3 Examining alternative equalisation approaches

Chapter 2 explained that, because of the large States' concerns, the Panel has been alert for any changes that may improve the transparency, simplicity, efficiency or stability of the system, even if such changes might come at a small cost to the theoretically equal outcome. That Chapter drew out the differences in viewpoints of the small States (that support the 'fuller' HFE model, based on the Buchanan idea of providing States with the capacity for horizontal interpersonal equity) and the large States (that favour a more partial equalisation, or an approach that would reach the same, or very similar outcome in a simpler, more general way).

In this Chapter the Panel examines the specific proposals and ideas that have been put to us by the large States to modify the system in order to establish whether any of them are viable approaches in the short to medium term. These proposals fall under two categories, namely, proposals to do *less equalisation* than under the present model and proposals to perform equalisation in a *less precise* or more general way.

The notion of an equal per capita (EPC) approach has not been considered at length here as the Panel has interpreted that to be beyond our Terms of Reference, especially since the Commonwealth has made it clear that there is no additional money available to compensate States that would be otherwise worse off under an EPC model. However, the Panel has further considered the EPC model in Chapter 12, as part of examining a long term view of Commonwealth/State relations.

3.1 Proposals to do 'less' equalisation

The Panel notes that large States and some academics are concerned that, although the current system seeks to deliver close to full equalisation, that degree of equalisation is not necessary. Amongst other things, it is suggested that seeking full equalisation dulls incentives to deliver services efficiently, does not recognise States' property rights and reduces confidence in the federation. It has been put to the Panel that partial equalisation would address these concerns.

The process for evaluating options in this Chapter is somewhat akin to a cost-benefit style exercise in which the 'cost' against the HFE benchmark should be measured and compared with the 'benefit' to be gained. However, as with any cost/benefit analysis, the costs and benefits are not always readily identifiable or quantifiable. Further, in the context of HFE, there are some inherently subjective perspectives on whether a change is a cost or benefit. Because of the difficulty in putting a precise number on the cost/benefit ratio in these circumstances, the Panel has found it best to examine the purported benefit first and, where that has been found likely to be small, or the conceptual case for it is not compelling, we have concluded that detailed attempts to quantify the cost/benefit are not necessary.

Table 3.1 shows a range of headline approaches (each with a myriad of variations) that have been considered by the Panel. Some of these apply to revenue assessments only, some affect expense assessments, while some apply overall.

Table 3.1: Approaches that give rise to 'less equalisation'

Approach
Revenue side
Apply a revenue discount to recognise States rights to having a share of revenue unequalised
Equalise to the standard of the State with the minimum revenue 'effort'
Expenditure side
Apply an efficiency dividend to expenditure needs
Equalise to an externally determined efficient standard
Equalise to the standard of the State with the minimum expenditure 'effort'
Equalise to a 7-State average
Overall
Equalise to a proportion of the strongest State
Raise recipients to a proportion of donor States
Distribute a set (minimum) amount of GST on an EPC basis
Establish a relativity floor

Note: The current standard is the Australian, or all States, average.

For convenience, in the sections that follow, the Panel has considered these approaches in categories according to the issues they seek to address, rather than the effect they have. Four broad categories have been identified for these purposes:

- equalising to a capacity other than the 'all States' average', to promote efficiency
- allowing one State to remain above the average capacity to address 'confidence in the federation'
- allowing States to retain some greater proportion of a 'fiscal benefit' to address States 'rights'
- equalising to a capacity other than the 'all States' average', to recognise that differences in expenditure 'effort' are States' policy choices.

Approaches to promote efficiency

In the course of its Review the Panel has noted the concern that the current approach to equalisation dulls incentives to deliver services efficiently. This concern is distinct from the theoretical issue about whether HFE promotes *locational* efficiency or inefficiency. It is also quite separate from the concern that States do not receive the benefit from any efficiency savings made (that has previously been addressed by the CGC[1]).

1 In Box 2-1 of its 2012 Update, the CGC notes States that are more efficient than the average get to keep the benefits of their efficiency, and those States that are less efficient than the average bear the costs. Commonwealth Grants Commission, *Report on GST revenue sharing relativities*, 2012 Update, page 31.

The efficiency concern arguments proceed on the basis that, by using the Australian average expense[2] for all States, the CGC's processes send a signal to every State that operating at the average efficiency is acceptable, rather than encouraging States to pursue greater efficiencies in service delivery. When this issue first arose in the initial round of consultations with States, the Panel was determined that States should be encouraged to be as efficient as possible in delivering services. The various proposals intended to encourage efficiency all operate through some type of discount, at least on expenses and, possibly, to overall relativities.

