# Tasmanian Legislative Council Inquiry into the Impact of the Commonwealth Grants Commission Horizontal Fiscal Equalisation System in Tasmania — submission by the Commonwealth Grants Commission

1 The principal role of the Commonwealth Grants Commission is to recommend a distribution of GST revenue among the eight States and Territories (States) in a way that ensures *each State has the same capacity to provide the same (average) standard of services to its residents*. This approach is called horizontal fiscal equalisation (HFE). In performing this function, the Commission must act in accordance with its legislation and the specific terms of reference issued by the Commonwealth Treasurer to the Commission for its periodic reviews and annual updates.

## HFE

2 In 1978, the Commonwealth asked the Commission to review the six States' shares of general revenue grants. It specified the principle[1] it wanted the Commission to apply in subsection 13(3) of the *States Personal Income Tax Sharing Amendment Act 1976*:

> The respective payments to which the States are entitled ... 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.

3 From 1985 until 1999, the terms of reference for the Commission's method reviews instructed it to apply the principle of HFE in its work. In 1999, as part of the move to A New Tax System, the principle of HFE was incorporated into the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (the IGA), which was signed by all Australian governments.[2] While the specific wording has evolved over time, it has essentially remained the same in intent and has continued to this day as the basis for the Commission's recommended distribution of GST revenue amongst the States.[3] Therefore, in terms of the Legislative Council's inquiry,

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1 This was similar to the equalisation principle the Commission had used in its work prior to 1978.

2 Later IGAs signed in 2008 and in 2011 also specified for the GST revenue to be distributed according to the principle of HFE. In addition, the IGAs provide for the revenue collected from the GST to be paid to the States for them to use for any purpose. That is, GST revenue is provided to States as general revenue assistance.

3 In 2018, the Commonwealth enacted legislation so that GST revenue is distributed to ensure reasonable equalisation of each State's fiscal capacities. While this change will affect States' shares of an expanded GST pool, it is unlikely to affect the Commission's approach to assessing State's expense needs and revenue capacity.

HFE is not the Commonwealth Grants Commission's concept, but a policy commitment of all Australian governments that the Commission is obliged by terms of reference to give effect to.

## Commission's assessment of each State's equalisation needs

4 To carry out its role, the Commission assesses the relative fiscal capacities of each of the States. The fiscal capacities of some States are higher than the average (for example, because those States have stronger revenue raising capacity than the average, or lower expenditure needs than the average); while other States have lower fiscal capacities than the average (because they have weaker revenue raising capacity than the average, or greater expenditure needs than the average).

5 The assessment of each State's fiscal capacities requires the Commission to calculate each State's revenue raising capacity and its expenditure needs. One of the supporting principles that the Commission applies in this work is to reflect 'what States do'. The Commission observes the range of services that States provide to their communities and collects data on how much it costs States to provide those services, given the circumstances of each State — that is, by taking account of factors ('disabilities') affecting State finances that are beyond States' direct control and which would cause their fiscal capacities to diverge. Such factors, for example, include the proportion of younger and older people in a State's population, the distribution of its population by where they live, prevailing wage pressures and the distribution of mineral resources across the States.

6 From those data, the Commission derives an Australian average standard of service for each service sector. It then looks at the fiscal capacity of each State — what it is capable of raising from its own revenue sources and receives from the Commonwealth in payments for specific purposes (PSPs) — and identifies the funding shortfall that each State has between that fiscal capacity and what it would require to be able to provide that Australian average standard of service. This approach gives effect to HFE — to provide each State with the fiscal capacity, through the distribution of GST revenue, to provide the same (average) standard of service as every other State.

7 It should be noted that, in developing an 'Australian average standard' as part of its revenue and expense assessments, the Commission does not purport thereby to identify an optimal or desirable level of State government spending or revenue raising: it merely uses the Australian averages to provide a simple measure of what, on average, Australian States do when they provide services and raise revenue. Nor, when it assesses each State's revenue raising capacities and expense needs, does the Commission form an opinion on how much a State should spend on any particular service it provides to its population, nor on how much tax it should raise under the revenue heads available to States. The Commission does not have a view on how a

State should spend its GST revenue. Indeed, alongside the distribution of GST revenue according to the principle of HFE, the IGA specifies that the States may spend their GST shares as they see fit.

8 The Commission advises that caution is needed in interpreting its published ratios, such as the ratios of actual to assessed expenses and revenues. First, actual revenues, expenses, investment or net borrowing for each State used to derive these ratios may not be strictly comparable between States, because States sometimes classify similar revenues, expenses, investment or net lending differently under the ABS Government Finance Statistics (GFS) framework. For example, in the case of the ACT, its revenue and expenses in some categories include municipal transactions, making its ratios of actuals to assessed revenue and expenses not directly comparable with those of other States.

9 Secondly, the assessed figures for each State may not capture all influences on State expenses or revenue raising capacities. Consistent with its terms of reference, the Commission has not assessed some influences where they could not be reliably calculated. Also, discounting has been applied to some influences when there was uncertainty surrounding the results.

## Treatment of other Commonwealth 'tied' payments

10 Equalising the fiscal capacity of the States to provide services requires the Commission to take account of the total expenditure and investment all States would incur to provide the average level of services and the revenue they have available to finance it. This includes not just the revenue the States can collect from their own tax bases under average policies but also, consistent with the terms of reference, the Commonwealth tied funding revenue they receive as Payments for Specific Purposes (PSPs). The Commission has adopted a single guideline to decide the treatment of PSPs — payments which support State services, and for which expenditure needs are assessed, will have an impact on the distribution of the GST revenue. To the extent that a State receives above average per capita amounts of PSPs, less GST is required to equalise its fiscal capacity. Conversely, if a State receives below average amounts of PSPs, it requires more GST.

11 The Commission excludes revenue received through PSPs under certain circumstances, such as when the requirements of its guideline are not met, as well as when directed to do so by its terms of reference. Payments under the latter case are known as 'quarantined payments'. The Commission has no role in identifying payments to be quarantined.

## Conclusion

12 The Commission's role is to assess each State's relative fiscal capacity (against Australian average standards that reflect what all States do in practice) in order to recommend a distribution of GST revenue that would ensure each State has the capacity to provide State services to the same standard. Any GST revenue provided to a State by the Commonwealth is general revenue assistance — that is, as agreed in IGAs by all Australian governments, it is untied revenue which the State can spend in accordance with its own spending priorities. States are accountable to their electorates, and not to the Commission or the Commonwealth more generally, for how GST revenue is spent.