commission’s judgment about the reliability of the data. The Commission has simplified the discussion of discounting in the assessment guidelines   
   (Box 3-1). This change seeks to clarify when discounting should apply.
3. States raised concerns about the appropriateness of having discounts and with the consistency of their application. The Commission notes that the 2020 Review assessments include fewer discounts than the 2015 Review and the Commission has considered each discount carefully, having regard to the need to recognise all material disabilities affecting State fiscal capacities and the data and methods available for measuring these influences. Where discounts are applied, the Commission has explained its concerns with the data or methods, or both.
4. In some instances, the Commission removed or reduced discounts in this review. This reflects improvements in the available data (for example, land tax and service-specific regional cost gradients), or further consideration of the suitability of proxies (for example, community health). Victoria and Queensland urged caution in removing discounts from existing assessments if the concerns about the data or methods are unresolved. Where discounts have been reduced or removed, the Commission has explained its reasons in the relevant assessment chapters.[[50]](#footnote-51)
5. Occasionally, the Commission addresses data concerns by adopting a blended assessment (for example, urban transport). Blending allows the Commission to moderate the influence of an assessment due to data concerns when a discount towards an equal per capita (EPC) assessment does not achieve the best equalisation outcome. In the case of urban transport expenses, discounting towards EPC is inferior to blending with urban population shares because the urban population is the relevant service population.[[51]](#footnote-52)
6. In the final stages of the review, the Commission considered the consistency of discounting across all assessments. Compared to the draft report, this led the Commission to reinstate a low-level discount (12.5%) in the community health SDC assessment (compared with 25% in the 2015 Review), and a 25% discount to the regional costs and service delivery scale general gradients when they are used as proxy indicators. Despite reinstating the discount to the general gradient, this discount affects fewer assessments in this review because the Commission has more information about how remoteness affects costs for a greater range of services.
7. Box 3-2 summarises the changes to discounts in this review and their effects on the GST distribution.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Box 3-2 Discounting in the 2020 Review  The 2020 Review assessments include fewer discounts than the 2015 Review — there are four discounts in the 2020 Review compared with eight in the 2015 Review. In this review, the Commission removed discounts from the community health non-State sector adjustment, police custody weights, police SDS factors and net borrowing. The following table summarises the remaining discounts, the reasons for them and their level. The Commission’s reasons for discounting are explained in greater detail in the relevant assessment chapters.   |  |  |  | | --- | --- | --- | | Assessment | Reason for discount | Discount level | | Land tax | Concern over the comparability of State land holdings data, primarily related to State adjustments to data to address differences in the treatment of jointly owned properties. | 12.5% | | Wage costs | Concerns about how accurately the data measure wage costs and the econometric model controls for differences in productivity; and how well private sector wages proxy wage pressures in the public sector. | 12.5% | | Health, community health, SDC assessment | Concerns about how well the proxy data used in the assessment (Emergency Department triage 4/5) measure the use and cost of community health services. | 12.5% | | Regional costs and service delivery scale (SDS) when the general gradient is used as a proxy | Concerns about how well the schools and hospitals data reflect regional cost and SDS influences for other services. | 25% |   Source: Commission calculation.  The Commission also discounted these assessments in the 2015 Review; however, the discounts for the land tax and community health SDC assessments have been reduced in this review from 25% to 12.5%. This reflects improvements in State Revenue Office land tax data and partial information on the user profile of the population using community health services. The discounts for the wage costs and the general regional costs and SDS gradients are unchanged. However, the Commission notes that the general regional costs gradient is applied to fewer assessments in the 2020 Review, which has significantly reduced the effects of this discount.  The following table shows the effect on the GST distribution in 2020-21 of including the discounts.   |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | NSW | Vic | Qld | WA | SA | Tas | ACT | NT | Redist | |  | $m | $m | $m | $m | $m | $m | $m | $m | $m | | Land tax (12.5%) | 156 | 92 | -123 | -28 | -60 | -22 | -14 | -2 | 248 | | Wage costs (12.5%) | -58 | 46 | 28 | -55 | 45 | 21 | -8 | -19 | 139 | | Community health SDC (12.5%) | 24 | 38 | -21 | -10 | -5 | -12 | 6 | -22 | 68 | | Regional costs and SDS (25%) (a) | 40 | 35 | -12 | -21 | -2 | -2 | 3 | -39 | 77 | | Total ($m) | 162 | 212 | -128 | -114 | -21 | -15 | -13 | -82 | 374 | | Total ($pc) | 20 | 31 | -25 | -43 | -12 | -28 | -30 | -333 | 14 |   Note: For a comparison of the effects of discounting in the 2015 Review, see pages 18-19 of Volume 2 of the 2015 Review report.  (a) SDS refers to service delivery scale. The only assessment affected by the discount to the SDS general gradient is the child protection and family services assessment in the Welfare category.  Source: Commission calculation. |

1. Queensland, South Australia, Tasmania and the ACT agreed with the Commission’s approach to discounting. These States considered the current levels of discounting acceptable.
2. The Northern Territory considered that use of discounting should be more limited and the Commission should work with data providers to improve national datasets. Where a national dataset is designated the best available, the Northern Territory argued it should be used unadjusted.
3. Western Australia said the application of discounting is selective and inconsistent, which biases HFE. It argued that discounting the best available information usually entails a risk of moving one or more jurisdictions away from a better HFE outcome. For example, it said the wages assessment significantly understates Western Australia’s wage pressures, so that discounting would move the assessment even further away from HFE. It suggested using a global discount as an alternative to a profusion of individual discounts.
4. Although Victoria raised concerns about the removal of some discounts, it also said that if the Commission is only able to deliver proximate equalisation then the widespread use of discounting is not required.
5. New South Wales objected to discounting because it relies on judgment.
6. Overall, States are either comfortable with the level of discounting in the 2015 Review or would prefer less discounting. As explained above, the Commission uses discounting as a tool to better achieve HFE while recognising the limitations of the data and methods for measuring disabilities. The Commission considers that the discounts it applied reflects appropriately the level of concern with the available data used in assessments.
7. While the Commission considers discounting as a tool to better achieve HFE, there are instances when the Commission does not consider discounting appropriate. For example, the Commission does not discount the best available estimates of national revenue or spending, such as those derived from ABS Government Finance Statistics. In addition, the Commission considers that discounting is also not appropriate for judgment-based estimates, such as the proportion of expenses to which a disability should be applied, because in making that judgment the Commission would already have incorporated all relevant information and weighted it according to its reliability.
8. Queensland supported the use of discounting to address policy neutrality issues in the mining assessment. The Commission has not used discounts to address concerns about policy neutrality or general uncertainty. As discussed under policy neutrality in Chapter 2, while conceptually differences in tax rates or State development policies may affect the observed bases, the Commission’s view is that discounting does not necessarily move assessments in a direction appropriate to achieving HFE.

