

Productivity Commission Review into Horizontal Fiscal Equalisation

Submission by the Tasmanian Government in response to
the Productivity Commission's Draft Report

November 2017

KEY POINTS

1. Tasmania is of the view that the Productivity Commission has not been able to demonstrate that Horizontal Fiscal Equalisation (HFE) has been detrimental to the Australian community, economy and State and Territory governments. Its conclusions on these issues are predicated on assertions, not evidence, and if anything, its conclusions point to minimal or positive impact.
2. On the basis of the Commission's own inquiry scope, there is no basis for it to give consideration to alternatives to the current system of HFE. To do so is to effectively exceed the scope of its intended inquiry.
3. Tasmania believes that the Commission's assessment of the alternatives to HFE is inadequate, and that it has not addressed the following important questions in relation to alternative HFE options that it initially posed for itself in the Guidance Note, namely:
 - a) how do they affect States' incentives to pursue higher prosperity?
 - b) how do they perform in terms of efficiency, equity and simplicity? and
 - c) which approach is best for national productivity and wellbeing?
4. Tasmania does not believe that the Productivity Commission has provided sufficient evidence that the current system of HFE has impacted on taxation, and development of mineral resources and policies relating to resource extraction. Despite this lack of evidence, those two arguments form the basis for the Commission's recommended change to HFE.
5. The Commission has not been able to demonstrate that providing more GST to the strongest, or even second strongest, State from the other States provides a greater national economic benefit than the current distribution. In fact, such an outcome may create undesirable economic consequences, particularly in terms of States continuing to erode their collective tax bases.
6. The Commission has not quantified the economic and efficiency impacts of its recommendation that the Commonwealth Grants Commission should be directed to consider approaches to HFE assessment that deliver a 'good enough' equalisation outcome.
7. Tasmania believes that the Commission's findings, and the major recommendations to alter the current system of HFE, are predicated on solving the financial difficulties being experienced by Western Australia, not on improving the current HFE system in terms of efficiency, effectiveness and simplicity. Western Australia knew that its vigorous level of revenue growth was temporary and that its increase in own source revenue would affect its GST payments. It is impossible to avoid the conclusion that the weak current fiscal position that Western Australia now faces was predicted and entirely avoidable.
8. Tasmania has made separate comments on each of the Draft Findings and Draft Recommendations. These are included in this submission in Part B.
9. Tasmania believes there is a number of questions that formed part of the Guidance Note that the Commission has left unanswered. These are set out in Attachment A to this submission.
10. In Attachment B, Tasmania highlights what it expected from the Productivity Commission inquiry, and compares what was achieved against a number of principles for good policy making methodologies, and the approach of the Commission when establishing the methodology for its 5-Year Productivity Review.

INTRODUCTION

Tasmania's response to the Productivity Commission's Draft Report into Horizontal Fiscal Equalisation is approached from two perspectives. Firstly, in Part A, a broad introduction offers comment on the nature of the report, its findings and the lack of evidence to substantiate any claims that HFE, in its current form, has had a negative impact on the Australian economy, productivity and efficiency.

Second, in Part B, comment is provided on each of the Draft Findings and Recommendations.

PART A: TASMANIA'S RESPONSE TO THE COMMISSION'S MAJOR RECOMMENDATIONS

Tasmania is of the opinion that the Commission:

- a) has exceeded the scope of its initially intended inquiry;
- b) has failed to prove that HFE has a negative national economic impact;
- c) has not under-pinned its major recommendation with evidence heavy argument; and
- d) has placed too much emphasis on ameliorating the budget position of Western Australia.

In a public lecture in 2009¹, the former Chairman of the Productivity Commission, Gary Banks, outlined what features comprise a good methodological approach to evidence-based policy making. These included the following:

- a) they test a theory or proposition as to why policy action will be effective - ultimately promoting community wellbeing — with the theory also revealing what impacts of the policy should be observed if it is to succeed;
- b) they have a serious treatment of the 'counterfactual'; namely, what would happen in the absence of any action?
- c) they involve, wherever possible, quantification of impacts (including estimates of how effects vary for different policy 'doses' and for different groups);
- d) they look at both direct and indirect effects (often it's the indirect effects that can be most important);
- e) they set out the uncertainties and control for other influences that may impact on observed outcomes;
- f) they are designed to avoid errors that could occur through self-selection or other sources of bias;
- g) they provide for sensitivity tests; and, importantly
- h) they have the ability to be tested and, ideally, replicated by third parties.

Tasmania does not believe that the findings and recommendations contained in the Draft Report measure up to these evidence-based policy making principles.

¹ ANU Public Lecture Series, *Evidence-based policy making: What is it? How do we get it?* Canberra, February 2009.

The Commission has exceeded its scope of its Inquiry

The Terms of Reference² for the Commission's Inquiry state, among other things, that the Commission was to:

'...consider the effect of Australia's system of HFE on productivity, economic growth and budget management for the States and for Australia as a whole'.

In doing so, the Commission was to consider whether:

- (a) HFE was in the best interests of national productivity;
- (b) HFE restricts the appropriate movement of capital and labour across State borders;
- (c) sufficient consideration is given to the different underlying and structural characteristics of the different revenue bases of each State, particularly in relation to energy and resource development; and
- (d) HFE acts as a disincentive for a State in developing a potential industry, or raising royalty rates for an existing industry.

These over-arching Terms of Reference were expanded by the Commission in its Guidance Note that was used to obtain consistent responses from those parties making submissions to the Inquiry.

On page 39 in its Draft Report, the Commission has articulated that its Terms of Reference can be addressed by responding to two broad issues:

First, how does the current HFE system impact the Australian community, economy and State and Territory governments?

- What are the effects on economic activity, national productivity, incentives for State revenue and expenditure reforms, and on States' budgeting activities? Does HFE produce disincentives for States to develop a potential industry (particularly in energy or resources) or to alter tax arrangements for an existing industry?
- Does HFE restrict the appropriate movement of capital and labour across State borders to more productive regions during times of high labour demand?

Second, what preferable alternatives are there, if any, to the current HFE system? What improvements could be achieved by changing particular aspects of the existing system?

- How do other federations internationally approach fiscal equalisation, and how might those different approaches translate to the Australian context?

Tasmania considers that the clear implication of the first issue is that the Commission must initially demonstrate that the impact of the current system of HFE has been detrimental to the Australian community, economy and the State and Territory governments before it can address the second issue and propose 'preferable' alternatives.

² Commonwealth Treasurer, *Terms of Reference: Productivity Commission Inquiry into HFE*, May 2017, pages 1-2.

Tasmania further considers that if the Commission was able to demonstrate that HFE was detrimental to the Australian community, economy, and the State and Territory governments, it would then need to clearly demonstrate that any alternatives to the current system of HFE were materially better over the short and long term.

Putting to one side the difficulty of assessing the current system of HFE against the counterfactual, Tasmania contends that the Commission has not been able to demonstrate that HFE has been detrimental to the Australian community, economy, and State and Territory governments.

Nevertheless, the Commission has considered alternatives that have not been adequately assessed against the current HFE system to demonstrate whether they are in fact superior. That is, the Commission should have answered:

- how do the alternatives affect States' incentives to pursue higher prosperity?
- how do the alternatives perform in terms of efficiency, equity and simplicity? and
- which approach is best for national productivity and wellbeing?

Tasmania does not believe that the Commission has proven that the current system negatively impacts on productivity, efficiency and growth. Rather, it merely asserts that, because it is technically possible under the Commonwealth Grants Commission's (CGC) revenue assessments that HFE could discourage major tax reform or mineral/energy development, it should be changed. However, it could find no evidence that this has actually occurred.

Figure 1 lists the various economic issues that the Commission investigated and discussed in the Draft Report, and what its findings were in relation to each of those issues. In nearly all instances, the evidence is that negative impacts are unlikely, difficult to prove or produce no direct evidence.

Despite this, the Commission makes a 'leap of faith'

FROM: providing no evidence of HFE being a negative influence

TO: recommending a major adjustment to the HFE process that it fails to assess in terms of efficiency, productivity or equity.

The Commission has failed to demonstrate that HFE has a negative impact

Out of all the issues considered by the Commission, there is no evidence of any negative impact that can be attributed to the current HFE process. In those two instances where the Commission has inferred that HFE has the potential to impact negatively - tax reform and the development of mineral resources, and policies relating to resource extraction - there is, according to the Commission, **little direct evidence or no direct evidence** of HFE being a direct negative influence. Tasmania agrees there is insufficient evidence. The lack of evidence therefore does not support the Commission's findings on these two issues.

Figure 1: Evidence of Draft Findings

DOES THE CURRENT HFE PROCESS NEGATIVELY IMPACT ON:	FINDING	JUSTIFICATION
ECONOMIC GROWTH AND PRODUCTIVITY	UNLIKELY	HFE is unlikely to discourage — nor encourage — States from pursuing growth strategies or addressing their structural disadvantages given the broader and more significant benefits of doing so to the community (p106).
MOVEMENT OF LABOUR AND CAPITAL	UNLIKELYthe GST distribution and net fiscal benefits are unlikely to be a significant driver of interstate movement of people (p141).
POTENTIAL POLICY REFORM	DIFFICULT TO PROVE	It is difficult to conclusively link HFE to specific State behaviour on the expenditure side, as GST effects are likely to be just one of many factors that States consider when pursuing reform (p104).
EFFICIENT DELIVERY OF STATE SERVICES	UNLIKELY	...the current HFE system is unlikely to materially distort State incentives to provide public services cost effectively (p102).
EFFICIENT INFRASTRUCTURE DEVELOPMENT	NO EVIDENCE PROVIDED	Not specifically addressed.
STATE TAXATION REFORM	NO DIRECT EVIDENCE	Though there is no direct evidence that GST effects have played into specific policy decisions in the past, this in itself is not proof that GST effects do not and will not influence State policy (p100).
DEVELOPMENT OF REVENUE BASES AND TAX RATES		
STATE POLICIES TO FACILITATE, RESTRICT OR TAX THE DEVELOPMENT OF RESOURCES	POTENTIAL, BUT LITTLE DIRECT EVIDENCE	While there is little direct evidence that GST effects have influenced past royalty policy decisions, there are likely to be strong incentive effects at the margin, especially in the context of a mining boom (p109).
STATE POLICY CHOICES RELATING TO RESOURCE EXTRACTION	POTENTIAL, BUT NO DIRECT EVIDENCE	While there is no direct evidence that GST effects have influenced specific policy decisions, the incentive effects are large and have the potential to undermine State policy neutrality over time (p115).

(a) Tax reform and mining royalty policy

In relation to State tax reform, the Commission argues:

'Though there is no direct evidence that GST effects have played into specific policy decisions in the past, this in itself is not proof that GST effects do not and will not influence State policy. In other words, an absence of evidence is not evidence of absence.' (p100).

Tasmania would argue that 'an absence of evidence is not evidence of absence' is not a sufficiently sound justification for recommending a change to the current HFE system that would see most States receive significantly less GST, with a major redistribution to the fiscally strongest State.

In any event, 'absence of evidence' is more than likely to be 'evidence of absence'. The absence of evidence, or the failure to observe evidence that supports a hypothesis, is in all probability evidence against that hypothesis. This is because we are significantly more likely not to see evidence for a hypothesis when it is false than not to see it when it is true. The idea is often incorrectly summarised as absence of evidence is evidence of absence³.

If HFE had acted as a disincentive to tax reform, States would not have been observed undertaking tax changes that would result in a reduction in their GST share. However, there is evidence that this has been the case. One major example is the 2010-11 decision by the Western Australian Government to increase its royalties on iron ore fines despite the fact that it would have had the effect of reducing its GST share by more than the royalty revenue it received.

More recently, the Western Australian Government announced in its 2017-18 Budget that it would introduce a tiered gold royalty rate. From 1 January 2018, this measure would have seen the royalty rate gold producers pay be determined by the Australian dollar price of gold. The royalty rate would have increased from 2.5 per cent to 3.75 per cent when the price was above \$A1 200 an ounce. It was expected to deliver an additional \$392 million in royalty revenue over the four years to 2020-21. This is despite the fact that this measure would also have resulted in a reduction to Western Australia's GST share.

Governments make a wide-range of policy decisions, regardless of negative GST consequences. 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.

