Commonwealth Grants Commission 2020 Methodology Review

Tasmanian Government Submission in response to Commission Position Paper - *The Principle of HFE and its Implementation*

31 August 2018

Tasmania
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OBJECTIVE OF HFE

For the 2020 Review, the Commission proposes to continue using the specific definition first articulated in the 2010 Review:

State governments should receive funding from the pool of goods and services tax 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.

Subject to terms of reference, the Commission will continue to consider HFE as the sole objective that guides its choice of methodologies.

In the absence of an agreed position on the Commonwealth Government's interim response into the Productivity Commission's (PC) Inquiry into Horizontal Fiscal Equalisation (HFE), Tasmania supports the Commission's position.

SUPPORTING PRINCIPLES

The Commission's view is that the four existing supporting principles should be retained, but with some further clarification of their purpose and scope. The Commission considers that, wherever possible, methods should be chosen having regard to all of the supporting principles. The Commission does not propose to establish any prior ranking or weighting of the supporting principles.

Tasmania agrees with the Commission's position to retain the current supporting principles to give effect to achieving of HFE, namely:

- what States do;
- policy neutrality;
- practicality; and
- contemporaneity.

Tasmania also agrees with the Commission that the guiding principles should not be subject to a predetermined hierarchy of importance and that the Commission will apply the principles, with appropriate consideration, to the circumstances of each assessment.

What States do

The common policy assessed by the Commission generally is the (weighted) average policy of all States combined.

What States do sets the standard, rather than an external judgment of what States should, or could, do. As the roles, functions, priorities and circumstances of the States change, so does the assessment of their fiscal capacities.

Tasmania agrees with the Commission's position that its assessments are based on the weighted average of what States do, rather than some externally imposed standard of what they could or should do.

It is not the role of HFE to reward or punish States for the achievement or non-achievement of externally determined standards of service delivery or revenue raising effort. The role of HFE is to equalise States' capacity to deliver services to the same standard. The standard is in effect the weighted average of the collective policy choices of each of the States. To do otherwise would impinge on State autonomy.

Tasmania notes that the Commission intends to retain the existing scope of equalisation: that is, all general government sector plus urban transport and public housing (public non-financial corporations), and exclude local government except for interactions between it and the State sector. Tasmania has no concerns with this approach.

Tasmania also notes that the Commission intends to continue to equalise the fiscal outcome of States so that they have the same average per capita net financial worth. Tasmania is pleased that the Commission has acknowledged that some States, including Tasmania, have raised methodological issues associated with this approach and that this issue will be considered as part of the capital assessments for the 2020 Review.

Policy neutrality

The Commission considers that its current assessments of mining revenues appropriately support the achievement of HFE. However, the assessment methods risk undue conflict with the policy neutrality principle in some circumstances — the Commission will aim to modify the operation of its assessments in those circumstances to secure greater policy neutrality. In particular, the Commission wishes to ensure its assessment methods do not distort a State's consideration whether or not to make a tax rate change. Where practicable, the Commission will ensure that future discretionary revenue policy changes do not excessively change the GST distribution. It will do this by limiting the extent to which any discretionary change in royalty (or tax) rates by a State which has a dominant role in the production of a mineral (or tax base) flows through to the assessed revenue capacity of that State. The result generally will be that, after consideration of changes to its GST share, a dominant State will retain at least half of the own-source revenue effects of its tax or royalty rate change.

The Commission will also aim to strengthen application of the policy neutrality principle in two further ways.

1. It will aim to ensure that assessments do not unduly penalise or reward States which, in similar circumstances, adopt very different policies towards potential mineral and energy developments (for example, coal seam gas production).

2. For revenue assessments generally, the Commission will aim to minimise, to the extent practicable, tax reform disincentives arising from the effects on tax bases (elasticity effects) of tax policy choices.

Retention of at least half of own-source mining revenue from tax or royalty rate changes

The Commission notes that in most cases, each State has only a limited influence on the average policy of all States. However, the Commission also notes that over the last decade there has been a significant exception in the case of mining revenue where a tax base is concentrated in one or two States and that this may conflict with its principle of policy neutrality. This is particularly pronounced in its impact in relation to iron ore royalties and Western Australia's GST distribution.

Tasmania is of the view that HFE is the overriding objective for the Commission and that policy neutrality is one of the guiding principles to achieve HFE.

Tasmania has concerns with the Commission's proposal to limit the extent that tax or royalty changes impact a State's own GST distribution by allowing the State to keep at least half of the own-revenue effects of the royalty or tax change.