#### Materiality thresholds

1. In the 2010 Review, the Commission introduced materiality thresholds to help achieve greater simplicity. They were retained with higher thresholds in the 2015 Review. Materiality thresholds were set with reference to the effect an assessment had on the GST distribution in the application year.
2. The Commission considers that retaining materiality thresholds is an effective way of maintaining simplicity in its assessments. It ensures that attention focuses on the major drivers of differences between the States. The large increase in the disability threshold applied in the 2015 Review achieved its goal of limiting the number of disabilities assessed by the Commission to those that have a substantive effect on the States’ revenue and spending.
3. In this review, the Commission decided to increase the threshold only to the extent that it retains its value after adjusting for price and wages increases. Consistent with this, the Commission used a disability threshold of $35 per capita (up from $30 per capita) for any State for this review. The threshold for data adjustments remained at $10 per capita.
4. In summary, the Commission uses materiality thresholds to handle two circumstances.

* Disability assessment. A disability is considered material if it redistributes more than $35 per capita for any State, across all categories. When the threshold is reached, the disability is included in all assessments where there is a conceptual case for including it and this can be done reliably, regardless of its materiality in individual assessments.
* Data adjustments. Data are adjusted where necessary to improve interstate comparability, but only if the adjustment redistributes more than $10 per capita for any State.

1. Previously, materiality thresholds have been expressed in terms of the effect of a disability or data adjustment on the GST distribution. In this review and going forward, the materiality test uses the redistribution from an EPC assessment of revenue or expenditure, averaged over the three assessment years. This is to recognise that there is no longer complete congruence between the assessment of fiscal capacities and the final distribution of GST.
2. Since this was not a ‘clean-slate’ review, the Commission adopted a pragmatic approach to applying materiality thresholds. Initially, the Commission said it intended to apply a $35 per capita materiality threshold for disaggregating a disability in the socio‑demographic composition (SDC) assessments. The Commission found that implementing this threshold was problematic. For example, the decision to disaggregate remote and very remote populations in the health assessment was just below a materiality threshold of $35 per capita. However, the Commission disaggregates remote and very remote populations in other assessments, for example schools. It seemed inconsistent with the disability assessment threshold not to split remote and very remote populations in health. In other cases, it was material to split SES groups, but the use patterns that emerged from further splitting did not align with the underlying conceptual case for the disability. In addition, there are interactions between disabilities that further complicate the measurement of materiality. Therefore, the Commission decided to take a more pragmatic approach to decisions on the level of disaggregation to adopt in the SDC assessments, having regard to materiality and the conceptual case for different levels of disaggregation.
3. New South Wales and Queensland supported higher materiality thresholds ($60 and $50 per capita respectively) as this would lead to broader assessments and greater simplification while continuing to recognise the fiscal circumstances of recipient States. Western Australia did not suggest a threshold but said the Commission needs to be more consistent and transparent in applying materiality thresholds. It also said the current approach encourages marginal changes to assessments rather than fundamental reviews that would consider broader assessments.
4. Victoria, South Australia and Tasmania supported the current thresholds but did not support further increases beyond adjustments to maintain their real value. Victoria also noted that a case could be mounted for reducing the threshold because the size of the redistribution task is currently declining. The ACT and Northern Territory opposed materiality thresholds because they undermine HFE.
5. On balance, the Commission considers the thresholds strike the right balance between achieving HFE and maintaining simplification gains from the previous two methodology reviews. Since this review started with 2015 Review methods and not a clean slate, the Commission applies materiality tests in many instances by considering the effects of a change to current methods. However, this has not prevented consideration of new assessment approaches, consistent with HFE, using new data sources or methods, as suggested by Western Australia.
6. Western Australia said the Commission’s reports frequently quote materiality tests without providing calculations. Where possible, the final report includes the materiality tests. However, for practical reasons it is not always possible to include this information. States can request the materiality calculations that are not in the report.

#### Confidential data

1. The Commission continues to use confidential data but only in circumstances where a disability assessment is material and there is no alternative. Wherever possible, States are encouraged to share confidential data at the Treasury level to facilitate the review of assessments. States supported this approach, especially if it led to a better HFE outcome. The Commission’s data sharing protocol, introduced in the 2017 Update, maximises the sharing of data among State treasuries.[[52]](#footnote-53)

#### Quality assurance

1. An important way of ensuring the Commission’s assessments are as reliable and as accurate as possible is through a rigorous quality assurance process. As noted earlier, the terms of reference for the 2020 Review ask the Commission to ‘ensure robust quality assurance processes’ (clause 7(d)) are adopted in preparing assessments. The Commission has responded to similar terms of reference in the past (in the 2010 and 2015 Reviews) by undertaking a risk assessment and preparing quality assurance strategic plans and action plans.
2. The Commission released the 2020 Review Quality Assurance (QA) Strategic Plan to States in October 2018 following consultation with the States. It builds on the 2015 Review QA strategic plan. The aim of the QA strategic plan is to ensure there are strategies in place that will result in reliable and accurate assessments of State fiscal capacities and to strengthen confidence in the processes undertaken in their development.
3. The 2020 Review QA Strategic Plan documents the processes the Commission put in place to quality assure its work and to demonstrate compliance with these processes. The strategic plan is translated into actions through annual operational work plans of the Commission. The QA process seeks to:

* assure stakeholders of the conceptual validity, reliability and accuracy of the relativities that will be used to distribute GST revenue to the States
* ensure the reporting of methods, decisions and results is transparent and in appropriate detail for their purposes
* monitor and report on the effectiveness of implemented QA processes.

1. Performance targets for QA processes are:

* Commission decisions are evidence based and transparent
* Commission decisions on assessments are correctly implemented
* data are fit for purpose and of good quality
* calculations are error-free
* the work of the Commission and resulting relativities are reported in a transparent and verifiable manner.

1. The 2020 Review plan is on the [Commission website](https://cgc.gov.au/) (<https://cgc.gov.au/>).

# 4 Implementing legislated changes to the GST distribution

1. The purpose of this chapter is to outline the Commission’s preliminary understanding of the requirements for its future work in relation to the Commonwealth’s new equalisation arrangements enacted in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018*.