The way the Commonwealth, and many States, seek to achieve efficiency in service delivery is to impose an 'efficiency dividend' on Departmental budgets. For example, the Commonwealth generally has an efficiency dividend of around 1.25 per cent per annum. Other approaches such as equalising to less than the all-State average are also effectively discounts. There are, for example, a number of ways of equalising to less than the average, for example equalising to an efficient external standard, or equalising to a proportion of the average. As noted in our first interim report, using any standard other than the average creates the need to identify that standard, along with the attendant problems of who should determine the standard from time to time.[3]

Approaches to setting the standard for equalisation at lower than average that avoid the problems of determining an external standard are to exclude some States from the average, or to approximate that result by way of a general discount. For example, excluding the highest spending State from the average would lower the standard to which States are equalised, particularly if the highest spending State has a large population. A 7-State average could be approximated by an equivalent general discount for simplicity. There are numerous other variations that all rely on broadly the same mechanism and result in broadly the same outcome. However, the Panel notes that all such approaches assume that an efficient standard is somewhat *less* than the average standard, rather than more.

Do these approaches actually improve efficiency?

The proposed indicator of efficiency generally tends to be total expenses on services. This is based on the assumption that States with higher expenses are less efficient and those with low expenses are more efficient. The fundamental problem with this approach is that the level of State spending on its own is not an indicator of efficiency — actual levels of spending arise from both policy and non-policy influences. For example, a State may spend more on school education because it has a higher proportion of school aged children than other States, not because it spends more on each child for no improvement in outcome.

Unfortunately, because of the complexity of the system, outside observers sometimes appear to relate higher expenditure needs solely with either the quality of the service provided or the efficiency with which it is provided.

To recommend any form of approach to promote efficiency, the Panel would have to be able to conclude that States that have higher expenditure needs (either overall or at an assessment category level) are *less efficient* and those with lower expenditure are *more*

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2 The Australian average or population weighted average is the sum of all State expenditure on a service divided by the sum of all States' populations.

3 GST Distribution Review, *Interim Report*, March 2012, pages 79-80.

efficient. We have been presented with no evidence to support such a claim, and have no other basis to come to that conclusion.

> ### *Finding 3.1*
>
> *Despite our initial desire to provide incentives to States to deliver services more efficiently, the Panel has concluded that the HFE system as currently manifested cannot achieve this through efficiency discounts, as there are factors beyond a State's control that lead to higher than average expenditure. While it might theoretically be possible to overcome this deficiency if the CGC were to fully separate cost and use elements of its assessments, that result is not guaranteed, and the additional process would risk complicating the CGC's assessments further.*
>
> *Nevertheless, the Panel encourages States to continue to seek efficiencies wherever they can. In particular, we note that, under the present system, whenever large States such as New South Wales, Victoria and Queensland are able to reduce their costs of service delivery, their contribution to the average calculation (over 75 per cent) will drive the average to which all States are equalised.*

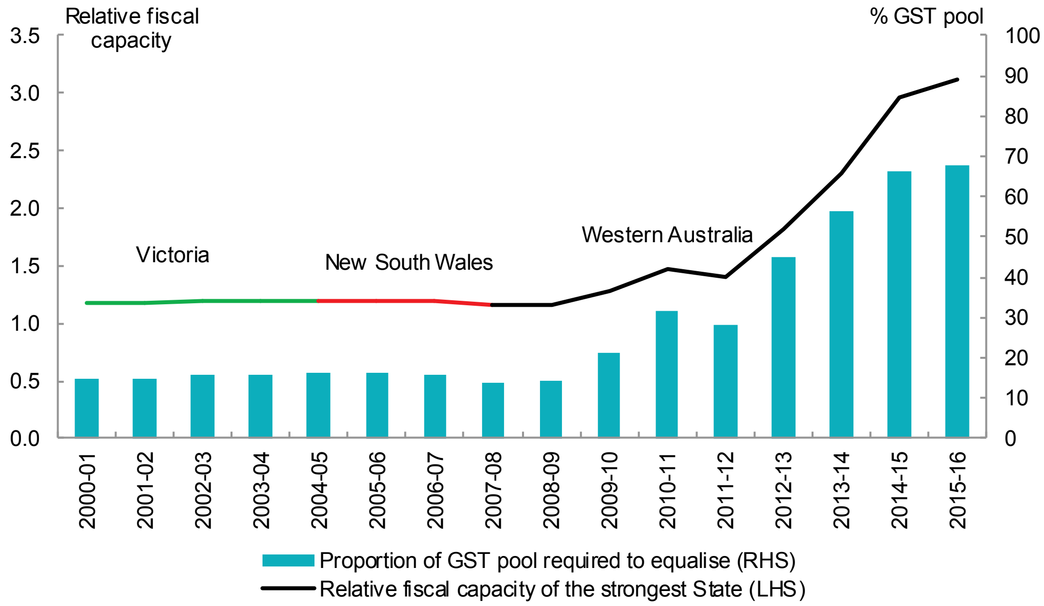
Approaches to address confidence in the federation

