

Commonwealth Grants Commission 2020 Methodology Review

Tasmanian Government Submission in response to Staff
Discussion Paper - The Principle of HFE and its Implementation

July 2017



Tasmania
Explore the possibilities

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EXECUTIVE SUMMARY

Tasmania welcomes the opportunity to have input into the Commission's Staff Discussion Paper - *The Principle of HFE and its Implementation* - and provides the following comments.

Objective and definition of HFE (pages 1-5)

- While there is no accompanying definition of Horizontal Fiscal Equalisation (HFE) in the Intergovernmental Agreement on Federal Financial Relations (IGA) or prescribed in legislation, its interpretation has been the responsibility of the Commission in forming its recommendations for the distribution of the Goods and Services Tax (GST).
- It is reasonable to conclude that the IGA's intention regarding HFE has been informed by the Commission's long standing methods and approach to HFE. As no other objective is stated or implied in the IGA, it is also reasonable to conclude that HFE is the sole objective.
- It would be contrary to the meaning of the term HFE to equalise to some other objective than the fiscal capacities between States, and to do anything less would result in partial equalisation.
- Tasmania believes it would be inappropriate to use HFE to achieve other broader objectives and to do so would overburden the equalisation system. Other objectives, such as service delivery efficiency, should be pursued through alternative Commonwealth funding mechanisms rather than through the GST distribution equalisation system (which is focused on equity).
- Tasmania supports the view that HFE should be the sole objective for the Commission in distributing the GST.
- Tasmania strongly believes that HFE is achieving its long standing, intended objectives. Therefore no changes are required to the Commission's interpretation of what HFE means and how it should be applied.

Supporting principles (pages 6-7)

- Without supporting principles underpinning the Commission's methods it would be difficult for the Commission to give effect to the overriding principle of HFE on a consistent and coherent basis. In Tasmania's view, nothing has changed since the 2015 Review that would necessitate a change to the Commission's supporting principles. The current principles remain appropriate and should continue to be used for the 2020 Review.

Internal versus external standards (pages 8-9)

- Tasmania supports the continuing use of the internal standard that serves to ensure that Commission assessments are, as far as possible, based on the principle of 'what States do'. Any attempt to incorporate external standards, such as efficiency standards into the current HFE system may overburden the system, resulting in it failing to achieve its aims.

Weighted average approach (pages 9-12)

- Tasmania has previously expressed support for the 'weighted average' approach, and suggests that it be continued by the Commission, but recognising that it does raise potential problems with achieving policy neutrality when the weighted average is dominated by a large State.

Equalising to average per capita NFW (pages 12-14)

- Tasmania continues to have concerns with the current approach to assessing capital needs as argued in its submissions to the 2010 and 2015 Reviews, and intends to re-examine the Commission's assumptions relating to Net Financial Worth (NFW) in the net lending/borrowing assessment during the course of the 2020 Review.
- While Tasmania has some concerns with the current approach to equalising on the basis of average per capita NFW, at this stage it has not formulated a view as to whether there is a better alternative approach.

Use of broad indicators (page 14)

- Tasmania accepts that for some assessments the Commission has had to take an indirect approach to determine what States do. The use of broad indicators and proxy data is used as an alternative where actual State data is unavailable or unreliable, or where it is policy influenced. Whilst accepting this, Tasmania continues to have concerns with the use of average private sector wages as a proxy for public sector wages (because public sector wages are considered to be policy influenced).

Weighted average versus rotating State average (pages 15-16)

- Tasmania endorses the Commission continuing to base the standard to which its disabilities are applied as being derived from the weighted average of all the States but does not support the proposed rotating State average method. Tasmania therefore supports the Commission's current approach to policy neutrality, and notes that where there are circumstances where this cannot be adequately achieved, the Commission has, in the past, used its judgement and placed less weight on this principle to reach a better HFE outcome.

Impact of HFE on tax reform (pages 16-18)

- Tasmania does not believe that HFE acts as a disincentive to tax reform.

Quality assurance framework and confidentiality (page 19)

- Tasmania supports the Commission's existing quality assurance framework and accepts that, in some cases, the use of confidential data is required for specific assessments. Tasmania also notes that the majority of the Commission's information and assessment outcomes (excluding confidential data) are available publicly and that confidential data represents a relatively small proportion of the total data pool.

Discounts (pages 19-20)

- Tasmania supports the continued application of a uniform set of discounts within the 2020 Review. In principle, Tasmania believes that the concept of discounting is preferable to the alternative of the Commission making no assessment at all, where it is very clear that a disability exists and will have a material impact on the equalisation outcome.

Materiality thresholds (pages 20-21)

- Tasmania opposes any further changes to the materiality threshold levels, given the significant increases that were made as part of the 2015 Methodology Review.

Quality assurance framework and data reliability (pages 21-23)

- Tasmania continues to support the existing quality assurance framework the Commission operates within, believing it is a practical approach to ensuring assessment methods are conceptually sound and based on robust and reliable data.

Contemporaneity (pages 24-25)

- Tasmania is of the opinion that the benefit of increased contemporaneity is not sufficient to outweigh the detrimental impacts of increased volatility, reduced reliability and additional complexity.
- Tasmania is of the opinion that the methods of 'improving' contemporaneity discussed by the Commission are likely to make it more difficult for Tasmania to manage its budget, rather than improving its management of cyclical cash flows.

Improving cyclical cash-flow management (pages 25-26)

- Rather than changing the GST methodology and subjecting all States to greater volatility and less predictability of GST shares, those States that experience large and volatile own-source revenues should consider putting in place appropriate budget strategies to better manage the consequential impacts upon variability in GST revenues.

Backcasting (page 26)

- Tasmania supports the current approach of backcasting major changes to Commonwealth-State arrangements, where changes can be made reliably and they are material.

Treatment of Commonwealth payments (pages 27-29)

- Tasmania supports the Commission's current approach to the treatment of all Commonwealth payments. Unless specifically quarantined by instruction from the Commonwealth, or otherwise not assessable because they do not support State services, they should be included in aggregate as they are a source of State revenue for equalisation purposes.
- However, Tasmania reiterates its previous concerns regarding the Commission's 2010 Review decision to exclude 50 per cent of Commonwealth payments for National Network Roads projects, and its extension to exclude 50 per cent of Commonwealth payments for National Network Rail project payments in the 2015 Review. Tasmania considers these decisions to be arbitrary and, in the case of the National Network Roads funding, may capture funding directed toward State arterial roads which States would have ordinarily built and upgraded using their own funds.

Assessment guidelines (page 30)

- Tasmania supports the Commission continuing to be guided by the same set of assessment guidelines for the 2020 Review in implementing HFE as used in the 2015 Review.

OBJECTIVE AND DEFINITION OF HFE

Do the IGA and the Terms of Reference (ToR) require the Commission to distribute the GST in such a way as to achieve HFE as the sole objective?

These two documents provide the Commission with the primary direction that it requires to determine the distribution of the GST to the States and to ensure that it is based on the principle of HFE.

The IGA, as amended, was signed by all States and unequivocally requires the Australian Government, on advice from the Commission, to distribute the GST to the States in accordance with the principle of HFE.

Schedule D of the IGA states that:

D63 - The Commonwealth will distribute GST payments among the States and Territories in accordance with the principle of horizontal fiscal equalisation.

D65 - The Commonwealth Treasurer will determine the GST revenue sharing relativities, which embody per capita financial needs based on recommendations of the Commonwealth Grants Commission, after consulting with each State and Territory.

While there is no accompanying definition of HFE in the IGA or prescribed in legislation, its interpretation has been the responsibility of the Commission in forming its recommendations for the distribution of untied general purpose Australian Government funding to the States since the 1930s. It is therefore reasonable to conclude that the IGA's intention regarding HFE has been informed by the Commission's long standing methods and approach to HFE. Further, as no other objective is stated or implied in the IGA, it is also reasonable to conclude that HFE is the sole objective.

The Terms of Reference (ToR) for the Commission's 2020 Review of GST Relativities (2020 Methodology Review) states that:

5. In undertaking the review, the Commission should take into account the Intergovernmental Agreement on Federal Financial Relations (as amended), which provides that GST revenue will be distributed among the States in accordance with the principle of horizontal fiscal equalisation.