### Objective of Horizontal Fiscal Equalisation in Australia

1. From 2021-22, legislated changes will see a change to the objective of HFE in Australia. The changes will result in a gradual move away from distributing GST revenue using the current arrangements (based on State relative fiscal capacities as measured by the Commission) to new arrangements (equalising to a standard State, being the fiscally stronger of New South Wales or Victoria). The transition to the new arrangements will be completed in 2026-27.[[53]](#footnote-54) The new policy was enacted in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018*, which amends the *Commonwealth Grants Commission Act 1973* and the *Federal Financial Relations Act 2009*.
2. The legislation states that the new arrangements will ensure that the States, the Australian Capital Territory and the Northern Territory (the States) each have the fiscal capacity to provide services (including associated infrastructure) at a standard that is at least as high as the standard for whichever of New South Wales and Victoria has the higher standard.[[54]](#footnote-55)

### Implementing the new legislation

1. The new HFE arrangements transition into effect from 2021‑22, with the new arrangements fully applying in 2026‑27.[[55]](#footnote-56) Therefore, the legislation will not affect the Commission’s work until the 2021‑22 payment year.
2. Terms of reference received from the Australian Treasurer determine the work of the Commission. Until the Commission receives terms of reference, it is only able to provide indicative information about how it intends to give effect to the new legislation.
3. The new arrangements involve:

* introducing a minimum GST revenue sharing relativity (relativity floor), with an initial floor (of 0.7) introduced for 2022‑23 which is then raised (to 0.75) from 2024‑25[[56]](#footnote-57)
* from 2021-22, permanently boosting the GST revenue pool with additional Commonwealth financial assistance, referred to as ‘pool top-ups’[[57]](#footnote-58)
* transitioning the HFE system from the previous arrangements to new arrangements, based upon the fiscal capacity of the stronger of New South Wales and Victoria[[58]](#footnote-59)
* providing for additional financial assistance to any State to ensure that each receives total grants at least as much as it would have received had the new legislation not been enacted (the ‘no worse off’ provision).[[59]](#footnote-60)

1. Separately, from 2019-20 to 2021-22, States may receive short-term transitional assistance payments sourced from other Commonwealth revenue. However, these payments do not relate directly to the work of the Commission.
2. The legislation does not affect the Commission’s methodology for measuring State relative fiscal capacities, which is the focus of the 2020 methodology review. The measures of relative fiscal capacity derived by the Commission are the basic building blocks for deriving the GST revenue sharing relativities under the previous arrangements and will continue to be so under the new arrangements.
3. Table 4-1 summarises the transition arrangements and the changes to the general revenue assistance pool from 2020-21 to 2026-27, as specified in the legislation.

Table 4-1 Changes to the distribution of general revenue assistance grants

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Inquiry | R2020 | U2021 | U2022 | U2023 | U2024 | U2025 | U2026 |
| Application year | 2020-21 | 2021-22 | 2022-23 | 2023-24 | 2024-25 | 2025-26 | 2026-27 |
| Relativities transition |  |  |  |  |  |  |  |
| Relative fiscal capacities (a) | 6/6ths | 5/6ths | 4/6ths | 3/6ths | 2/6ths | 1/6th | 0/6ths |
| Standard State capacities (b) | 0/6ths | 1/6th | 2/6ths | 3/6ths | 4/6ths | 5/6ths | 6/6ths |
| Relativity floor (c) | External | External | 0.70 | 0.70 | 0.75 | 0.75 | 0.75 |
| Grant pool |  |  |  |  |  |  |  |
| GST revenue | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| New pool top-up (d) | No | $600m | No | No | $250m | No | No |
| Indexation of top-up (e) | No | No | Yes | Yes | Yes | Yes | Yes |

(a) Relative fiscal capacities refers to the previous arrangements, or applying a full equalisation standard.

(b) Standard State capacities refers to the new arrangements, or equalising to the stronger of New South Wales and Victoria.

(c) Commonwealth funding external to the GST pool (if required) will ensure in 2020-21 and 2021-22 Western Australia’s grant share is equivalent to a relativity of 0.7 and the Northern Territory’s grant share equivalent to a relativity of 4.66. From 2022-23, the floor will be funded from the expanded pool.

(d) New pool top-ups represent ongoing top-ups to the general revenue assistance grant pool.

(e) Once commenced, pool top-ups are indexed by the growth in GST revenue.

#### Giving effect to the new legislation

1. Most existing legislative mechanisms will continue from 2021-22. The Commission’s recommendations, in response to terms of reference, will continue to be the basis for the Treasurer determining the GST revenue sharing relativities used to distribute the GST revenue pool.[[60]](#footnote-61) From 2021-22, in preparing its recommended GST revenue sharing relativities, and subject to terms of reference from the Treasurer, the Commission proposes to do the following:

* measure State relative fiscal capacities (as per the previous arrangements)
* from these relative fiscal capacity measures, derive the corresponding standard State capacities (new arrangements)
* during the transition period, blend the previous and new fiscal capacity measures as prescribed in the legislation
* adjust as required if the relativity floor provision is activated.

##### Previous arrangements

1. Beyond 2020-21, the Commission will continue to calculate State relative fiscal capacities using the methodology adopted in the 2020 Review. The pool used to measure the relative fiscal capacities of the States will be the GST revenue, plus any top‑up payments.
2. Western Australia said that because the process of using relativities effectively escalates each State’s assessed requirements by the growth in that State’s population share of the grant pool between the assessment and application years, the increase in the pool due to the top‑up payments should be backcast.[[61]](#footnote-62) While acknowledging Western Australia’s point in relation to the use of relativities, the Commission’s view is that a 0.8% increase in the pool size is unlikely to be sufficiently large as to have a distorting effect on the grant distributions. Annual growth in the GST revenue can vary by more than this and the Commission’s decisions on recommended relativities are not currently subject to expected growth rates in the GST pool.[[62]](#footnote-63)

##### New arrangements

1. The Commission will use its relative fiscal capacity measures based on the 2020 Review methods to identify the fiscally stronger State as between New South Wales and Victoria (the standard State). Having identified the standard State in an assessment year, the Commission will then derive the corresponding standard State capacities for that assessment year by:

* bringing States fiscally weaker than the standard State to the capacity of the standard State[[63]](#footnote-64)
* allocating the remainder of the GST revenue pool on an equal per capita (EPC) basis across all States
* dividing the resulting GST distributions by an EPC distribution.

1. The Commission would derive standard State capacities from the same pool and population estimates used to calculate the associated relative fiscal capacities.[[64]](#footnote-65) In the same way that the relative fiscal capacities are the average of three assessment years, the standard State capacities would similarly be calculated over the average of three assessment years.

##### Transition period

1. Subsection 16AB(3) of the amended *Commonwealth Grants Commission Act 1973* includes a schedule which specifies the proportions of the previous and new arrangements to be blended over the transition years 2021‑22 to 2025‑26 to derive the GST revenue sharing relativities for those years. This schedule is shown in Table 4A-1.