In our first interim report, the Panel observed that it is possible for a State to receive no GST funding because of the strength of its own revenue, and still have the capacity to provide at least the same standard of services to its citizens as the other States. While that observation is technically correct, it has been suggested that if a State received no GST, that very fact could lead to fractious relationships with other States and/or the Commonwealth, regardless of the circumstances. This dynamic already appears to be in play as Western Australia's relativity declines, even though it is not likely to reach zero in the short to medium term. This section deals with approaches that lend themselves to addressing these sorts of concerns about confidence in the federation.

The current HFE process effectively starts from a population share of GST, referred to as an EPC share. The CGC, through its assessment of revenues and expenses, determines the factors that result in a State requiring more or less than their population share of GST. This is equivalent to giving all States the same fiscal capacity as the strongest State. The strength of the State with the strongest fiscal capacity (in terms of the ability of its own-source revenues and Commonwealth payments other than GST to meet its expenditure needs) determines the amount required to equalise.[4] The strongest State changes over time and is currently Western Australia — see Figure 3.1.

4 This alternative way of viewing the GST distribution is presented in Table 5-3 of the CGC's *Report on GST revenue sharing relativities — 2012 Update*, page 64.

Figure 3.1 Amount required to equalise, 2000-01 to 2015-16



Source: Historical years (2000-01 to 2012-13) are based on GST revenue sharing relativities. Forward estimates (2013-14 to 2015-16) use Secretariat estimates based on data available at August 2012.

Figure 3.1 shows that the amount required to deliver equalisation has increased between 2008-09 and 2012-13 and, based on forward estimates, is expected to rise significantly. By 2015-16 the proportion of the GST pool required to deliver equalisation is expected to be about 70 per cent, compared with around 10 to 15 per cent for all the years prior to 2008-09. This increase reflects the expected strength of Western Australia's own-source revenue.

Approaches that have been proposed as supporting confidence in the federation considered by the Panel include:

- equalising to a set proportion of the strongest State's capacity
- equalising recipients to the average capacity of some or all donor States
- establishing a relativity floor.

Under the first type of approach, States would be equalised to a set proportion — say, 95 per cent — of that of the strongest State. The main consequence is that less of the GST pool would be required to deliver 'equalisation', with more being allocated on an EPC basis. The strongest State would therefore end up with a higher fiscal capacity than all other States, while the other States would have the same fiscal capacity as each other. Using the example of equalising to 95 per cent of the strongest State in 2012-13 would have seen Western Australia receive an additional $130m in GST at the expense of all the other States.

There are a range of variations to this approach, including equalising States to the average of the two strongest States, or to the State with the second strongest capacity. Under any of these approaches, less of the pool is required to 'equalise', leaving more distributed EPC. By way of example, equalising to the average capacity of the two strongest States in 2012-13 would have required about 20 per cent of the GST pool to achieve equalisation rather than 45 per cent.

The second type of approach that seeks to deal with confidence in the federation is to raise small States to a proportion of the average fiscal capacity of donor States. As the average fiscal capacity of donor States would be higher than the average that includes all States, the proportion of the donor State average would need to be quite low, and much lower than the proportion considered when compared with the strongest State.

The last type of approach that seeks to deal with confidence in the federation is having a floor on relativities. Say a floor of 0.3 was established, it would benefit any State with an assessed relativity below 0.3 and those States with relativities above 0.3 would have reduced GST payments. Historically, a floor at this level would have had no impact as no State has had a relativity below 0.3.[5]

The Panel observes that the approaches seeking to improve confidence in the federation cannot achieve that aim in the normal course of events. Because these approaches redirect GST funding to the strongest State and reduce the GST funding received by the other States they would, in our opinion, potentially *undermine* their confidence in the federation. Furthermore, these types of approaches have been proposed as a result of anticipation of a prolonged and increasing mining boom. Recent signs are that relativities may start to converge again sooner than was expected at the time this Review was commissioned.