While the ToR are less unequivocal and state that the Commission should take account of the IGA, Tasmania would argue that the IGA gives no discretion to the Australian Government other than to distribute the GST in accordance with HFE. Therefore, given the IGA's requirements, the Commission also has little choice other than to recommend GST relativities to the Treasurer that conform to the principle of HFE. As there are no alternative objectives contemplated in either the IGA or the ToR for the 2020 Methodology Review, the achievement of HFE is the sole objective for the Commission in determining GST relativities.

The Commission has previously expressed the view in the 2010 Review that it clearly has the single objective under the IGA, and its ToR, to equalise fiscal capacity on the principle of HFE, and if governments want the Commission to implement a different distribution principle than the one used by the Commission they must provide explicit instructions to this effect.

It is clear the States hold different views on the continued appropriateness of distributing the GST solely on the basis of equalisation. However, the IGA, which all States signed, says the GST distribution is to be based on equalisation principles. We have not augmented the equalisation objective with other objectives. We consider the terms of reference, the context in which they were developed and the IGA all strongly imply the relativities we recommend should be based on a single objective, fiscal equalisation. We consider that if governments wanted us to include other objectives they would tell us to do so through explicit terms of reference.¹

In the 2015 Review, HFE was again cited as the sole objective and the Commission considered its ToR were clear:

...we are to recommend how the GST should be distributed in accordance with the 'principle of HFE'. We are not asked, nor given the discretion, to decide when other policy objectives or agreements between the Commonwealth and the States should moderate the achievement of HFE, unless explicitly directed in our terms of reference²...

Tasmania is therefore of the view that while there has been pressure to consider other alternatives to the current approach to HFE, it remains the sole objective.

Is the aim of HFE to achieve equal fiscal capacities?

As previously noted, while there is no legislated definition of HFE, it has been the fundamental principle for distributing untied Commonwealth funding to the States for many decades. It would seem contrary to the meaning of HFE to equalise to some other objective than the fiscal capacities between States. This would be inconsistent with its meaning and to do anything less would result in partial equalisation.

The current definition of HFE as developed and used by the Commission is:

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.

The current definition developed by the Commission refers to fiscal capacity which is a measure of each State's revenue capacity relative to its expenditure needs, assessed according to a State's ability to pay for a given level of public services. This has been a long standing principle for distributing untied Commonwealth funding to the States.

The aim of HFE is therefore about equalising the capacity of governments to provide services. It reflects a belief that Australians should have access to similar standards of service, regardless of the jurisdiction in which they live. This is a strong egalitarian principle that has been widely held over time within the Australian community and has been reflected in the Commission's approach, in one form or another, since its inception.

Australians do not want the extent of regional disparities that exist in some other federations. Full equalisation is a cornerstone of the Federation and reflects the Australian public's support that everyone should have similar levels of public services available to them. The 2014 Australian Constitutional Values Survey found that 77.5 per cent of the sample agreed with the

¹ CGC Report on Revenue Sharing Relativities, 2010 Review: Volume I. Page 30.

² *ibid*, page 29.

statement that, 'money should be transferred from richer parts of Australia to the poorer parts to ensure that everyone can have similar levels of public services'³. Partial equalisation or the introduction of other objectives in the HFE process would potentially reduce the level of equity between the States in Australia.

A 2007 OECD paper⁴ described fiscal equalisation as:

.... a transfer of fiscal resources across jurisdictions with the aim of offsetting differences in revenue raising capacity or public service cost. Its principal objective is to allow sub-central governments to provide their citizens with similar sets of public services at a similar tax burden. Fiscal equalisation can be seen as the natural companion to fiscal decentralisation as it aims at correcting potential imbalances resulting from sub-central autonomy.

The approach to HFE, as implemented by the Commission, is consistent with that description.

Further, HFE was extensively reviewed in 2012 by the GST Distribution Review and in its final report it found:

...the current HFE system is well established and internally consistent ... (and) ... works satisfactorily if the goal and definition of equalisation as currently set out is accepted...⁵

The aim of HFE has therefore been the achievement of equalisation of fiscal capacity between the States and the Commission has been effective in achieving that aim to date.

If it is, then, how would different approaches to the achievement of HFE, such as including other desirable policy goals, be implemented consistent with this? How would the definition need to be modified to support them?

It is hard to imagine how including other policy goals, such as some externally imposed or arbitrary national efficiency targets, would be consistent with the achievement of HFE. Invariably the achievement of other policy goals outside the principle of HFE would involve a trade-off between efficiency and equity. For example, if the basis of the GST distribution was to address certain efficiency targets in the delivery of a Government provided service, States would no longer be equalised to the same capacity but to a differing capacity depending on their relative efficiency of service delivery. States that are less efficient than the 'target' efficiency standard would receive less GST than they currently do. This would further weaken their capacity to provide services compared to the current approach of equalising to a national average efficiency standard. Over time this could lead to serious inequity between the States.

Tasmania believes it would be inappropriate to use HFE to achieve other broader objectives and to do so would overburden the equalisation system. Equalising States' fiscal capacities is a large and sufficiently complex task without obscuring the process further with additional requirements. It is more appropriate to pursue other objectives, such as service delivery efficiency targets, through alternative Commonwealth funding mechanisms, such as national partnership payments rather than through the GST distribution, which is focused on equity.

An example of this is the recent National Health Reform Agreement that requires the States to agree to establish an 'efficient price' for health services to underpin Commonwealth health funding.

³ Griffith University, *Australian Constitutional Values Survey 2014*, October 2014, page 10.

⁴ Hansjörg Blöchliger, Olaf Merk, Claire Charbit, Lee Mizell *Fiscal Equalisation in OECD Countries*, OECD France September 2007, page 5.

⁵ GST Distribution Review 2012, Final Report, page 9.

This national agreement has been structured to more directly target mutually agreed efficiency objectives and it provides mechanisms to share the benefits of efficiency gains.

In many OECD countries, fiscal equalisation plays an important role by enabling sub-central governments to have similar tax raising capacity and equal access to public services across jurisdictions. The earlier cited OECD paper sets out the rationale for fiscal equalisation as follows:

1. EQUITY

To equalise per capita tax revenue raising capacity and the per-beneficiary cost of providing public goods and services across regions. Tax raising capacity per capita and cost of providing public services can differ across regions for geographic or socio-economic reasons. The objective of equalisation is to provide every citizen with an average level of public services at comparable tax rates.

To equalise the marginal benefit of public spending across regions. OECD countries that have central government programs for important public services (such as health and education) administered by sub central governments, may use equalising transfers to equalise the marginal social benefit of public spending across regions.

2. EXTERNALITIES

To avoid fiscal externalities resulting in a misallocation of labour and/or capital across regions. A decentralised fiscal system could distort the location decision of mobile factors. Unequal tax bases result in pecuniary incentives to locate in high tax base regions, thereby distorting location decisions of mobile factors of production. Grants that equalise tax bases across regions will eliminate this source of inefficiency.

3. INSURANCE

To provide insurance against asymmetric income or employment shocks. If the regions of a country are subject to asymmetric shocks, redistributive grants may provide regions with insurance against the adverse effects of such shocks on income or employment.

Tasmania considers that this rationale is appropriate and is consistent with the current objectives of HFE in Australia.

Alternative approaches to HFE that aim to achieve other objectives are inevitably going to result in a lesser form of HFE. For the smaller States, fiscal equalisation makes a vital contribution to their economies and their budgets as their GST share represents a higher proportion of Gross State Product (GSP) and General Government revenue compared to the larger States. The way the GST is distributed has the potential to significantly impact small State economies and communities, while for the larger States it has a relatively smaller impact.

In the 2020 Review Staff Research Paper, *Achieving HFE - Other Approaches to Distributing the GST*, three alternative approaches were explored:

- an equal per capita (EPC) distribution;
- a partial EPC distribution; and
- an actual per capita (APC) distribution.

An EPC distribution in effect removes HFE as the objective as it takes no account of States' differing fiscal capacities. The States simply receive their per capita share of the GST. For small States like

Tasmania this results in a very significant reduction in its GST distribution (\$1.1 billion or 18 per cent of its total General Government revenue).

A partial EPC approach by definition results in less than full equalisation and therefore it is argued it does not satisfy the HFE principle.

An APC distribution is only appropriate where State revenue or expenses are not policy influenced and are sufficiently comparable to make a reliable assessment. For example, the Commission assesses natural disaster relief expenses on an APC basis because State spending on natural disasters is clearly in response to unforeseen events and is not policy driven.

However, the majority of State revenue and expenditure is policy driven. An APC distribution does not satisfy the Commission's principle of policy neutrality and so to avoid policy neutrality issues, the Commission uses average national revenue and expenditure in its assessments rather than the actual State revenue or expenditure.