The Commission itself provides an example on page 95 of its Draft Report of the reverse of this response to potential GST impacts:

'There are also examples of States not pursuing efficiency-enhancing reforms even where these would be associated with an increase in GST payments. One example is the NSW Government's decision not to replace insurance taxes with higher payroll taxes, despite its own Financial Audit recommending this in 2012 (Brumby, Carter and Greiner 2012b, p. 36).'

³ This quote is generally attributed to Martin Rees, an English cosmologist and astrophysicist. It is used as a quote in the study by Bernard M Oliver and John Billingham entitled *Project Cyclops: A Design Study for Detecting Extraterrestrial Intelligent Life* (1971), presumably to support the objective of finding extraterrestrial life despite on-going argument to the contrary. Kim Oyhus, a Norwegian physicist and programmer from the Norwegian University of Science and Technology, is of the contrary view that the more that statements are made that cannot be supported by evidence, the more the lack of evidence confirms that the statement is wrong. Oyhus uses Bayesian probability to demonstrate his argument. Oyhus's conclusion is that every time something is not observed, the more likely it is to be untrue. This is the reason why people with claims should justify their claims themselves, because if one claims something without evidence, that is evidence of being wrong. A later version of this proof was produced by Oyhus in 2007. (*Absence of evidence is evidence of absence*. Kim Oyhus 2004, and <http://kim.oyhus.no/AbsenceOfEvidence.html>).

Successive Western Australian Governments have chosen not to introduce electronic gaming machines (EGMs) into venues other than casinos. This is in the knowledge that under the CGC's revenue assessment, gambling revenue is not equalised and so the revenue from EGMs would not affect Western Australia's GST share. The GST distribution is not a disincentive to implementing this new source of revenue and, therefore, it is clear that other policy objectives have been the driver of successive Government positions on EGMs in Western Australia.

These examples demonstrate, without doubt, that considerations other than the distribution of GST influence the design of State taxation and revenue raising measures.

The GST Distribution Review Panel found⁴:

'Nevertheless, a number of factors other than changes in GST shares drive State tax policy decisions.'

It also found:

'The significance of changes in GST shares to State tax policy decisions is probably diminished further by the delay in changes to GST being felt because of the lag, any change in GST will not occur until several years after a tax policy change has been implemented. Examining the empirical evidence, States do not necessarily appear to act in accordance with the apparent GST share incentives. Ultimately, there is no hard evidence on whether GST share effects influence State tax reform decisions. The Panel doubts that GST share effects are a very powerful factor when States are considering tax reform.'

The Commission's Cameos

The Commission has presented two hypothetical reform cameos in an attempt to show how GST payments can be affected by changes in State policy. The two cameos are:

- (a) the introduction of a broad based land tax to replace 50 per cent of revenue from stamp duty on property (pages 237-243); and
- (b) the introduction of a congestion tax (pages 243-246).

The Commission argues that HFE creates a potential disincentive, and is therefore a barrier to efficient tax reform. It cites switching stamp duty on property for a broad based land tax, and introducing a congestion tax as examples of efficient tax policy that could be advanced if there was no such barrier.

Tasmania considers that the two tax reform cameos present an overly simplistic view of the impacts of tax reform on GST payments. The cameos only depict a single-year impact on GST payments (and corresponding annual relativities) and they do not account for implementation issues, such as transitional arrangements. Rather, they depict the ongoing annual impact on State budgets once a reform is fully in place.

In the case of stamp duty reform, the Commission has illustrated that switching stamp duty for land tax can potentially reduce a State's GST, thereby acting as a barrier to this type of tax reform.

Tasmania acknowledges the widely considered view that good taxation design involves replacing inefficient taxes with broader, more efficient tax bases. However, Tasmania considers that while, hypothetically, the GST distribution could be perceived as a barrier to tax reform, more significant barriers than GST distribution exist including the complexity of implementing such changes and the impacts on taxpayers.

⁴ GST Distribution Review, Final Report, October 2012, page 136.

Tax reforms are complex largely because they move the burden of paying taxes from one group of taxpayers to another and can have significant impacts on the cost of living for families. Tax reforms may also reduce own-source revenues for State Governments, particularly throughout any transition phase associated with that reform and any offsetting compensation that must be paid.

For this reason, while *Australia's Future Tax System - Report to the Treasurer - December 2009* (the Report) stated that 'the Australian Government should consider facilitating a transition away from stamp duties, reflecting the national benefit of reforms to State taxes and the quality of the Australian Government tax base'. It also noted that any such transition would be challenging.⁵

The Report stated that transitional mechanisms are most likely to be effective when they reflect agreement between the Australian Government and all the State Governments, recognising that the Australian Government has access to larger and more efficient tax bases with which to finance revenue shortfalls. In deciding on an acceptable transition mechanism, the Report further noted that it would be necessary to strike a balance between revenue cost, complexity of design and the extent of shift in policy.⁶

The Report also noted that, in relation to such tax reform, '*transitional arrangements are important to build community acceptance and to minimise potential disruption*' and that '*any special transitional arrangements to a broader land tax regime should be limited to existing owners.*'⁷

Tasmania considers that all of these issues would be at the forefront of a State tax review into a broad based land tax and are more likely to drive recommendations than consideration of the impact on GST distribution. Indeed, other than the ACT, no States have moved to implement such tax reform and in the ACT's case, the reform will occur within a very long transition period of 20 years.

Given this, any GST benefits of this reform, if they were to eventuate, would only occur after a significant period of time. In Tasmania, there are further key demographic characteristics that would also present a challenge to broad tax reform. Such characteristics range from average wages in the State to the features of Tasmania's property market. These characteristics would again be considered well ahead of any GST impact.

The Commission also argues that HFE is a potential barrier to the introduction of new efficiency enhancing tax reform such as congestion charging. A congestion tax is taken to mean a tax or charge imposed on road users within designated congested areas. There are already congestion levies on parking within the Sydney and Melbourne CBDs. A congestion tax is a new alternative to existing parking levies.

The Commission acknowledges that the impacts on GST shares are much more modest in this example with the impacts of multilateral reform being higher than for unilateral reform.

The Commission's illustrative example shows that the States most likely to introduce a congestion tax, New South Wales (NSW) and Victoria, actually increase their GST share by \$69 million and \$6 million respectively if each acted alone to introduce the tax, or \$214 million and \$23 million respectively if it is adopted nationally. This demonstrates that these States would receive both additional tax and GST from implementing a congestion tax, yet they have not done so. Clearly, HFE is not the barrier currently impeding the introduction of a congestion tax in these States.

⁵ The Treasury, *Australia's Future Tax System - Report to the Treasurer*, December 2009, page 263.

⁶ Op cit page 268.

⁷ Op cit. page 267

In addition, the Commission refers to estimates by the NSW Government that congestion pricing in Victoria would result in that State receiving \$900 million in additional revenues that would be offset by \$22 million in forgone GST payments. This example demonstrates that the Victorian Government would be \$878 million better off through the introduction of the tax, so clearly the GST impact is not the key deterrent preventing the introduction of the tax in that State.

It is far more likely that community considerations, such as impacts on the costs of living for working families and political considerations regarding introducing a 'new' tax, take precedence over any GST considerations, noting to date that governments have resisted calls to introduce such measures when the issue has been raised.

Most recently, the Grattan Institute's October 2017 Report entitled *Stuck in traffic? Road Congestion in Sydney and Melbourne*⁸ recommended, among other things, establishing network-wide time-of-day congestion charging. Both the NSW and Victorian Governments were quick to reject the proposal. NSW Acting Roads Minister Andrew Constance was reported as saying "This government will not be introducing a congestion tax"⁹ while Victoria's Roads Minister Luke Donnellan said "We have no plans to introduce a congestion charge of any kind"¹⁰.

It is highly unlikely that the impacts of the GST distribution were forefront in their minds when making such statements.

Tasmania concludes that it would be highly unlikely that a change to the definition of HFE as recommended by the Commission in its Draft Report would see the States, without hesitation, implement major tax reforms whether they be a broad-based land tax, a congestion tax or other tax reform.

(b) Mineral and energy development

In examining the issue of whether HFE influences States' policy on developing mineral and energy resources, the Commission notes that:

- States may be discouraged from developing or approving contentious mining or other activity because they would bear the full political cost but retain only part of the revenue benefits after equalisation (page 111);
- the distortions arising from the treatment of resource restrictions could have large financial implications for some States, especially over the long term. Although the policy counterfactual is unobservable, the fiscal incentives that arise through HFE are likely to distort policy decisions at the margin (page 113); and
- States may have a stronger incentive to rely on taxes that the CGC does not differentially assess (such as gambling, user charges, fines and licensing fees) rather than those which it does (such as mining royalties and land taxes) (page 113).

⁸ Grattan Institute, *Stuck in traffic? Road congestion in Sydney and Melbourne*, October 2017.

⁹ News.com.au. 2017. Sydney congestion tax won't work: expert. [ONLINE] Available at: <http://www.news.com.au/national/breaking-news/sydney-congestion-tax-wont-work-expert/news-story/1e61e6249ea2474fb483f3f4a5346828>. [Accessed 2 November 2017].

¹⁰ The Age Online. 2017. Call for driver charge to ease Melbourne's peak-hour traffic. [ONLINE] Available at: <http://www.theage.com.au/victoria/call-for-driver-charge-to-ease-melbournes-peakhour-traffic-20171002-gysva6.html>. [Accessed 2 November 2017].

Based on these viewpoints the Commission comes to the conclusion that:

'The potential for HFE to distort State policy is pronounced for mineral and energy resources. While there is no direct evidence that GST effects have influenced specific policy decisions, the incentive effects are large and have the potential to undermine State policy neutrality over time.' (page 115).

This finding is similarly based on the Commission's previous finding on the perceived influence of HFE on tax reform (discussed above). That is, because HFE could influence State policy, it therefore must be an impediment to action. Tasmania does not believe that the conclusion reached by the Commission has sufficient evidence to underpin it.

Tasmania's position on this issue is also supported by other submissions made to the Commission's initial Guidance Note that have argued that HFE has not discouraged States from pursuing mineral and energy development. For example:

The South Australian (SA) Government argued in its submission that¹¹:

'The South Australian Government has actively pursued expansion of mining through investments in geological mapping and creating regulatory certainty – even though additional royalties would be shared with other states through HFE.'

'South Australia actively pursued the expansion of the Olympic Dam mine through creation of inter-departmental task forces, accelerated environmental assessment processes and other streamlined approval processes. Ultimately a decision was made by the private sector not to pursue expansion at this stage due to lower commodity prices. HFE was not a significant consideration in this process.'

More recently, on 24 August 2017 the SA Government¹²:

'...welcomed OZ Minerals' decision to invest \$916 million in Carrapateena, Australia's largest undeveloped copper project. The Carrapateena project will create up to 1,000 new jobs in regional South Australia during the construction and operation phases of its 20-year plus mine life as well as opportunities for Aboriginal employment and supply contracts in the Upper Spencer Gulf. SA's Plan for Accelerating Exploration (PACE) funding was crucial to the discovery of Australia's largest undeveloped copper deposit and the Government has continued to support this major project through our Copper Strategy. Approvals for the project are expected to be completed by the end of the year and the project would be worth \$30 million in royalties annually.' Source: Government of South Australia, Department of Premier and Cabinet, News Release 24 August 2017.

Clearly, the SA Government is not deterred from sharing some of its royalty revenue with other States through the current HFE process.

The Australian Chamber of Commerce and Industry commented in its submission¹³:

'There has been speculation that some governments have introduced state-based laws banning certain mining activities on the basis of HFE rules. Our analysis suggests there is no evidence that decisions on resource exploitation are influenced by HFE distribution effects.'

¹¹ South Australian Government, *Submission to Productivity Commission Inquiry into HFE*, June 2017, page 5.

¹² Government of South Australia. 2017. OZ Minerals approve \$916 million investment in major copper project. [ONLINE] Available at: <https://www.premier.sa.gov.au/index.php/jay-weatherill-news-releases/7947-oz-minerals-approve-916-million-investment-in-major-copper-project>. [Accessed 2 November 2017].

¹³ Australian Chamber of Commerce, *Submission to the Productivity Inquiry into Horizontal Fiscal Equalisation*, June 2017, page 5.

