GST Distribution Review

Issues Paper

July 2011

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Issues Paper

This Issues Paper has been released to assist individuals and organisations to prepare submissions to the Review. It contains and outlines:

- the scope of the Review;
- matters about which the Review is seeking comment and information; and
- how to make a submission.

Participants should not feel that they are restricted to comment only on matters raised in this paper. The Review wishes to receive information and comment on issues which participants consider relevant to the Review's terms of reference.

Review Panel members

The Hon Nick Greiner AC, the Hon John Brumby and Mr Bruce Carter.

Key dates

Release of Issues Paper	1 July 2011
Initial submissions due by	14 October 2011
Release of Interim Report	February 2012
Further submissions due by	June 2012
Final Report	September 2012

Provide us your comments and ideas

By email: gstdistributionreview@treasury.gov.au

By post: GST Distribution Review
The Treasury
Langton Crescent
PARKES ACT 2600

All submissions will be available for reading and downloading from the Review website at http://www.gstdistributionreview.gov.au.

Should you require further assistance with your submission, the GST Distribution Review may be contacted on 02 6263 3855.

Contents

How to read this Issues Paper

This Issues Paper is intended to assist you in preparing a response to the Review's call for submissions addressing the issues relevant to the distribution of the Goods and Services Tax (GST) and the current form of equalisation.

You will see that the Review has posed many questions (in italics) about several issues throughout this paper. The Panel would welcome your answers to any of them, but does not expect people to respond to all of them. You may also have other issues relevant to the Review's task on which you may want to comment or ideas that you wish to contribute.

Sections 1 and 2 summarise what the Review has been asked to do and how you might contribute. Section 1 is set out in a non-technical manner to enable a general understanding of fiscal equalisation and the purpose of the Review.

Section 3 provides more detailed material on the evolution of fiscal equalisation in Australia, its key features and current form as well as providing some comparison with other international approaches to equalisation.

Section 4 discusses the core issues that the Review will need to consider and which give rise to the questions that at this stage the Panel sees as relevant to its task. You do not need to address all the issues raised and you may comment on any other issues you consider relevant to the terms of reference.

The full terms of reference can be found at Attachment A.

1 What has the Review been asked to do?

The Panel has been asked to consider whether the current form of horizontal fiscal equalisation (HFE) used to determine the distribution of the GST amongst the States and Territories (the States) will ensure Australia is best placed to respond to significant structural changes in the economy (as outlined in the Review's terms of reference) and to maintain public confidence in the financial relationships within the Australian Federation. These changes are likely to have differing impacts on States to deliver broadly equivalent levels of services and infrastructure to their residents, in ways that maximise sustainable growth and improvements in quality of life for all Australians.

This Review is not a debate about whether HFE should continue. HFE has and will continue to serve Australia well. The Review's focus is to examine whether HFE and the resulting distribution of GST can work better and encourage the growth necessary for all States to best handle the challenges Australia is facing.

What does horizontal fiscal equalisation mean?

In Australia, it currently means that GST revenue is distributed so that, when combined with State taxes levied at comparable effort, States have the same capability to provide comparable services to their residents. If all States had equal circumstances, GST would be distributed on the basis of a State's population (an equal per capita GST share). But because there are different revenue and service cost drivers in each State that government policy cannot address, some States receive more than equal per capita GST (recipient States — South Australia, Tasmania, the Australian Capital Territory and Northern Territory) while others receive less than equal per capita GST (donor States — New South Wales, Victoria, Queensland and Western Australia). A more detailed explanation of HFE is provided in Section 3.

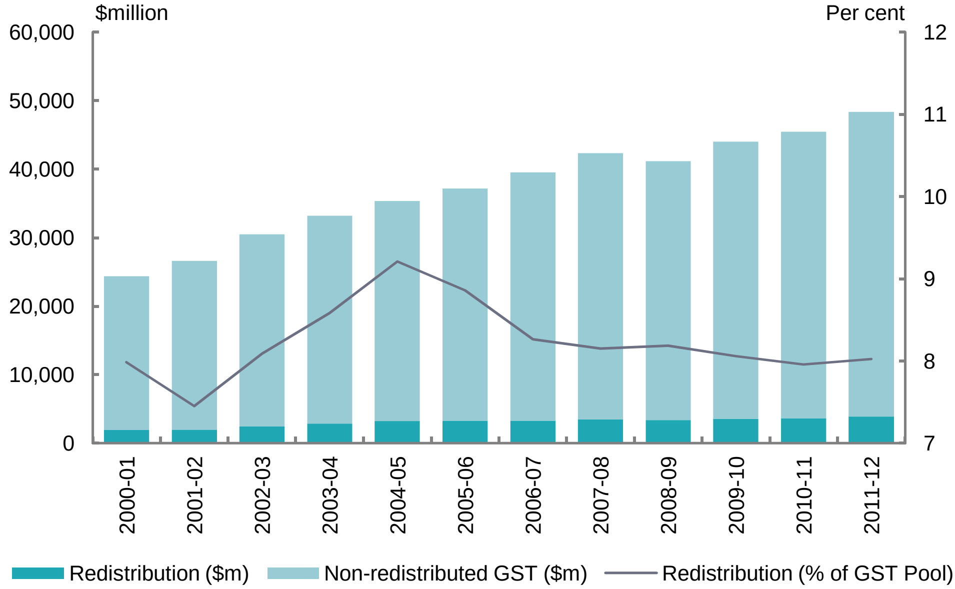
In 1901, Australia became a federation of six colonies. On 1 January 1911, the Territory for the seat of Government (now known as the Australian Capital Territory) was established within the borders of New South Wales, and the Northern Territory was separated from South Australia and became the sole responsibility of the Commonwealth.

Since 1910, the Australian Government has provided some form of financial support for fiscally weaker States, recognising the impact that federation had on States' fiscal capacities. The view was taken that unless some type of intervention occurred, the federation would be unsustainable. This would have seen State budget outcomes diverge as a result of factor endowments — not policy choices. Less endowed States with weaker financial positions would have to reduce services and/or raise additional revenue. In response, people would either relocate or exert political pressure for some equalisation of services.

To enable the States to provide services to their residents at the same standard, it was recognised that a mechanism was required to adjust their fiscal capacities. In Australia, as in many other federations, the system continues to involve transfers from the national government to the sub-national governments (the States), which recognise and adjust their disparate capacities. These transfers are designed to achieve horizontal fiscal equalisation, which broadly means that when they are combined with State taxes levied at comparable effort, States have the same fiscal capacity to provide comparable services.

The current source of funds for fiscal equalisation is the GST revenue. Prior to the introduction of the GST in 2000, the Australian Government and all States and Territories signed an agreement in 1999 that all GST would be distributed on the basis of the principles of horizontal fiscal equalisation to the States. In 2011-12, total GST revenue is estimated at over $48 billion, having grown at an average 6.5 per cent annually since the GST was introduced. Over the last decade, around 8 per cent of the GST revenue pool has been redistributed away from an equal per capita outcome. Chart 1 shows the redistribution as a proportion of the total GST pool for each year since the introduction of the GST.

Chart 1: Redistribution as a proportion of the total GST pool[1]



Source: Final Budget Outcomes and Budget Paper No. 3, *Australia's Federal Relations 2011-12*

While fiscal equalisation is sometimes referred to as the glue that holds the federation together, the underlying aim of equalising the fiscal capacity of the States and the way it is done have often given rise to contentious debates between the Australian Government and the States and amongst States. These debates about the equalisation system, its processes and outcomes have occurred over time in varying levels of intensity. Most recently, the current mining boom and the global financial crisis have contributed to substantial changes in the distribution of the GST amongst the States and heightened scrutiny about the equalisation process and its outcomes. Australia's demographic and other structural policy challenges are also having a differential impact on the States.

In considering any possible changes to the form of equalisation, in accordance with the terms of reference, the Review does not intend to consider detailed methodological and data issues. In considering the current and alternate forms of fiscal equalisation, the Review will consider their overall merit and will specifically have regard to the following:

- efficiency;
  - the effect of the existing equalisation system and alternate approaches on the allocation of resources in the national economy and on the States' reform, service delivery and investment decisions;

1 Redistribution is calculated as the absolute value of the sum of all positive (or negative) redistributions (from an equal per capita distribution).