##### Relativity floor

1. From 2022‑23, as a final step in its work of developing its recommendations to the Treasurer on the distribution of the GST pool, the Commission may have to adjust the blended (or from 2026‑27 the standard State) capacities, should the relativity floor be activated.
2. The simplest way for the Commission to adjust for activation of the floor is to:

* determine the additional amount required to meet the provision of the floor relativity (using the application year estimates of State populations and the GST pool available to it at the time the Commission is required to report)
* fund this amount by deducting it on a population basis from the other States
* divide the resulting GST distributions by an EPC distribution to derive the GST revenue sharing relativities.

1. This approach will maintain the same relative fiscal capacities for all States other than the State receiving the floor relativity. These adjusted relativities will then be the Commission’s recommended GST revenue sharing relativities.[[65]](#footnote-66)
2. Western Australia has said that, to avoid using forecasts, any floor adjustment could be made in the assessment years. The application of the floor requirement is a final step following the outcome of blending the averaged assessment year relative fiscal capacities and averaged standard State capacities. While using forecast application year populations and pools is not ideal, the effects (compared to those if final estimates were available) are not likely to be substantial. However, the Western Australian proposal can be considered further should using application year pool and population estimates to implement the floor be considered problematic.

##### Summary

1. Over the period the 2020 Review methods are applied, the process used by the Commission to derive its recommended relativities for use in distributing the GST pool (including any top‑ups) will vary depending upon the inquiry year’s place in the transition period.
2. Box 4-1 provides a summary of the derivation of the recommended GST revenue sharing relativities during the transition period.

|  |
| --- |
| Box 4-1 Summary of the process for deriving the recommended GST revenue sharing relativities   * For 2020‑21, the State relative fiscal capacities will be the Commission’s recommended GST revenue sharing relativities. * For 2021‑22 to 2025-26, the blended proportions of the previous and new arrangements (as prescribed in the legislation) will form the Commission’s recommended GST revenue sharing relativities. * From 2022‑23, as a final step, the Commission may have to adjust the blended (or from 2026‑27 the standard State) relativities, should the relativity floor be activated. * For 2026-27, the transition will be complete and the relative fiscal capacities based upon the standard State (fiscally stronger of New South Wales and Victoria) will form the Commission’s recommended GST revenue sharing relativities. The process beyond 2026 is subject to the government’s response to the outcome of the Productivity Commission review inquiry. |

#### Determination of ‘no worse off’

1. Section 5 of the amended *Federal Financial Relation Act 2009* specifies the criteria for determining whether the ‘no worse off’ provisions will be triggered. It states that the ‘no worse off’ comparison over the transitional years be made on the basis of a comparison between the grants received by a State under the legislated changes and those it would have received if the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* had not been enacted.
2. To facilitate this comparison, the Commission will continue to calculate relative fiscal capacities on a GST revenue only basis (that is, excluding pool top-ups). For the Commission to determine the relative fiscal capacities on a GST revenue only pool in assessment years when the GST pool includes top-up payments, it proposes to assess the top-up payments on an EPC basis, instead of including them in the pool of general revenue assistance.
3. The Commission also proposes not to make any corresponding adjustment to State expenditures. This is how the Commission usually treats expenditure related to no impact Commonwealth payments when it does not know where States have spent those payments.

#### Presentation of results

1. The legislation does not affect the Commission’s work in relation to its recommendations for the relativities used for distributing the grant assistance pool in 2020-21. That is, the recommended relativities for 2020-21 are the last which solely reflect current (or which the new legislation refers to as previous) arrangements, prior to the commencement of the transition to the new arrangements in 2021-22. Accordingly, for 2020-21, the Commission has presented its findings in this report using the same approach adopted in the previous review and subsequent update inquiries. This approach provides the Commission’s recommended relativities for the upcoming year, alongside the relativities used for the previous year. Forecasts of the upcoming year’s population and pool size are used to show an illustrative distribution of the pool (GST revenue) in the upcoming year, with a comparison to the previous year’s distribution, alongside information on the main drivers of the change in distribution. The effects of the disabilities included in the Commission’s work are shown as effects on the GST revenue distribution in the upcoming year.
2. Attachment A illustrates the Commission’s proposed approach for presenting its findings from the 2021 inquiry (that is, as the transition to the new arrangements commences), including recommendations for the distribution of the grant assistance pool in 2021-22. The attachment uses the Commonwealth’s estimated future relativities to demonstrate how the Commission would bring together the following elements of the legislation:

* the relative fiscal capacities
* the standard State capacities
* the blended capacities
* any floor adjustments
* the recommended grant pool revenue sharing relativities
* the associated ‘no worse off’ provision relativities.

1. The Commonwealth and the States are welcome to provide any feedback on the Commission’s proposed presentation approach.

# Attachment 4A: Proposed presentation approach from 2021

1. This attachment describes the proposed approach to presenting the Commission’s findings for the 2021 and subsequent inquiries. Illustrative report text is indented and italicised.
2. Relativities and grant pool distributions shown in this attachment are for illustrative purposes only. They are based on relativity projections included in the Productivity Commission’s Report on its inquiry into HFE, GST revenue forecasts in 2019-20 Budget Paper No. 3 and pool ‘boost’ arrangements described in the new legislation.

### Chapter 1 Recommended grant distribution

#### Recommended grant distribution

1. Table 4A-1 shows the per capita relativities the Commission recommends for use in distributing the pool of funds comprising GST revenue and any pool top-ups. This is similar to the Table 1 used in previous inquiries, although it uses the recommended grant sharing relativities (incorporating the transition to standard State capacities along with any floor provision effects), not the relative fiscal capacities.

Table 4A-1 Relativities, shares and illustrative grant distribution, 2021‑22 and 2022-23

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Relativities | |  | Shares | |  | Distribution | |
|  | 2021‑22 | 2022‑23 |  | 2021-22 | 2022-23 |  | 2021‑22 | 2022‑23 |
|  | Rel | Rel |  | % | % |  | $m | $m |
| NSW | 0.81821 | 0.80841 |  | 27.2 | 27.3 |  | 19,594 | 20,384 |
| Vic | 0.93794 | 0.92817 |  | 25.5 | 25.2 |  | 18,394 | 19,260 |
| Qld | 1.13751 | 1.14774 |  | 21.8 | 20.7 |  | 16,971 | 18,003 |
| WA | 0.66022 | 0.70861 |  | 5.5 | 7.2 |  | 5,062 | 5,693 |
| SA | 1.41689 | 1.39725 |  | 10.2 | 9.9 |  | 7,203 | 7,418 |
| Tas | 1.77611 | 1.74656 |  | 3.7 | 3.6 |  | 2,722 | 2,790 |
| ACT | 1.15746 | 1.14774 |  | 2.0 | 2.0 |  | 1,451 | 1,514 |
| NT | 4.65978 | 4.83049 |  | 4.2 | 4.1 |  | 3,334 | 3,592 |
| Total | 1.00000 | 1.00000 |  | 100.0 | 100.0 |  | 74,730 | 78,652 |

1. Table 4A-2 is a simplified version of the process used to calculate the recommended grant sharing relativities. Text along the lines of the following may provide suitable guidance for understanding this table.

