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

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

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

### Per capita GST requirement and relativities

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Ave
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Assessed expenses	8 541	8 113	9 383	9 644	9 136	9 736	8 475	18 671	8 899
plus: Assessed investment	487	554	484	745	335	160	364	735	514
Assessed expenditure	9 028	8 667	9 866	10 390	9 471	9 896	8 839	19 406	9 412
less: Assessed net borrowing	481	493	488	520	464	445	484	493	488
less: Assessed revenue	4 928	4 528	4 967	7 953	4 224	3 746	4 245	5 018	5 080
Total requirement for assistance	3 619	3 646	4 411	1 916	4 784	5 706	4 110	13 894	3 844
less: Commonwealth payments	1 591	1 753	1 627	1 579	1 577	1 680	1 664	2 837	1 652
GST requirement	2 028	1 893	2 785	337	3 207	4 026	2 446	11 058	2 192
Per capita relativity	0.925	0.864	1.270	0.154	1.463	1.837	1.116	5.045	1.000

## Appendix C: Alternative HFE models raised in the 2012 GST Distribution Review.

From the *less equalisation* perspective, the Inquiry considered the following options:

### **Equalising to a capacity other than the 'all States' average', to promote efficiency.**

On this option, the Inquiry 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'.*

### **Allowing one State to remain above the average, either by:**

#### Equalising to a set proportion of the strongest State's capacity

Under this approach, States would be equalised to a set proportion (the Inquiry used 95 per cent as an example) of that of the strongest State. This would result in less of the GST pool required to deliver 'equalisation', with more being allocated on an EPC basis. The strongest State would end up with a higher fiscal capacity than all other States, while the other States would have the same fiscal capacity as each other.

OR

#### Equalising recipients to the average capacity of some or all donor States

On this option, the Inquiry concluded that:

*'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'.<sup>47</sup>*

OR

#### Establishing a relativity floor

This would be equivalent to all States receiving a set amount of the GST pool on an EPC basis. Therefore, if the relativity floor was set at 0.3, 30 per cent of the GST pool would be distributed on an EPC basis.

Because these approaches redirect GST funding to the strongest State and reduce the GST funding received by the other States, the Inquiry concluded that they would *'...potentially undermine their confidence in the federation'*.

### **Allowing States to retain some greater proportion of a 'fiscal benefit'**

The basis of this option 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. The Inquiry suggested that 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.

However, the Inquiry expressed concern that large discounts would produce *'severe impacts on recipient States'* and subject the smaller States to *'very high risks and costs'* as their economies adjusted. The option was effectively dismissed by the Inquiry.

<sup>47</sup> GST Distribution Review. Final Report. Page 52.

**Equalising to a capacity other than the 'all States' average', to recognise that differences in expenditure 'effort' are States' policy choices.**

This option suggests 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. The minimum or acceptable level of service identified was that of the State with the lowest assessed *effort*. Although the original option proposed using the minimum State effort for all expenditure and revenue categories, the Inquiry suggested that a more practical approach would be to use the minimum effort concept at the overall spending and revenue levels rather than category-by-category.

The Inquiry found that the adoption of the minimum effort concept would result in small discounts - 5 per cent for expenditures and 3 per cent for revenues, but concluded that these would have a significant impact on the small States<sup>48</sup>.

The Inquiry concluded that:

*'...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 Inquiry determined on balance), not to recommend adopting discounts to reflect the minimum effort.'*

On balance, the Inquiry came to the conclusion that

*'.. it can neither recommend very small changes that would deliver only symbolic benefits to the large States (at the cost of even less simplicity), nor .....recommend larger changes that would have major negative impacts on small States.'*

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<sup>48</sup> In an effort to overcome this adverse outcome and to protect the small States in transition, the Inquiry suggested a fiscal guarantee funded out of GST growth. However, it did not prove to be a mechanism that the Inquiry could recommend.



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# Glossary of terms

## **Actual per capita (APC) assessment method**

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

## **Application year**

The year in which the average of the assessed GST distributions for each assessment year (expressed as relativities) is to be used to distribute the GST revenue. For example, in the 2017 Update the year of application is 2017-18.

## **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, assessed revenue and average 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 exclude differences from the average due to policy choices under the control of a State.