  - what approach best meets the requirements for growth;

- equity;

  - including the extent to which current and alternate approaches would affect States' fiscal capacities to provide for Australians' access to government services, regardless of where they reside;

- simplicity;

  - including the extent to which alternate approaches would provide for reduced complexity and increased transparency; and

- predictability and stability;

  - greater predictability and stability in the determination of States' GST revenue shares to better support long term decision making and reform by governments.

The scope of the Review makes it clear that there are some matters that will not be considered.

The rate and base of the GST are not a matter for this Review. Its focus is the distribution of GST revenue and not the design of it. Nor is the long-standing practice of equalisation between the States which has served Australia well. Accordingly, this Review does not address whether or not equalisation should occur, but will examine the current and alternate forms of equalisation.

The Australian Government, through the terms of reference, has made it clear to the Panel that the GST will continue to be distributed to the States on the basis of equalising payments to the States, consistent with the principle that jurisdictions should have equal capacity to provide services and infrastructure to their residents. In addition, the Australian Government has made it clear that all the GST revenue will be distributed to the States as ‘untied’ payments; that is, States are free to allocate those funds to their own priorities.

With respect to institutional issues relevant to the equalisation process, the Review notes that its terms of reference make it clear that the Commonwealth Grants Commission (CGC) will continue to make recommendations on the distribution of the GST.

2 How you can contribute your views

2.1 The key questions

The key issues for the Review are to examine the GST distribution and the current form of horizontal fiscal equalisation. The results of the Review will be provided to the Australian Treasurer who will bring the final report to the Council of Australian Governments (COAG) for consideration before a final decision is made on new arrangements by the end of 2013.

The following sections of this Issues Paper provide more detail on many issues and include questions which provide an insight into the matters on which the Review panel is seeking views. There are many questions raised later in this paper, some of which are presented below:

Key questions

Has the fiscal equalisation system evolved to effectively operate in an open economy subject to global volatility?

Is the fiscal equalisation system a passive and reactive mechanism? Should it, or can it, be a more active and dynamic policy tool?

Does the current fiscal equalisation process complement or encourage or discourage productivity enhancing reforms by the States?

Does fiscal equalisation in its current form have a neutral or distortionary effect on government decision making, for example on large infrastructure projects? Does equalisation lead to governments over/undersupplying services to particular population groups?

Equalisation provides for the States to have the same capacity to deliver services, but does not specify the standard of those services States provide. Does this mean that the process creates an opportunity which may not be realised in practice?

Do the outcomes of the current process result in an appropriate level of predictability and stability in the determination of GST shares?

Key questions (continued)

Fiscal equalisation currently redistributes around $4 billion of an estimated $48 billion of GST (in 2011-12) away from an equal per capita outcome. Is the level of complexity in the current system consistent with this amount of transfer?

Is full fiscal equalisation required or is there a form of partial equalisation that can sufficiently recognise underlying differences amongst the States?

2.2 Making a submission

Should you have ideas or comments on these questions, or other matters that arise from the Review's terms of reference, you can send the Review a submission. Where possible, you should provide supporting evidence and documentation.

A submission sets out your views. A submission can be short, setting out key points in one or two pages. Longer submissions may be required should you wish to cover many issues. You decide what goes in a submission and how long it is.

You can make more than one submission. While every submission is welcome, multiple, identical submissions do not carry any more weight than the merits of an argument in a single submission.

If possible, you should send in submissions by email, and as a text document (.txt, .rtf), a Microsoft Word document (.doc or .docx) or similar format, rather than Adobe Portable Document Format (.pdf), to ensure screen readers can access it. Please remove any drafting notes, track changes and other hidden text, as well as any internal links and large logos and graphics. This will enable people to easily view and download submissions from our website.

You may also send submissions by mail. Our contact details are on page iii of this Issues Paper.

2.3 You can find out other peoples' views sent to the Review

As this is a public Review, the Review will make all submissions available for others to read on our website (www.gstdistributionreview.gov.au).

3 Fiscal equalisation in Australia[2]

3.1 Evolution of fiscal equalisation

The Australian Constitution makes no mention of horizontal fiscal equalisation or of a specific obligation for the Australian Government to support fiscally weak States.

As a result of federation, the six States lost their ability to impose tariffs with an adverse revenue effect. As a transitional measure, the Constitution required the Australian Government to pass three quarters of the net revenue from customs and excise duties to the new States for the first ten years of federation (section 87). After that transition, however, the Australian Government continued to provide some form of financial support to the States that remained fiscally weaker.

In the early years, deciding which States to support and the level of financial support was often acrimonious and was done on the advice of a range of ad hoc advisory mechanisms.

Against that background, and after a secession referendum in Western Australia, the Australian Government legislated for the establishment of an independent Commission to provide impartial advice on the appropriate financial support for State budgets.

The CGC was established in 1933 to advise the Australian Government on grants to the States. The CGC quickly adopted the concept of 'fiscal need' as its guiding principle to allow the recipient States to function at a standard not appreciably below that of other States.

Up to 1981, the CGC's advice related to applications by the fiscally weaker States (initially Western Australia, South Australia and Tasmania and later Queensland) for what were known as special grants.

From 1981, the CGC provided advice on grants to all States, including New South Wales and Victoria, but not the territories. The Northern Territory was included in the process from 1988-89 and the Australian Capital Territory from 1993-94.

Since 1933, New South Wales and Victoria have always been donor States. That is, they have received less than their population share of equalisation

2 This section of the Issues Paper draws on material published by the CGC.

funding provided by the Australian Government over the years. On the other hand, South Australia, Tasmania and the Northern Territory have always been recipient States. The Australian Capital Territory was a donor State from 1993-94 — when it joined the equalisation pool — until 1998-99, but has been a recipient State since then. Queensland and Western Australia were recipient States for a long period, but have become donor States in the last several years (with Western Australia also a donor during the late 1990s and early 2000s).

The source of the funding distributed amongst the States has changed over time. The current source of funding is the GST which was introduced in July 2000.

In an agreement between the Australian Government and the State Governments, the States agreed to abolish certain State taxes in return for receiving all of the revenue from the GST. This agreement between the Australian Government and the States included that the GST revenue would be distributed ‘in accordance with horizontal fiscal equalisation (HFE) principles’. This commitment to HFE principles was reaffirmed in the *Intergovernmental Agreement on Federal Financial Relations* (IGA 2008), which was signed by all the States.

Under the current system, the CGC provides advice to the Australian Treasurer on the distribution of the GST revenue amongst the States for an upcoming financial year. The CGC's advice is considered by the Ministerial Council for Federal Financial Relations, after which the Australian Treasurer makes a formal determination of how the GST revenue is to be shared amongst the States.

Most recently, the CGC provided advice on the distribution of GST for 2011-12 in February 2011. The Ministerial Council met in April to discuss the recommended relativities which were included in the 2011-12 Australian Government’s budget.

There has only been one occasion, in the early 1980s, when the Australian Government has not accepted the CGC’s advice. On that occasion, further advice was sought from the CGC, considered in 1982, and then implemented over a longer period.

3.2 The principle of horizontal fiscal equalisation

The principle of horizontal fiscal equalisation is not referred to in Australia's Constitution. Nor is it currently defined in legislation or in any agreement between governments. By convention, the definition adopted has been developed by the CGC, in consultation with State and the Australian Governments. This definition has evolved over time (see Attachment C).

The definition currently used by the CGC is:

> State Governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

Put more simply, the aim is for all States to have the same fiscal capacity to deliver services to their populations, after the distribution of the GST and taking into account their capacities to raise revenue from their own sources.

There are some things that fiscal equalisation in Australia does not do.

- It does not ensure the same levels of services are actually provided — the actual level delivered is a matter of policy for each State.
- It does not provide the capacity for equal services in all regions of the States. Equalisation reflects the policies of all States to provide different services to people living in different regions (such as urban and rural areas). It provides the capacity for equal services in comparable regions but for different levels of service between those regions.
- It does not set out to directly penalise inefficient States; nor reward efficient ones.
- It does not include a qualitative assessment of what State Governments could or should do.
- It does not focus on equality of individuals but equalisation of State fiscal capacities.

The methods used by the CGC to derive the recommended GST distribution are reviewed periodically, around every five years. The last review was completed in 2010. Between reviews, the GST distribution is updated annually to reflect changes in the circumstances of the States. Changes to methods are not generally made in updates.