*Table 4A-2 shows how the grant sharing relativities are derived from the assessed relative fiscal capacities. The Commission calculates each State’s relative fiscal capacity, and then adjusts it to ensure that no State has a fiscal capacity below that of the stronger of New South Wales or Victoria, to form the standard State fiscal capacities.[[66]](#footnote-67) This has the effect of increasing the measure of fiscal capacity of States below the standard State, while decreasing the fiscal capacity of all other States, including the standard State. The Commission then blends these two approaches as prescribed in the legislation, for 2022-23 being 4/6ths relative fiscal capacities and 2/6ths standard State fiscal capacities.[[67]](#footnote-68) The final stage is to ensure that no State is below the prescribed relativity floor, being 0.7 in 2022‑23.[[68]](#footnote-69) In the event moving Western Australia’s relativity to this floor is required, it would result in other State relativities falling slightly to compensate.*

Table 4A-2 Fiscal capacities and grant sharing relativities, 2022-23

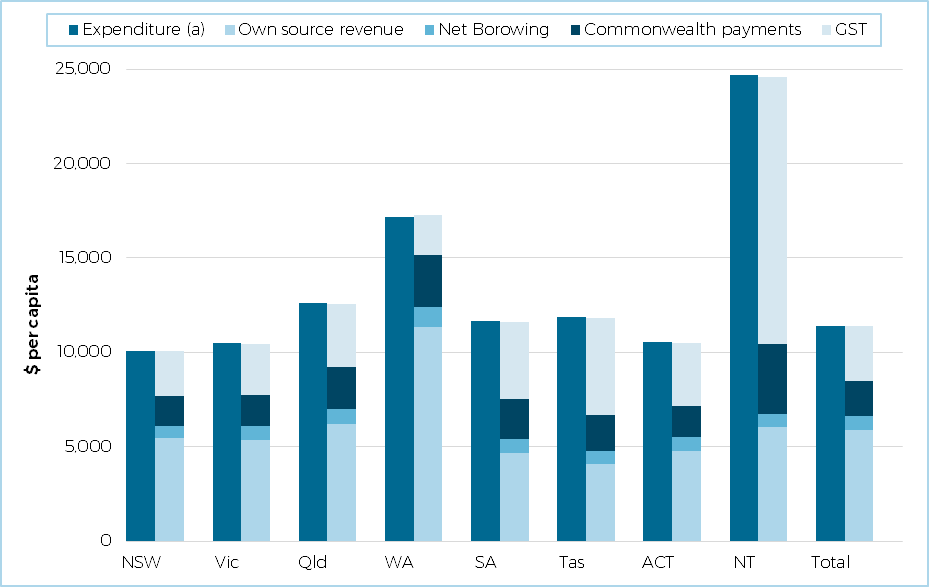
|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Fiscal capacity (a) |  | Standard state |  | 2/6ths transition |  | Implement floor |  | GST  Relativities |
| NSW | 0.813 |  | 0.800 |  | 0.808 |  | 0.700 |  | 0.808 |
| Vic | 0.933 |  | 0.919 |  | 0.928 |  | 0.700 |  | 0.928 |
| Qld | 1.154 |  | 1.136 |  | 1.148 |  | 0.700 |  | 1.148 |
| WA | 0.662 |  | 0.800 |  | 0.709 |  | 0.700 |  | 0.709 |
| SA | 1.404 |  | 1.383 |  | 1.397 |  | 0.700 |  | 1.397 |
| Tas | 1.756 |  | 1.729 |  | 1.747 |  | 0.700 |  | 1.747 |
| ACT | 1.154 |  | 1.136 |  | 1.148 |  | 0.700 |  | 1.148 |
| NT | 4.855 |  | 4.782 |  | 4.830 |  | 0.700 |  | 4.830 |
| Total | 1.000 |  | 1.000 |  | 1.000 |  |  |  | 1.000 |

Note: Numbers have been rounded for presentation purposes. Fiscal capacities and relativities are generated to five decimal places.

(a) Fiscal capacities are illustrative only, using relativity projections published in Productivity Commission 2018, *Horizontal Fiscal Equalisation*, Report no. 88.

1. Recent inquiry reports have included in the Overview a chart showing the GST acting as a balancing item to ensure that total assessed State revenue per capita matches total assessed State expenditure per capita. Figure 4A‑1 shows that increasing Western Australia’s GST relativity above the Commission’s measure of its relative fiscal capacity means that, with average revenue raising effort, it would have slightly more total revenue per capita than it requires to provide expenses and investment at the average level. All other States have less revenue than they ‘require’. The chart highlights that the transition to ‘reasonable equalisation’ is not significantly different from ‘full equalisation’.

Figure 4A‑1 Illustrative assessed budgets per capita, 2022‑23



Note: For illustrative purposes only.

(a) Includes expenses and investment.

Source: Commission calculation.

#### Movements in the grant distribution

1. Table 4A-3 is similar to a table that has been produced by the Commission for several inquiries, identifying changes in grant distributions due to changes in State populations, changes in the size of the grant pool and changes in State fiscal capacities. Note that ‘change in fiscal capacities’ would become ‘change in relativities’.

Table 4A-3 Distribution of the 2021‑22 grants and illustrative 2022‑23 grant distribution

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | NSW | Vic | Qld | WA | SA | Tas | ACT | NT | Total |
|  | $m | $m | $m | $m | $m | $m | $m | $m | $m |
| Estimated 2021-22 | 19,594 | 18,394 | 16,971 | 5,062 | 7,203 | 2,722 | 1,451 | 3,334 | 74,730 |
| Illustrative 2022-23 | 20,384 | 19,260 | 18,003 | 5,693 | 7,418 | 2,790 | 1,514 | 3,592 | 78,652 |
| Change caused by new: |  |  |  |  |  |  |  |  |  |
| Population | 23 | 113 | -5 | -19 | -50 | -24 | 1 | -39 | 0 |
| Pool | 1,030 | 971 | 891 | 265 | 375 | 142 | 76 | 173 | 3,922 |
| Change in relativities | -263 | -218 | 146 | 385 | -110 | -49 | -14 | 124 | 0 |
| Total | 790 | 866 | 1,032 | 630 | 215 | 68 | 63 | 258 | 3,922 |

Note: For illustrative purposes only.