As noted in the Staff Paper, an APC distribution provides more GST per capita to States that have higher per capita spending and lower per capita revenue raising. States could therefore 'game' the system if this principle was removed by compensating them for inefficient service delivery and lower taxes.

Tasmania is therefore of the view that none of the proposed alternatives are appropriate, as they are inconsistent with HFE and the Commission's guiding principles.

If not, what should HFE be achieving and what changes to the definition would be required?

As stated, Tasmania strongly believes that HFE is achieving its long standing objectives. Therefore no changes are required to the Commission's interpretation of what HFE means and how it should be applied in Australia.

Are changes to the definition necessary, or are State concerns more about the way HFE and its current definition is implemented?

Again, no change to the definition is required. Tasmania supports the current definition of HFE as it has been interpreted by the Commission and is generally satisfied with the way it is implemented.

SUPPORTING PRINCIPLES

Should the Commission continue to adopt supporting principles (or guiding considerations) to assist it in developing methods to give effect to the principle of HFE?

Tasmania considers that without supporting principles underpinning the Commission's methods it would be difficult for the Commission to give effect to the overriding principle of HFE in a consistent and coherent basis. Tasmania therefore agrees with the Commission adopting supporting principles to assist it to give effect to HFE.

Should HFE continue to be the priority, or are there circumstances under which certain supporting principles should take precedence over HFE?

HFE should always be the overriding priority in the Commission's considerations, and as noted earlier it is a requirement under the IGA. The supporting principles are simply there to guide the Commission in its judgements in achieving the overriding principle of HFE to the fullest extent that is practical and they should not take precedence over HFE.

Should the supporting principles have a pre-determined hierarchy, or should the Commission seek to balance the supporting principles case by case in order to best achieve HFE?

As stated in our response to the Commission's 2020 Review work program, Tasmania is of the view that the current supporting principles are appropriate, and will remain appropriate during the life of the 2020 Review. In the 2015 Review, the Commission noted that it had not set rules for how it would trade off each principle nor did it establish a hierarchy among the principles. As required, the Commission has, on a case-by-case basis, used its judgement to devise the best overall equalisation result. While the Commission's judgement decisions have not always been supported by the States, they nevertheless have the opportunity to raise concerns about proposed judgement decisions in draft reports and to provide alternative arguments.

Tasmania continues to support the Commission in using its judgement when applying its guiding principles for the 2020 Review. While it is acknowledged that at times there will be a conflict between supporting principles in achieving HFE, the establishment of a hierarchy of supporting principles is unlikely to resolve such conflicts and satisfy all situations and this may lead to sub-optimal decisions.

Should any of the 2015 Review supporting principles be removed, or any new supporting principles introduced? For any new principles, what is it that the new principle would achieve, not otherwise achieved?

Each time the Commission undertakes a review of its methodology it also considers whether its supporting principles remain appropriate. The supporting principles that were developed for the 2010 Review were considered by the Commission in consultation with the States and were still considered appropriate for the 2015 Review. These current supporting principles:

1. reflect what States collectively do;
2. are policy neutral;

3. are practical; and
4. deliver relativities that, as far as possible, are appropriate to the application year (contemporaneous relativities).

It is noted that at the request of the then Commonwealth Treasurer in late 2014, the Commission revisited the principle of contemporaneity in the 2015 Review in relation to volatile revenues. The Commission concluded that the current three-year averaging remained appropriate and balanced the competing considerations of practicality, data reliability, contemporaneity and policy neutrality,

In Tasmania's view, nothing has changed since the 2015 Review that would necessitate a change to the Commission's supporting principles. The current principles remain appropriate and should continue to be used for the 2020 Review.

WHAT STATES DO

Is the use of internal standards a sound approach to the achievement of HFE with no further consideration necessary?

Tasmania supports the continuing use of the internal standard that serves to ensure that Commission assessments are, as far as possible, based on the principle of 'what States do'.

It is noted that in practice, HFE is equalised to a 'materially the same' standard, rather than the 'same' standard, due in part to the limitations inherent in the data available to the Commission to assess HFE needs, the introduction of materiality thresholds, and stronger reliability criteria in the 2010 Review.

To equalise to a standard other than 'materially the same' standard, such as a discounted standard, a minimum standard or an external standard, would fundamentally change the objective of HFE.

Adoption of a minimum standard or an external standard is likely to be more complicated, raising a number of practical questions such as:

- who sets the minimum standard?
- how is an appropriate external standard determined?
- how do you then measure relative needs against the external standard?

It is also likely to be more controversial, giving rise to another area of contention in an already contentious field. It would likely contribute to greater uncertainty and possible increases in the resourcing effort for the Commission and the States in developing, arguing, assessing and monitoring of any proposed external standards.

As noted earlier, to incorporate efficiency standards into the current HFE system is likely to overburden the system, resulting in a lesser form of HFE.

It is argued that the current system of HFE, that applies an average of 'what States do,' does not encourage States to operate less efficiently. By setting the internal standard to the average cost of service delivery, it encompasses the average level of technical efficiency. Therefore, if a State has above average efficiency in delivering a particular service, it will benefit from the difference between the national average and its actual expenditure. Conversely if it is less efficient than the national average, it bears that cost.

Tasmania therefore endorses the Commission continuing to base its assessments on 'what States collectively do' from both a principle and practical perspective.

Alternatively, are there circumstances in which it would be appropriate for the Commission to apply an external standard?

As the Commission has argued in its staff paper, external standards are not affected by the policies of any State, and they may be based on some 'ideal' level of services or an economically efficient tax policy. Implicitly, these external standards are often premised on the presumption that the lowest tax or expenditure policy reflects 'efficient' best practice.

However, a State can be the lowest taxing or lowest spending State within a particular assessment category due to policy choice, higher revenue capacity or lower expenditure needs. There can be no presumption that this reflects efficiencies or that it will generate incentives to create efficiencies or stimulate reform. A small State may be operating as efficiently as it can but still be operating at a less efficient level than some national target because of its inherent disadvantages such as scale or regional dispersion.

Rather, as noted earlier, it will severely complicate the assessment of disabilities as the 'standard' set by a single State becomes an additional point of contention. Tasmania therefore supports the Commission's view that:

We do not consider it is our role to base our recommendations on any normative view of service delivery or revenue policy. We consider the most relevant and neutral approach is to base our recommendation on the actual average policy of the States as revealed in the data. Only in circumstances where other supporting principles come into play would we consider an alternative approach.⁶

Tasmania agrees with the Commission's view that:

The only case when it may be appropriate to use a standard different from the one dictated by what States do could be to overcome policy neutrality concerns. As noted by two States, an external standard might be used in such a case as a last resort. However, in our view, primacy should still be given to achieving HFE.⁷

In its first interim report, the GST Distribution Review Panel noted that:

The key problem with the approach of equalising to an external standard is that it is not clear how such a standard would be determined. Determining the standard and the administration of compliance with it may significantly increase the administrative costs of HFE.⁸

Tasmania is therefore of the view that the use of external standards should only be a last resort such as where policy neutrality is a significant concern and cannot be addressed through the application of internal standards, and where it does not compromise HFE. Tasmania believes that the use of internal standards avoids the problems associated with subjective measures of what States should do. For example, in the case of the Commission's Roads assessment, practical issues mandate making an assessment based on a stylised view of average policy (synthetic road network), rather than the measured average policy of the States.

Should the Commission retain the 2015 Review approach - the 'weighted average' approach - to determine average policy, or is there a better alternative?

The 'weighted average' approach introduced in the 2015 Review replaced the 'double majority' approach - that is, requiring a majority of States and a majority of the tax or service base to be affected - that had previously applied.

⁶ CGC 2015 Methodology Review Volume 2, page 8.

⁷ *Ibid*, page 8.

⁸ GST Distribution Review, *Interim Report*, March 2012, page 80.

Under the weighted average approach, if only one State raises a particular revenue or provides a service, an initial assessment is made and if it results in a material difference in fiscal capacity between the States it is included as part of what States do.

Tasmania has previously expressed support for the weighted average approach, as it overcomes the problems of confusion as to whether 4 out of 8 States is a majority, and suggests that it be continued by the Commission.

While the weighted average approach is an improvement on the previous approach, it does raise potential problems with achieving policy neutrality when the weighted average is dominated by a large State.