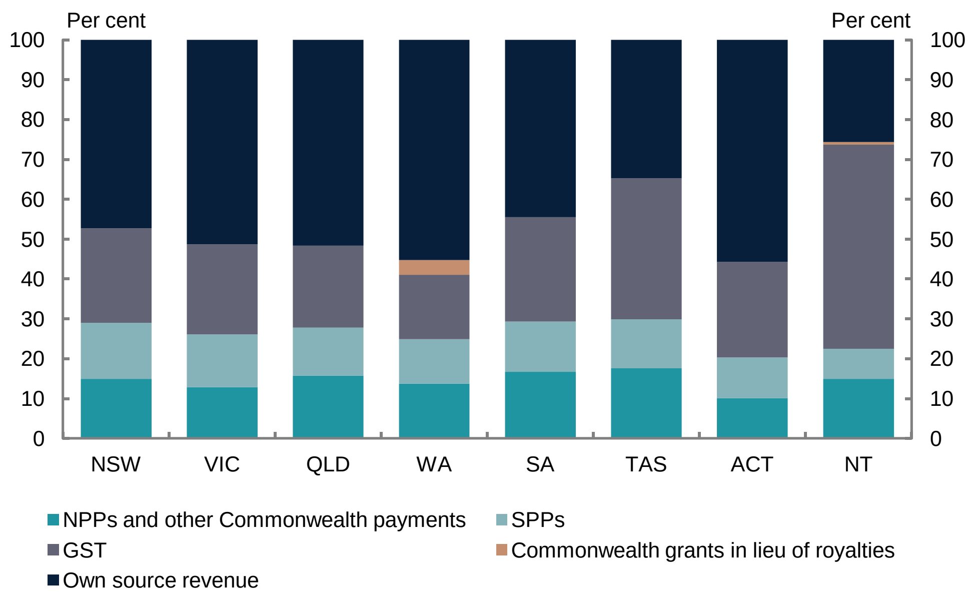
3.3 Fiscal equalisation in the context of Australia's intergovernmental relations

There are three levels of government in Australia, each with different service delivery responsibilities and tax and revenue raising bases.

While all three levels of government have expenditure responsibilities, the Australian Government has the greatest ability to raise revenue from taxation. The Australian Government provides substantial funding every year to State and local Governments.[3]

Funding from the Australian Government forms a significant part of State budgets. In 2009-10, the Australian Government funding to the States accounted for just over 50 per cent of total State revenue. The GST revenue alone formed on average over 20 per cent of total State revenue. Chart 2 shows State revenue sources as a proportion of total revenue in 2009-10.

Chart 2: Revenue sources as a per cent of total State revenue 2009-10



Source: Australian Government and State Final Budget Outcomes.

The States also have a range of sources of revenue they collect themselves. These include items such as payroll tax, land tax, mining royalties and other fees and charges.

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3 This Review does not address local government funding.

The percentage of total State revenue made up of Australian Government grants represents the vertical fiscal imbalance (VFI) present in Australia. Vertical fiscal imbalance is generally understood to be the extent to which sub-national governments (in Australia's case, the States) rely on grants from the national government to meet their expenditure responsibilities. Australia experiences a relatively high degree of VFI, partly on account of Constitutional limitations on States' revenue raising powers.

Vertical fiscal imbalance and horizontal fiscal equalisation are distinct concepts. In Australia the vehicle for the achievement of horizontal fiscal equalisation is a funding stream from the Australian Government to the States (the revenue from the GST).

3.4 Key features of the implementation of fiscal equalisation in Australia

Key features of fiscal equalisation in Australia are:

- it sets out to achieve 'full equalisation' in a comprehensive manner;
- it aims to equalise for all material factors outside of a State Government's control;
  - and, by averaging all State policies to set a benchmark, seeks to avoid any State being able to directly affect its GST share;
- the bigger the intrinsic differences in State fiscal capacities, the more is required to achieve fiscal equalisation; and
- it aims to stabilise its impact on State budgets through the use of an average relativity.

3.4.1 Full equalisation

Australia's comprehensive approach is known as full equalisation. The CGC identifies and measures (or assesses) the differences between the States in:

- what it costs to provide the average standard of services[4] — the relative costs of providing services and acquiring the infrastructure necessary to provide the services;

4 This average is defined as the population weighted mean of all eight States and Territories.

- the revenue they could raise from each tax or charge if they made the average effort — the relative revenue raising capacity;
- payments received from the Australian Government, known as 'Commonwealth payments' (excluding the GST); and
- the net lending (fiscal surplus) or borrowing (fiscal deficit) States would make to finish the year with the same per capita value of net financial worth.

3.4.2 Aims to equalise for factors outside of a State Government's control

The Australian fiscal equalisation process aims to avoid creating incentives or disincentives for State Governments to change their policies so as to directly affect their GST shares. Only differences that are beyond the control of individual States, for example, increased education costs due to a higher than average school-age proportion of a State's population, are taken into account in determining the GST each State needs.

However, each State's own policies affect the average policy against which all States are benchmarked. The CGC calculates each State's share of GST as if it, and all the other States, applied the average policies and practices in delivering services and that they all made the same effort to raise revenue. This is known as the principle of policy neutrality.

Each State affects the averages calculated by the CGC in proportion to its population share. Therefore, the more populous States, such as New South Wales and Victoria generally have a greater effect on the average.

The objective of policy neutrality is that a State's own policies do not directly affect its GST share, although they do affect the average policies against which all States are benchmarked.

While this feature of fiscal equalisation offers several benefits, it can be difficult in practice to avoid some States having a disproportionate effect on the average in some circumstances. For example, where only one or two States have a particular capacity (such as raising revenue from mining royalties) the policy choices of those State Governments may be more likely to affect their GST share.

3.4.3 The bigger the differences in State fiscal capacities, the more work for fiscal equalisation

Fiscal equalisation seeks to offset intrinsic differences between the States. It therefore follows that the equalisation effort is greatest where these differences are greatest.

Currently, the two areas where there is the greatest variance in States' circumstances are the ability of State Governments to raise revenues from mining royalties (because not all States have mineral resources) and the additional costs of providing services to Indigenous people (because Indigenous people are not evenly distributed across the States).

In 2009-10, around 75 per cent of mining production took place in Queensland and Western Australia and these two States collected 79 per cent of mining royalties. This means that the remaining six States received only 21 per cent of mining royalties between them. The Australian Capital Territory raised no mining royalties. Fiscal equalisation acts to effectively contribute to the distribution of the benefits of mining more evenly across the States.

States on average spend more per Indigenous person than they do per non-Indigenous person in providing health, welfare and housing services due to their entrenched disadvantage. If States all had the same shares of Indigenous people in their populations, this result would have no effect on fiscal equalisation outcomes.

However, States have differing proportions of Indigenous people in their populations. For example, around 30 per cent of the population of the Northern Territory are Indigenous people. This compares with the average across all States of around 2.5 per cent of the population. Fiscal equalisation acts to recognise the higher costs faced in delivering average services by the Northern Territory, due to its having a much higher than average proportion of Indigenous people in its population.

3.4.4 Stability of impact on State budgets

The CGC calculates a relativity (discussed in detail in the next section) for each of the last three years for which the latest financial data are available (known as the assessment years). The relativities from each of these years are averaged to create the relativity for the current year (known as the application year). For example, the relativities for 2007-08, 2008-09 and 2009-10 were averaged to obtain the relativities that will be applied to the 2011-12 GST pool.

The period of averaging is currently three years. Between 1990-91 and 2009-10 a five year average was used. The movement to three year averaging was considered to make the relativities more contemporaneous and better reflect States' GST requirements in the application year.

3.5 Calculating the GST shares

The starting point for calculating a State's share of the GST is to determine what it would be if it was simply based on the State's population. That is, if a State represents 25 per cent of Australia's total population, then that State would receive 25 per cent of the GST revenue as a starting point[5]. This would be called an equal per capita (EPC) share.

To calculate if a State's GST share should differ from EPC, the CGC analyses the non-policy drivers of fiscal capacities of the States in the key areas of expenses, new investment, net lending, revenue and Commonwealth payments to see if they result in higher or lower than average outcomes.

Expense assessments

States may have factors beyond their control which lead to different costs in providing services to their residents.