'...There is also the broader question as to why the impact of GST distribution, assuming there was one, would only affect decisions on resources and not all industries. Taken to its logical conclusion, questions could also be raised on whether HFE distribution prevents a state utilising its land mass for other revenue raising purposes.'

The Australia Institute noted in its submission that¹⁴:

'All states have well-established mining industries and mineral exploration has been undertaken by public and private sector organisations for decades or centuries. New discoveries and developments are likely to be marginal additions to the existing minerals industry and marginal additions to existing royalty revenue streams. Given this, it is extremely unlikely that state governments would restrict development of resource projects due to HFE changes. Aside from the dubious logic of doing so, state governments would have to overcome powerful lobbying from resource industries to pursue such policies, something few Australian governments have ever been willing to do.'

'In our experience, the idea of redistribution of revenues through the Commonwealth Grants Commission system rarely enters the thinking of state governments. We have never seen an example of this reasoning in state government agency submissions or public statements on planning processes despite extensive experience.'

The NSW Business Chamber submission noted that¹⁵:

'A related claim is that the current system provides significant disincentives for resource development because jurisdictions would lose a portion of GST for additional royalties that could be raised upon developing that resource. There are several deficiencies with this argument:

- 1. Decisions regarding resource development are not made on the basis of GST distribution but rather threshold issues associated with economic development, environmental impacts, and broader political considerations.*
- 2. Conceptually this argument can be applied to any industry. It is equivalent to arguing that a jurisdiction has no incentive to implement a combination of policies which would promote an industry (such as tourism, financial services or manufacturing) because it would lose a portion of GST as it collects more payroll tax. It therefore becomes a theoretical argument which has no natural limit or counterfactual upon which to base.*

...Ultimately arguments supporting fundamental changes in the treatment of mining royalties boil down to arguing that residents of resource rich jurisdictions should benefit more from those endowments than residents of other jurisdictions. This is a difficult proposition to justify in the context of a federated commonwealth.'

While State Governments do influence mining development in their States through financial support, regulation, the setting of royalty rates, energy supply, infrastructure and regional development, by far the greatest factors that determine whether a mineral development proceeds are the State's resource endowment, the economic viability of extraction, and commodity prices. These latter factors are outside the control of State Governments and so there is no case to argue that HFE is a major disincentive to State Governments developing their mineral and energy resources. Clearly the ACT could not be criticised for not having a thriving mining industry and nor could it be argued that HFE was a factor in that scenario.

¹⁴ The Australia Institute, *Inquiry into Horizontal Fiscal Equalisation Submission*, June 2017, page 5.

¹⁵ NSW Business Chamber, *Submission to the Productivity Commission's Public Inquiry*, June 2017, pages 7-8.

Tasmania therefore disagrees with the Commission’s conclusions and strongly argues that it has been unable to demonstrate that a change to a lesser form of HFE can improve national efficiency, productivity or growth. The Commission merely asserts that it can.

The Commission’s major recommendation is not under-pinned by comprehensive ‘evidence heavy’ argument

The Commission’s major recommendation is that the objective of HFE should be to aim for reasonable rather than full equalisation. The impact of this recommendation is illustrated with two alternatives for less than full equalisation - equalising to the average of all States, and equalising to the second strongest State. In both cases there is a large redistribution to the strongest States - NSW (Tasmanian modelling shows this from 2018-19 onwards) and Western Australia (from 2017-18 onwards) when equalising to the average of all States, and Western Australia only (from 2017-18 onwards) when equalising to the second strongest State.

Tasmania finds it disturbing that such a significant finding and resultant recommendation are not underpinned by a greater degree of comprehensive qualitative and quantitative evidence. There is no analysis provided by the Commission as to how its recommended change in GST distribution will enhance national prosperity or economic efficiency. It assumes that \$100 of additional GST revenue spent in Western Australia will produce a better economic outcome than \$100 spent in another State.

The major Draft Finding (2.1) and Draft Recommendation (2.1) are ones that will have far-reaching and long-term impacts on the financial capacity of Tasmania and other States. They suggest that alternative HFE distributions based on equalising to less than the strongest State - either by equalising to the average of the States or equalising to the second strongest State - are foremost in the mind of the Commission.

The Commission itself estimates that such a change would result in Tasmania losing \$168 million if the change to the average of the States was implemented in 2017-18, or \$77 million if the change to equalising to the second strongest State was implemented in 2017-18. Tasmanian Treasury modelling using information obtained from the CGC provides an estimate of the on-going impact of these proposed changes to the distribution system.

Equalise to the Average fiscal capacity - impact compared to current CGC distribution

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
2017-18	- 110	- 972	-1 588	3 602	- 557	- 168	- 130	- 79
2018-19	920	-1 079	-1 468	2 484	- 512	- 154	- 120	- 72
2019-20	1 497	- 868	-1 509	1 757	- 524	- 156	- 123	- 74
2020-21	1 639	- 757	-1 570	1 595	- 543	- 161	- 128	- 76
Total	3 946	-3 675	-6 134	9 439	-2 135	- 639	- 501	- 301

Equalise to the second strongest state - impact compared to current CGC distribution

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
2017-18	-1 167	- 920	- 729	3 244	- 256	- 77	- 60	- 36
2018-19	- 697	- 552	- 434	1 937	- 152	- 45	- 35	- 21
2019-20	- 401	- 319	- 250	1 114	- 87	- 26	- 20	- 12
2020-21	- 334	- 267	- 207	928	- 72	- 21	- 17	- 10
Total	-2 599	-2 057	-1 620	7 224	- 565	- 170	- 132	- 80

Source: Commonwealth Grants Commission and Tasmanian Treasury modelling

Tasmania believes that it would be inequitable to provide Western Australia with a significant increase in GST in addition to its current strong revenue capacity. For example, Western Australia (and NSW under the average fiscal capacity approach) could increase services beyond all other States, or decrease taxes and own source revenue, or both. This could provide Western Australia with the potential to undertake significant reductions in its taxation in an attempt to attract businesses from the Eastern seaboard. This would not be a desirable outcome. The additional revenue diverted to Western Australia by equalising to the average fiscal capacity or equalising to the second strongest State would - at the extreme - have the potential to allow that State to reduce its payroll tax severity by 55 and 70 per cent, respectively¹⁶.

The implications of this would be significant for businesses in the Eastern States, with a potential for companies to move their centre of location to Western Australia as they seek out and assess the implications of lower taxation benefits. The Commission's own proposal would potentially result in movement of capital and labour and result in incentives to change taxes. It has been this 'beggar thy neighbour' approach that has contributed to the erosion of the States' collective tax bases over the years and previous inquiries have pointed out the disadvantages of overly aggressive tax competition in relatively mobile tax bases.

This would seem at odds with the Commission's own finding (Finding 2.1) that articulates that a change to the objective of HFE to a reasonable standard should be pursued to the greatest extent possible, provided that it, among other things, 'does not unduly hinder efficient movement of capital and people between States' (page 25).

The CGC, in its submission to the Commission Draft Report, is obviously concerned at these potential implications and it suggests that such a system would create a different playing field for the advantaged State, which would attract what it calls a 'strong State premium'¹⁷.

The CGC sees this 'strong State premium' effect as having a number of consequences that would exacerbate the fiscal strength of those other States that are treated differently to the strongest State. The CGC stated that: ¹⁸

'...under this proposal, the fiscally strongest State would receive more than it requires to provide the average level of service. If it remained the fiscally strongest State over the intermediate term, it would be able to:

¹⁶ Based on a forecast 2017-18 revenue of \$3.224 billion.

¹⁷ CGC, *Submission on the Draft Report from the Commonwealth Grants Commission (CGC 2017-22)*, October 2017, page 5.

¹⁸ Op cit. page 6.

- a) *provide services in excess of the average; and/or*
- b) *provide services of a higher quality than the average; and/or*
- c) *levy lower than average own-source taxes and charges; and/or*
- d) *retire debt at a faster rate than other States.'*

The Commission has not been able to demonstrate that providing more GST to the strongest, or even second strongest, State from the other States provides a greater national economic benefit than the current distribution. As noted, is a dollar of additional GST nationally more productive in the hands of the strongest States than the weaker States? This has not been demonstrated. Tasmania would argue that there could be greater benefits if it remained with the weaker States by enabling them to improve their productivity through equitable access to national standards of health and education services.

In addition to equalising to the average of all States or the second strongest State, the Commission also recommends that the Commonwealth Government should direct the CGC, through the Terms of Reference it receives, to consider approaches to HFE assessment that deliver significant simplification and 'good enough' equalisation outcomes. The Commission believes that the use of more highly aggregated assessments should receive detailed consideration as part of the current CGC process.

If this recommendation was also adopted, it would further disadvantage the smaller States, as greater simplification will lead to a higher proportion of GST being distributed on an EPC basis. The Commission has not attempted to quantify what the impacts of this simplified process would be.

The GST Distribution Review panel found¹⁹:

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

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

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

In addition, the CGC's Terms of Reference²⁰ for the 2020 Methodology Review already contains a requirement to consider simplification of its methods. In this respect, the CGC, in reviewing the methodology underlying its assessments, should:

- a) aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data;
- b) use the latest available data consistent with this; and
- c) ensure robust quality assurance processes.

¹⁹ GST Distribution Review, *Final Report*, October 2012, page 57.

²⁰ Commonwealth Treasurer, *Terms of Reference - 2020 Methodology Review*, November 2016, pages 1-2.

Tasmania notes that the existence of complexity in legislation relating to law, superannuation, and energy policy, to name a few, does not lead to the inevitable conclusion that simplification will lead to better outcomes. The GST distribution process is complex, and understandably so, given the importance of the process in ensuring the highest degree of fiscal equity between the States and the significant amount of revenue distributed. In many respects it is no more complicated than the methodology used to distribute health and education grants where recognition is also given to such factors as location, socio-economic disadvantage and indigeneity.

Further, complexity does not mean more expensive. Of the \$62.7 billion of GST funds expected to be distributed to the States in 2017-18, only \$6.2 million is appropriated to fund the CGC in 2017-18. To put this in perspective, the Australian Energy Regulator, which oversees the National Electricity Market and wholesale gas markets that have a combined annual turnover of over \$9 billion, had an operating budget of \$40.7 million in 2016-17.

The Commission's findings place too much emphasis on ameliorating the financial position of Western Australia

In recent times the system of HFE has had to respond to volatile State revenues, such as the rapid growth in mining royalty revenue in Western Australia, which has seen large GST redistributions from this fiscally strong State. The Commission concludes that:

'...equalisation is taken too far; equalising comprehensively and to the fiscally strongest State means that, when there is an outlier, the redistribution task is considerable and the standard being equalised to is potentially volatile.' (Page 16).

It recommends instead that HFE be defined to aim for 'reasonable' rather than 'full' equalisation.

Tasmania does not agree with the Commission that, because the current system of HFE is comprehensive, it is therefore in some way deficient. Rather, it is a strength of the system and it is what supports equity between the States. Tasmania regards HFE's strength to be its capability of maintaining equal fiscal capacity between the States during periods of uneven economic activity. This ensures that the fiscal capacity between States does not diverge excessively, potentially leading to greater inequality. It is also a misnomer to describe the current system as full HFE as the CGC already applies limits to its methodology by the use of discounts, ignoring immaterial assessments and erring on the side of caution using EPC where assessments prove to be problematic.

In this respect, the findings and recommendations of the Commission place too much emphasis on ameliorating the offsetting GST impacts where the fiscal capacity of Western Australia has strengthened significantly from the national average because of a dramatic increase in its own source revenue from mining royalties in the decade through to 2014-15. Through the *Intergovernmental Agreement* that came into effect on commencement of the GST on 1 July 2000 and subsequently reiterated in the *Intergovernmental Agreement on Federal Financial Relations* that replaced it from 1 January 2009, all States and the Commonwealth agreed that the GST pool would be distributed between the States on the basis of HFE.

As a signatory to these IGAs and as a member of the Australian Federation, Western Australia has both committed to, and benefitted from, the HFE distribution of GST (and the prior financial assistance grants).

Through the fortunate abundance of natural resources within its State boundaries, Western Australia was able to take advantage of world demand for these minerals and reap the unprecedented economic benefits of the recent mining boom. As a result, Western Australia has had, and will continue to have, extremely high mining royalty revenues compared to other States. HFE balances this out by allocating it a smaller share of GST grants.