> ***Finding 3.2***
>
> *Approaches to address confidence in the federation would only make sense if there was a real likelihood of a strong State seeking to leave the federation. In the Panel's view, whatever concerns States may have about the delivery of HFE, they are not sufficient for them to realistically contemplate leaving the federation and we do not see the need to pursue these approaches. If a situation arose where the risk of a State seeking to leave the federation became realistic, this type of approach might be considered as an 'emergency break glass' option to apply in the short term to allow time for a negotiation of broader Commonwealth-State financial relations issues.*

Approaches that address State 'property rights'

During the course of the Review, the idea that States have some form of 'property rights' in the revenue they raise has been identified — particularly in academic work — and appears to underlie the positions of the resource States of Queensland and Western Australia. Broadly, the line of reasoning is that, although revenues should be generally subject to equalisation, a State should have some proportion of its revenue kept out of the equalisation process. Analogies have been drawn with Canada, where only 50 per cent of mining revenue is equalised.[6]

5 If a relativity floor were to have an effect on GST shares, it would be akin to all States receiving a set amount of the GST pool distributed on an EPC basis. In this example, the set amount would be equivalent to 30 per cent of the GST pool being distributed EPC.

6 Canada's system for determining equalisation transfers for the Provinces includes no expenditure side equalisation. See GST Distribution Review, *Interim Report*, March 2012, page 5.

These approaches are most often raised in relation to resource States' mineral wealth and the question of whether mining revenue should be treated differently from other revenue is dealt with at some length in Chapter 7.[7]

Leaving that issue aside, the Panel has reasoned that if there was a basis for concluding that States have such property rights, then all general revenue sources should have the same right. Indeed, under the current HFE system, which looks not just at *revenue*, but 'net fiscal benefits'[8], it would follow that, if States had some form of right to have some of the revenue they raise not equalised, so too they would have the same right in respect of their total fiscal capacity. States could, for example, therefore have a right to the 'low cost' advantages of their State due to their compact size, or population distribution, age structure and so on. Extended further it could be argued that States have a right to the above-average Commonwealth payments they receive.

If the argument for allowing States to have some portion of their revenue or other fiscal advantages excluded from the equalisation process was accepted, the possible ways to implement this would be to apply a discount to own-source revenue, all revenue, to both revenue and expenses separately, or to relativities overall[9]. Discounts made for these reasons would not suffer from the same defects as discounts for 'efficiency', even though they may produce a similar effect. They would be justified solely by concluding that States should keep some portion of the accidental/historical benefit of their situation despite the otherwise homogeneous nature of the Australian Federation.[10]

What would the size of such a discount be?

Costs and benefits of these sorts of discounts would depend on their size. Clearly, very small discounts could produce only very small benefits and would result in only very small costs to 'equity', particularly since the current outcomes achieved through HFE are — as acknowledged by the CGC — only comparable anyway.[11] Having said that, it is possible that the further one moves from the HFE 'target', the greater the impact each additional incremental movement might have. Large discounts, on the other hand, would have severe impacts on recipient States. Severe impacts on very small States would undoubtedly subject them to very high costs and risks, even if one could conclude that they were to some degree temporary, while their economies adjusted.

It seems that there is no theoretical answer to the question of what sort of discount might be appropriate[12] and there is no definitive guidance from international experience either. While Canada applies a 50 per cent discount to mining revenue, they do so in the context of having no expenditure equalisation at all. It turns out that, in Australia, where we have close to full expenditure side equalisation, the result for Western Australia is currently about the same as if we had adopted the Canadian approach of a 50 per cent revenue discount with no expenditure equalisation. Historically, Australia's approach of full mining and expenditure equalisation has served Western Australia much better than Canada's would have.

7 See Section 7.1.
8 See Chapter 1 for the origin of the term.
9 The joint State submission proposal to calculate relativities with reference to the whole of the GST pool, but then apply relativities to only 60 per cent of it, with the remaining 40 per cent distributed EPC, is equivalent to a 40 per cent discount on relativities.
10 Although some States would counter that homogeneity has only been achieved *because of* HFE.
11 See Section 3.3.
12 See Buchanan's comments about applying HFE in the circumstances on the ground in Chapter 1.

For these reasons, the Panel has explored the fourth category of approaches — ones that seem to offer other avenues for determining the appropriate levels of discounting — before concluding its findings on this category.

Approaches that equalise to the minimum 'effort'

It has been suggested to the Panel that, rather than seeking to equalise to the average of all States, the standard should be set at the minimum service level that any State's residents, in practice, are willing to accept.

This approach was initially suggested by Queensland in its first submission to this Review and subsequently presented as a common position of New South Wales, Victoria, Queensland and Western Australia in their joint submission. It was asserted that this approach would enable all States to provide an acceptable standard of services in major service delivery areas. The joint submission stated that revenue would also need to be 'scaled down'.

The minimum or acceptable level of service identified was that of the State with the lowest assessed *effort*. Effort in this context is a term that describes the differences between what the CGC assesses each State would need to spend to provide the average level of services and what each State actually spends.[13] Those States that spend less than they are assessed to need to spend have 'below average effort'.