- For example, as older people and Indigenous Australians utilise hospital services more than the average, those States with a higher proportion of these groups in their population may have above average per capita costs in delivering hospital services.
- Similarly, it costs States more to deliver some government services in remote areas and States with lower proportions of their populations living in these areas may have lower costs of providing standard services.

The factors beyond a States' control which may affect its cost of providing services are known as 'disabilities'. The financial impact of these 'disabilities' are known as 'needs' or 'assessed differences'.

Investment and net lending assessments

Investment and net lending are primarily influenced by State population growth. States with higher than average population growth are assessed as having greater needs.

5 The fiscal equalisation process does not consider the amount of GST that is actually raised in a State. There is no reliable data on how much GST revenue is collected in each State. Many businesses in Australia operate in several, if not all, States, while having their headquarters or reporting entity in only one State.

Revenue assessments

States have different capacities to raise revenue from their own sources, which would arise even if they imposed the same taxes and charges and collected them with the same effort.

- The CGC measures tax bases using the value of transactions or goods in each State that would be taxed under the average tax policy. For example, the tax base for stamp duty on conveyances is the value of property sold and for mining revenue it is the value of mining production.
- A State is considered to have a revenue raising advantage if its share of the national tax base is greater than its population share.

Commonwealth payment assessments

In addition to GST, States also receive significant revenue from the Australian Government, identified in the CGC's process as Commonwealth payments. Where these payments provide support for State budgets they are included in the equalisation process. If a State receives below average payments per capita from the Australian Government, then its share of the GST would increase, all other things being equal.

Calculating the total shares

All these factors — expenses, revenue, investment, net lending and Commonwealth payments — are considered when determining State GST shares. A State's GST share divided by its population share of the total GST revenue is commonly referred to as its 'relativity'. Further details on the calculation of the relativities are in Box 1.

As the amount of annual GST revenue is fixed, it is axiomatic that if any State's share of GST is increased, then the share of one or more States has to decrease. Put another way, the annual redistribution of GST revenue through the fiscal equalisation process is a zero sum game.

Box 1: The current method to calculate the GST relativities

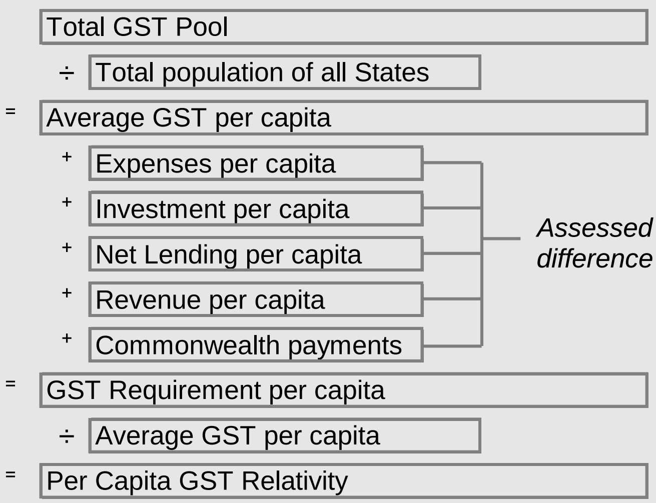
Currently, the first step in the CGC calculating the GST shares is to calculate a per capita share of the GST revenue (known as average GST per capita). This is done by dividing the annual GST revenue, or 'total GST pool', by that year's total of all States' populations.

The CGC then analyses the fiscal capacities of the States in the key areas of expenses, investment, net lending, revenue and Commonwealth payments against the all-State per capita average. The differences in the fiscal capacities of States in these areas against the all-State average are known as the 'assessed differences' or 'needs'. The total 'assessed differences' are used to adjust the average GST per capita to obtain the 'GST requirement per capita'.

If a State has above average costs associated with delivering services to its residents due to factors outside of its control — such as a greater than average share of school age children or more difficulty raising revenue from applying the same taxes (for example, lower conveyance duty revenue due to lower than average prices), then it will receive more GST per person (GST requirement per capita).

The final step in calculating the GST relativities is to divide the GST requirement per capita by the average GST per capita.

Chart 3: Calculation of relativities



Box 1: The current method to calculate the GST relativities (continued)

A GST relativity is a weighting which indicates whether a State needs more or less than its population share of GST. A weighting of 1 results in a State receiving an equal per capita share.

- If a State needs more than an equal per capita share of GST, the GST relativity will be greater than 1. If it needs less, then the GST relativity will be less than 1.
- Therefore, a State with a GST relativity of 1.1 requires an additional 10 per cent of its population share of the GST revenue.

The CGC calculates relativities for each of the last three years for which the latest financial data are available (known as the assessment years), which is averaged to create the relativity for the current year (known as the application year).

For example, the fiscal equalisation distribution recommended to apply in 2011-12 was based upon the years 2007-08, 2008-09 and 2009-10. Prior to the 2010 Review, a five year average was used.

Data averaging process

The CGC uses an average of three year's data in its calculation of the GST relativities, implying the data used is between two and four years old when the associated relativities are used to distribute the GST (see Box 1). Prior to its 2010 Review, the CGC used an average of five year's data.

The movement to three year averaging was considered to make the relativities more contemporaneous and better reflect States' GST requirements in the application year.

The CGC produces a relativity for each of the last three years for which data is available, and averages them to produce the relativity which is used to distribute the GST.

Further information

If you are interested in finding out more about the current form of equalisation or the distribution of the GST, see the CGC's *About Fiscal Equalisation* and Budget Paper No. 3 of the Australian Government's 2011-12 Budget.

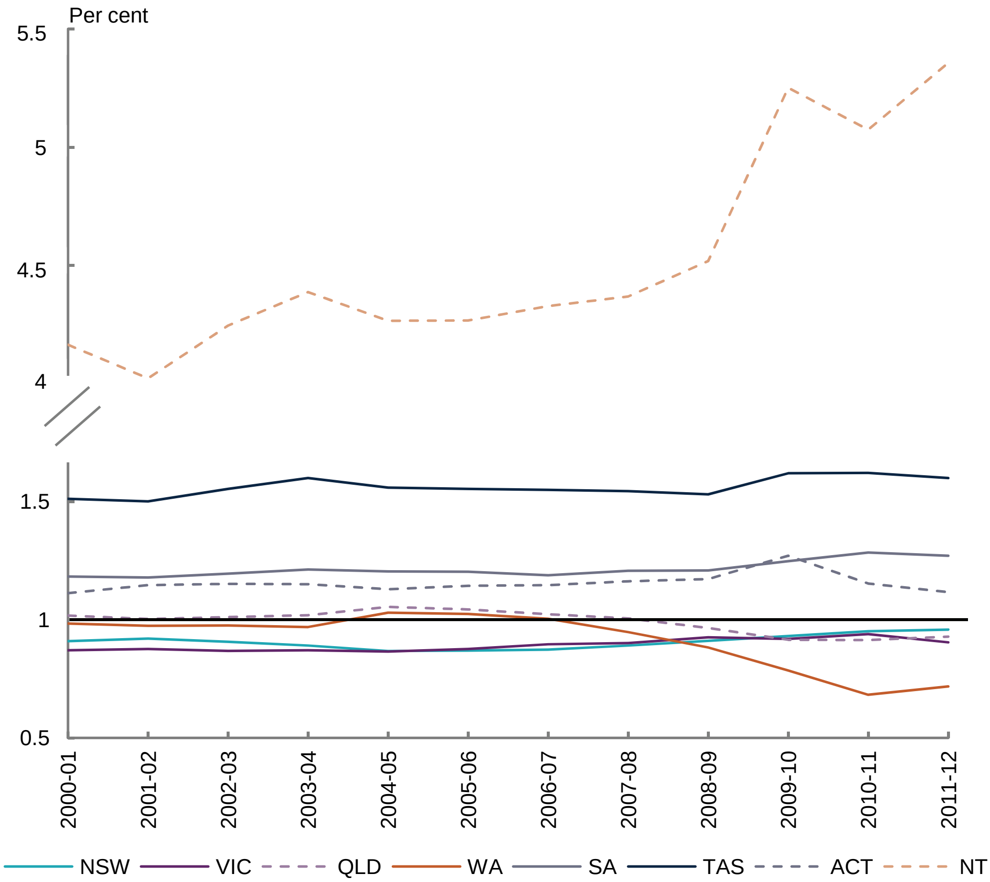
3.5.5 Changes to the relativities over time

States' fiscal capacities can change over time, reflecting changes in their economic and social conditions. Relativities can also change as a result of changes in methods of assessing fiscal capacity.