1. Table 4A-4 divides the change in relativities between the change in relative fiscal capacities and changes due to the new arrangements. The text will emphasise that this table reflects a change from the previous inquiry, and therefore negative values for most States from legislative changes cannot be confused with whether those States are ‘worse off’ because of the changes. Table 4A-4 relates to whether a State receives more or less grant revenue than it did in the previous inquiry. This has little relationship to whether it receives more grant revenue than it would GST revenue under the old arrangements.

Table 4A-4 Contribution to change in relativities from the previous inquiry, 2021-22 to 2022-23

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | NSW | Vic | Qld | WA | SA | Tas | ACT | NT | Redist |
|  | $m | $m | $m | $m | $m | $m | $m | $m | $m |
| Fiscal capacity | -226 | -183 | 181 | 248 | -97 | -44 | -11 | 131 | 561 |
| Transition | -38 | -36 | -34 | 136 | -14 | -5 | -3 | -7 | 0 |
| Implement floor (if req.) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Total change | -263 | -218 | 146 | 385 | -110 | -49 | -14 | 124 | 655 |

Note: For illustrative purposes only.

### Chapter 2: Changes since the 2019 Update

1. Tables in this chapter describing the changes in fiscal capacities would not change.

### Chapter 3: State by State changes

1. The State specific main changes tables would remain unchanged. They would continue to show the disabilities having the largest effects on State fiscal capacities, in application year dollars.

### Chapter 4: Why State relative fiscal capacities differ

1. Tables describing why State relative fiscal capacities differ would not change. The analysis on drivers of difference from an EPC grant distribution, in addition to the fiscal capacity effects, will have additional lines, not included in previous update reports, to quantify the effects flowing from the legislation. Table 4A-5 shows the proposed approach.

Table 4A-5 Drivers of difference from an equal per capital distribution of grants, 2022‑23

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | NSW | Vic | Qld | WA | SA | Tas | ACT | NT | Redist |
|  | $m | $m | $m | $m | $m | $m | $m | $m | $m |
| Revenue raising capacity |  |  |  |  |  |  |  |  |  |
| Mining production | 3,470 | 12,792 | -3,544 | -3,990 | 533 | 207 | 152 | -92 | 12,390 |
| Property sales | -3,392 | -3,689 | 2,073 | 862 | 748 | 255 | 15 | 179 | 5,606 |
| Taxable payrolls | -1,110 | 1,588 | 1,673 | -713 | 450 | 216 | -4 | -66 | 2,910 |
| Taxable land values | -1,231 | -979 | 1,589 | -42 | 287 | 115 | 54 | 35 | 2,166 |
| Other revenue | 261 | 508 | -214 | -170 | -40 | 0 | 27 | 6 | 613 |
| Total revenue | -2,001 | 10,217 | 1,580 | -4,054 | 1,977 | 793 | 244 | 62 | 10,464 |
| Expenditure requirements |  |  |  |  |  |  |  |  |  |
| Socio-demographic characteristics |  |  |  |  |  |  |  |  |  |
| Remoteness | -2,003 | -4,239 | 2,268 | 337 | 80 | 428 | -106 | 957 | 5,209 |
| Indigenous status | 53 | -7,230 | 2,361 | 175 | -119 | 130 | -51 | 1,027 | 5,573 |
| Socio-economic status | 139 | -542 | 362 | -152 | 411 | 64 | -181 | -175 | 1,014 |
| Other SDC | -113 | -3,079 | 1,118 | 117 | 145 | 26 | 10 | 133 | 2,371 |
| Total | -1,923 | -15,090 | 6,106 | 477 | 517 | 649 | -328 | 1,941 | 13,515 |
| Urban centre size | 846 | 5,121 | -2,577 | -87 | -252 | -321 | -61 | -182 | 4,724 |
| Administrative scale | -795 | -1,370 | -564 | 42 | 126 | 274 | 189 | 372 | 1,866 |
| Wage costs | 304 | -819 | -496 | 306 | -228 | -180 | 103 | 88 | 1,262 |
| Population growth | -143 | 2,768 | -81 | -263 | -212 | -73 | -10 | 110 | 1,830 |
| Small communities | -410 | -970 | 270 | 112 | 43 | 21 | -11 | 266 | 1,051 |
| Economic activity | -261 | -605 | 257 | 127 | 66 | 18 | -38 | 34 | 703 |
| Non-State sector | -270 | -357 | -223 | 190 | 7 | 69 | 32 | -38 | 594 |
| Other expenses | -493 | -4,067 | 316 | 352 | 81 | 20 | 12 | 792 | 3,066 |
| Total expense and investment | -3,141 | -15,393 | 3,008 | 1,256 | 148 | 477 | -114 | 3,384 | 13,461 |
| Commonwealth payments | 436 | 4,004 | -2,212 | 10 | -62 | -93 | 73 | -598 | 3,744 |
| Total effect of fiscal capacities | -4,706 | -1,172 | 2,376 | -2,788 | 2,064 | 1,176 | 202 | 2,848 | 8,666 |
| Effect of legislation | -104 | -99 | -92 | 374 | -38 | -14 | -8 | -18 | 374 |
| Total | -4,810 | -1,271 | 2,284 | -2,414 | 2,026 | 1,161 | 194 | 2,830 | 8,495 |

Note: For illustrative purposes only.  
Uses 2020 drivers of difference scaled to relativities based on the Productivity Commission projections and legislated changes.

### No State worse off

1. The legislation tasks the Minister with ensuring that no State is worse off under the new arrangements. In reaching an opinion about any necessary top-ups required, ‘the Minister must … have regard to any report of the Commonwealth Grants Commission that the Minister considers relevant.’[[69]](#footnote-70)
2. The Commission would include in this section a table showing the fiscal capacity relativities based solely upon a GST revenue only grant pool, as shown in Table 4A-6.[[70]](#footnote-71) These relativities are applied to GST revenue to determine whether entitlements under the no worse off provisions of the legislation may arise.

Table 4A-6 ‘No worse off’ fiscal capacity relativities, 2022-23

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | NSW | Vic | Qld | WA | SA | Tas | ACT | NT |
| Fiscal capacity relativities | 0.82039 | 0.95045 | 1.12054 | 0.62030 | 1.43068 | 1.80086 | 1.18056 | 4.75227 |

Note: Relativities calculated as if the new legislation had not been enacted.

1. Table 4A-7 shows an illustrative comparison, indicating whether States are better off or worse off under the new arrangements, in the upcoming year.