These approaches require that, once the State with the minimum effort is identified, assessments by the CGC would be scaled down or discounted to ensure that States were only equalised to the standard of the minimum effort, rather than the average. The benefit of this type of approach over other rationales for discounts is that it *takes into account* the non-policy factors that cause differences in State spending. As the comparison being made is between the actual expenditure in the States and the level of expenditure required as assessed by the CGC, it would not, in theory, inadvertently punish efficiency or reward inefficiency. However, the approach does require acceptance that the effort calculations are sufficiently robust to be relied upon for this purpose and that over effort expenditure is purely an individual State's choice.

The approach proposed by Queensland and supported by the other large States is to use the minimum State effort for *each assessment category* to determine a discount. That is, the State with minimum effort in each of the CGC's categories of School Education, Admitted Patients, Justice Services and so on, would set the benchmark for all. It is highly likely that no single State would have the minimum effort in every assessment category, which means that different States would determine the discounts across categories, some of which may be offsetting.

The effort approach has also been suggested for revenue assessments. The logic for doing so is that, if a State *spends* less, they will need less *revenue*, and States that raise less own-source revenue will spend less (in the absence of other sources of revenue).

The Panel notes the practical concerns about adopting an approach based strictly on CGC categories. There have been examples in the recent past where reliance on

13 For simplicity, effort is used here to describe both revenue and expense ratios. Technically, the CGC uses *effort* to describe revenues only. For expenses, the CGC uses the term *assessed level of service*, although the concept is the same – see Glossary.

State-provided data has led to a temporary incorrect result that had to be corrected. Without overstating concerns about the quality of State Government Finance Statistics (GFS) data at a category level, we note that the CGC does not 'vouch for' State data at a category level. Moreover, adopting a further process to be applied category by category could hardly make the overall process simpler.

To overcome these concerns, an alternative could be to use the minimum effort concept at the overall spending and revenue levels rather than category-by-category. The overall approach would result in a single measure of effort for expenses, or revenue, rather than one for each of the 22 categories. Arguably, this would also better capture differences between States in their residents' preferences for service levels overall. To avoid the policy neutrality problems that arise from adopting a standard set by a single State, rather than basing this approach on the State with the minimum effort for either expenses or revenues, it would be possible to use a proxy. Alternatives could be to average the effort ratios of all States with below average effort or, for simplicity, to pick a 'half way point' between the lowest effort and the average.

Adopting the minimum effort concept at the overall spending and revenue levels would result in small discounts. The minimum revenue effort averaged over the three 2012 Update assessments years was around 88 per cent, meaning that that State raised 88 per cent of the own-source revenue it was assessed as being able to raise if it followed average policy given its tax bases. This would imply an own-source revenue discount of 12 per cent. The average effort of the five States below 100 per cent was around 95 per cent implying a five per cent own-source revenue discount.

The minimum effort ratio for expenses was around 97 per cent, meaning that that State spent 97 per cent of the funds it was assessed as needing to spend if it provided the average level of service at the average efficiency given its population characteristics and distribution. This would imply a three per cent discount on expense assessments. The average effort of the five States with below average effort was around 98 per cent, implying a two per cent expense discount.

Even at these levels, discounts have a significant effect on small States. Secretariat calculations show that a five per cent discount on own-source revenue and a two per cent discount on expenses would have an impact averaging $50 per capita across the small States. Whilst this might be a relatively small amount in total dollars — around $150 million — the loss of those funds would affect the small States significantly.[14]

Finding 3.3

The effort approach provides an interesting and credible basis for adjusting the present system. However, the discounts indicated could only be considered to be minimal — perhaps even symbolic — from the large States' point of view, while having a significant impact on small States. After deep deliberation, the Panel has decided, on balance, not to recommend adopting discounts to reflect the minimum effort.

14 In an effort to escape this conundrum, the Panel asked the Secretariat to find a way to protect the small States in transition, by way of a fiscal guarantee funded out of GST growth. This is dealt with in Appendix C, although ultimately it did not prove to be a mechanism that the Panel could recommend.

Returning to the issue canvassed in the previous section on States rights' justifications for discounts, whilst it would be possible to argue for higher discounts on that basis, the Panel have been unable to find a sensible rationale for determining how much these might be. Any decision to increase beyond the levels indicated by the effort rationale would be purely arbitrary, or guesswork. In addition, larger discounts would have significant impacts on small States.

Moreover, none of the approaches considered in this Chapter would be simpler, more transparent or improve efficiency. They all require additional steps in the CGC's process, from applying a single discount to the final State relativities or applying discounts within each assessment category. Additional steps would require additional explanation about how the distribution was determined, making the process less transparent.

Finding 3.4

Whether any of the approaches examined above would improve the HFE system is ultimately a matter of judgement, depending on one's point of view. On balance, the Panel has come to the conclusion that we can neither recommend very small changes that would deliver only symbolic benefits to the large States (at the cost of even less simplicity), nor are we prepared to recommend larger changes that would have major negative impacts on small States.