Chart 4 shows the relativities for each year since the introduction of the GST.

As shown in the chart, since 2000-01, the fiscal capacities of Western Australia and the Northern Territory have shown the greatest change (as reflected in their changing relativities). Queensland's fiscal capacity has increased over the period, moving from a recipient to a donor (in 2008-09). The fiscal capacities of Victoria, South Australia, Tasmania and the Australian Capital Territory have remained relatively stable over the period, with some fluctuation in recent years, while New South Wales' fiscal capacity has experienced a slow decline in the latter half of the period (as reflected in its increasing relativity).

Chart 4: Relativities from 2000-01 to 2011-12 (all States)



Source: Final Budget Outcomes, and Budget Paper No. 3, *Australia's Federal Relations 2011-12.*

States' actual GST payments are not only determined by their relativities, but also by their populations and the overall size of the GST revenue pool.

Table 1 shows the GST payments to each State since its introduction.

Table 1: Total GST payments from 2000-01 to 2011-12

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
	$m	$m	$m	$m	$m	$m	$m	$m	$m
2000-01	7,258	5,099	4,658	2,375	2,279	988	473	1,226	24,355
2001-02	8,132	5,593	5,019	2,518	2,477	1,060	544	1,290	26,632
2002-03	9,080	6,365	5,888	2,910	2,859	1,247	616	1,515	30,479
2003-04	9,667	6,961	6,553	3,158	3,146	1,395	658	1,681	33,219
2004-05	9,884	7,346	7,329	3,624	3,293	1,436	680	1,730	35,323
2005-06	10,362	7,833	7,689	3,804	3,442	1,496	723	1,834	37,182
2006-07	10,938	8,588	8,092	3,968	3,605	1,568	778	2,015	39,552
2007-08	11,916	9,249	8,549	3,984	3,914	1,665	846	2,207	42,330
2008-09	11,844	9,315	7,973	3,594	3,787	1,595	835	2,248	41,189
2009-10	13,330	10,047	8,152	3,550	4,055	1,630	896	2,380	44,041
2010-11	14,023	10,629	8,414	3,202	4,296	1,672	842	2,372	45,450
2011-12	14,950	10,889	9,139	3,598	4,493	1,743	867	2,672	48,350

The influence of the pool size on States' GST payments is illustrated by the general upward trend in States' GST payments and the impact in 2008-09 of the global financial crisis on States' GST payments.

Further information on relativities, State populations, redistributions and a worked example of the calculation of GST payments to the States is contained in Attachment D.

3.6 Australian arrangements in an international context

Most formal federations and some countries with other forms of decentralised government redistribute funds between different levels of governments to enable each to fulfil its responsibilities. Those arrangements often aim for a distribution of funds that allows the sub-national governments to provide basic or comparable levels of services and to do so with comparable tax efforts.

Table 2 summarises the key elements of arrangements operating in two other developed, federal countries. It is widely acknowledged that Australia's approach to equalisation is the most comprehensive. The equalisation arrangements operating in different countries are products of historical, social, demographic, economic, geographic and political circumstances so caution is required in concluding that one country's equalisation approach is suitable for another.

Table 2: How Australia compares with other countries[6]

Country	Australia	Canada[7]	Germany[8]
Objective	For all States to have the same fiscal capacity to deliver services to their populations, after the distribution of the equalisation funds and taking into account their capacities to raise revenue from their own sources.	To ensure provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation across provinces.	To ensure uniformity of living standards throughout the federation.
Form of equalisation	Full equalisation covering interstate differences in capacity to raise revenue and the costs of providing services and acquiring infrastructure. Capacity to which States are equalised is an average of what they all do. Equalisation funds are untied.	Partial equalisation covering differences in capacity to raise revenue. Provinces with above average capacity are not equalised down. Provinces get the greater of the amount they would receive by fully excluding natural resource revenues, or by excluding 50 per cent of natural resource revenues. Capacity to which states are equalised is an average of what they all do. Equalisation funds are untied. Transfers to Canada's three Territorial Governments are done through a separate program. It is designed to enable the Territorial Governments to provide their residents a range of public services comparable to those offered by Provincial Governments, at comparable levels of taxation. It takes account of expenditure requirements and revenue capacity.	Partial equalisation predominantly in terms of differences in revenue capacity but with some small adjustments to recognise cross-border service use, diseconomies of small scale and the effects of sparse population. Also takes account of financial strength of municipalities. Poor Lander (the title of sub-national jurisdictions in Germany) receive adjustment payments which are funded by the wealthy Lander. The starting point for financial equalisation is the financial capacity per inhabitant of all Lander. The Federal Government also provides the fiscally weak Lander with an above average share of value added tax revenue and supplementary grants to complement financial equalisation among the Lander.

6 The United States is not included because while it is a developed, federal country it does not have a formal equalisation process.

7 Department of Finance Canada, Equalization Program, http://www.fin.gc.ca/fedprov/eqp-eng.asp.

8 Bundesministerium der Finanzen, The Federal Financial Equalisation System in Germany.

Table 2: How Australia compares with other countries (continued)

Country	Australia	Canada	Germany
Size of equalisation transfers[9]	A predetermined pool of GST revenue net of collection costs is the source of funds for equalisation transfers. The redistribution was $3.55 billion, or 0.3 per cent of GDP, in 2009-10.	There is a fixed pool with a growth factor applied annually. Annual growth factor is based on thee year moving average of GDP growth. System includes a cap to ensure no receiving province ends up with a fiscal capacity higher than that of the lowest non-receiving province. 0.9 per cent of GDP in 2009-10.	The level of payments is predetermined. Adjustment amounts for rich and poor Lander are scaled to ensure the sum of adjustment amounts correspond with the sum of adjustment payments. 0.3 per cent of GDP in 2009. Calculation excludes supplementary federal grants.
Lags and averaging	Based on three most recent years and averaged.	Based on three most recent years and averaged.	No averaging. Equalisation payments made at least every six months based on a simple formula as actual revenue data become available.
Institutional arrangements and legal status	Intergovernmental Agreement on Federal Financial Relations. Independent grants commission established by federal law.	Constitution	Constitution and federal law.

Further information on the current Australian system of fiscal equalisation in an international context is available in Chapter 6 of the CGC's *Commonwealth Grants Commission: the last 25 years,* 2008, Boadway and Shah (2007) and the OECD (2007).

9 Calculations are based on explicit equalisation transfers. For Canada the amount used is payments to the Provinces as part of the Equalisation Program. They do not include Canada Health Transfer, Canada Social Transfer or Territorial Formula Financing. For Germany the amount used relates to financial equalisation among the Lander. It does not include the above average share of the value added tax that is provided to the fiscally weaker Lander or supplementary federal grants.

4 Issues arising from the terms of reference

4.1 Broad considerations

The Review's terms of reference task the Panel to consider whether the distribution of the GST and the current form of horizontal fiscal equalisation will ensure that Australia is best placed to respond to a number of significant structural changes in the economy and to maintain public confidence in the financial relationships within the Australian federation.

These changes can arise from external influences like the rise of China and India and continuing globalisation; population growth and demographic change; and the continuing effects of innovation and technological change. They are likely to have differing impacts on States to deliver broadly equivalent levels of services and infrastructure to their residents, in ways that maximise sustainable growth and improvements in quality of life for all Australians.

These issues give rise to questions that address the overall framework of equalisation and the distribution of the GST.

In considering the overall framework of equalisation and the distribution of the GST, the Review's terms of reference make it clear that the GST will continue to be distributed to the States on the basis of equalising payments and that all GST revenue distributed to the States will be 'untied' payments. Further, the Review's terms of reference also makes clear that the CGC will continue to make recommendations on the distribution of the GST.

4.1.1 The fiscal equalisation system and governance

Fiscal equalisation has served Australia well. From the early days of the federation when special grants were paid to a few States, it has evolved into a system involving full equalisation between all States. At the same time, the amount of funds distributed has increased significantly, resulting in GST revenues having greater significance in State budget outcomes.

This increase in the size and significance of fiscal equalisation gives rise to questions that go to the overall design, governance and workings of the system.