## **Assessed GST requirement**

A State's requirement for funds from GST revenue in an assessment year. It is measured as its assessed expenses, plus its assessed investment, less its assessed revenue, less assessed Commonwealth payments and less assessed net borrowing.

## **Assessed net lending**

The net lending assessment aims to provide each State with the same per capita stock of financial assets at the end of the year, assuming it started the year with the average at that time. A State with above average population growth is expected to need above average net lending.

## **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**

The financial years used in a review or an update to calculate the assessed GST requirement, from which an annual relativity is calculated. The Commission uses data for three assessment years (where each assessment year corresponds to a financial year). For example, the GST distribution recommended in the 2017 Update (for the application year 2017-18) is based on the average of three assessment year annual relativities calculated for the most recent completed financial years at the time the relativities are released (2013-14 to 2015-16 assessment years).

## **Average (or Australian average)**

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

## **Average expenses**

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

## **Average revenue**

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

## **Category**

A classification of in-scope transactions relating to distinct services or revenue sources, used for analytical purposes. In the 2017 Update, the adjusted budget is divided into Commonwealth payments, seven revenue categories, thirteen expenditure categories and net borrowing.

## **Commonwealth payments**

Payments to States made by the Australian Government, including general revenue grants, payments for specific purpose (PSPs) and Commonwealth own purpose expenses. The Commission 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.

## **Disability factor**

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

## **Distribution**

State shares of GST revenue based on the principle of horizontal fiscal equalisation.

## **Distribution model**

A formulation, mathematical or otherwise, of the way in which State GST shares (and relativities) are calculated. A mathematical presentation of the model is provided on the [Commission's website](http://www.cgc.gov.au) ([www.cgc.gov.au](http://www.cgc.gov.au)).

## **Equal per capita (EPC) assessment method**

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

## **Equalisation**

See horizontal fiscal equalisation (HFE).

## **Fiscal capacity**

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

The relative capacity of each State is a comparison of its fiscal capacity with the average capacity.

**Goods and Services Tax (GST) revenue or GST pool**

The funds made available by the Australian Government for transfer to the States as untied financial assistance, consistent with the principle of horizontal fiscal equalisation.

**Horizontal fiscal equalisation (equalisation)**

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

**National partnership payments (NPPs)**

Commonwealth payments to States that support the delivery of specified projects, facilitate reforms, or reward those jurisdictions that deliver on nationally-significant reforms.

**National specific purpose payments (SPPs)**

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

**Needs**

See assessed differences.

**Payments for specific purposes (PSPs)**

Australian government payments to the States for specific purposes in policy areas for which the States have primary responsibility. These payments cover most functional areas of State (and local government) activity, including health, education, skills and workforce development, community services, housing, Indigenous affairs, infrastructure and the environment. PSPs include SPPs, National Health Reform funding, Students First funding and NPPs.

**Per capita**

Population share of a total.

**Policy average**

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

**Policy neutral assessment**

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

**Redistribution**

The difference between an equal per capita distribution of GST revenue and one based on the principle of horizontal fiscal equalisation.

**Relativity**

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

**Revenue base**

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

**Revenue effort**

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

**Review**

The process in which the Commission reconsiders the methods used to calculate the GST distribution, 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 GST distribution using the methods determined in the last review and the latest financial data.

**Socio-demographic composition disability**

A disability that measures differences in both the average use and cost of providing services due to differences between States in the relative size of various socio-demographic groups. It can reflect differences between States in some or all population characteristics such as age-sex structure, socio-economic status, Indigenous status and location.

**State(s)**

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

**Tax base**

See revenue base.

**Update**

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

**Vertical Fiscal Imbalance**

Vertical Fiscal Imbalance refers to the imbalance between the revenue raising powers and functional responsibilities at each level of government.

## Acronyms

ABS	Australian Bureau of Statistics
APC	Average per capita
CGC	Commonwealth Grants Commission
HFE	Horizontal Fiscal Equalisation
EPC	Equal per capita
GST	Goods and Services Tax
IGA	Intergovernment Agreement on the Reform of Commonwealth-State Financial Relations 1999
IGAFFR	Intergovernmental Agreement on Federal Financial Relations 2008
MRRT	Minerals Resource Rent Tax
NCP	National Competition Policy
NRA	National Reform Agenda
ToR	Terms of reference
VFI	Vertical Fiscal Imbalance