On face value, the weighted average approach may be of concern if, for example, a large State is the only State that raises a tax and the other States have similar tax bases (on a per capita basis) but through policy choice do not tax them. Will the tax be assessed as 'what States do' and potentially redistribute GST?

Under the weighted average approach it is unlikely that the assessment will result in a material redistribution as the assessed per capita revenue for each of the States in this scenario will be similar to an EPC distribution. That is, even though the other States do not levy the tax, because their tax bases are similar in size they are assessed as being able to generate similar revenue on a per capita basis.

If, on the other hand, the other States have a much smaller tax base then it is likely that there will be a material redistribution. This is what HFE is designed to do. That is, to redistribute GST from States with stronger tax bases to those with weaker tax bases. The weighted average approach therefore does not disturb this objective, even if only one State determines 'what States do'.

This is shown in Table I where NSW is assumed to be the only State levying a hypothetical tax. In the first table all States have similar sized tax bases on a per capita basis. In the second table all the other States apart from NSW have weak tax bases (10% of NSW). The GST redistribution in the first table is immaterial (less than \$30 per capita) and would not result in a redistribution of GST, while in the second table it is material and would result in a redistribution of GST.

Tasmania supports the Commission continuing to use the current weighted average for the 2020 Review.

Table 1: Example of Weighted Average Tax Redistribution

Other States tax bases are equal per capita to NSW but are not taxed									
	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	TOTAL
Population ('000)	7 672	5 998	4 808	2 603	1 703	517	393	244	23 938
Tax Base (units)	76 000	60 000	48 000	26 000	17 000	5 000	4 000	2 500	238 500
Revenue (\$)	10 000 000	0	0	0	0	0	0	0	10 000 000
Av. Tax Rate Per Unit									41.93
Assessed Revenue (\$)	3 186 583	2 515 723	2 012 579	1 090 147	712 788	209 644	167 715	104 822	10 000 000
Assessed Revenue (Per capita)(\$)	415.37	419.43	418.60	418.74	418.63	405.21	426.64	429.82	417.75
EPC (\$)	417.75	417.75	417.75	417.75	417.75	417.75	417.75	417.75	417.75
Relativity	1.0057	0.9960	0.9980	0.9976	0.9979	1.0310	0.9792	0.9719	
Redistribution (\$PC)	2.37	-1.68	-0.85	-0.99	-0.88	12.54	-8.89	-12.07	
Redistribution (\$)	18 220	-10 097	-4 089	-2 590	-1 493	6 489	-3 496	-2 943	0

Other States tax bases are 10% per capita of NSW but are not taxed									
	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	TOTAL
Population ('000)	7 672	5 998	4 808	2 603	1 703	517	303	244	23 938
Tax Base (units)	76 000	6 000	4 800	2 600	1 700	500	400	250	92 250
Revenue (\$)	10 000 000	0	0	0	0	0	0	0	10 000 000
Av. Tax Rate Per Unit									108.40
Assessed Revenue (\$)	8 238 482	650 470	520 325	281 843	184 282	54 201	43 360	27 100	10 000 000
Assessed Revenue (Per capita)(\$)	1 073.89	108.44	108.22	108.26	108.23	104.76	110.30	111.12	417.75
EPC (\$)	417.75	417.75	417.75	417.75	417.75	417.75	417.75	417.75	417.75
Relativity	0.3890	3.8524	3.8601	3.8587	3.8598	3.9876	3.7873	3.7593	
Redistribution (\$PC)	-656.14	309.31	309.53	309.49	309.52	312.99	307.45	306.63	
Redistribution (\$)	-5 033 680	1 855 220	1 488 164	805 714	527 014	161 932	120 858	74 778	0

Source: Tasmanian Treasury calculation

How might the practical problems arising from a weighted average approach be handled to ensure HFE is achieved?

While there is little evidence that the GST redistribution impact has been a primary influence on a State's policy decision to materially affect the average of 'what States do', the Commission will from time to time need to respond to situations where this may occur.

In the case of the mining revenue assessment where the weighted average is dominated by one State, the Commission has treated policy neutrality as a second order principle to HFE in adopting its mineral by mineral assessments as this better reflected fiscal capacity. While policy neutrality may be an issue with the mineral assessment the Commission noted that there is no evidence that it has influenced State behaviour⁹.

⁹ In 2020 Review Staff Research Paper CGC 2017-04-S State Mining Policies, page 5.

As mentioned, HFE should be the overriding principle where there is a potential conflict with the principle of 'what States do' and policy neutrality. If this was to occur the Commission could change the assessment by replacing the weighted average approach with an appropriate external standard (noting earlier that the selection of a robust external standard that does not diminish HFE can be difficult). Tasmania does not support returning to the double majority approach in the 2010 Review or replacing the current weighted average with a rotating average (discussed in further detail in Tasmania's response to the issue of policy neutrality).

Should the fiscal outcome of States the Commission equalises continue to be the same average per capita net financial worth?

Tasmania continues to have concerns with the current approach to assessing capital needs as argued in its submissions to the 2010 and 2015 Reviews.

The fiscal outcome the Commission seeks to achieve is for States to have the capacity to have an equal holding of financial worth per capita. For each State, the assessed GST revenue a State needs can be calculated as the difference between what it needs to save each year to give it the average fiscal outcome and what it would save if it delivered the average level of services and made the same revenue effort (with no GST revenue) expressed as follows:

$$\text{Assessed GST requirement} = \text{Assessed net lending} - (\text{Assessed revenue} - \text{Assessed expenditure})$$

As shown above, Net lending is a fundamental component of the equalisation process.

However, the current net lending/borrowing assessment does not take into account the fact that States will not have equal starting positions in terms of their Net Financial Worth (NFW). The Commission determines the change in assessed NFW from the start of the assessment year to the end of the year and measures what additional funding is required to equalise NFW per capita. However, net lending/borrowing is a consequence of many transactions such as revenue raising, service delivery expenses or net acquisition of non-financial assets over time. States will have had different starting amounts of NFW developed over many years prior to the introduction of the current net borrowing assessment and these differences may have arisen from fiscal imbalances outside the control of the States. The current assessment does not attempt to close this gap and so the inherent differences are likely to remain in each subsequent assessment.

The assessment approach also assumes that States can earn the same rate of return on their NFW. That is, all States receive the national average return which implies all States have the same mix of assets and equity in their Public Non-Financial Corporations (PNFC). PNFC equity encompasses a range of activities; some will provide income for the State such as dividends while others can be a drain on a State's financial capacity. The Commission's objective of providing States equal capacity to earn income from PNFC equity is therefore problematic if there are significant variances in the States' mix of equity in their PNFCs.

While Tasmania generally accepts the concept that population growth dilutes NFW, the current assessment approach assumes that there is a linear relationship between population growth and its dilution impact on NFW, and that this dilution needs to be fully equalised. However, this assumes that all other aspects of population growth do not impact NFW, such as the economic growth benefits that flow through to the State budget, increased GST revenue being based on a per capita share, and equity growth in State investments because of larger populations.

Tasmania and other States questioned the assumption in the 2010 Methodology Review and again in the 2015 Methodology Review that faster growing States experience larger equity revaluations and that this should offset the population dilution disability. However, the Commission concluded in the 2015 Methodology Review that “The case for revaluation disabilities is not strong and we have not introduced any.”¹⁰

Tasmania intends to re-examine the Commission’s assumptions relating to NFW in the Net lending/borrowing assessment during the course of the 2020 Review. In particular, Tasmania will re-examine the assumptions that the States have equal NFW starting positions, that PNFC equity growth is unaffected by population growth, and that the capacity to earn income from equity is the same for all States.

If not, what fiscal outcome should the Commission equalise?

While Tasmania has some concerns with the current approach to equalising on the basis of average per capita NFW, at this stage it has not formulated a view as to whether there is a better alternative approach. As noted, Tasmania will be exploring these issues and raising them for further discussion once the basis of the 2020 assessments becomes clearer.

Given current State circumstances, does the existing scope of equalisation (general government plus urban transport and public housing PNFCs, but excluding local government except for the interactions between it and the State sector) remain appropriate?

Tasmania supports the current exclusion of local government activities within the scope of the Commission’s equalisation task except where there are transactions between the States and local government such as the provision of grants and subsidies, and where local government provides State-like services that relieve the State from the fiscal requirement to provide those services. As noted by the Commission, the local government sector already has a process in place for equalising local government fiscal capacity.