Table 4A-7 Illustrative comparison of grant share distribution under new and previous arrangements, 2022-23

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | NSW | Vic | Qld | WA | SA | Tas | ACT | NT | Total |
|  | $m | $m | $m | $m | $m | $m | $m | $m | $m |
| New arrangements | 20,384 | 19,260 | 18,003 | 5,693 | 7,418 | 2,790 | 1,514 | 3,592 | 78,652 |
| Previous arrangements (a) | 20,324 | 19,203 | 17,950 | 5,276 | 7,396 | 2,782 | 1,509 | 3,582 | 78,021 |
| Difference | 60 | 57 | 53 | 416 | 22 | 8 | 4 | 11 | 631 |

(a) Relativities calculated as if the new legislation had not been enacted, and applied to GST revenue only.

1. The legislation specifies that the no worse off test be calculated annually during the transition period, on a cumulative basis. That is, gains in earlier years may offset losses in later years. As an aside, the legislation appears to allow for compensated losses in earlier years not to be recouped where there are gains in later years.
2. In the absence of the final population and pool numbers for a given year, the Commission cannot provide a final value for the top-up required at the time of its report. Commonwealth Treasury could produce the final ‘no worse off’ outcomes at a later time as data are finalised.



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1. Clauses 5 and 7 of the terms of reference (ToR). [↑](#footnote-ref-2)
2. Clause 6 of the ToR. [↑](#footnote-ref-3)
3. Clauses 8(a) to 8(c) of the ToR. [↑](#footnote-ref-4)
4. Clause 8(d) of the ToR. [↑](#footnote-ref-5)
5. Clause 3(a) of the ToR for the 2020 methodology Review. [↑](#footnote-ref-6)
6. Clause 3(b) of the ToR. [↑](#footnote-ref-7)
7. Clause 1(b) of the ToR. [↑](#footnote-ref-8)
8. In addition to estimates based on Commission assessment data, elasticities were estimated for motor taxes using Household, Income and Labour Dynamics in Australia (HILDA) survey data, and for stamp duty on conveyances using CoreLogic property sales data. [↑](#footnote-ref-9)
9. An elasticity adjustment is a data adjustment as it aims to adjust a revenue base for the effects of tax rates that differ from the average. For Stamp duty on conveyances, the Commission used the midpoint of the elasticity range estimated by the consultants using Commission data. [↑](#footnote-ref-10)
10. For example, State and average effective rates, and hence the effect of an elasticity adjustment, would vary with differing treatments of non‑real property and land rich transactions. [↑](#footnote-ref-11)
11. The subtraction approach refers to the method the Commission adopted in the 2010 Review but discontinued in the 2015 Review in favour of a more direct assessment. [↑](#footnote-ref-12)
12. In this review, the Commission improved the measurement of remote health service costs to reflect better the low level of non-State sector services in these locations. [↑](#footnote-ref-13)
13. The stage 1 and stage 2 reports are available on the [Commission website](https://cgc.gov.au/) (https://cgc.gov.au/). [↑](#footnote-ref-14)
14. The presence of other transport modes, including heavy rail, buses and light rail, is recognised through the inclusion of passenger numbers by mode. [↑](#footnote-ref-15)
15. For further information about the assessment guidelines including the materiality threshold, see Chapter 3 of Volume 2. [↑](#footnote-ref-16)
16. For example, refer to the Commission’s Report on State Revenue Sharing Relativities 2004 Review, Chapter 7, Report on GST Revenue Sharing Relativities — 2010 Review, Volume 1, Chapter 3, Report on GST Revenue Sharing Relativities 2015 Review, Volume 1, Chapter 1. [↑](#footnote-ref-17)
17. Productivity Commission 2018, *Horizontal Fiscal Equalisation*, Report no. 88, page 352. [↑](#footnote-ref-18)
18. Ibid. Chapter 3. [↑](#footnote-ref-19)
19. The Commission has conducted reviews of its methods in each of 2004, 2010 and 2015. [↑](#footnote-ref-20)
20. Commonwealth Grants Commission, *Report on General Revenue Grant Relativities 1993*, Volume 1, Chapter 7, paras. 7.29 to 7.34. [↑](#footnote-ref-21)
21. Chapter 4 of Volume 2 describes the new arrangements for determining the GST revenue sharing relativities from 2021-22. The reference to current arrangements is to those that currently apply and will continue to apply up to and including 2020-21. Chapter 4 refers to these as the ‘previous arrangements’. [↑](#footnote-ref-22)
22. A disability is 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. See also paragraph 11. [↑](#footnote-ref-23)
23. The calculations include most, but not all, PSPs. The ToR quarantine (or exclude) some payments and the Commission excludes others because they do not affect fiscal capacities. [↑](#footnote-ref-24)
24. The Commission derives a per capita relativity for each State by expressing its per capita GST requirement as a ratio to the national average per capita GST distributed in a year. [↑](#footnote-ref-25)
25. The GST pool refers to the total GST entitlement of the States plus any permanent top-up payments. [↑](#footnote-ref-26)
26. Under an EPC assessment, each State is assessed as needing to spend the average per capita amount on delivering services or being able to raise the average per capita revenue from its revenue bases. [↑](#footnote-ref-27)
27. Materiality thresholds represent a minimum change from an equal per capita distribution of expenditure or revenue that must be met before the Commission will recognise a disability. The section on Implementation issues discusses material thresholds in more detail. See paragraph 6 in Chapter 13. [↑](#footnote-ref-28)
28. Paragraph 11 defines disabilities. [↑](#footnote-ref-29)
29. Sometimes this is referred to as the revenue or expenditure ‘standard’. [↑](#footnote-ref-30)
30. Materiality thresholds represent a minimum change to the redistribution from an equal per capita assessment for a revenue or expense before the Commission will recognise a disability. The section on Implementation issues discusses them in more detail in. [↑](#footnote-ref-31)
31. Paragraph 58 and following discusses internal standards. [↑](#footnote-ref-32)
32. Western Australia’s Submission in response to the draft report, September 2019, page 5. [↑](#footnote-ref-33)
33. The simplified and integrated approach uses a modified operating statement to recognise State capital needs. The modified operating statement would include the holding cost of capital and the activities of housing and urban transport PNFCs. Under this approach, net financial worth would be equalised. [↑](#footnote-ref-34)
34. Although the Commission excludes local government activities from the equalisation process, transactions between States and their local governments, including State support for natural disaster relief, are included. [↑](#footnote-ref-35)
35. The effective tax rate for a State is the actual tax raised by that State divided by the assessed tax base from which that tax is raised. The average effective tax rate is the sum of the revenues raised by each State, divided by the sum of the assessed tax bases. [↑](#footnote-ref-36)
36. Under a rotating standard approach, each State in turn is chosen as the standard State and its policies are applied to every other State. The results for each standard State are then population weighted to obtain a State’s assessed expense or assessed revenue. [↑](#footnote-ref-37)