However, if governments were minded to make changes, the Panel considers that the 'effort' approach would be the best way of determining the size of those changes.

3.2 Proposals for 'less precise' or 'more general' equalisation

As well as proposals to do *less equalisation* than occurs under the present model, the Panel has been presented with numerous options to perform equalisation in a *less precise* or *more general* way.

When considering the submissions to the Review and consultations, the Panel noted that there was a level of concern, again mainly from the large States, that the current system was too precise, or actually had 'false' precision. While it is not clear that the current system in total is too precise, especially given the portions of State budgets that are not differentially assessed, the use of judgement, proxy data and 'reliability' discounts, there are elements of it that can lead in that direction. While the Panel has not examined methodological issues, due to the comprehensive nature of the system it is conceivable that the level of detail could be finer than is necessary.

In our consideration of these issues, we have again found it convenient to group the suggested approaches, this time into those that seek to deal with both revenue and expenses assessments together, those approaches that apply to revenue assessments only, and approaches that apply to expense assessments only. A multitude of suggested approaches have been considered by the Panel, ranging from adopting a single global indicator of State fiscal capacities to examining indicators for individual revenue or expense assessment categories, and multiple variations in between.

The Panel was initially drawn to the prospect of 'broad indicators' — particularly on the revenue side — as their proponents suggested they could achieve much the same outcomes, but in a very much simpler way. Unfortunately, the quest for similar outcomes through simpler processes has proven grail-like in its elusiveness. While there is no end of 'simpler' ways to determine the allocation of Commonwealth grants to States, the natural rule seems to be:

- the simpler the method, the less representative of current outcomes
- the less representative of current outcomes the method, the greater the differences in redistribution. (To some, these differences will seem arbitrary, volatile or unpredictable.)

To pick an example, an EPC allocation is *very* simple, but it would take away $2.4 billion annually from Northern Territory — the proportional equivalent of an annual reduction for Victoria of $60 billion, or $75 billion for New South Wales.

Coming down just one level of detail, approaches such as using Gross State Product (GSP) or Household Disposable Income (HDI) as broad indicators of State fiscal capacity are only a little more complicated,[15] but they still produce very large changes from the current GST shares for States. Of course, such results should probably not be a surprise, as the broader indicators do not seek to account for the variations in State policies and States do not directly tax gross state product or household incomes.

The impact of most of the combined revenue and expense approaches is a much different redistribution in aggregate and across States. An EPC approach would result in no redistribution in aggregate, with the impact on States simply the reverse of the current redistribution. The use of alternative single global indicators for both revenue and expenses results in an aggregate distribution ranging from $2 billion less to $9 billion more than the current distribution. At a State level, most of the global indicator approaches benefit the donor States. Where a single global indicator is used just for revenue assessments, the aggregate redistribution tends to increase by around $1 billion, and tends to redirect GST towards resource States. The other revenue assessment only and expense only approaches tend to redistribute a similar amount of GST in aggregate, but can have substantial changes for individual States.

After continuing this process down several levels of detail, the Panel has come to the conclusion that it is not possible to use simple broad indicators and deliver States with the same, or very nearly the same GST shares. The approaches that differ most from the current system tend to produce the biggest changes in GST shares, while those that are similar tend to have smaller changes in GST shares. Where broader measures are restricted to revenue assessments only, the less closely the measures reflect the current arrangements, the greater the change in GST shares. The broadest measures of revenue raising capacity, such as GSP or HDI, reflect what States do as simply raising revenue, without reference to where or how the revenue is raised. These measures do not seek to account for the issues considered by States in raising revenue. These issues may be constitutional, legal and historical constraints, tax competiveness, stability, administrative burden, efficiency and equity.

15 For example, in terms of defining which data sources and/or definitions of the terms are used.

While it might be possible to arrive at a combination of indicators to replicate the result of the present system relatively closely, the adjustments and judgements required to get there would probably end up being as complicated and contested as the present system. Worse, whereas the present system has a basis to resolve arguments in that the touch stone is 'what States do', any replacement construct would not have that advantage. It would be unlikely to remain robust over an extended time period and, once the existing arrangements were dismantled, it could be hard to replicate when that occurred.

> ***Finding 3.5***
>
> *The Panel concludes that the ultimate goal of improving simplicity by adopting broad 'cut-through' indicators that can produce closely comparable results to those under the present arrangements remains elusive. That does not mean that we have concluded that no break-through simplification via broader indicators is possible, but just that it cannot be achieved in one bold stroke.*

For completeness, and to relieve anyone from having to undergo the full exercise again in the near future, we have included a table listing the outcomes of all the major approaches and variations we have considered.[16] Table 3.2 lists the category of indicator, describes how it was modelled and indicates how closely it would match the existing arrangements by showing the impact on the jurisdiction on which it would have the largest negative effect.