In an earlier submission, Tasmania supported the decision of the Commission to include the operations of urban transport and public housing PNFCs within its coverage of State activities, rather than being outside the scope of the General Government sector, as this better reflects how these public services are delivered. Tasmania still supports this decision.

Tasmania did, however, express some concern with the consequence of this decision, whereby urban transport and public housing are included within the investment assessment that assesses public sector infrastructure needs.

In the 2010 and 2015 Methodology Reviews, Tasmania and other States raised concerns regarding the direct approach of the investment assessment. That is, assessed investment is the difference between a State’s population share of the average stock of infrastructure at the end of the year compared to the start of year. Stock disabilities are applied to the assessed quantity of stock required by a State at the start and end of each year. The assessment makes the rather bold assumption that there is a linear relationship between the need for all types of investment in public infrastructure and each State’s population growth. The decision to include public transport and

¹⁰ CGC 2015 Methodology Review Volume 2 Assessments, page 530.

housing infrastructure within the investment assessment increases the stock of public infrastructure in the assessment and so increases the scope of infrastructure captured by this assumption.

If not, what activities should the Commission equalise?

Apart from the comments above, Tasmania supports the scope of the existing equalisation.

Should assessments reflect what States do on average?

Earlier comments above support assessments being made that reflect what States do 'on average'.

Should changes be made to the general approaches used by the Commission in the past?

Tasmania accepts that for some assessments the Commission has had to take an indirect approach to determine what States do. The use of broad indicators and proxy data is used as an alternative where actual State data is unavailable or unreliable, or where it is policy influenced.

However, Tasmania continues to have concerns with the use of average private sector wages as a proxy for public sector wages. Private sector wages are used because public sector wages are considered to be policy influenced. The use of private sector wages as a proxy for public sector wages overstates the relative cost advantage faced by the Tasmanian government in setting public sector wages. Tasmania will again raise this issue in its responses to the wages assessment.

POLICY NEUTRALITY

Do States consider that a rotating State average would improve policy neutrality? If so, how could such an approach be implemented in practice?

Tasmania continues to support the use of policy neutrality as a supporting principle. It appropriately ensures that a State's own policy choices do not directly influence the level of grants it receives. It also ensures that Commission methodologies do not influence State decision making.

However, in considering a rotating State average it is important to remember that the goal of policy neutrality is subsidiary to the requirement to achieve equalisation, as acknowledged by the Commission in its 2015 Review¹¹. HFE should always be the overriding priority in the Commission's considerations, and as noted earlier, this is a requirement under the IGA.

Policy neutrality was a key area of discussion in the Commission's 2010 and 2015 Reviews, as well as the GST Distribution Review. Under the 2015 Review approach, the Commission addressed policy neutrality by undertaking assessments on the assumption that each State broadly followed the same (or average) policies in delivering services and raising revenue. Tasmania believes there is no firm evidence to refute this assumption.

Policy neutrality is generally not an issue because most States' approaches to service delivery or revenue raising are similar. Issues arise when one State raises significantly more than its population share of a particular revenue or accounts for significantly more than its population share of an expenditure category. The most obvious example is the disparity between Western Australia's mining revenues and those of the other States, particularly with regard to iron ore.

As the Commission Staff Discussion Paper¹² acknowledges, situations where a tax base is very unevenly distributed across States, so that a particular State has a large effect on average policy, can prove problematic for the Commission. As noted earlier, the overriding principle should be HFE and the Commission has at times had to change its approach. For example, in the case of the mining assessment in the 2010 Review approach, it placed a greater emphasis on policy neutrality. For the 2015 Review, its mineral by mineral approach placed less weight on policy neutrality as the Commission considered that such an approach improved the HFE outcome.

In the 2015 Review Report¹³, the Commission considered that:

...while it is theoretically possible for changes in State policies to affect GST shares, in practice we do not observe that States adopt policies for this purpose. If we do observe a significant change in behaviour which raises policy neutrality concerns, we will revisit the assessment in a future update.

Tasmania questions what evidence exists to show that the Commission has observed a significant change in behaviour which raises policy neutrality concerns. The Commission's 2017 Staff Research Paper on State Mining Policies concluded that¹⁴:

¹¹ 2015 Methodology Review Report, Volume 1, Chapter 2, page 37.

¹² 2020 Review, CGC Staff Discussion Paper, CGC 2017-02 S.

¹³ 2015 Methodology Review Report. Volume 1. Chapter 2, page 37.

¹⁴ 2020 Review, State Mining Policies, Staff Research Policies.

There is no evidence the mineral by mineral approach has influenced State behaviour. There were no legislated rate changes like those observed after the 2010 Review. The only change was the removal of a concession.

The current system of using State averages to determine GST relativities does not appear to have an impact on States' policy settings. Western Australia does not appear to have experienced a disincentive to increasing its iron ore fines royalty rate in 2010-11, despite the obvious fact that it would have the effect of reducing its GST share by more than the royalty revenue it received¹⁵.

Rotating average proposal

The effect of using the rotating standard approach is that, for any particular State, the standard to which its disabilities are applied is derived from the weighted average of the other seven States, so that the State has no influence on the standard applied to itself. However, this approach would compromise the primary principle of HFE. While a rotating average may improve policy neutrality, it would result in States' revenue raising capacities being assessed with regard to the capacity of other States rather than their own capacity. This may not result in material changes for most assessments, but would result in a significant redistribution in the mining assessment.

In practice, if the rotating State average was applied to the mining revenue assessment it would disproportionately benefit one or two States while leaving all other States worse off. The mining assessment is the area with the most significant disparity between the tax base and the tax rate of one State and the rest of the States, so Tasmania has focused on the impact of that assessment.

Tasmanian Treasury modelling indicates that a rotating State average approach to the mining revenue assessment could result in Western Australia receiving an additional \$2 500 million per annum under the mining revenue assessment. The modelling further shows that \$2 108 million less would have been equalised in the 2015-16 assessment year under the mining revenue assessment. Table 2 clearly demonstrates that a rotating State average would disproportionately benefit one State, while the zero-sum nature of equalisation will leave all other States, except the Northern Territory, significantly worse off.

Table 2: Assessed mining revenue 2015-16 assessment year - current and rotating State average methods

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	TOTAL
GST redistributed (current) \$m	1 543	2 025	(304)	(3 830)	347	148	139	(68)	(4 203)
GST redistributed (rotating) \$m	487	1 214	(842)	(1 244)	220	91	82	(8)	(2 094)
Change \$m	(1 056)	(811)	(538)	2 586	(127)	(57)	(57)	61	(2 108)

Source: Tasmania Treasury calculations based on Commonwealth Grants Commission data

¹⁵ From 1 July 2010, Western Australia increased its royalty rate for iron ore fines from 3.75 per cent to 5.625 per cent through the removal of a royalty concession. In the CGC's mining revenue assessment at that time, it classified mineral royalties as either being in a low royalty group or high royalty group. The removal of the concession moved iron ore fines from the low royalty group into high royalty rate group. Based on the CGC's mining revenue assessment it would have reduced Western Australia's GST by more than the increase in royalties it received from iron fines because the actual royalty rate applied to iron ore fines was lower than the average rate for the high royalty rate group. Thus, its assessed revenue (for GST distribution purposes) using the average royalty rate for the high royalty group would be greater than its actual royalty revenue.

Adopting the rotating State average approach may improve policy neutrality where there are vastly disparate tax bases, but this would come at a significant cost to HFE.

Adopting a rotating State average is likely to be more complicated, raising the question of whether an achievement of greater policy neutrality will also come at the cost of delivering simple and practicable methods. A rotating State average would increase complexity because standards would have to be calculated eight times instead of once. As acknowledged by the Commission, the approach could introduce technical complications. It would be unlikely for the sum of the assessed outcomes for each State under this approach to match the States' total actual outcome. The Commission would have to make decisions on how to treat the difference. While Tasmania is confident the Commission would exercise its judgement appropriately in these situations, on balance, it does not believe that a rotating State average is consistent with the principle of equalisation.

Tasmania endorses the Commission continuing to base the standard to which its disabilities are applied as being derived from the weighted average of all the States, but does not support the proposed rotating State average method. Tasmania therefore supports the Commission's current approach to policy neutrality, and notes that where there are circumstances where this cannot be adequately achieved, the Commission has, in the past, used its judgement and placed less weight on this principle to reach a better HFE outcome.

Does HFE act as a disincentive to tax reform? If so, how does it do so — in reality as opposed to theory — and could such effects be mitigated in practice?

It has been suggested that HFE may act as a disincentive to tax reform.