37. See Chapter 11 Mining revenue, for further details on the policy neutrality of the Mining assessment. [↑](#footnote-ref-38)
38. The Commission’s proposal was outlined in *CGC 2017-21 — The Principle of HFE and its Implementation*, which is available on the [Commission website](https://cgc.gov.au/) (https://cgc.gov.au/). [↑](#footnote-ref-39)
39. Western Australia said that the revenue assessments should recognise the effects of past policies on current revenue bases in some manner, including by applying a discount. [↑](#footnote-ref-40)
40. The particular example Western Australia provided was the North West Shelf project. [↑](#footnote-ref-41)
41. This refers to the historical assessment years (currently three years) on which the relativity calculations are based. [↑](#footnote-ref-42)
42. It is worth noting that Western Australia’s budget papers for 2011-12 provided a reasonably realistic forecast of the impact on its GST share in future years of its surging own-source revenues. This suggests that the problem Western Australia then faced was something other than its ability to predict its future relativities. [↑](#footnote-ref-43)
43. For example, the application year for the relativities recommended by the Commission in the 2020 Review report is 2019-20. These relativities were derived from the average of the relativities calculated for the 2016-17, 2017-18 and 2018-19 assessment years (the assessment window). [↑](#footnote-ref-44)
44. It would require application year data on State revenues, spending and associated State disabilities. [↑](#footnote-ref-45)
45. Under an absorption approach, State GST shares in the application year depend on the distribution of PSPs in the application year, rather than their distribution in the assessment years. [↑](#footnote-ref-46)
46. See *Staff Research Paper CGC 2017-05 S* — *Options for Improving Contemporaneity,* which sets out options for making the Commission’s recommendations more contemporaneous. [↑](#footnote-ref-47)
47. The response to the Treasurer’s letter on the treatment of large and volatile State revenue, prepared as part of the 2015 Review, is available on the CGC website. [↑](#footnote-ref-48)
48. *Staff discussion paper* *CGC 2017‑05‑S —* *Options for Improving Contemporaneity* is available on the CGC website. [↑](#footnote-ref-49)
49. Under an EPC approach, there would be no assessments and so no issues regarding what State do, policy neutrality and practicality would arise. The only issue would be the choice of a year, with contemporaneity suggesting application year populations. [↑](#footnote-ref-50)
50. See Chapter 7 Land tax and Chapter 15 Health for discussion of the decisions to reduce or remove discounts. [↑](#footnote-ref-51)
51. See Chapter 21 Transport for discussion of the decisions to blend assessments rather than discount towards EPC. [↑](#footnote-ref-52)
52. See the final report for the 2017 Update, which is available on the [Commission website](https://cgc.gov.au/) (<https://cgc.gov.au/>). [↑](#footnote-ref-53)
53. Clause 4 of the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* also specifies that by the end of 2026 the Productivity Commission is to hold an inquiry into whether the changes are operating efficiently, effectively and as intended, as well as into the fiscal implications for the States. [↑](#footnote-ref-54)
54. Subsection 16AB(2) of the amended Commonwealth Grants Commission Act 1973. [↑](#footnote-ref-55)
55. The *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* and its explanatory memorandum variously refer to the current, old or previous HFE arrangements as ‘applying a full equalisation standard’ (which this chapter refers to as the previous arrangements). The new or updated HFE system is referred to as ‘applying a reasonable equalisation standard’ (which this chapter refers to as the new arrangements). [↑](#footnote-ref-56)
56. Subsections 8(2A) and 8(2B) of the amended *Federal Financial Relations Act 2009.* [↑](#footnote-ref-57)
57. Section 8A of the amended *Federal Financial Relations Act 2009* describes the pool top-ups for a payment year*.* [↑](#footnote-ref-58)
58. The legislation refers to arrangements in place prior to 2021-22 as ‘previous’ arrangements. This terminology is used for the remainder of this chapter. Years 2021-22 to 2025-26 are transition years where the move from the full equalisation standard to the reasonable equalisation standard is ‘rolled out in broadly equivalent steps’ (see paragraph 1.54 of the explanatory memorandum). Subsection 16AB(3)(b)(ii) of the amended *Commonwealth Grants Commission Act 1973* includes a table describing the proportions of the relativities to be derived from the previous and new arrangements over the transition years 2021-22 to 2025-26. [↑](#footnote-ref-59)
59. Subsections 5(2) and (3) of the amended *Federal Financial Relations Act 2009.* [↑](#footnote-ref-60)
60. In the *Federal Financial Relations Act 2009* relativities are also referred to as ‘factors’. The relativities (or factors) determined by the Treasurer are used to adjust State populations and hence determine State shares of the GST revenue pool (with each State’s share based upon its share of the total adjusted populations). [↑](#footnote-ref-61)
61. Where there is a major change in Commonwealth State arrangements in an application year that is not present in the relevant assessment years for an inquiry, the Commission may ‘backcast’ the effect of the changed arrangements into the assessment years. It can occur when there is a change in the distribution pattern across States of Commonwealth Payments for Specific Purposes. [↑](#footnote-ref-62)
62. For example, from 2014-15 to 2015-16, GST revenue grew by 5.5%, while growth reduced to 4.3% from 2015-16 to 2016-17, before returning to 5.5% in the following year. [↑](#footnote-ref-63)
63. It is conceivable that the standard State will vary between New South Wales and Victoria from assessment year to assessment year. [↑](#footnote-ref-64)
64. This approach differs slightly from that adopted by the Productivity Commission and the Australian Treasury. In their modelling, they derived standard State relativities using application year estimates of the GST pool and State populations. If standard State relativities are based on application year pools and populations, then the calculation of standard State relativities could differ, most likely only slightly, depending on the estimates used. The Commission’s approach avoids the question of which application year pool and population estimates to use in the calculations. [↑](#footnote-ref-65)
65. From 2022‑23, the Treasurer cannot make a determination of a relativity factor for a State less than the relevant relativity floor applying at the time. [↑](#footnote-ref-66)
66. *Treasury Laws Amendment (Making sure every State and Territory gets their Fair Share of GST) Act 2018*, Schedule 1, section 1, paragraph 16AB(2). [↑](#footnote-ref-67)
67. Ibid. Schedule 1, section 1, paragraph 16AB(3). [↑](#footnote-ref-68)
68. Ibid. Schedule 1, section 4. [↑](#footnote-ref-69)
69. Ibid. Schedule 1, section 3, paragraph 5(4). [↑](#footnote-ref-70)
70. Note that the Commission does not propose to produce any analysis of change in respect of the ‘no worse off’ relativities. [↑](#footnote-ref-71)