Firstly, this approach would be a departure from the Commission's current objective of full equalisation. By allowing a State to retain at least half of its own source revenue that would otherwise have been redistributed to other States, would leave that State with a stronger fiscal capacity than if it was equalised to the same fiscal capacity consistent with the current definition of HFE.

Second, it is not clear what would trigger such an approach. Would it apply to a change to a State's tax or royalty rates that would have the direct effect of reducing its GST share irrespective of how significant the GST effect was, or would there need to be a materiality test? On what basis would the amount retained by a State be determined by the Commission? The Commission propose that at least half of the own-source revenue effects be retained by the State which suggests that this percentage could go higher.

Finally, the recent PC Inquiry into HFE has recommended that equalisation should be to the average of all States, not the current strongest of all States (Western Australia). In its interim response to the PC Inquiry, the Commonwealth Government has indicated that while it does not accept the PC's recommendation to equalise to the average, it does propose a change from equalisation to the strongest State to equalisation to the stronger of NSW or Victoria.

Either the PC's recommendation or the Commonwealth's interim response mean that the most contentious issue which has triggered the Commission response to its principle of policy neutrality (the impact of mining royalty changes in relation to iron ore on the strongest State, Western Australia), will have limited effect on policy neutrality under either change to HFE.

If the Commonwealth's change to HFE is implemented, it will obviate the need to make any adjustments to the mining revenue assessment to address policy neutrality.

Treatment of bans on mineral and energy development

Tasmania agrees with the Commission's position that it is not appropriate to impute a revenue base for those States that prohibit the exploration or extraction of a particular mineral (such as coal seam gas).

The Commission suggests that there are similarities to its treatment of gambling revenue in that States impose various restrictions including prohibition on gambling activity and so a comparable revenue base is difficult to determine. For this reason the Commission treats the gambling assessment as equal per capita (EPC).

Tasmania agrees that there are similarities with some mining activity where States adopt different policies including the prohibition on extraction. It is therefore appropriate to address this issue, and the broader issue of average policy, as part of the 2020 Methodology Review and Tasmania's response to this issue is covered in its submission to the Commission staff draft assessment paper.

Until this matter is resolved, Tasmania agrees with the Commission staff recommendation, as part of the 2018 Update, that the Commission not change its treatment of royalties where bans on extraction are in place, given that current production levels for coal seam gas and uranium are low in those States where it is not prohibited, and consequently, have no material impact on GST relativities.

Adjusting for elasticity effects on tax bases

In the past, elasticity adjustments have been assessed on a limited basis, though these were discontinued in the 1999 Review over concerns about reliability of the elasticity effects. Their use was again rejected by the Commission in the 2004 and 2010 Reviews. In the 2015 Review, the Commission rejected suggestions that it make elasticity adjustments based on judgement, as these would, in all probability, be small in nature and would fail the Commission's materiality threshold.

The Commission has commenced a consultancy to examine whether elasticity effects can be reliably estimated and are material and how they should be recognised, consistent with achieving HFE.

The scoping study prepared by the consultants indicates that reliable elasticity estimates can be obtained for payroll tax, land tax, stamp duty and insurance tax using an instrumental variable approach. Less reliable estimates of elasticity can be obtained for motor tax using an alternative difference-in-differences approach. It does not appear likely that reliable estimates of elasticity can be obtained for mining royalties due to data limitations and methodological difficulties.

Tasmania would support further work being undertaken by the consultants to establish the nature and size of elasticities in those tax bases where reliable outcomes can be supported by appropriate econometric techniques. However, Tasmania would reserve its opinion on the extent to which the elasticities should be used to make adjustments to the relevant tax bases until the results of the consultants' work are available for further analysis and consideration.

Tasmania notes that the PC also examined the potential to apply elasticity adjustments. However, it concluded that:

Elasticity adjustments may help to mitigate the impact of policy-induced changes to tax bases on the GST distribution (albeit only those arising from tax rate changes), but would be difficult to implement, subject to dispute, and only possible to apply on an ad hoc basis…

There would also be uncertainty about the quality of estimates used to adjust GST payments and whether these estimates would change over time.[1]

Practicality

The Commission has decided to add a further element to the practicality principle, namely 'fitness for purpose'. States have emphasised to the Commission their need for transparent, reliable and, where possible, reasonably predictable relativities in time for their State budgets. The Commission therefore intends that this principle also support methods that provide relativities that are practical for States to incorporate into their budget management processes.

While Tasmania would not have an issue with the Commission including a 'fitness for purpose' requirement as an element of its practicality principle, at this stage it is not clear what the Commission intends to do in this regard. Tasmania would be concerned if issues of practicality took precedence over the higher objective of achieving HFE.