HFE ensures that States have the capacity to deliver an average level of service, on the assumption of an average level of revenue raising effort. If there is a change in the tax mix from an inefficient tax in which a State has a relative revenue raising advantage to an efficient tax in which it has a relative disadvantage, HFE ensures that States receive sufficient funding in order to provide an average standard of services.

In this way, HFE actually supports tax reform by removing this disincentive for change. In reality, in considering tax reform, States are concerned with broader economic development issues, rather than temporal direct fiscal consequences. If this were not the case, no State would ever provide tax relief.

One of the principles used by the Commission in its methodology is that its assessments should, as far as practicable, reflect what States collectively do. That is, they should reflect the average range of services actually provided by the States and the average range of taxes they impose. This approach removes the need for the Commission to make judgements on what States could or should do.

If a State was to introduce a reform that increased its revenue raising capacity or reduced its cost of delivering services then there may be redistribution effects because of HFE. However, this would require the reform by that State to materially affect national average spending on that service or the average taxation rate; an impact largely confined to the most populous States which predominantly determine the population weighted national average standard.

However, these effects are a secondary issue as the primary reason for undertaking reform is to increase efficiency and to improve the general welfare of the community.

For small States like Tasmania, changes in State tax rates are unlikely to affect the average tax rate as assessed by the Commission and consequently unlikely to affect its GST share. Tasmania will still be assessed on the average tax rate not on the actual tax rate it imposed. The more likely impediment to tax reform is that any reform will result in ‘winners and losers’, the difficulty of implementing tax reform in challenging economic conditions, and the need for a national approach.

Consideration of the GST impacts of tax changes is also not evidenced by the fact that for example¹⁶, the New South Wales Financial Audit (the Lambert Report) recommended a switch from insurance taxes to payroll tax. Despite the recommendation, and though at the time New South Wales would have gained GST share by switching from insurance tax to any other tax, it chose not to do so.

The Mining Assessment

The Commission’s Staff Discussion Paper raises a related but slightly different issue when a State prohibits a tax base being accessed.

Where a State prohibits the extraction of a mineral resource, usually for environmental or political reasons, the Commission assesses that State to have no capacity in relation to the banned activity.

Coal seam gas (CSG) is banned in all States except Western Australia and Queensland. For those States that produce CSG, it is assessed as part of the onshore oil and gas component of the Commission’s mining revenue assessment. However, as the current value of production of CSG is relatively low it is not material enough to be separately assessed by the Commission nor does it have a material impact on the relevant State’s assessed mining capacity. However, the Commission notes that this could change in the future with projected increases in CSG production in Queensland.

The Commission therefore suggests that it may have to review its treatment of banned mineral exploitation should it become material. Because a number of States prohibit this activity, this could involve the Commission having to estimate the unexploited revenue base for those States, so as to not ‘penalise’ the States that do not impose the ban.

Tasmania would be concerned if the Commission was to depart from its current principle of assessing ‘what States do’ and attempted to estimate ‘what States could do’ where a policy decision has been made to not develop a resource for sound environmental reasons, and where HFE was not a consideration in that decision. This approach would open up other sources of revenue that are either partially, or not fully, exploited and would create added complexity and argument over how such an assessment could reasonably be made.

It is worth considering whether resource rich States that have concerns that their revenue from resources is being ‘equalised away’ have stopped putting significant effort into supporting resource industries? The answer is clearly no. No government would expect to be returned to office, nor opposition expect to win government, if it did not actively propose and implement policies which are designed to increase economic development.

Therefore, the argument that HFE acts as a disincentive affecting State policy choices relating to resource extraction does not hold.

¹⁶ GST Distribution Review, Second Interim Report, March 2012, pages 35-36.

PRACTICALITY

A further aspect of practicality is the transparent use of data. In the 2015 Review the Commission made use of data that were in some cases confidential. Should assessments be made using confidential data?

Tasmania supports the Commission's existing quality assurance framework and accepts that, in some cases, the use of confidential data is required for specific assessments.

Tasmania continues to support the Commission's approach of developing its methodology in consultation with the States in order to provide the greatest level of transparency. Tasmania is of the view that while the use of confidential data may, to a limited degree, reduce transparency, the Commission should use the best available data in its assessments, including confidential data, and that this requirement should take precedence over transparency.

Tasmania notes that the majority of the Commission's information and assessment outcomes (excluding confidential data) are available publicly and that confidential data represents a relatively small proportion of the total data pool.

Are the three levels of discounting appropriate? If not how could discounts be changed?

Tasmania supports the continued application of a uniform set of discounts within the 2020 Review.

Consistent with past submissions¹⁷, Tasmania supports the Commission's continued use of judgement, which includes the current use of discounting. Tasmania maintains that exercising judgement, where appropriate, will enhance equalisation outcomes (when applied consistently and where justified).

The Commission's Assessment Guidelines¹⁸ for the 2020 Review provide for the use of discounting where a presumptive case for including a disability in a category is established, but the Commission is unable to make a suitable assessment of its impact.

Tasmania understands that circumstances for discounting may relate to:

- particular concerns about the assessment;
- the strength of the conceptual case for assessing the category or the disability;
- the reliability of the methodology and data;
- the sensitivity of the assessment to the data used, measured in terms of the likely impact on State revenue shares of an error in the data; and
- consistency with State circumstances.

In principle, Tasmania believes that the concept of discounting is preferable to the alternative of the Commission making no assessment at all, where it is very clear that a disability exists and will have a material impact on the equalisation outcome.

¹⁷ Refer Tasmanian Government Submissions to the 2010 and 2015 Reviews.

¹⁸ Commonwealth Grants Commission, *The Principle of HFE and its Implementation, Attachment A (CGC 2017-02-S)*, May 2017, pages 49-50.

With regard to the appropriateness of the existing discounting levels¹⁹, Tasmania reiterates its support for the continued use of discounts and that the three levels of discount, namely 15 per cent, 25 per cent and 50 per cent remain appropriate for the 2020 Review.

However, it is expected that consultation between the Commission and the States will occur when reviewing where discounts have previously been applied, or where new discounts may be considered appropriate, to provide assurance that they have been applied consistently and to explain the reasons for them.

It is Tasmania's understanding that the specific application of discounts within individual assessment contexts will be considered later in the 2020 Review process.

Should the materiality thresholds remain at the 2015 Review levels or should they be increased? If increased, to what levels?

Tasmania opposes any further changes to the materiality threshold levels as part of the 2020 Review, given the significant increases that were made as part of the 2015 Methodology Review.

In the 2012 GST Distribution Review, the Panel recommended substantial increases to the materiality thresholds as a means of simplifying the Commission's processes without affecting the small States. This recommendation was made within a context where the Panel considered:

...steps should be taken 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.²⁰

Tasmania considered that the Panel had stepped outside its purview and into issues of methodological detail in making such a recommendation, an area considered solely the province of the Commission. Tasmania rejected this premise and did not agree that the Commission's assessments were 'falsely precise', that the existing materiality provisions were inadequate, or that a robust case for further simplification had been made in this context.

Despite significant opposition from a majority of States, the Commission substantially increased materiality thresholds in the 2015 Review, effectively tripling the 2010 Reviews levels.

The Commission argued:

We do not consider an increase in the materiality threshold in this review reflects an implied recommendation for real growth in materiality thresholds in each review. Rather, we consider we introduced materiality at a conservative level in the 2010 Review, and, reflecting our conclusion that it was effective, have set it at a less conservative level.²¹

In its 2015 submission to the Commission²², Tasmania argued that the proposal to triple the existing thresholds from \$10 per capita to \$30 per capita would do more than simply preserve simplification, it would substantially increase it.

¹⁹ *ibid*, pages 28-29.

²⁰ 2012 GST Distribution Review, Final Report, October 2012, page 59.

²¹ Commonwealth Grants Commission, Report on GST Revenue Sharing Relativities 2015 Review, Volume 2 Assessments, February 2015, page 20.

²² Tasmanian Government, Submission in Response to Staff Discussion Paper CGC 2013-06S, January 2014, page 5.

Tasmania questioned the Commission's rationale for the significant increases in its *Response to Staff Discussion Paper CGC 2013-06-S*²³, noting that they appeared arbitrary in nature and risked setting a poor precedent for future reviews.

Tasmania has ongoing concerns that incremental simplification of assessments through increasingly higher materiality thresholds will lead to an erosion of HFE as more assessment categories are removed from the equalisation process. Any increases to materiality thresholds need to be debated as part of a system wide consideration rather than determined in isolation.