Consultation questions

Q1. Has the fiscal equalisation system evolved to effectively operate in an open economy subject to global volatility?

Q2. Is the fiscal equalisation system a passive and reactive mechanism? Should it, or can it, be a more active and dynamic policy tool?

Q3. While the level of interest in equalisation outcomes is high, do governments pay sufficient attention to the form of equalisation that underlies the dollar impacts?

Q4. Is greater clarity required in the 'governance' of fiscal equalisation? Should governments determine aims, objectives and definitions and leave administration only to the responsible public sector agency?

Q5. Should the body that administers equalisation be an Australian Government, joint State Government or joint Australian and State Government body?

4.1.2 Scope of fiscal equalisation

The current form of equalisation aims to achieve 'full' equalisation — that is, it includes all States, all State general government revenues (including other Commonwealth payments) and expenditures and differing State circumstances outside government control. Alternative forms include 'partial' equalisation (involving a restriction of any of the elements above) or 'proximate' equalisation (equalising to less than 100 per cent of an agreed standard).

A comprehensive approach to equalisation involves disaggregating State budgets by function and revenue source, and is data intensive. An alternative may be a more selective, or aggregated approach, which may be less data intensive.

The Review's terms of reference ask the Panel to consider current and alternate forms of equalisation within the context of equalisation continuing.

Consultation questions

Q6. Does an alternate form of equalisation need to be 'full' equalisation?

Q7. If 'partial' equalisation occurred, what elements of 'full' equalisation should be removed?

Q8. Would a move away from 'full' equalisation significantly lessen the ability of the current definition of fiscal equalisation to be achieved?

4.2 Specific matters to which the Review will have regard

In undertaking the Review's task, the Panel has also been asked to have regard to the following:

(a) efficiency, including the effect of alternate approaches on the allocation of resources in the national economy and on the States' reform, service delivery and investment decisions to best meet the requirements for growth;

(b) equity, including the extent to which alternate approaches would affect States' fiscal capacities to provide for Australians' access to government services, regardless of where they reside;

(c) simplicity, including the extent to which alternate approaches would provide for reduced complexity and increased transparency; and

(d) predictability and stability in the determination of States' GST shares so as to better support long term decision making and reform by governments.

In considering the merits of the current and any alternate forms of fiscal equalisation, the Panel will need to appropriately balance the factors above in order to arrive at an overall conclusion. To assist the Panel in determining the right balance, the Review poses a number of questions relating to each of the matters listed above on which the Review would appreciate your comments. This will enable the Panel to get a wider understanding of State and community views on preferences for the approach to achieve horizontal fiscal equalisation.

4.3 Efficiency issues

The fiscal equalisation system should be implemented in a way which results in the least possible distortion to efficient economic activity. The Review would like to receive views in relation to two perspectives on efficiency.

Firstly, whether the *outcomes* of fiscal equalisation create inefficiencies in the national economy over time. That is, what are the efficiency implications of the outcomes of equalisation whereby the distribution of the GST to State Governments is less than or more than an equal per capita share? This could give rise to issues relating to the efficient location of resources and grant dependency.

Secondly, whether the *process* of implementing equalisation has efficiency implications. For example, there may be implications for efficiency if the equalisation process created distortions in government policy and funding decisions.

The current form of fiscal equalisation is based on an internal standard, represented by the average of what States actually do. It is not based on an external standard, such as international best practice or what might be considered the most efficient or effective policy design or service delivery.

Inefficiencies may arise if a State Government could, through its own actions, influence the amount of GST revenue that it received by changing its expense or revenue policies (grant design inefficiency).

Consultation questions

Q9. Does the current fiscal equalisation process complement or encourage or discourage productivity enhancing reforms by the States?

Q10. Economic analysis (see Table 4-2, p 47 of CGC (2008)) suggests the efficiency impacts of equalisation on economic welfare are small (less than ± 0.05 per cent of GDP). Are efficiency impacts material and can such impacts be modelled effectively?

Q11. Does fiscal equalisation in its current form have a neutral or distortionary effect on government decision making, for example, on large infrastructure projects? Does equalisation lead to governments over/undersupplying services to particular population groups?

Q12. What influence does the current form of fiscal equalisation have on the incentives for States to fully exploit their own source revenue bases and/or to levy taxes efficiently?

Q13. Does the current form of fiscal equalisation actually or unintentionally penalise or reward States?

Q14. What would be the characteristics of an alternate form of equalisation that might better address efficiency issues and provide incentives to the States to have growth enhancing policy settings?

4.4 Equity issues

While on the face of it, fiscal equalisation is about financial transfers among levels of government, it has flow on implications for the ability of individuals to access comparable levels of service, regardless of which State they reside in.

With regard to the distribution of the GST, the Australian Government makes payments to the State Governments so that each has the same fiscal capacity to provide government services, regardless of their geography, demography, natural resource endowments and economies. The Australian Government also provides other funding to States for the delivery of services.

The terms of reference for the Review make it clear that there will continue to be fiscal equalisation and that the GST payments will remain ‘untied’. However, different forms of implementing fiscal equalisation may have different implications from an equity perspective.

Consultation questions

Q15. In considering any alternatives, how important is it that State Governments in Australia have the same capacity to provide comparable services to their residents?

Q16. Equalisation provides for the States to have the same capacity to deliver services, but does not specify the standard of those services States provide. Does this mean that the process creates an opportunity which may not be realised in practice?

Q17. The current process equalises State Government fiscal capacities so that comparable government services can be accessed in comparable locations in different States (for example, Brisbane and Adelaide) but it does not address differential levels of service across regions (for example, Sydney to Broken Hill), as it is based on 'what States do'. Does this limit the capacity of the process to facilitate equitable access to government services?

Q18. What would be the characteristics of an alternate form that might better address equity issues?

4.5 Simplicity issues

The fiscal equalisation process has long been criticised for being complex. In recognition of this, the simplification of the fiscal equalisation process was a particular objective in the most recent CGC methodology review (the 2010 Review). In that review, significant progress was achieved through a reduction in the number of areas separately assessed by the CGC (assessment categories) and by introducing materiality thresholds which required a minimum effect on the redistribution for an adjustment to be included. As a result, the 2010 Review reduced expense categories from 39 to 14, revenue categories from 21 to 8, and the total number of disabilities were reduced from 373 to 106.

The current comprehensive nature of the equalisation process is built on an extensive range of data that covers State revenues and expenditure, State populations, revenue bases, the users of State services and their effects on the costs of services. While the data come from a range of sources, including the ABS, AIHW, and States, it remains a challenge to ensure data is fit for purpose, of good quality and is provided on a comparable basis.

Consultation questions

Q19. Fiscal equalisation currently redistributes around $4 billion of an estimated $48 billion of GST (in 2011-12) away from an equal per capita outcome. Is the level of complexity in the current system consistent with this amount of transfer?

Q20. Should there be fewer assessment categories in the equalisation system?

Q21. Is full fiscal equalisation required or is there a form of partial equalisation that can sufficiently recognise underlying differences amongst the States?

Q22. What is the appropriate balance between complexity and transparency in achieving fiscal equalisation? How important is it that the process be readily understood?

Q23. Should a 'reasonableness' test be applied to assessments to ensure outcomes based on available data and modelling also take into account intuitive expectations?

Q24. Is the data used fit for purpose and of sufficient quality, that is, relevant, reliable, timely, accurate and comparable?

Q25. Where there is insufficient or poor quality data, is the basis for the use of judgement appropriate? Does it give rise to false precision?

Q26. What would be the characteristics of an alternate form that might better address simplicity issues?

4.6 Predictability and stability issues

Predictability and stability helps support long term decision making and reform by State Governments.

Some level of variability in the GST shares is inherent to the fiscal equalisation process. Equalisation acts to offset changes in States' fiscal circumstances, to ensure that States' have the same fiscal capacities to provide services and the associated infrastructure. Therefore, if States' fiscal capacities change from year to year, so too will the GST shares.

However, data constraints may also add further volatility to the process. Data used in the current fiscal equalisation process may be only infrequently available or of poor quality. If the data are subsequently revised, it may have substantial effects on the fiscal equalisation outcomes.

Under the current system, historic data are used to derive a fiscal equalisation outcome that is applied to a current year. This means that differences that existed in one year may not be fully equalised until five years into the future. This may give rise to a circumstance where, if a State's circumstances change quickly, its GST share could fall just as its own source revenues fall or vice versa.