As raised in Tasmania's initial submission, while Western Australia has recently been experiencing both a decline in its GST share and falling iron ore royalties, it benefited from the lagged assessments when iron ore royalties were rising rapidly and its GST had yet to fully adjust downwards to reflect its higher royalty income. The CGC has estimated that Western Australia benefited by about \$7 billion in additional GST from 2010-11 to 2013-14 because the overall assessments including that for mining revenue are lagged compared to a fully contemporaneous assessment.

The period when Western Australia was experiencing rapid increases in its royalty revenue, its GST share had yet to adjust to offset this, meaning that the State had significant cash surpluses over the period. Much of this was spent on higher recurrent expenditure on wages and salaries, services and infrastructure.

The fact that Western Australia now finds itself in a difficult financial situation is not the fault of HFE or the GST distribution method. When downgrading Western Australia's Aa1 credit rating outlook from stable to negative in June 2015, Moody's noted that as iron ore and other commodity prices spiked to record highs in 2013, along with adjustments to the royalty rate, Western Australia's reliance on this volatile source of revenue grew from 8.4 per cent of income in 2006-07 to 21.6 per cent in 2013-14. Moody's noted that, at the same time, these windfalls fuelled a rapid rise in recurrent expenditures, with significant enhancements to healthcare, education and justice services resulting in deficit operations during a period of strong economic growth.

The lagged GST assessment and the decline in Western Australia's share were predictable and well known by the Western Australian Government. In its 2011-12 Budget, the Western Australian Government forecast that its relativity would reduce from 0.72 in 2011-12 to 0.33 in 2014-15, with a corresponding significant decline in GST revenue. Despite this, the Government announced, in its Budget, unprecedented levels of expenditure on infrastructure funded through borrowings.

As stated by the Western Australian Treasurer, Hon Christian Porter in his 2011-12 Budget Speech to Parliament²¹:

'What we reasonably anticipate is that in 2013-14 the CGC will have brought in a new GST system. We expect it will produce a floor of around 75 per cent of our population share of the GST. Therefore we expect revenue of \$1.8 billion in 2013-14 and \$2.5 billion in 2014-15. These amounts will allow for reduced borrowings and will be used to progressively reduce existing debt to less than \$18 billion while maintaining strong infrastructure spending.

If that change does not occur in that year, the State Government will then have no choice but to wind back infrastructure investment to decrease debt.'

However, the GST distribution was not changed (for sound reasons) and so as a result of those unrealistic assumptions, and its failure to respond to known changing circumstances, the Western Australian Government's financial position has deteriorated significantly.

²¹ Western Australian Government, *Budget Speech 2011-12*, May 2011, page 3.

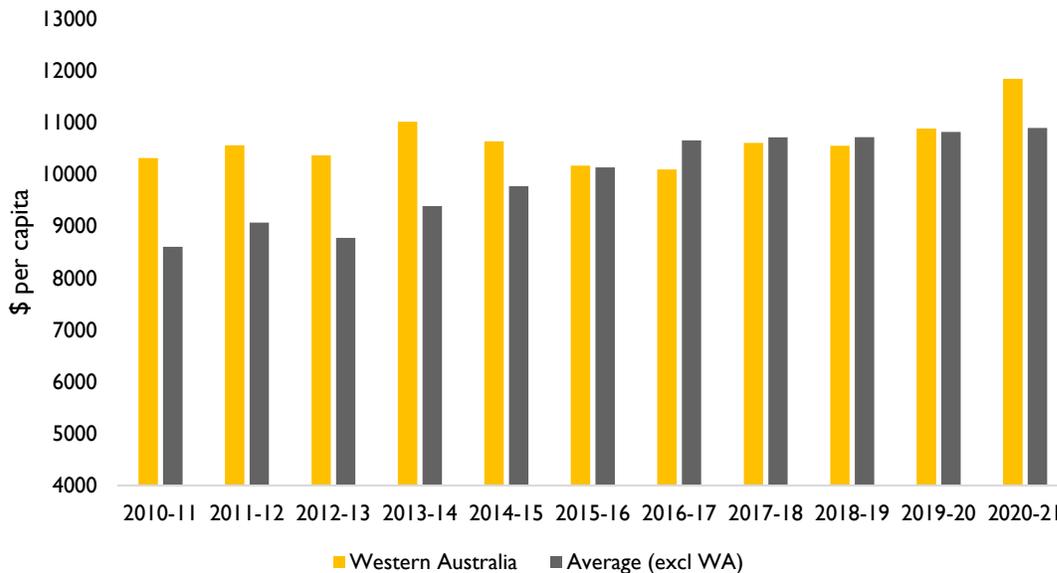
As Saul Eslake has observed²²:

‘Western Australia has behaved like a pensioner who has won the lottery, and starts complaining about no longer being eligible for the pension and having to pay income tax instead. Now it has in effect spent the lottery winnings, it wants its income tax payments refunded and to go back on the pension.’ The Mercury Newspaper. (16 August 2016).

However, even as Western Australia’s GST share has fallen sharply to around 0.3 of an equal per capita share as a result of its large increase in mining royalties, when taking into consideration all other income, it has remained at above per capita total revenue compared to the national average.

Western Australia’s above average total and own source revenue from 2010-11 to 2020-21 is shown in Figure 1A. Despite the decline in its GST share, its total revenue per capita remained higher than the average of other States until 2016-17. However, its total per capita revenue is forecast to once again exceed the average in 2019-20 and 2020-21, largely due to the lagged effect of GST distribution.

Figure 1A: Total revenue per capita, Western Australia and an average of all States (excluding WA)



Adopting the Commission’s recommendation of equalising to the second highest fiscal capacity would see Western Australia’s total revenue per capita significantly exceed the average of all other States from 2017-18 onwards, as illustrated in Figure 1B. Equalising to the average of the States would produce a similar result, as illustrated in Figure 1C. Both these alternatives result in an outcome that cannot be considered equitable, and stray significantly from the core objective of HFE.

²² Eslake, S. (2016). *WA wasted its boomtime revenue and now it wants more.* [online] Themercury.com.au. Available at: <http://www.themercury.com.au/news/opinion/talking-point-wa-wasted-all-its-boomtime-revenue-and-now-it-wants-more/news-story/952b2bb5910f44323519a923e5afc5db> [Accessed 2 Nov. 2017].

Figure 1B: Total revenue per capita, equalising to the second highest fiscal capacity, Western Australia and an average of all States (excluding WA)

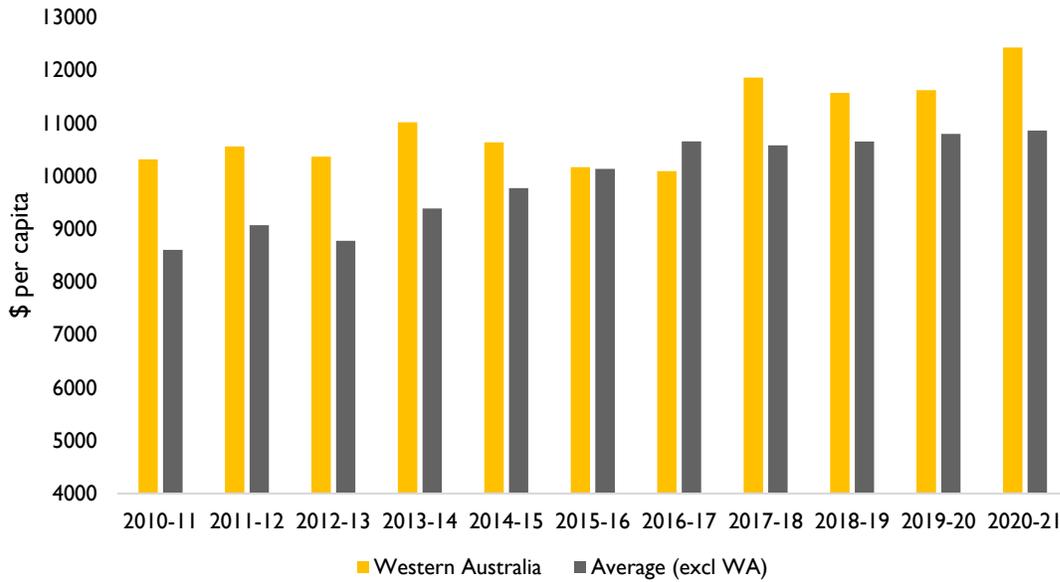
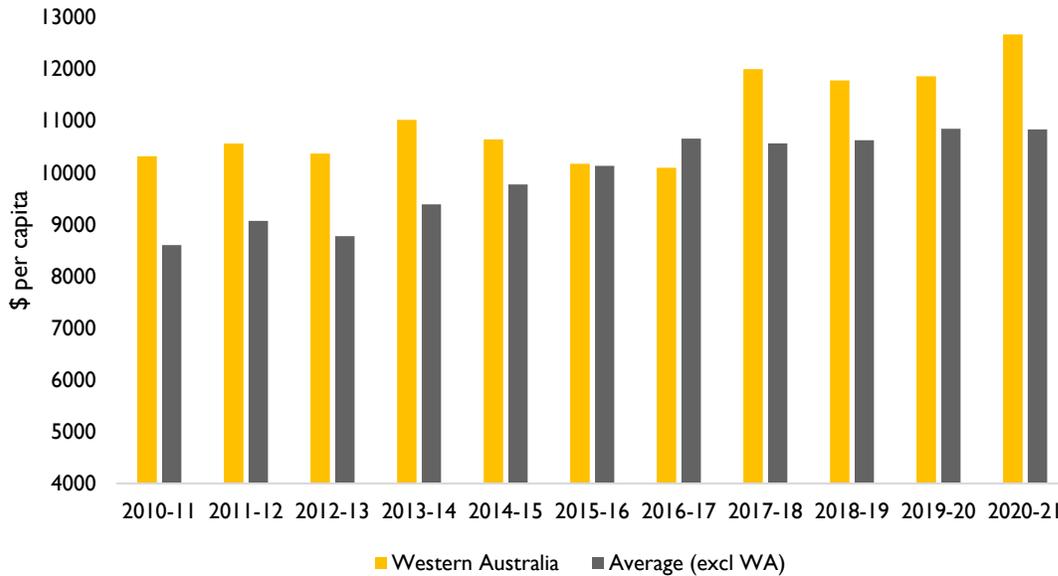


Figure 1C: Total revenue per capita, equalising to the average fiscal capacity, Western Australia and an average of all States (excluding WA)



Source: State Budgets and Treasury calculations.

The Commission’s Draft Report fails to provide any substantial argument as to why Western Australia, which has a very strong fiscal capacity, should retain much of its share of GST to place it in an even stronger fiscal position relative to other States. Similarly, the Commission fails to demonstrate the national benefit of such a situation, or how this outcome improves efficiency and productivity.

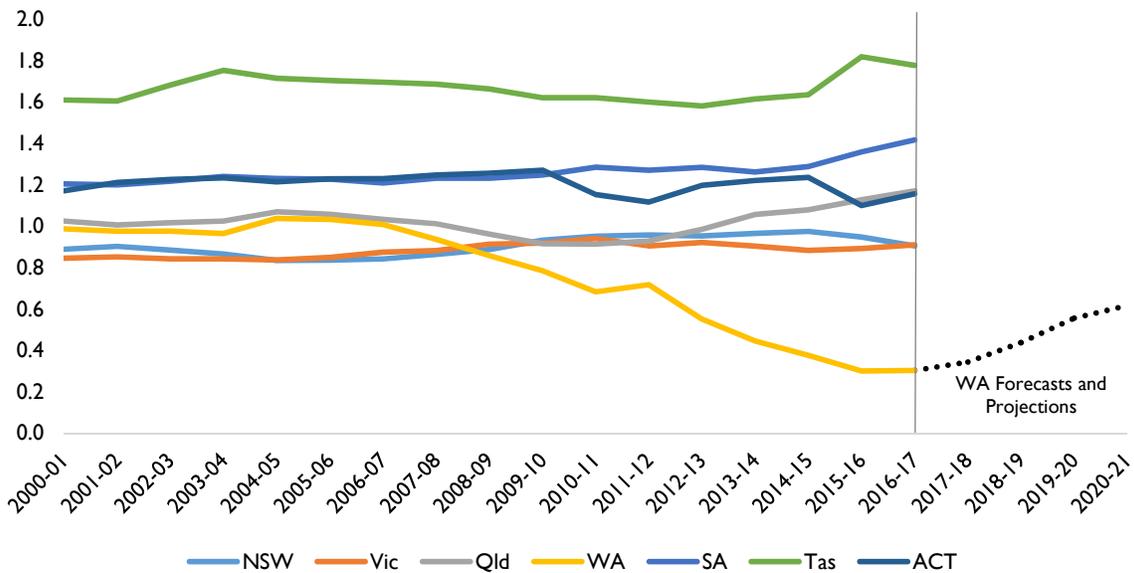
Rather than making reactive changes to the GST distribution methodology in response to the temporary and avoidable circumstances that continue to affect Western Australia, the Australian Government has addressed such circumstances outside the GST distribution methodology. It has announced substantial additional Commonwealth infrastructure funding to Western Australia in the order of \$500 million in 2015-16 and again in 2016-17, with a further \$226 million committed in 2017-18. These payments are compensation for Western Australia's low share of GST and were quarantined from the CGC's calculations. In its report the Commission noted that:

'Since 2014-15, the Australian Government has provided over \$1.2 billion in infrastructure funding to Western Australia, which has been quarantined from the HFE process, to effectively maintain Western Australia's relativity at 2014-15 levels.' (page 4).