With regard to the staff proposal to increase materiality thresholds to account for price and wage increases over the past five years (paragraph 127(ii))²⁴, Tasmania supports indexation as a future option to avoid a recurrence of the significant ad hoc treatment of threshold levels introduced in the 2010 Review and increased in the 2015 Review.

However, Tasmania reaffirms its view that further changes in materiality thresholds in the 2020 Review are not warranted given the significant increase in the 2015 Review.

With regard to setting disability materiality thresholds at \$50 per capita (paragraphs 127(iii) and 129)²⁵, Tasmania reiterates previous concerns that there appears to be an absence of supporting evidence as to the necessity for such a significant increase, or on what premise this increase is based.

If a threshold of \$50 per capita was set, then for the 2017 Update the Insurance tax and Net lending/borrowing assessments would be immaterial. For Tasmania, this would result in a reduction in GST of \$46 million. As noted earlier, Net lending is a fundamental component of the equalisation process and should not be removed for simplicity grounds because it does not meet the materiality test.

The Staff Discussion Paper noted:

...that the resultant large increases in the 2015 Review achieved its goal of reducing the number of disabilities and that those left were highly material (paragraph 129).²⁶

Tasmania would therefore question why further changes would be required within the scope of the 2020 Review and opposes further arbitrary increases in the materiality thresholds.

Is this an acceptable way to ensure 'robust quality assurance processes'?

The terms of reference for the 2020 Review ask the Commission to 'ensure robust quality assurance processes' (clause 7d).

Tasmania continues to support the existing quality assurance framework the Commission operates within, believing it is a practical approach to ensuring assessment methods are conceptually sound and based on robust and reliable data.

²³ *ibid*, pages 5-6.

²⁴ Commonwealth Grants Commission. *The Principle of HFE and its Implementation* (CGC 2017-02-S), May 2017, pages 30-31.

²⁵ *ibid*, page 31.

²⁶ *ibid*, page 31.

It is understood that the *2020 Review Quality Assurance Strategy* will continue to embrace the following main elements (adopted from the 2015 Review and subsequent updates) to ensure quality assurance guidelines are established:

- development of equalisation principles;
- development of a work plan (in consultation with the States);
- use of formal assessment guidelines, which are simple and consistent with the quality and fitness for purpose of the available data (terms of reference clause 7a);
- use of external consultants;
- identification, development, and use of the best available data for assessments;
- transparent reporting of decisions, methods and results; and
- performance of internal and external audits and error checks of calculations to identify and correct any errors.

Tasmania supports the Commission's approach for continued input to be provided by the States at appropriate stages of the review and regards this as an appropriate measure to further improve the quality of data reported. This will only be successful if the States are given adequate time to provide their responses to the work of the Commission and the consultants it uses.

Consistent with past reviews, Tasmania supports the Commission appointing external auditors to review the Commission's decision making methods and to ensure due process is followed.

External auditing of the 2015 Review reported high compliance with regard to the Commission's decision making and quality assurance processes. However, it is noted that a number of issues were identified for the Commission to consider.

These included:²⁷

- improving disclosure in the final report on how discounting had been applied by the Commission and, in part, to address continuing State concerns as to the consistency of its application;
- reviewing the processes and timeframes adopted for the development of assessments (in order to improve the timeliness of their completion and the availability of information for State consideration); and
- developing guidelines to ensure best practices in managing supporting data.

Tasmania would anticipate that the Commission will give due consideration to the proposed recommendations going forward.

Tasmania supports the Commission's quality assurance framework for as long as it assists the underlying principles of equalisation, by ensuring assessment methods are conceptually sound, consistently applied and free from error.

²⁷ Lace Wang, 2015 Review - Audit of Staff Compliance with Quality Assurance Processes, January 2015 and Glenn Poole, Audit of the Commission's decision making process in the 2015 Review, January 2015.

Are there any new risks that the Commission should take into account from a State perspective?

Tasmania has not identified any new quality assurance related risks at this time other than those in the 2015 Review Audit reports noted earlier.

How might the 2015 Strategic Plan be changed to deal with those risks?

Consistent with previous reviews and updates of the Commission's strategic plan and framework, Tasmania supports continued communication with the Commission in order to ensure improvements to future plans are reflective of changing requirements as they arise.

Should any other changes be made?

Tasmania supports the continued process by which the Commission ensures assessments are as reliable and accurate as possible. As such, Tasmania has no further suggested changes to be examined by the Commission at this time.

CONTEMPORANEITY

Should the Commission maintain the aim of achieving a GST distribution relevant to the application year, or should the aim be varied to achieve equalisation over time using historical assessments?

The Commission Staff have comprehensively discussed the options for making the GST distribution methodology more contemporaneous in Staff Research Paper CGC 2017-05-S.

Staff discuss:

- a single assessment year model;
- a later reporting date;
- the use of projections or forecasts;
- a different treatment to volatile revenues; and
- options for correction gaps:
 - an advance and completion approach; and
 - a completion only approach.

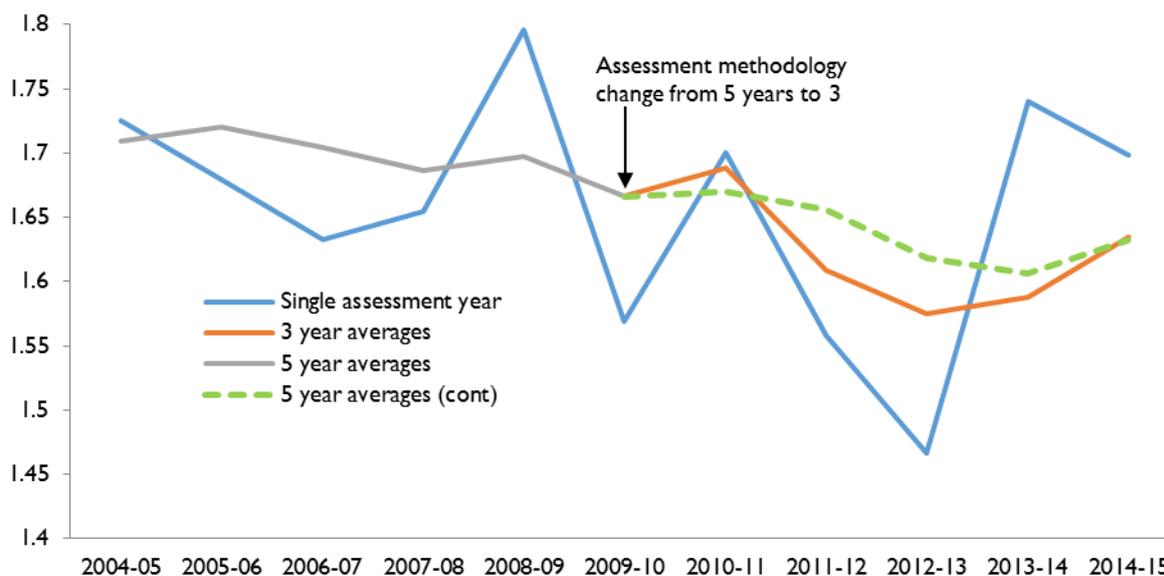
Staff acknowledge that a fully contemporaneous GST distribution is not feasible. While staff note that different approaches provide different trade-offs in terms of contemporaneity, volatility and reliability, the options involve additional calculations and increase complexity of the HFE process. Tasmania is of the opinion that the benefit of increased contemporaneity is not sufficient to outweigh the detrimental impacts of increased volatility, reduced reliability and additional complexity.

Does the current three-year lagged average approach present undue difficulties to managing your State's cyclical cash flows?

The current three-year lagged average approach presents benefits with regard to managing the State budget, compared with the alternatives. The three-year average provides stability in Tasmania's GST share and revenue, compared with a single year assessment. Under a single-year assessment, Tasmania's GST share would become highly volatile and may swing significantly as a result of changed circumstances in other States.

Chart I below compares Tasmania's single-year relativity with both three-year and five-year average relativities from 2004-05. Chart I illustrates that the change from five-year to three-year averaging has increased contemporaneity without resulting in significantly increased volatility. However, further increasing contemporaneity by removing three-year averaging would have resulted in a high level of volatility in Tasmania's relativity. The consequent fluctuations in Tasmania's GST revenue would have caused significant budgetary challenges.