The current process also involves average historic outcomes over a three year period. Previously the averaging was done over a five year period. A shorter averaging period may have a greater impact on the volatility of the outcomes of the fiscal equalisation process, albeit achieving equalisation more quickly. Conversely, a longer averaging period may result in more stable outcomes but take a longer period to achieve equalisation.

Changes in the size of the GST pool itself can also generate volatility in States' GST payments. Significant economic shocks, such as those following the global financial crisis, can have substantial adverse impacts on the amount of GST revenue that is raised.

Consultation questions

Q27. Do the outcomes of the current process result in an appropriate level of predictability and stability in the determination of GST shares?

Q28. Does the current averaging process result in an appropriate balance between achieving equalisation and reducing volatility?

Q29. As the current equalisation process is heavily reliant on the provision of data from States could more be done to address the quality of State data?

Q30. Could more be done to improve forward estimates of GST distribution outcomes? To what extent should States take responsibility for forecasting future GST shares?

Q31. Should some form of limit, or other transitional approach, be used to minimise the volatility of these outcomes on State budgets?

Q32. What would be the characteristics of an alternate form that might better address predictability and stability issues?

Attachment A — Terms of reference

Objectives and scope

1. Australia is facing a number of long-term trends that are driving pronounced and challenging structural change in the economy, including:

    a. the rise of China and India, and continuing globalisation;

    b. the challenge of mitigating and adapting to climate change;

    c. population growth and demographic change; and

    d. the continuing effects of innovation and technological change.

2. In addition, Australia has ongoing challenges in tackling the entrenched disadvantage of many Australians, especially Indigenous Australians.

3. These trends and challenges are likely to have differing impacts on the ability of States and Territories (the States) to deliver broadly equivalent levels of services and infrastructure to their residents, in ways that maximise sustainable growth and improvements in quality of life for all Australians.

4. In this context, the Review will consider whether the distribution of the GST and the current form of horizontal fiscal equalisation will ensure that Australia is best placed to respond to these challenges and public confidence in the financial relationships within the Australian Federation is maintained.

5. In considering any possible changes to the form of equalisation, the Review will have regard to the following:

    a. efficiency, including the effect of alternate approaches on the allocation of resources in the national economy and on the States' reform, service delivery and investment decisions to best meet the requirements for growth;

b. equity, including the extent to which alternate approaches would affect States' fiscal capacities to provide for Australians' access to government services, regardless of where they reside;

c. simplicity, including the extent to which alternate approaches would provide for reduced complexity and increased transparency; and

d. predictability and stability in the determination of States' GST shares so as to better support long term decision making and reform by Governments.

6. The Review will be guided by the following:

a. that the long-standing practice of equalisation between the States has served Australia well;

b. that the GST will continue to be distributed to the States on the basis of equalising payments to the States, consistent with the principle that jurisdictions should have equal capacity to provide infrastructure and services to their citizens;

c. as per the current arrangements, all the GST revenue will be distributed to the States as 'untied' payments;

d. that the Commonwealth Grants Commission will continue to make recommendations on the distribution of the GST; and

e. it is not intended that the Review will consider detailed methodological and data issues, however the Review will seek the assistance and advice of the Commonwealth Grants Commission on technical matters as required.

Composition and consultation

7. The Review would be undertaken by two or three eminent people.

8. The Treasurer will bring the final report to the Council of Australian Governments (COAG) for consideration before a final decision is made on new arrangements by the end of 2013.

9. The Review will be supported by a Secretariat in the Commonwealth Treasury. It is expected that the Review will second a number of staff with particular expertise, including officials from State Treasuries and the CGC. A Heads of Treasuries Advisory Committee, consisting of all States, will provide advice to the Review.

10. The Review will consult the public and State Governments and seek written submissions.

Timing

11. The Review is to provide an interim report to the Treasurer by February 2012 and a final report by August/September 2012.

12. The GST shares will be distributed in 2011-12 and 2012-13 based on the current arrangements.

Attachment B — List of references

Commonwealth publications

Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities — 2011 Update*

Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities — 2010 Review*

Commonwealth Grants Commission, *The Commonwealth Grants Commission: The Last 25 Years*, 2008

Other publications

Boadway and Shah, *Intergovernmental Fiscal Transfers*, 2007

OECD, *Fiscal Equalisation in OECD Countries*, 2007

Acronyms

ABS	Australian Bureau of Statistics
AIHW	Australian Institute of Health and Welfare
CGC	Commonwealth Grants Commission
EPC	Equal per capita
GST	Goods and Services Tax
HFE	Horizontal Fiscal Equalisation
NPP	National Partnership Payment
SPP	Special Purpose Payment
VFI	Vertical Fiscal Imbalance

Equalisation terms

These terms are primarily drawn from the CGC and reflect the current form of equalisation.

Assessed differences (also known as needs)

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

Assessed expenses

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

Assessed GST requirement, or share

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

Assessed investment

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

Assessed net lending

The transaction-based change in net financial worth that a *State* would require to achieve the *average* net financial worth at the end of each year. The CGC's method for calculating assessed net lending assumes that each State has the average net financial worth at the start of each year.

Assessed revenue

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

Assessment years (period)

The financial years used in a *review* or an *update* to calculate *relativities*. The CGC uses data for three financial years. For example, the *relativities* recommended in the *2011 Update* are based on the average of three annual *relativities* calculated for the most recent completed financial years at the time the relativities are released (2007-08 to 2009-10).

Average (or Australian average)

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

Average expenses

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

Average revenue

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

Category

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

Commonwealth payments

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

Disability

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

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

Distribution

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

Donor State

A donor State is a State that receives less than its population share of GST revenue in any one year. In the early years of fiscal equalisation, a donor State could be regarded as one that did not receive special grants from the Australian Government. See also 'recipient State'.

Fiscal capacity

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

Goods and Services Tax (GST) revenue / GST pool

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

Grant design inefficiency

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

Horizontal fiscal equalisation (fiscal equalisation)

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

Infrastructure

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

Investment

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

Material, materiality test, materiality threshold (see the Assessment Guidelines, Attachment A of the 2010 Review Report, Volume 1)

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

National partnership payments (NPPs)

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

Needs

See 'assessed differences'.

Net lending

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

Policy neutral assessment

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

Recipient State

A recipient State is a State that has received more than its population share of GST in any one year. In the early years of fiscal equalisation, a recipient State was one that received special grants from the Australian Government. See also 'donor State'.

Redistribution

The difference between an *equal per capita* share of the GST and the distribution determined by the *relativities*.

Relativity

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

Revenue base

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

Revenue effort

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

Revenue raising capacity ratio

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

Revenue raising effort ratio

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

Review of methodology

The process in which the CGC reconsiders the methods used to calculate *State relativities*, according to terms of reference given to it. From 1988 onwards, reviews have usually been done every five years. By contrast, an *update* is conducted every year other than a *review* year and updates the *relativities* using the methods determined in the last *review* and the latest financial data.

Specific purpose payments (SPPs)

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

State(s)

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

Tax base

See 'revenue base'.

Untied payments

Untied payments to States from the Australian Government may be spent solely in accordance with State priorities. States receive the GST revenue as untied payments.

Update

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

Vertical fiscal imbalance

Vertical fiscal imbalance is generally understood to be the extent to which sub-national governments rely on grants from the national government to meet their expenditure responsibilities.

Year of application

The year in which the *relativities* assessed are to be used to distribute the *GST revenue*. For example, in the 2011 Update, the *year of application* is 2011-12.

Years of assessment

See 'assessment period'.

Attachment C — The principle of horizontal fiscal equalisation over time

This section provides further information on the definition of fiscal equalisation as it has applied in different periods.

1936 CGC Third Report

Special grants are justified when a State through financial stress from any cause is unable to efficiently discharge its functions as a member of the federation and should be determined by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States.

1978 *States (Personal Income Tax Sharing) Amendment Act 1978*

(3) ...

(a) on the basis of the principle that the respective payments to which the States are entitled under this Act should enable each State to provide, without imposing taxes and charges at levels appreciably different from the levels of the taxes and charges imposed by the other States, government services at standards not appreciably different from the standards of the government services provided by the other States;

(b) taking account of -

- (i) differences in the capacities of the States to raise revenues; and

- (ii) differences in the amounts required to be expended by the States in providing comparable government services; and

(c) in the light of an examination by the Commission of -

- (i) the matters that influenced the determination of the State factors; and

(ii) any events that have occurred since those State factors were determined that, in the opinion of the Commission, affect the appropriateness of the continued application of those factors.