[1] Productivity Commission Inquiry into HFE - Final Report 15 May 2018

Contemporaneity

The Commission is not settled on whether the size of the assessment window should be changed, and will give further consideration over the course of the review as to whether the assessment window should comprise the most recent one, two or three years.

Tasmania notes the Commission's intention to consider this matter further during the course of the review.

Tasmania responded to the issue of Contemporaneity in the 2015 Methodology Review[2] and noted "that reducing the number of assessment years averaged to produce the relativities will increase the level of volatility in States' shares of GST revenue. The use of three-year averaging is designed to deliver a level of stability through effectively 'smoothing' the impact of large movements in circumstances and data irregularities, and preventing 'one-off' anomalies from having a large effect on the GST distribution. Tasmania would argue that averaging is necessary for these reasons, and considers that the use of three-year averaging achieves an appropriate balance between contemporaneity and stability in States' shares of GST revenue."

Tasmania also agrees with the Commission's position that applying a differential weighting for each assessment year is inappropriate because it would add complexity and require a high degree of judgement by the Commission as to the size of the weights. Tasmania notes that the Commission shared this view during the 2010 Review, concluding that it was not viable as "there is no objective way of deciding how to give more weight to more recent years"[3].

Tasmania also agrees with the Commission's position that there is unlikely to be any reliable data to enable the use of projections or forecasts of State circumstances, instead of historical data, in the application year as the basis for the Commission's assessments. The use of historical data creates an unavoidable "lag" in the assessment of State circumstances, and will reduce contemporaneity. However, Tasmania considers this reasonable and necessary when balanced against the need to ensure reliability in the Commission's methodology.

[2] Contemporaneity 2015 Review - Tasmanian Government Submission January 2015.

[3] Commonwealth Grants Commission Report on GST Revenue Sharing Relativities – 2010 Review – Main Report, pg.55.

IMPLEMENTATION ISSUES

Discounting assessments

> The Commission will continue its current approach of discounting its measurement of disabilities where there are substantive concerns about the data available. Three levels of discount may be applied – low (12.5%), medium (25%) and high (50%) – depending on the Commission's judgment about the reliability of the data for the purposes of the assessment.

Tasmania agrees with the Commission's position.

Materiality thresholds

> For this review, the Commission intends to increase materiality thresholds only to the extent that they retain their value after adjusting for price and wages increases. The materiality threshold for a disability will be set at $35 per capita (an increase of $5 since the 2015 Review) while the threshold for data adjustments will remain at $10 per capita.

Tasmania would support materiality thresholds being adjusted so they are maintained in real terms. Any increase in above real terms would potentially undermine HFE.

However, Tasmania reiterates the view raised in its submission to the Staff discussion paper - *The Principle of HFE and its Implementation 2017-2-S*, that further changes in materiality thresholds in the 2020 Review are not warranted given the significant increase in the 2015 Review where they were increased well above CPI (threefold from their 2010 level).

Quality assurance

> The Commission's view is that its terms of reference task it as the body, in consultation with the States and the Commonwealth, to address all necessary methodological considerations in developing the relativities the Commission recommends for the distribution of GST revenue. Any additional accountability controls over and above those put in place by the Commission, such as the Quality Assurance Strategy, are at the discretion of the Commonwealth.

Tasmania agrees with the Commission's position.

Backcasting

> In this review the Commission intends to use backcasting but, to avoid situations where renegotiations of Commonwealth-State agreements can lead to uncertainty in application year funding distributions, only in exceptional circumstances. These circumstances include where there are major changes in Commonwealth-State relations, such as transfers or changes in function, and where the budget implications of any such changes are known.

The Commission's approach has been to only apply backcasting to major changes in Commonwealth-State relationships where it provides a more contemporaneous outcome and the changes can be made reliably and are material. Tasmania agrees with the Commission's position.

Treatment of other Commonwealth payments to States

> Subject to terms of reference, the Commission will retain its current guideline for the assessment of Commonwealth payments to the States, namely that payments which support State services, and for which expenditure needs are assessed, will affect GST shares.

Tasmania agrees with the Commission's position.

However, Tasmania also notes that Commonwealth Government has agreed to the PC recommendation, in consultation with the States, that:

The Commonwealth Government develop clear guidelines detailing the basis on which Commonwealth payments are to be quarantined from HFE by the Commonwealth Treasurer (so that they do not unnecessarily erode the efficacy of the CGC's relativities and compromise the objective of HFE).

The guidelines should strike a balance between enhancing accountability and transparency, while not unduly affecting the Treasurer's ability to quarantine payments in exceptional circumstances that are in the national interest.

The assessment guidelines

> The Commission intends to maintain the Assessment guidelines developed in the 2015 Review in this review.

Tasmania agrees with the Commission's position.