Table 3.2: Approaches to less precise considered by the Panel

For both revenue and expense assessments		**Biggest 'loser' ($pc)**
Equal per capita	Each State receives its population share of the GST pool	NT ($10,015)
Gross State Product (GSP) options	Each State receives its population share of the GST pool:	
	— minus one percentage point for every point its share of total GSP exceeds its population share (and vice-versa)	NT ($10,477)
	— multiplied by growth in total GSP divided by its growth	NT ($10,683)
Household disposable income (HDI)	States with HDI above Australian HDI receive a smaller share of GST (and vice-versa)	NT ($10,270)
Materiality thresholds	All materiality thresholds increase from current thresholds:	
	— twofold	ACT ($19)
	— fourfold	QLD ($36)
Rounding relativities options	Each State's final relativity is rounded to:	
	— two decimal places	QLD ($4)
	— one decimal place	NT ($119)
For revenue assessments only		
GSP options	A State's share of total own-source revenue is assessed as:	
	— its share of GSP	ACT ($2,303)
	— half its share of GSP and half its population share	ACT ($1,291)
HDI options	A State's share of total own-source revenue is assessed as:	
	— its HDI relative to Australian HDI	ACT ($3,507)
	— its HDI relative to Australian HDI except for mining which is assessed in the same way it is now	ACT ($2,840)

16 Limitations of space prevent us from reproducing the work in full.

For both revenue and expense assessments		Biggest 'loser' ($pc)
	— its HDI relative to Australian HDI except for mining and land taxes which are assessed as they are now	ACT ($1,968)
	— it is now, with the exception of other revenue which uses HDI instead of population shares	ACT ($1,386)
Thresholds and progressivity removed options	A State's share of total own-source revenue is determined using current assessments except that tax-free thresholds and progressive scales are removed:	
	— but other adjustments (such as for public sector payrolls) continue to be made	TAS ($153)
	— and all other adjustments cease being made	ACT ($610)
Broader indicators	A State's share of GST, due to revenue assessments, is determined according to the indicators proposed in the:	
	— Victorian submission	ACT ($796)
	— Commonwealth Treasury submission	SA ($197)
For expenses assessments only		
Remove low reliability disabilities	A State's share of GST, due to expense assessments, is determined in line with the proposed materiality and reliability guidelines in the Queensland submission	SA ($73)
Double any existing CGC discounts	A State's share of GST, due to expenses assessments, is determined using the current assessments with any existing discounts being doubled	NT ($1,021)
*Core services of national importance assessed only**	A State's share of GST, due to expenses assessments, is determined using the current assessments with the exception of the following 'non-core services of national importance', which are removed:	
	— Services to communities, justice, roads, other transport and services to industry	NT ($3,853)
	— Roads, other transport and services to industry	NT ($5,010)

* Variations to this approach included assessing and not assessing disabilities such as location costs and administrative scale.

Minor, but nevertheless important changes

The process described above has convinced the Panel that it is not possible to closely replicate the outcomes of the current system in a dramatically simpler way. However, in the process of examining the full suite of approaches, the Panel has identified two small steps that can be taken relatively easily without creating the problems mentioned.

Although changing these will alter little of substance, the Panel believes they should be taken up in order to act as resistance against the tension created by the contested nature of the current system, which can apply pressure on the CGC to adopt processes and assessments that are overly (or falsely) precise.

Increasing the 2010 CGC Review materiality thresholds

Materiality thresholds were introduced in the 2010 Review to assist with the simplification of the CGC's processes — see Table 3.3. At the conclusion of the 2010 Review, the CGC suggested that materiality thresholds should at the least be indexed to reflect movements in price levels, to ensure the simplification gains achieved in that review are not eroded over time.[17]

When considering how much materiality thresholds should be increased, the Panel has examined maintaining thresholds in real terms, doubling the current thresholds and increasing the thresholds four-fold. Maintaining thresholds in real terms and doubling the current thresholds produce similar outcomes. The approach considered here is that of a four-fold increase in the 2010 Review materiality thresholds, as shown in Table 3.2 to deliver further simplicity.

To prevent the system becoming, or being viewed as, falsely precise the Panel considers greater simplicity is required. A four-fold increase in materiality thresholds would have a small impact on the current assessments —it is expected to remove one assessment category, and six disabilities — and ensure a greater degree of simplicity in the future, without affecting small States significantly.