Figure 1D illustrates the State's historic actual relativities and Western Australia's forecast relativities through to 2020-21 (excluding the outlier Northern Territory). It illustrates the decline of Western Australia's relativity as its own-source revenues grew rapidly from the mid-2000s until 2013-14. As Western Australia's need for GST fell, the comparative need of other States grew.

However, with the 2014-15 correction in Western Australia's iron ore revenues, and strong growth in revenues in other States projected, the Western Australian Department of Treasury forecasts its relativity to grow over the next three years to 0.617 by 2020-21. This would result in other States relativities experiencing a corresponding decline and a subsequent narrowing of the current divergence.

Figure 1D: Historic Actual State Relativities and Western Australia's Forecast Relativities



Source: Commonwealth Grants Commission and 2018 WA State Budget.

Note: Northern Territory relativities are not shown. Its relativities fluctuated between a minimum of 4.61 and a maximum of 5.66 between 2000-01 and 2016-17.

In conclusion, Tasmania reiterates its belief that the current system of HFE has served Australia well. Even the Commission makes the point that the basic premise of HFE has broad support and its findings in relation to alternative approaches to HFE (Draft Findings 8.2, 8.3, 8.4 and 8.5) refer to the fact that:

'...equity is the core rationale underpinning HFE.' (page 30).

It is unclear, therefore, why the Commission finds it necessary to recommend that the definition of HFE be changed to a lesser form of equalisation, when the outcome is one that is significantly less than equitable, as observed from the graphed outcomes in Figures IB and IC.

Further support that the proposed changes are inequitable is provided by the CGC in response to the Commission's proposal of equalising to the second strongest fiscal capacity. It noted that²³:

'Compared to full equalisation, a minimum per capita GST payment would affect States unequally. It would provide additional assistance to the fiscally strongest State and, therefore, create a system with: one playing field for seven States, with less than full equalisation among them, and a different playing field for the fiscally strongest State, which would attract a 'strong State premium'.

Finally, the Productivity Commission, in its recently released 5-Year Productivity Review²⁴, noted that the Commission's yet to be released HFE Report...

'...should not be viewed as a cynical effort to side-track tax reform, nor is it merely a chance to fiddle with the formulae for a portion of the grants made to States and Territories.'

Unfortunately, Tasmania believes that this is what has happened.

²³ CGC, *Submission on the Draft Report from the Commonwealth Grants Commission*, October 2017, page 5.

²⁴ Productivity Commission, *Shifting the Dial. 5-Year Productivity Review*, August 2017, page 185.

PART B: COMMENTS ON DRAFT FINDINGS AND RECOMMENDATIONS

OBJECTIVE OF HFE

Draft Finding 2.1

While it has a number of strengths, there are also several deficiencies with the objective of Australia's horizontal fiscal equalisation (HFE) system. In particular, equalisation is always to the fiscally strongest State; it provides for limited consideration of efficiency; and it results in a complex system.

The primary objective of the system may be better refocused to provide the States with the fiscal capacity to allow them to supply services and the associated infrastructure of a reasonable standard.

This objective should be pursued to the greatest extent possible, provided that:

- it does not unduly influence the States' own policies and choices beyond providing them with fiscal capacity
- it does not unduly hinder efficient movement of capital and people between States
- the process for determining the distribution of funds is transparent and based on reliable evidence.

Draft Recommendation 2.1

The Commonwealth Government should clearly articulate the objective of HFE. This objective should aim for reasonable rather than full equalisation (as envisaged in draft finding 2.1).

The objective should be established through a process led by the Commonwealth and involving consultation with the States, and should be reflected in the Intergovernmental Agreement on Federal Financial Relations.

The objective should also be reflected in the terms of reference which the Commonwealth Government issues for the yearly update and five-yearly methodology review. The *Commonwealth Grants Commission Act 1973* (Cwth) should also be updated to reflect the adopted objective.

Tasmania does not agree with this Draft Finding and Draft Recommendation.

Tasmania does not agree that HFE is deficient because it gives limited consideration to efficiency. It is not, nor should it be, the role of HFE to promote efficiency. Its role is to ensure that all States have equal capacity to provide services to the average, nationally efficient standard. If the nationally efficient standard can be improved, then there are other mechanisms for doing so.

The provision of Commonwealth funding to the States to encourage national efficiency is better dealt with outside the HFE process. It would only complicate HFE's primary task of equalising State fiscal capacities and potentially conflict with other programs trying to achieve a similar goal.

National objectives to improve efficiency, be it service delivery or tax reform, should be done through targeted Commonwealth programs that have clear objectives and measurable outputs. They can be tailored to specifically address the reform that is required in the national interest. For example, the National Health Reform Agreement and the *Intergovernmental Agreement on Federal Financial Relations* demonstrate that the Commonwealth and the States were able to cooperatively agree on, and pursue, shared policy objectives. At no stage has any party made a convincing case that HFE could be used to enhance this process or better achieve these objectives.

In relation to the finding that the system is complex, refer to Tasmania's response to Recommendation 7.1.

As discussed in Part A, Tasmania does not consider the Commission has made a case to change the current objective of HFE and therefore believes that the Commission's concept of equalising to 'a reasonable standard' has not been supported in the Draft Report. Further, even if a change to HFE was warranted, there is no clarity on what a 'reasonable standard' should be. This issue has been noted by the CGC in its submission to the Draft Report:

*'If the equalisation objective is to be changed to aim for reasonable equalisation, then it would assist public debate if the policy rationale for 'less than full equalisation' was clearly articulated. In particular, a definition of 'reasonable' would provide clear political endorsement of a central feature of our federal arrangements. It would allow the Commonwealth to specify the equalisation objective in terms of reference, providing the Commission with a clear mandate as to the form of equalisation it is to deliver.'*²⁵

The Commission's recommendation, if implemented, would leave the States exposed to the vagaries of the Government of the day as to its interpretation on what is a reasonable standard of equalisation. This would introduce significant ongoing uncertainty as to how the GST will be distributed.

HFE AND EQUALISATION

Draft Finding 3.1

Australia achieves a high degree of horizontal fiscal equalisation and to a much greater extent than other countries.

Tasmania agrees with this Draft Finding.

On release of the Commission's draft report the Commonwealth Treasurer, the Hon Scott Morrison stated in his media release on 9 October 2017 that:

'the draft report affirms that Australia does better than any other comparable federal system in the world in how we seek to deliver HFE.'

This is something to applaud, not consider a deficiency of the system.

As noted in Tasmania's initial submission, and by the Commission in its Draft Report, Australia's fiscal equalisation transfers are not large by OECD standards.

This is possibly because the differences in fiscal capacity within regions are not as great as in some other countries due to Australia's long history of fiscal equalisation and community expectations. However, for the smaller States, equalisation is highly important as their GST share represents a higher proportion of Gross State Product and General Government revenue compared to the larger States.

²⁵ CGC, *Submission on the Draft Report from the Commonwealth Grants Commission (CGC 2017-22)*, October 2017, page 4.

Draft Finding 8.1

Fiscal equalisation to address disparities in the fiscal capacity of sub-central governments is common among OECD countries. But other countries' approaches to fiscal equalisation are inextricably linked to their unique institutional frameworks — this limits those schemes' applicability to Australia.

Despite this, overseas experience provides lessons that can inform the elements of our system in order to better meet the objectives of our fiscal equalisation scheme.

Australia is the only OECD country with a federal government that totally eliminates disparities in fiscal capacity between sub-central governments.

Tasmania agrees with this Draft Finding, but argues that this does not mean there is a problem in the way that fiscal equalisation is approached in Australia. Each country treads its own path and has different national/subnational fiscal arrangements.

In the OECD's report on fiscal equalisation in OECD countries²⁶, it surveyed member countries to compare fiscal equalisation systems. The report showed that in 2004, of those countries surveyed, fiscal equalisation as a percentage of gross domestic product (GDP) was the lowest in Australia at 0.49 per cent. The highest was Japan at 4.04 per cent and the unweighted average was 2.26 per cent.

While more recent estimates for other countries are not available, for Australia the current amount of the total GST pool that is used for fiscal equalisation is \$7 928 million or 12.6 per cent of the total GST pool. Australia's GDP is \$1 684 trillion for the four quarters ending March 2017. Thus, as a proportion of GDP, fiscal transfers remain at a similar proportion of GDP (0.47 per cent).

Tasmania also agrees with the observation made by the GST Distribution Review panel in its Interim Report²⁷

'While comparing the range of HFE approaches around the world can be useful, care is required before concluding that one country's approach is suitable for another, as a wide range of factors influences the chosen form of HFE. The political structures, the degree of VFI, and the historical and social circumstances of a nation all have a significant bearing on the form of HFE that is most appropriate for a particular country.'

HFE AND STATE POLICIES

Draft Finding 4.1

For the most part, States considering tax reforms would generally not be deterred by the effects on GST redistribution. However, there are circumstances where the GST effects can be material — such as for a State undertaking large-scale tax reform — and act as a significant disincentive to States implementing efficient tax policy. These disincentives are likely to be exacerbated where the State is a first mover on reform or where there is uncertainty about how significant tax changes will be assessed by the CGC.

Tasmania does not agree with this Draft Finding. The Commission merely asserts that, because it is technically possible under the CGC's revenue assessments that HFE could discourage major tax reform, it should be changed. However, it could find no evidence that this has actually occurred. This finding is discussed in detail in Part A of this submission.

²⁶ Hansjörg Blöchliger, Olaf Merk, Claire Charbit, Lee Mizell, *Fiscal Equalisation in OECD Countries*, OECD, France, September 2007.

²⁷ GST Distribution Review, *Interim Report*, March 2012, page 5.

Tasmania acknowledges the widely considered view that good taxation design involves replacing inefficient taxes with broader, more efficient tax bases. However, Tasmania considers that while, hypothetically, the GST distribution could be perceived as a barrier to tax reform, there are more significant barriers than GST distribution that exist, including the complexity of implementing such changes and the impacts on taxpayers.

Tax reforms are complex largely because they move the burden of paying taxes from one group of taxpayers to another and can have significant impacts on the cost of living for families. Tax reforms may also reduce own-source revenues for State Governments, particularly throughout any transition phase associated with that reform.

The Commission's arguments around tax reform ignore the fact that the smaller States are generally unable to influence the average tax rate as assessed by the CGC and therefore the impact of any reform is likely to be immaterial on those State's GST shares. Such considerations therefore would not enter into the decision making process of those smaller States. While this does not appear to be the case with the Commission's modelling of the replacing stamp duty with land tax cameo, this is a theoretical example which does not factor in the impact the likely transitional arrangements which would dilute the impact of GST distribution effects of the reform.

Information Request

What further 'cameos' would usefully illustrate how particular State reforms can influence GST shares?

Tasmania does not consider the cameos usefully illustrate how particular State reforms can influence GST shares.