(4) For the purposes of sub-section (3), the State factors are -

(a) in the case of a State other than Victoria-the number by which the estimated population of the State on 31 December in a year is, by virtue of the definition of 'adjusted population figure' in sub-section 4 (1), required to be multiplied for the purpose of ascertaining the adjusted population figure of that State in respect of that year; and

(b) in the case of Victoria — the number one.

Source: *States (Personal Income Tax Sharing) Amendment Act 1978* no. 85, 1978 — sect 5.

1999 CGC Review — Terms of Reference[10]

... should enable each State to provide the average standard of State-type public services assuming it does so at an average level of operational efficiency and makes the average effort to raise revenue from its own sources.

1999 CGC Report

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

2010 CGC Report

State Governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

10 Terms of reference provided by the then Minister for Administrative Services. The Minister responsible for providing the CGC with its terms of reference has varied over time. The Australian Treasurer is currently responsible for providing the CGC with its terms of reference.

Attachment D — Additional tables

Table 3: State populations

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
2000-01	6,502,615	4,797,366	3,597,203	1,897,381	1,500,491	470,142	312,384	196,308	19,273,890
2001-02	6,642,879	4,854,133	3,670,459	1,918,805	1,518,874	473,252	322,638	199,868	19,600,908
2002-03	6,671,426	4,902,920	3,750,543	1,940,485	1,524,136	474,388	322,680	197,374	19,783,952
2003-04	6,716,277	4,947,985	3,840,111	1,969,046	1,531,375	479,958	322,579	198,700	20,006,031
2004-05	6,728,890	5,013,967	3,945,990	1,998,756	1,545,528	484,640	328,155	203,784	20,249,710
2005-06	6,786,435	5,085,505	4,043,814	2,037,272	1,559,372	488,495	332,380	208,407	20,541,680
2006-07	6,858,555	5,170,618	4,139,685	2,084,733	1,576,491	491,783	337,077	212,335	20,871,277
2007-08	6,954,961	5,268,760	4,247,043	2,141,057	1,593,743	495,509	342,317	217,473	21,260,863
2008-09	7,075,707	5,381,828	4,366,397	2,211,608	1,612,625	500,935	348,506	222,784	21,720,390
2009-10	7,190,482	5,501,387	4,475,132	2,272,556	1,634,835	505,360	355,311	227,949	22,163,012
2010-11	7,277,478	5,587,207	4,551,906	2,316,385	1,651,847	509,548	360,720	230,975	22,486,066
2011-12	7,360,346	5,674,844	4,640,631	2,365,603	1,667,161	513,875	365,984	235,207	22,823,651

Table 4: Relativities applied

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2000-01	0.909130	0.870491	1.018304	0.983650	1.182577	1.510913	1.112894	4.163852
2001-02	0.920323	0.875395	1.002691	0.975158	1.179413	1.500952	1.146330	4.021657
2002-03	0.906308	0.868243	1.011741	0.975915	1.194470	1.554191	1.152163	4.244837
2003-04	0.891171	0.870095	1.019018	0.969458	1.212145	1.599478	1.149793	4.386377
2004-05	0.867495	0.865342	1.055045	1.030540	1.204074	1.559394	1.129296	4.265377
2005-06	0.868458	0.875518	1.043896	1.025000	1.203254	1.552992	1.142996	4.266820
2006-07	0.873320	0.895590	1.023870	1.004800	1.188620	1.549310	1.145750	4.327550
2007-08	0.890790	0.900960	1.006070	0.947470	1.207910	1.544650	1.162930	4.368240
2008-09	0.910600	0.925400	0.965080	0.882880	1.208560	1.529940	1.172050	4.518350
2009-10	0.931857	0.918746	0.915564	0.784852	1.247238	1.620397	1.270513	5.250734
2010-11	0.952046	0.939947	0.913216	0.682983	1.284969	1.620910	1.152953	5.073827
2011-12	0.957763	0.904755	0.928605	0.717285	1.270702	1.599415	1.116465	5.357084

Table 5: Total redistribution from 2000-01 to 2011-12

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
	$m	$m	$m	$m	$m	$m	$m	$m	$m
2000-01	-959	-963	113	-23	383	394	78	978	1,945
2001-02	-894	-1,002	32	-89	413	417	106	1,018	1,985
2002-03	-1,198	-1,188	110	-79	511	516	119	1,210	2,465
2003-04	-1,485	-1,255	177	-112	604	598	122	1,351	2,851
2004-05	-1,853	-1,400	445	137	597	590	108	1,375	3,253
2005-06	-1,922	-1,372	370	116	619	612	121	1,456	3,295
2006-07	-2,060	-1,211	247	17	617	636	140	1,613	3,270
2007-08	-1,931	-1,241	93	-279	741	678	165	1,774	3,451
2008-09	-1,574	-891	-308	-600	728	645	174	1,825	3,373
2009-10	-958	-885	-741	-966	806	626	190	1,927	3,549
2010-11	-686	-664	-787	-1,480	957	642	113	1,905	3,617
2011-12	-642	-1,133	-692	-1,413	961	654	91	2,174	3,880

Table 6: Per capita redistribution from 2000-01 to 2011-12

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Average
	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc
2000-01	-147.52	-200.68	31.33	-12.11	255.15	838.08	249.26	4,979.63	100.91
2001-02	-134.54	-206.47	8.59	-46.38	271.84	880.69	327.08	5,094.55	101.27
2002-03	-179.54	-242.37	29.20	-40.87	335.29	1,087.42	367.49	6,132.65	124.62
2003-04	-221.08	-253.60	45.97	-56.66	394.19	1,245.03	379.69	6,799.05	142.52
2004-05	-275.45	-279.17	112.90	68.72	386.50	1,217.64	329.05	6,746.99	160.66
2005-06	-283.25	-269.86	91.39	57.00	397.05	1,253.23	364.26	6,988.59	160.39
2006-07	-300.32	-234.12	59.75	8.37	391.62	1,292.54	413.93	7,596.09	156.69
2007-08	-277.69	-235.56	22.01	-130.21	464.63	1,369.03	481.12	8,158.21	162.33
2008-09	-222.39	-165.56	-70.47	-271.47	451.69	1,287.30	500.45	8,191.96	155.28
2009-10	-133.28	-160.78	-165.47	-424.87	493.13	1,238.31	534.34	8,453.81	160.13
2010-11	-94.30	-118.79	-172.89	-638.90	579.53	1,259.48	312.33	8,248.21	160.85
2011-12	-87.29	-199.68	-149.10	-597.25	576.37	1,273.49	249.29	9,242.39	170.02

Table 7: Example calculation of GST entitlement – 2011-12

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
2011-12 popn	7,360,346	5,674,844	4,640,631	2,365,603	1,667,161	513,875	365,984	235,207	22,823,651
Pop. Share (%)	32.249	24.864	20.333	10.365	7.305	2.252	1.604	1.031	100.000
EPC dist ($m)	15,592.3	12,021.7	9,830.8	5,011.3	3,531.7	1,088.6	775.3	498.3	48,350.0
GST relativities	0.95776	0.90476	0.92861	0.71729	1.27070	1.59942	1.11647	5.35708	na
Adjusted pop.	7,049,445	5,134,372	4,309,336	1,696,823	2,118,461	821,902	408,610	1,260,023	22,798,973
Adj. Pop. Share (%)	30.920	22.520	18.901	7.443	9.292	3.605	1.792	5.527	100.000
Share of GST ($m)	14,949.8	10,888.5	9,138.9	3,598.5	4,492.6	1,743.0	866.5	2,672.1	48,350.0
Redistn from EPC ($m)	-642	-1,133	-692	-1,413	961	654	91	2,174	3,880
Redistn from EPC ($pc)	-87.29	-199.68	-149.10	-597.25	576.37	1,273.49	249.29	9,242.39	170.02

Note: Results from this example calculated for years prior to 2009-10 will not be consistent with Tables 5 and 6 as the relativities included in Table 4 prior to this year were derived for a total pool of GST payments and health care grants.