Table 3.3: Proposed materiality thresholds

Level at which threshold applies	2010 Review thresholds	Quadrupling thresholds
Category — total	$50 per capita	$200 per capita
Category — redistribution	$30 per capita	$120 per capita
Disability	$10 per capita	$40 per capita
Data adjustment	$3 per capita	$12 per capita

Based on the size of categories, redistributions and disabilities, it is expected that increasing the materiality thresholds four-fold would remove one revenue category (Insurance tax). The impact of this increase in materiality thresholds would be largest in relation to disabilities, where it is expected that the following six disabilities would no longer be assessed:

- first home owners scheme expenses
- cultural and linguistic diversity
- natural disasters
- urban roads disabilities
- water subsidies
- concessions for water and electricity users on low incomes.

Some of these disabilities are volatile, such as the natural disasters assessment. Given this, and the potential for some disabilities to be material in some years and not others, materiality should be evaluated over a number of years rather than simply in one year.

17 CGC, *Report on GST revenue sharing relativities — 2010 Review, volume 1 – Main Report*, page 93.

Recommendation 3.1

To ensure the system is not driven to become falsely precise, the Panel recommends that materiality thresholds for the next methodology review be set at:

- *category total expense or revenue average of $200 per capita*
- *category redistribution $120 per capita for any State*
- *disability $40 per capita for any State*
- *data adjustments $12 per capita.*

Rounding relativities

One of the concerns reported to the Panel was that the current system is overly precise. The CGC's detailed analysis of conceptual matters and rich datasets culminates in a single relativity for each State presented at five decimal places. The Panel believes that reporting relativities at five decimal places could lead observers to the conclusion that the relativities themselves, or the process used to derive them, are too precise. Prior to the 1999 Review, relativities were presented at three decimal places.

Altering the number of decimal places relativities are reported at does not tend to have a significant impact on State GST shares unless they are rounded to one decimal place, where impacts can be in the order of hundreds of millions of dollars for some States.

The size of the impacts on GST share of rounding to two decimal places varies from year to year and for each State, but the impacts remain small. While the Panel recognises this change is essentially presentational, it could help overcome concerns that the CGC's outcomes are too precise.

Recommendation 3.2

To ensure the system does not appear to be falsely precise, the Panel recommends that relativities produced from the CGC's process be rounded to two decimal places in the annual Updates and Reviews.

3.3 'Comparable' or 'materially-the-same' capacity?

In our first interim Report, the Panel flagged a willingness to consider whether providing comparable capacities for States would be more suitable to present circumstances than providing materially the same capacities. We therefore invited submissions on how this concept might be accurately described and effectively implemented.

States' views

As with all important issues in this zero-sum game, responses were effectively divided.

As a general statement, the larger States favoured various ways to reduce the degree of equalisation, as well as various forms of less precise HFE, all potentially under the banner of moving from the present goal of providing 'materially-the-same' capacities to one of providing 'comparable' capacities. On the other hand, the smaller States do not favour a change, believing that the 2010 CGC review went as far as could feasibly be done without compromising equalisation too much.

In short, the four larger States see a move to comparable as a potential step on the path to less equalisation and therefore *support* it, while the four smaller States see a move to comparable as a step on the path to less equalisation and therefore *oppose* it.

The CGC's perspective

While the CGC has been careful not to enter the fray on issues requiring judgements that are rightly left to governments, they have made a contribution that may explain this impasse. Essentially, they point out that the Commission's current approach to equalisation results in comparable, not the same, State fiscal capacities. They say that lags in the system, and data and method problems dealt with through reliability and materiality criteria, mean that States fiscal capacities are not the same after the distribution of the GST, merely comparable. Perhaps, less helpfully, but equally consistently, they have told the Panel that a change in the stated goal to 'comparable' by itself would therefore change nothing — that if governments require some other degree of comparability than the present, that goal would need to be specified.

The Panel's view

The Panel can see both groups of States' and the CGC's points of view. We understand that a change to 'comparable' is being urged by the large States as a step in the direction of an EPC distribution and that outcome is strongly opposed by the small States. Given our analysis earlier in this Chapter, it should be clear that we do not support changes in this direction on that basis. We simply do not see an EPC outcome as a viable short or medium term position.[18] However, as explained in Chapter 4, we also think the system would benefit if its governing principles were clearer and used language that better reflected the current practices.

Nevertheless, we are split on the question of whether to:

- change the wording to reflect the CGC's current interpretation and practice of HFE (on the strict understanding that it does not signal a step to EPC), or

- not change, as there is no demonstrated need.

While we have been able to reach a unanimous view on the myriad of other issues considered during the course of the Review, this question alone has eluded consensus. As a result, we neither reach a finding in support of the status quo, nor recommend change, but leave that vexed matter to the wisdom of governments.

18 For a very long term view, see Chapter 12.