Tasmania considers that the cameos present an overly simplistic and theoretical view of the impacts of tax reform on GST payments. The cameos only depict a single-year impact on GST payments (and corresponding annual relativities) and they do not account for implementation issues, such as transitional arrangements. Rather, they depict the ongoing annual impact on State budgets once a reform is fully in place.

Draft Finding 4.2

Changes in State service delivery policies can impact on GST payments, but the impacts are mostly trivial. HFE is unlikely to discourage — nor encourage — States from pursuing growth strategies or addressing their structural disadvantages given the broader and more significant benefits of doing so to the community.

Tasmania agrees with this Draft Finding.

The claim by some commentators that HFE reduces the incentive for States to promote economic growth or improve the efficiency of service delivery because the benefits of economic reform and development, through higher revenue, may be equalised away, is a simplistic one. It overlooks that there is a range of incentives for State governments to pursue economic reform and development, the most significant of which is the desire to improve the welfare of their communities through the increased employment and higher incomes that are generated by economic development.

Draft Finding 4.3

The potential for HFE to distort State policy is pronounced for mineral and energy resources. While there is no direct evidence that GST effects have influenced specific policy decisions, the incentive effects are large and have the potential to undermine State policy neutrality over time.

However, making adjustments to the HFE system specifically to add incentives for resource exploration policies that are deemed to be desirable would be an intentional breach of policy neutrality and State autonomy; be a source of additional complexity; and come at the expense of equity.

Tasmania does not agree with the substance of this Draft Finding, and notes that the Commission has found *'no direct evidence that GST effects have influenced specific policy decisions'*.

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 and employment.

Tasmania agrees with the Commission's second finding that making adjustments to the HFE system specifically to add incentives for resource exploration policies that are deemed to be desirable would be an intentional breach of policy neutrality and State autonomy; be a source of additional complexity; and come at the expense of equity.

HFE AND STATE BUDGETS

Draft Finding 5.1

Features of Australia's HFE system detract from its contemporaneity. While this works to smooth out changes in GST payments, it can exacerbate the fiscal impact of economic cycles when States experience large economic shocks. Such a situation has occurred in Western Australia in recent years.

However, offsetting cyclical factors is not the primary objective of HFE, and alternative approaches do not offer unequivocal improvements. Reducing the length of the assessment period would have mixed impacts across States, and reducing the lag due to delayed data availability would introduce additional scope for dispute, volatility and the potential for unintended consequences.

Tasmania agrees with this Draft Finding.

The current 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.

Draft Finding 5.2

GST payments are less volatile than other major sources of State government revenue. While some States have reported difficulty forecasting GST payments, others consider GST payments to be no less unpredictable than other sources of revenue.

Tasmania agrees with this Draft Finding.

Tasmania acknowledges that while the GST distribution methodology is complex, it can nevertheless be modelled with reasonable accuracy for budgeting purposes. The complexity and potential volatility is no argument to simplify the GST distribution using the justification that it will increase States' forecasting accuracy. Modelling other revenue sources such as conveyance duty and mining royalties is also complex and volatile. The GST distribution is but one factor and it should not be ignored that GST pool and population share forecasts are equally as important and therefore have equal potential to impact on the accuracy of States' GST forecasts.

HFE AND MIGRATION

Draft Finding 6.1

The redistribution that arises from Australia's system of HFE is small in magnitude relative to total government revenue for most States. As such, the GST distribution and net fiscal benefits are unlikely to be a significant driver of interstate movement of people.

Tasmania agrees with this Draft Finding, and would argue that HFE actually discourages inefficient migration. While there have been a limited number of empirical studies into the impact of HFE, the most recent study by Independent Economics²⁸ found that there would have been a welfare loss of about \$500 million in 2015-16 if there had been no equalisation, primarily due to inefficient interstate migration.

The Commission's finding on this issue is also in accord with the conclusion drawn by the Commonwealth Treasury in its submission to the 2012 GST Distribution Review where it suggested that, because the amount of funding redistributed by the HFE system is only small from a national perspective, it would only have a small impact on the decision by individuals to migrate.

The Commonwealth Treasury therefore concluded that²⁹:

'...there does not appear to be a need for reform of the system on the basis of location decisions.'

While Tasmania agrees with the Draft Finding of the Commission, it finds little comfort in the fact that the Commission has not assessed, against any key criteria, what the impact of equalising to less than the strongest State could have on interstate migration of labour, or national productivity and efficiency. If the proposed alternatives provided by the Commission create a situation where there is unequal treatment of the States and the fiscally strongest State attracts a 'strong State premium'³⁰ thereby allowing it to provide above average services of a higher quality and levy lower than average own-source taxes and charges,³¹ the GST distribution may well become a significant driver of interstate labour movement.

²⁸ Independent Economics, *Horizontal Fiscal Equalisation: modelling update and scenarios*, May 2015.

²⁹ The Treasury, *Submission to the GST Distribution Review*, October 2011, page 33.

³⁰ CGC, *Submission on the Draft Report from the Commonwealth Grants Commission (CGC 2017-22)*, October 2017, page 5.

³¹ CGC, *Submission on the Draft Report from the Commonwealth Grants Commission (CGC 2017-22)*, October 2017, page 6.

That interstate movement of labour would, however, be generated by an inequitable treatment of the States and the creation of a different playing field for the fiscally stronger State. Tasmania's earlier comments in Part A of this submission also refer, for example, in relation to the potential for significant differences in payroll tax to generate a less than desirable impact on national efficiency.

As mentioned, the Commission found alternative equalisation objectives should not unduly hinder efficient movement of capital and people between States.

METHODOLOGICAL CHANGES TO THE CURRENT SYSTEM OF HFE

Draft Finding 7.1

Removing mining from the HFE process, or the use of a discount factor within the mining assessment, is inequitable and not justified. However, there is a need to consider potential improvements in the assessment method in light of problems with policy neutrality.

Tasmania agrees with this Draft Finding.

When considering the issue of mining revenue, the 2012 GST Distribution Review made it clear that it did not consider it appropriate to remove or quarantine mining revenues, and that it should continue to be equalised through the HFE process in the same way as other own-source revenues.

Tasmania notes that the CGC is already looking at policy neutrality issues with mining revenue as part of the 2020 Methodology Review.

Draft Finding 7.2

The introduction of a minimum relativity floor would blunt extreme equalisation outcomes and might theoretically introduce greater incentives for States to pursue development opportunities. But a floor will likely prove a band-aid solution as it does not address the identified deficiencies of HFE, and may even introduce greater uncertainty and unpredictability into the HFE system.

Tasmania agrees with the Draft Finding that a relativity floor is unwarranted but does not agree that there are deficiencies with HFE that need addressing.

A relativity floor is an arbitrary form of partial equalisation and the degree of partial equalisation would depend on at what level the floor is set.

Such an outcome would undermine Australia's system of comprehensive fiscal equalisation. It would allow one State to maintain a fiscal capacity in excess of the other States and would risk permanently entrenching that fiscal advantage.

In recommending that the minimum per capita GST payment be based on the fiscal capacity of either the second strongest State or the average of the other fiscally strong States, the Productivity Commission has effectively introduced a relativity floor with the minimum per capita GST payment being the level of the floor - a point recognised by the CGC in its submission³².

³² CGC, *Submission on the Draft Report from the Commonwealth Grants Commission (CGC 2017-22)*, October 2017, page 4.

Draft Finding 7.3

The introduction of a broad indicators approach for assessing fiscal capacity could potentially deliver benefits in terms of simplicity, but would also have significant costs in terms of loss of accuracy, and may not achieve a 'reasonable' level of equalisation. The broader the indicators that are used, the more such risks may arise.

Tasmania agrees with this Draft Finding.

Draft Recommendation 7.1

The Commonwealth Government should direct the CGC, through the terms of reference it receives, to consider approaches to assessment that deliver significant simplification and 'good enough' equalisation outcomes. The use of more highly aggregated assessments should receive detailed consideration as part of the current CGC process.

Tasmania disagrees with the Draft Recommendation that flows from the Draft Finding from several perspectives.

Firstly, the greater the system is simplified the less able it is to achieve HFE.

The 2012 GST Distribution Inquiry³³ concluded that:

'...while there seemed to be an endless range of simpler methods by which to determine the distribution of GST to the States, the 'natural rule' appeared to be:

- *the simpler the method, the less representative it was of current outcomes; and*
- *the less representative of current outcomes the method, the greater the differences in redistribution.'*

As an extreme example, significant simplification could be achieved with an equal per capita distribution but this would be at the expense of completely abolishing the principle of HFE.

Simplification is already an objective of the CGC.

The CGC also has in its Terms of Reference³⁴ for the 2020 Methodology Review that it should *aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data.*

The CGC does not aim for perfect equalisation. Instead, it uses materiality tests which limit equalisation to 'materially the same' rather than 'precisely the same'. If an assessment no longer meets the current materiality test then it is removed from the differential assessment and is treated as equal per capita.

Finally, if the CGC was to be directed to consider approaches to assessment that deliver 'significant simplification' in addition to equalising to a 'reasonable' standard (such as to the average of all States) then both recommendations each have the effect of reducing the amount of GST redistributed on an equalisation basis. The Commission has not attempted to quantify what the total impact of recommendations 2.1 and 7.1 would be, particularly for the smaller States.

Criticism that the current system of HFE in Australia is too complex overlooks the fact that there are many other systems that are equally, if not more complex, such as the tax system, the superannuation system, energy regulation and so on. These systems are by necessity complex because of the range of issues that they are

³³ GST Distribution Review, *Final Report*, October 2012, page 57.

³⁴ Commonwealth Treasurer, *Terms of Reference - 2020 Methodology Review*, November 2016, pages 1-2.

required to address. HFE is no different in that it needs to respond to a broad range of services delivered, and the revenue raising capacities of State governments.

Draft Finding 7.4

The use of externally defined benchmarks for efficient service delivery within the HFE process would encourage greater efficiency and reduce the potential for gaming the system. However, it faces daunting practical difficulties and involves a high degree of scope for dispute.

Tasmania does not agree with this Draft Finding in respect of its view that it would encourage greater efficiency and reduce the potential for gaming the system.

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.

In its first *Interim Report*, the GST Distribution Review Panel noted that³⁵:

'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.'

In this respect, Tasmania agrees with the Commission's final view on this matter that the use of externally defined benchmarks would face daunting practical difficulties and involve a high degree of scope for dispute.

Information Request

Further views are sought on the potential to apply a simple cost benchmark approach to the expenditure assessments.

Consistent with its previously stated position, Tasmania does not agree that the application of a simple cost benchmark to the expenditure assessments would encourage greater efficiency, and is opposed to any changes to the current system of HFE, such as a move away from 'what States do'.

In support of the introduction of a simple cost benchmark, Tasmania does not believe that the Commission has provided any evidence that States either knowingly game the system nor that the introduction of cost benchmark has the potential to act as a disincentive.

Tasmania does agree with the Commission that the practical issues on applying a simple cost benchmark could become highly complex and overly subjective.

³⁵ GST Distribution Review, *Interim Report*, March 2012, page 80.

Information Request

The Commission seeks further information and views on changes to methodology, both within the current approach to HFE and in any alternative approach, that would deliver significant improvements in simplicity, reduce some of the distortionary effects of the current system, and still deliver a degree of equalisation consistent with the Commission's revised objective of HFE.

Tasmania believes that any change to the current system, such as an EPC or partial equalisation, requiring HFE to deliver other policy objectives, such as meeting efficiency or productivity benchmarks, or simplifying the methodology so that it does not achieve full HFE, would be inconsistent with the fundamental objective itself.

Tasmania does not believe that the case has been made by the Commission, nor evidence provided to the contrary, that the current HFE and GST distribution system requires reform. Further, Tasmania has concerns over the Commission's revised objective of HFE, believing that the Commission has not provided a comprehensive definition of what is 'reasonable'. Again, this difficulty has been recognised by the CGC in its submission to the Draft Report³⁶:

'If the equalisation objective is to be changed to aim for reasonable equalisation, then it would assist public debate if the policy rationale for 'less than full equalisation' was clearly articulated. In particular, a definition of 'reasonable' would provide clear political endorsement of a central feature of our federal arrangements. It would allow the Commonwealth to specify the equalisation objective in terms of reference, providing the Commission with a clear mandate as to the form of equalisation it is to deliver.'