Chart I: Tasmania's relativities²⁸ under different assessment periods



Source: Commonwealth Grants Commission

If so, which of the approaches discussed would result in an improvement to cyclical cash flow management and why, noting the concerns about using reliable and consistent data, the unreliability of forward estimates and the risk of policy contamination through the different budgeting practices of the States (with the consequent likelihood of increasing complexity through a completions type process)?

The Commission staff discuss a correction process, whereby data revisions with regard to the single assessment year may necessitate the adjustment of States' GST shares later in the application year or in a subsequent application year. Such a correction process is likely to add further volatility when the correction is made in a subsequent application year.

The GST is Tasmania's most significant source of revenue, making up approximately 40 per cent of its revenue. Predictability and stability in this revenue source is crucial to managing Tasmania's budget. Tasmania, and most other States, maintain a comprehensive GST relativity forecasting model. While Tasmania's GST relativity can be volatile, Tasmanian Treasury relativity forecasts have been comparatively accurate. Part of this accuracy can be attributable to the lagged three-year average methodology. Projections of relativities up to two years out from the current application year rely partially on the Commission's actual assessments, which improves forecasting accuracy compared to estimates of later years.

A single assessment year methodology, with or without completion corrections, would make it more difficult to accurately forecast relativities over the forward estimates period.

Likewise, a later reporting date would make framing the upcoming budget more challenging.

²⁸ Single year relativity data for the years prior to 2007-08 were provided to Tasmania by Commission Staff and were modified by Staff so that health care grants were treated as a specific purpose payment, to be consistent with the current methodology. For comparative purposes, averages are constructed based on the same adjusted single year relativities.

States' find it difficult to forecast large and volatile revenues, which can have a significant impact on the GST distribution. If the Commission was to base an assessment of application year relativities on State's forecasts (or Commission projections) there is a high likelihood that completion payments or adjustments would be required in subsequent years. The use of State forecasts may also create the opportunity for some States to "game" the system for short term advantage.

Tasmania is of the opinion that the methods of 'improving' contemporaneity discussed by the Commission are likely to make it more difficult for Tasmania to manage its budget, rather than improving its management of cyclical cash flows.

If none of the proposed approaches appeals, what approach would your State propose and why?

Rather than changing the GST methodology and subjecting all States to greater volatility and less predictability of GST shares, those States that experience large and volatile own-source revenues should consider putting in place appropriate budget strategies to better manage the consequential impacts upon variability in GST revenues.

Under any contemporaneous approach, should backcasting in its current limited form continue? If so, can/should backcasting be expanded to cover a wider range of Commonwealth payments or other volatile revenues?

Tasmania supports the current approach of backcasting major changes to Commonwealth-State arrangements, where changes can be made reliably and they are material. Noting the Commission's opinion that it would experience considerable difficulties extending backcasting beyond these criteria, Tasmania considers that it would be impractical to backcast minor changes to Commonwealth payment arrangements or State shares.

TREATMENT OF OTHER COMMONWEALTH PAYMENTS TO STATES

Are changes needed to the way other Commonwealth payments will be treated?

Tasmania supports the Commission's current approach to the treatment of all Commonwealth payments. Unless specifically quarantined by instruction from the Commonwealth, or otherwise not assessable because they do not support State services, Commonwealth payments should be included as they are a source of State revenue for equalisation purposes. This is consistent with the Commission's definition of HFE that it provides the States with the fiscal capacity to provide services and associated infrastructure at the same standard.

Tasmania supports the Commission using its judgement after having consulted with the States in assessing whether Commonwealth payments should be treated as included or excluded from its assessment and that, in exercising its discretion, it be guided only by the objective of the GST distribution which is the principle of HFE.

While this places a greater weight on Commission judgement, it also improves the consistency of payment treatment and should, in principle, improve HFE. The annual New Issues Paper provides a forum for each State to present its position prior to the Commission making a judgement in relation to the treatment of any particular Commonwealth payment.

However, Tasmania reiterates its previous concerns regarding the Commission's 2010 Review decision to exclude 50 per cent of Commonwealth payments for National Network Roads projects, and its extension to exclude 50 per cent of Commonwealth payments for National Network Rail project payments in the 2015 Review. While it is acknowledged that such payments can reflect national as well as State specific transport needs, the decision to exclude from equalisation 50 per cent of National Network road and rail projects that are funded by the Commonwealth is arbitrary and may capture funding directed toward State arterial roads which States would have ordinarily built and upgraded using their own funds.

The Commission concluded in the 2015 Review final report that it would be conceptually and practically difficult to develop and implement a framework to identify payments for nationally significant transport infrastructure projects and that the Commission would rely on advice from the Commonwealth Department of Infrastructure and Regional Development to decide which projects and payments related to the national networks.

The Grattan Institute in its submission to the 2017 Productivity Commission Inquiry into HFE, raised the issue of bias in Commonwealth transport infrastructure payments and the GST treatment of National Network projects to the States.

It noted in its submission that:

The special treatment of spending on the National Network is only justifiable if it is limited to nationally important roads and railway lines. The National Network legislation prescribes that it applies to roads and railway lines that connect capital cities, major centres of commercial activity, and/or inter-modal transfer facilities.

But in reality, while there are roads and rail lines on the National Network (that) are certainly important, others in fact carry very little freight or passenger traffic. For instance, the National Network includes the 89-kilometre Princes Highway West, a spur from Geelong to Colac. While Geelong is an important centre of commercial activity, it is hard to see how Colac, with a population of 11,939 and no heavy industry, could qualify as a transport hub or commercial centre. While some traffic from beyond Colac uses this section of road in transporting freight to Melbourne, its total use, measured as vehicle kilometres, is much lower than most other National Land Transport Network roads.²⁹

The Institute concluded that:

...there is clear evidence of biased Commonwealth decisions. Until there is a more disciplined and fair approach to the allocation of Commonwealth transport infrastructure funding, the case is strongest for all relevant payments to be fully included in the assessment of GST shares.³⁰

Tasmania shares the concerns raised by the Grattan Institute and recommends reconsideration of the current partial equalisation approach by the Commission.

Tasmania also reiterates the comments it made in the 2015 Review that the current treatment of Commonwealth Government payments can create volatility in GST distribution when relatively large one-off Commonwealth Government payments are treated by inclusion. While, over the long term, these lumpy capital payments tend to even out, in the short term they can create significant budget flexibility constraints (particularly for a small State). This was particularly relevant for Tasmania with the Commonwealth Government payments for the redevelopment of the Royal Hobart Hospital from 2012.

In the GST Distribution Review's first Interim Report the Panel saw merit in:

...equalising all capital payments over a longer period of time to recognise the lasting nature of the asset being funded and reduce the impact of the payment on GST shares in any one year.³¹

While Tasmania supported this proposition, it was not endorsed by all States. Tasmania remains open to the Commission considering an appropriate methodology to equalise capital payments over a longer timeframe, rather than as a lump sum in the year of receipt. This provides an effective means to reduce single year impacts and better reflects the useful life of the assets that these payments fund. It is acknowledged that this would create methodological issues in terms of the timing and treatment of capital receipts and infrastructure needs, particularly the direct assessment of capital. However, this approach is consistent with Tasmania's argument that capital funding of infrastructure needs to occur over time.

²⁹ Grattan Institute, Submission to the Productivity Commission Inquiry into Horizontal Fiscal Equalisation, 30 June 2017. Section 1.2.1.

³⁰ *ibid.* Conclusion.

³¹ GST Distribution Review Final Report, October 2012. Page 90.

In the 2015 Review, the Commission considered applying a materiality test to the treatment of Commonwealth payments. Tasmania argued that attempting to determine the materiality of individual National Partnership payments, whether on either an individual or grouped-by-category basis, would result in arbitrary outcomes and a diminishment of HFE. A materiality test could also result in Commonwealth funding agreements being structured into smaller agreements to remain under the threshold and thus be exempt from inclusion in a State's revenue capacity.

Tasmania's position has not changed. Rather than assessing each payment for materiality, the Commission should continue to consider all Commonwealth payments in aggregate.

THE ASSESSMENT GUIDELINES

Are changes needed to the assessment guidelines?

Tasmania supports the Commission continuing to be guided by the same set of assessment guidelines for the 2020 Review in implementing HFE as used in the 2015 Review.

The guidelines ensure that the Commission takes a consistent approach in developing assessments and that the assessments are conceptually sound, reliable and as transparent and simple as possible.

Tasmania's comments on the assessment guidelines relating to materiality and discounting were discussed in the Practicality section of this submission.