Finally, Tasmania strongly believes that the current GST distribution methodology is working as it was designed to, and reiterates the view that it should not be modified in response to foreseeable, avoidable and short term conditions being experienced by one or two States.

Draft Recommendation 7.2

The Commonwealth needs to 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.

The guidelines should be based on the principle that quarantining of payments ought to occur only in exceptional circumstances.

Tasmania has concerns with this Draft Recommendation.

While guidelines in relation to quarantining would aid transparency and accountability, Tasmania is not convinced that guidelines to govern the Commonwealth Treasurer's decisions in an area, which can be politically motivated, are likely to be effective.

However, if guidelines are adopted they should be developed in consultation with the States.

An alternative approach which would enhance transparency and certainty of the treatment of Commonwealth payments would be to clearly state the intended GST treatment in the associated funding agreement.

³⁶ CGC, *Submission on the Draft Report from the Commonwealth Grants Commission (CGC 2017-22)*, October 2017, page 4.

Information Request

The Commission seeks further views on the principles that should apply with respect to considering which (if any) Commonwealth payments should be quarantined by the Commonwealth Treasurer, and hence would not affect the distribution of GST revenue.

Tasmania reiterates its concerns raised in response to Draft Recommendation 7.2, about the likely effectiveness guidelines governing the quarantining of Commonwealth payments by the Commonwealth Treasurer would have in an often highly politicised environment.

The Commission notes that the quarantining of payments by the Commonwealth Treasurer without a clearly defined rationale can undermine the system or have the appearance of being unfair. Tasmania agrees, in principle, with this rationale and would argue that ongoing quarantining in unexceptional circumstances ultimately undermines the central objective of HFE.

Finally, whilst supportive, in principle, of greater transparency, Tasmania would expect any guidelines to be developed in consultation with the States and quarantining by the Commonwealth Treasurer only to occur in exceptional circumstances.

ALTERNATIVE APPROACHES TO HFE

Draft Finding 8.2

An equal per capita approach to distributing GST revenue is incapable of equalising the fiscal capacities of States. This approach is thus inimical to achieving the core equity rationale underpinning horizontal fiscal equalisation.

Tasmania agrees with this Draft Finding, but finds it unusual that the Commission's underlying argument that an EPC distribution is incongruous with achieving the core equity rationale underpinning HFE, when Draft Recommendation 7.1 effectively undermines that core equity rationale anyway.

An EPC share disproportionately impacts the smaller States such as the Northern Territory, Tasmania and South Australia, which would all be under-equalised, while the fiscally stronger States would be over-equalised.

If the GST was distributed on an EPC basis there would be a significant funding shortfall of around \$7.9 billion in 2017-18 for the recipient States that would require the Australian Government to provide if it was to maintain the current principle of equalising the capacity of States to provide services to their communities. The following table shows the impact of an EPC distribution based on the CGC's recommended GST distribution for the 2017-18 year.

Equal per capita - impact compared to current CGC distribution for 2017-18

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$b	\$b	\$b	\$b	\$b	\$b	\$b	\$b	\$b
Full equalisation	17.7	14.8	15.0	2.4	6.4	2.4	1.2	2.9	62.7
EPC	20.1	15.9	12.6	6.8	4.4	1.3	1.0	0.6	62.7
Difference	2.4	1.0	-2.4	4.5	-2.0	-1.1	-0.2	-2.3	7.9

Source: Commonwealth Grants Commission Staff Research Paper - 2020 Review Achieving HFE: Other Approaches to Distributing the GST, May 2017, page 7.

Note: the total difference figure represents the amount of additional redistribution under the EPC approach. It shows that \$7.9 billion less would be redistributed to the fiscally weaker States and \$7.9 billion more redistributed to the fiscally stronger States.

Draft Finding 8.3

An equal per capita with top-up funding approach would provide all States with the fiscal capacity to deliver a similar level of services. While this would meet the equity rationale underpinning horizontal fiscal equalisation, the top-up funding would always be hostage to fiscal constraints faced by the Commonwealth Government and, thus, this approach poses uncertainty for the fiscally weaker States. Such an approach should only be meaningfully considered as part of a broader reform of Commonwealth-State financial relations.

Tasmania does not agree with an EPC approach even if top up funding was provided.

An EPC distribution raises the question of how, in the current economic climate, the Australian Government would fund the additional payments to the smaller States in order to leave no State or Territory worse off.

Tasmania agrees with the argument in the Draft Finding that supplementary Commonwealth funding would leave those States exposed to the funding priorities of the Government of the day and would also increase their reliance on tied grants which, as noted earlier, reduces budget flexibility.

Draft Finding 8.4

An actual per capita approach (which is similar to the current system except that it uses actual revenue and expenses rather than assessed revenue and expenses) would provide all States with the fiscal capacity to deliver a similar standard of services and, in doing so, would meet the equity rationale that underpins horizontal fiscal equalisation. However, this approach has significant risks for adverse efficiency effects (less incentive to contain costs and pursue efficient service provision) — and on those grounds is an unacceptable alternative to current arrangements.

Tasmania agrees with this Draft Finding.

As noted in the CGC Staff Research Paper - 2020 Review Achieving HFE - Other Approaches to Distributing the GST³⁷:

‘...an APC distribution does not require the CGC to make assessments of States’ costs of providing services or capacities to raise revenue. In addition to the disabilities identified by the Commission, an APC distribution would reflect individual State spending and revenue raising policies.

This option provides more GST per capita to States that have higher per capita spending and lower per capita revenue raising. Thus, depending on its spending and revenue raising, it is possible for a fiscally weaker State to receive more than its recommended GST distribution, meaning it would be over equalised. Similarly, it is possible for a fiscally stronger State to receive less than its recommended amount, meaning it would be under equalised.’

The following table shows the impact of an APC distribution.

³⁷Commonwealth Grants Commission Staff Research Paper - 2020 Review Achieving HFE: Other Approaches to Distributing the GST, May 2017, page 7.

Actual per capita - impact compared to current CGC distribution for 2017-18

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$b	\$b	\$b	\$b	\$b	\$b	\$b	\$b	\$b
Full equalisation	17.7	14.8	15.0	2.4	6.4	2.4	1.2	2.9	62.7
APC	18.7	13.8	12.9	4.2	5.5	2.2	1.9	3.5	62.7
Difference	1.0	-1.1	-2.0	1.8	-0.8	-0.2	0.7	0.6	4.1

Source: Commonwealth Grants Commission Staff Research Paper - 2020 Review Achieving HFE: Other Approaches to Distributing the GST, May 2017, page 7.

Note: the total difference figure represents the amount of additional redistribution under the APC approach. It shows that \$4.1 billion less would be redistributed to the fiscally weaker States and \$4.1 billion more redistributed to the fiscally stronger States.

Tasmania agrees with the Commission's argument that such an approach would introduce significant risks for adverse efficiency effects.

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 CGC 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.

Draft Finding 8.5

Equalisation can be designed to provide a spectrum of fiscal equalisation outcomes — for example, from equalising to the average fiscal capacity across the States up to equalising to that of the strongest State. The extent to which this approach would meet the equity rationale underpinning horizontal fiscal equalisation therefore depends on the level of equalisation this approach is intended to deliver.

While Tasmania agrees that, in theory, equalisation can be designed to provide a spectrum of fiscal equalisation outcomes, it does not agree that a case has been made to change the current equalisation method. The options considered by the Commission of equalising to the average fiscal capacity across the States or to equalising to that of the strongest State are discussed in detail in Part A.

Tasmania is strongly of the view that full equalisation as currently adopted is the intention of the existing system that was agreed to by all States when they signed up to the *Intergovernmental Agreement on Federal Financial Relations*.

It reflects the belief that Australians should have access to a similar standard of service, regardless of the jurisdiction in which they live.

This is a strong egalitarian principle, which is supported by the Australian community and has been reflected in the CGC's approach, in one form or another, since its inception in the 1930s.

Tasmania contends that the equity rationale underpinning HFE is clear and that the current system of full equalisation delivers this equity outcome.

Equalising the fiscal capacity of States is a central element of federation. It protects State autonomy and enables the provision of services to State communities, reflecting the specific and varied priorities of those communities. The nature of the GST revenue pool distribution is a 'zero sum game' in that for a State to receive above population share, another has to receive below population share.

HFE provides each State and Territory with the same capacity to provide services. It does not 'compensate' for differences attributable to policy, practice and relative inefficiency.

Tasmania is concerned that any proposal to equalise to a standard other than that of the strongest State will create a system that is less equitable. It would, in effect, provide additional fiscal strength to the fiscally strongest State, and reduce the fiscal capacity of the other States. The CGC, in its submission to the Productivity Commission Draft Report, suggests that such a system would create a different playing field for the advantaged State, which would attract what it calls a 'strong State premium'.

Tasmania has discussed this issue earlier in this submission.

Information Request

The Commission seeks participant views on what level of fiscal capacity would be consistent with enabling States to provide a 'reasonable' level of services? For example, this could be the average fiscal capacity, the average of the 'donor' States, or the fiscal capacity of the second strongest State.

Tasmania considers that the current level of fiscal capacity would be consistent with enabling States to provide a 'reasonable' level of services. Tasmania strongly contends that it is reasonable that all States have the same fiscal capacity even when one State is significantly stronger than the average.

The arbitrary equalisation options selected by the Commission are simply methods developed to alleviate the current fiscal circumstances of Western Australia, rather than delivering national economic benefits. There is no conceptual basis for the selection of the reasonable equalisation options as chosen by the Commission.

Tasmania believes that the Commission's concept of equalising to 'a reasonable standard' has not been supported in the Draft Report by any definition of what a 'reasonable standard' is. However, the Commission is effectively seeking submissions from the States and Territories in attempt to develop a definition for what a 'reasonable standard' might be. This is likely to be heavily influenced by State responses and the Commission will have to objectively determine a definition. This process has a high risk of being prejudiced.

Information Request

The Commission seeks participant views on managing transition to any new approach, and the most amenable process for considering the transition path. For example, could it be considered via the CGC's 2020 Methodology Review?

While Tasmania would agree that any material change to HFE requires careful transition, it does not agree that such a transition is necessary as the changes proposed are not supported by any evidence that they are superior to the current system of HFE.

The major Draft Finding (2.1) and Draft Recommendation (2.1) are ones that will have far-reaching and long-term impacts on the financial capacity of Tasmania and other States. Any departure from the current HFE distribution would significantly disadvantage the fiscally weaker States.

The Commission itself estimates that such a change would result in Tasmania losing an average of \$160 million annually between 2017-18 and 2020-21 if the change to the average of the States was implemented in 2017-18, or an average of \$42 million per annum over that same period if the change to equalising to the second strongest State was implemented in 2017-18. Tasmanian modelling, using information obtained from the CGC, shows that this significant disadvantage continues beyond 2020-21.

As mentioned earlier, the perceived unfairness of the current divergence in relativities is likely to reduce over time and therefore significant changes, such as the ones proposed by the Productivity Commission, will become outdated. As shown in Figure 1D, the Commission's recommendation for lesser equalisation is based on a divergence in relativities that is expected to narrow. Consistent with its own 2017-18 State Budget, Western Australia has forecast its relativity to increase through to 2020-21. The full HFE GST distribution is returning towards equilibrium after a period of extreme disparity in State circumstances created by the mining boom.

Therefore, implementing changes as part of the 2020 Methodology Review to benefit one State, even if carefully transitioned, is unwarranted and would undermine the equitable basis on which the HFE system is built.

As part of its 2020 Methodology Review the CGC is examining alternative methodological approaches to address some of the issues raised by the Commission, such as policy neutrality specifically relating to the mining revenue assessment. Tasmania is of the view that the CGC is best placed to address these methodological issues and that the Commission's recommendations are a blunt approach that effectively pre-empts the work of the CGC.

INSTITUTIONAL REFORMS

Draft Recommendation 9.1

The CGC - through its Chairperson and Commission members - should provide a strong neutral voice in the public discussion on the HFE system.

The CGC should also enhance its formal interactions with the State and Commonwealth Governments. In particular, it could provide draft rulings to State Governments on the potential HFE implications of a policy change.

Tasmania agrees with the first part of this Draft Recommendation in relation to the provision of a strong neutral voice in the public discussion on the HFE system.

Tasmania supports the current governance arrangements underpinning the HFE system. The CGC is the appropriate, independent body, with responsibility for recommending State GST relativities to the Commonwealth Treasurer.

Tasmania believes that the CGC's processes are analytical and data driven. Such processes rely on historical, empirical data on what States do and the circumstances in which they operate.

The CGC is transparent, consults with the States on relevant matters, and discharges its responsibility with the highest integrity and expertise.

Given this position of neutral integrity, Tasmania agrees with the Commission's Draft Recommendation that there is a significant opportunity for the CGC, either through its Chairman or Commission members, to become more involved in arguing the case for HFE and clarifying the processes of the CGC in the community.

Tasmania, however, does not agree with the Commission's recommendation that the CGC provide draft rulings to State Governments on the potential implications of a policy change. Such a situation would serve to place too high an emphasis on GST equalisation implications.

The CGC points to the inherent difficulties that such a procedure would entail. It notes that it would not be possible to provide draft rulings, such as those made by the Australian Tax Office, because the HFE process is not a static one.

*'While the Commission can provide advice on the effect of a State policy change on its existing assessment methods, those methods are fluid. Moreover, HFE outcomes are not generally dependent on the actions of one government alone: as a relative system, changes in other jurisdictions also need to be taken into account.'*³⁸

Draft Recommendation 9.2

The CGC should make the data provided by the States publicly available on its website, along with the CGC's calculations on these data. Where there are risks identified with this approach, mitigating steps should be identified and taken.

Tasmania has some concerns with this Draft Recommendation.

While in principle Tasmania supports greater public access and transparency to the CGC's data and calculation methods, because of its complexity it also presents a risk of increasing the misunderstanding of how HFE works. Any increase in the availability of data should be considered carefully and accompanied with detailed explanation and guidance notes to users to mitigate the incorrect use and interpretation of the information.

The CGC already provides a number of data tables with each update and Methodology Review on its website. The CGC also provides extensive description of the methods it uses with each Methodology Review report and supporting information, again available on its website.

It is noted in the CGC's submission that³⁹:

- *the detailed data and calculations made by the Commission are routinely made available to all Treasuries, through access to the Commission's assessment system online (ASOL). All data are available to Treasuries, with the exception of a small number of datasets identified by individual States as being confidential. Data confidentiality was an issue raised by States and addressed by the Commission in the 2017 Update Report. The Commission changed the data sharing protocol to include:*

'... sharing non-confidential data among States which have not designated their data as confidential, provided any data designated as confidential by States cannot be back solved from the assessment outcome.'

- *CGC staff have, on a small number of occasions, received requests from members of the public (without exception, academics) to have access to the ASOL.*
- *CGC staff facilitate these requests, but the final decision on allowing access to the data lies with the States, not the CGC.*

³⁸ CGC, *Submission on the Draft Report from the Commonwealth Grants Commission (CGC 2017-22)*, October 2017, pages 10-11.

³⁹ CGC, *Submission on the Draft Report from the Commonwealth Grants Commission (CGC 2017-22)*, October 2017, page 11.

Draft Recommendation 9.3

The Commonwealth and State Governments, through the Council on Federal Financial Relations, should develop a process that would work towards a longer term goal of reform to federal financial relations.

In the first instance, it should assess how Commonwealth payments to the States — both general revenue assistance and payments for specific purposes — interact with each other today, given the significant reforms to payments for specific purposes that have occurred in recent years.

The process should also work to a well-delineated division of responsibilities between the States and the Commonwealth, and establish clear lines and forms of accountability. Policies to address Indigenous disadvantage should be a priority in this regard.

Tasmania considers that the Commission's recommendation for longer term reform of federal financial relations is outside its Terms of Reference for this inquiry.

The Commission's Terms of Reference specifically ask it focus on the impacts of HFE on productivity, economic growth and budget management for the States and for Australia as a whole. As argued in Part A, Tasmania is of the view that the Commission has not been able to find evidence that HFE has had a detrimental impact.

Recommendation 9.3 appears to acknowledge that reforming HFE is not the solution to improving federal financial relations:

'...the complex and intertwined nature of the policy landscape will constrain the benefits from reform to HFE in isolation. Over the longer term, the greater gains would be more likely to come from further reform to Australia's federal financial relations.'

and;

'In the Productivity Commission's view, reforming HFE in isolation will only go a small part of the way to improving outcomes within federal financial relations. There is a need to revisit the broader operating environment in which HFE takes place, and to renew efforts to reform federal financial relations in the broad.'

Tasmania supported the direction and intent of the Reform of the Federation White Paper and continues to believe that reform of Federal-State financial relations is a worthwhile goal.

ATTACHMENT A

WHAT QUESTIONS REMAIN UNANSWERED FROM THE SCOPE OF THE COMMISSION'S INQUIRY?

In its response to the Commission's Draft Report, Tasmania has consistently argued that the Commission has failed to provide substantial evidence to form the conclusion that the current HFE process is having a negative impact on national prosperity, efficiency or growth.

The Commission has left unanswered many of the questions on which it sought input from parties making submissions to the inquiry. Unfortunately, these were the questions that were critical to any Commission recommendations in relation to maintaining or changing the current HFE process.

For example, in relation to the alternatives proposed for the current HFE process, the Commission intended to answer the following questions:

How would these alternatives affect States' incentives to pursue higher prosperity?

How would these alternatives perform relative to the current system in terms of efficiency, equity and simplicity?

Which approach is best for national productivity and wellbeing?

Are some inequalities across States better dealt with outside the HFE system?

In relation to the discussion about the objectives of HFE, the Commission intended to answer the following questions:

Should HFE address fiscal divergences across States that are beyond State influence?

Should HFE compensate States for fiscal disadvantage where a State has diverged from efficiency?

Should past State policy decisions influence the form of or degree of fiscal equalisation?

To what extent should States be held accountable for how they use HFE funding?

Finally, in relation to financial and budget management issues, the Commission intended to answer the following questions:

Does the HFE process affect State fiscal management?

Does the HFE process impact the ability of States to manage budgets through cycles?

ATTACHMENT B

WHAT DID TASMANIA EXPECT FROM A METHODOLOGY PERSPECTIVE FROM THE COMMISSION'S DRAFT REPORT?

Tasmania is disappointed at the lack of a substantial methodological underpinning to the Commission's findings, particularly given the significant fiscal impacts that will flow from the associated recommendations.

On the two areas that the Commission has based its recommendations for change - taxation, and development, of mineral resources and policies relating to resource extraction - there is an absence of any practical examples to substantiate the conclusion that the current system of HFE has had a negative or detrimental impact. The recommendations are simply based on perception and the assumed potential for that negative outcome to occur.

Tasmania does not believe that this form of subjective 'non evidence' is sufficient for such an important study by the Commission. It is certainly unusual for the Commission to base its recommendations on the premise that 'evidence of absence is not absence of evidence'.

In its Discussion Paper that formed part of its Productivity Review Inquiry, the Productivity Commission emphasised that it was adopting a systematic approach to gathering ideas, and indicated that:

*'There should be reasonable grounds for a causal link between any proposed reform and productivity/efficiency. Ideally, this should be based on sound quantitative and qualitative evidence, though 'in principle' arguments also have validity.'*⁴⁰

On this basis, the Commission, in that Productivity Review, sought to establish a suitable framework for determining policy reform options that was based on seeking a broad set of ideas, assessing the nature of the policy impacts and their political and practical feasibility, and then determining the appropriate set of reform options. The Commission illustrated this approach in the following diagrammatic representation.

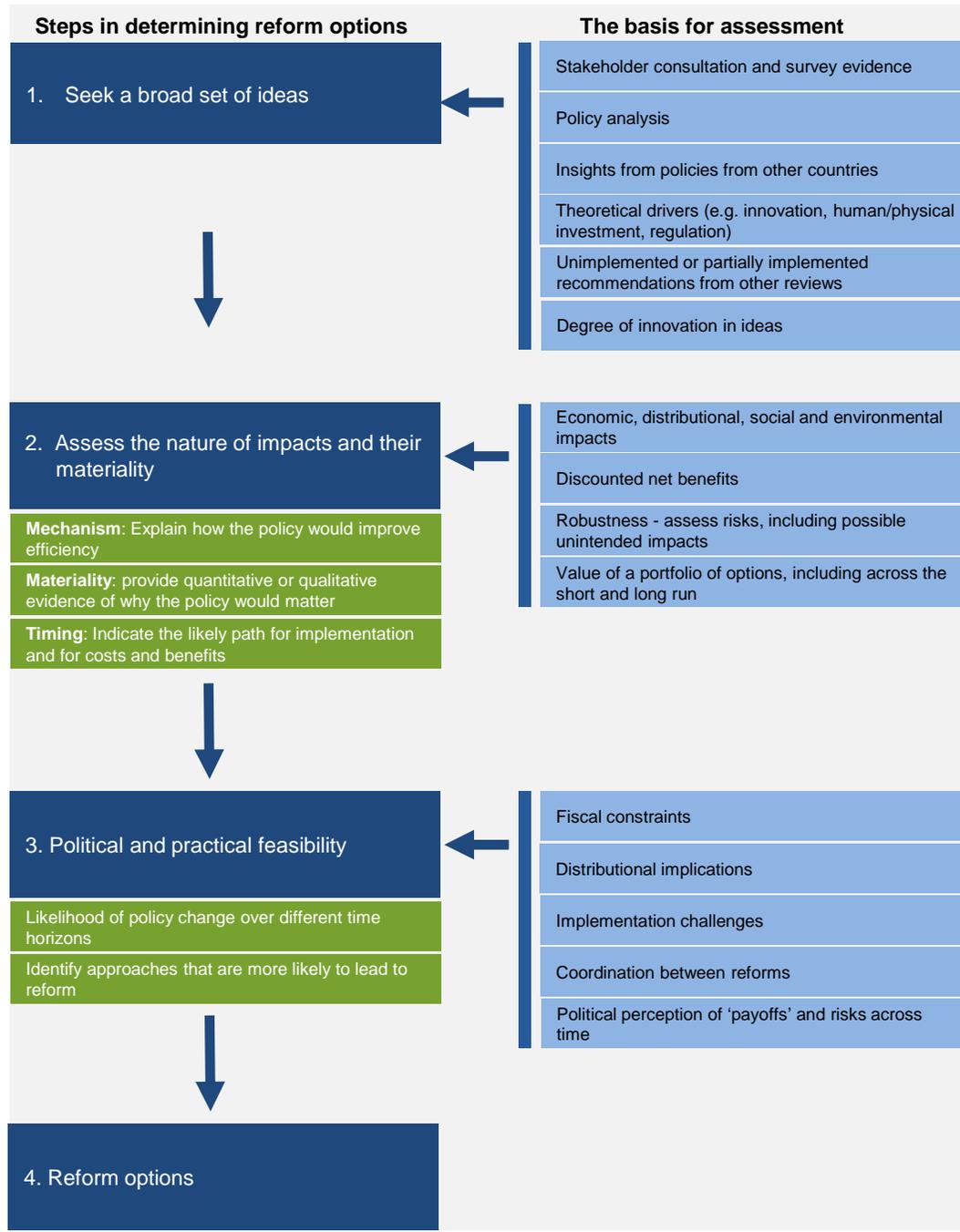
The Commission also questioned whether the outcome of particular reforms was known, and whether this posed inherent dangers.

'All policies pose risks for governments and society. Even if a policy has an expectation of a net benefit, there may also be substantial downside risks, which would suggest care in adoption or mitigation of those risks. This suggests trials of some proposals, in which case the design and implementation of those trials becomes a central concern.'

*It is important to assess, even if only qualitatively, the extent to which any policy initiative to promote productivity incidentally decreases other forms of efficiency.....or has significant distributional and structural adjustment effects. These may alter the appropriate timing, pace and design of pro productivity reforms, and indeed, in some cases, their desirability.'*⁴¹

⁴⁰ Productivity Commission Discussion Paper, *Increasing Australia's future prosperity*, November 2016, page 20.

⁴¹ Op cit. page 21.



It is the underlying methodological approaches outlined above that Tasmania had expected would be applied by the Commission to its inquiry into HFE. Additional comment on this issue is also outlined earlier in this submission, with reference to the best evidence-based policy principles as outlined by former Productivity Commission Chairman Gary Banks.