

24 OCT 2018

**Treasurer
Minister for Local Government
Minister for State Growth**

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Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
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Canberra ACT 2600
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Dear Secretary,

RE: Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018

Please find enclosed a submission prepared by the Tasmanian Government, regarding the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018* (the Bill). I would also like to comment on some key issues associated with the Bill.

I note that the Commonwealth Government in its proposed changes to the distribution of GST, will augment the GST pool with additional funding, with the intent that all states and territories will be better off. The Commonwealth will now also legislate a time-limited 'no worse off' guarantee and I welcome this new commitment.

Furthermore the Tasmanian Government's submission notes that the proposed changes to HFE will impose risks that will exist in perpetuity and I welcome the Commonwealth's acknowledgement of this by legislating for a review by the Productivity Commission (PC) into the operation of the new system by December 2026, to assess whether it is operating efficiently, effectively and as intended.

The Tasmanian Government considers the review should be comprehensive, and that a potential improvement to the process of the review would be for it to be conducted by the Commonwealth Grants Commission (CGC), as experts in HFE, instead of the PC. At the very least, it is the Tasmanian Government's view that the CGC should be sufficiently involved in the process, so that their expertise can be best utilised to inform the review and any recommendations.

I appreciate your careful consideration of our proposals and the enclosed submission.

Yours sincerely

A handwritten signature in blue ink, appearing to read "Peter Gutwein".

Hon Peter Gutwein MP
Treasurer

Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018

Submission by the Tasmanian Government to the Senate
Standing Committees on Economics

October 2018



Tasmania
Explore the possibilities

KEY POINTS

1. The Tasmanian Government remains of the view that the current system of Horizontal Fiscal Equalisation (HFE) is not “broken” and that the Productivity Commission (PC) did not make a convincing case that it needs changing.
2. The Tasmanian Government also considers that any changes to the current system of HFE are unwarranted and undermine the equitable basis on which the HFE system is built and will lead to growing inequality between the States.
3. The Commonwealth Government has presented a single scenario to demonstrate that its proposal detailed in the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018 will leave all States better off financially.
4. However, there are a number of feasible, alternate scenarios, based on different assumptions, which indicate that the proposed changes to the GST system may be detrimental to States’ fiscal position.
5. States therefore requested a formal guarantee from the Commonwealth Government that would provide a greater level of confidence that States will not be negatively impacted by the proposal.
6. The Tasmanian Government welcomes the Commonwealth Government’s decision to include a limited guarantee in the Bill to ensure that each State will get funding at least equal to the better of the current distribution system or the updated distribution system during the transition period until 2026-27.
7. The Tasmanian Government notes that the risks associated with the Commonwealth Government’s proposal will exist in perpetuity and that they are not restricted to the transition period. On this basis, the Tasmanian Government continues to support a guarantee in perpetuity.
8. The Tasmanian Government also welcomes the involvement of the Commonwealth Grants Commission (CGC) as an independent, external arbiter in the annual assessment process.
9. The Tasmanian Government considers that the CGC is better placed to undertake the proposed review to be undertaken by the PC by December 2026 to assess whether the updated system is working effectively.
10. The Tasmanian Government also notes that the legislation if enacted will ensure that Western Australia has a greater permanent and increasing fiscal capacity than any other jurisdiction which will enable it to deliver a higher standard of services and/or lower taxes to its constituents relative to all other jurisdictions. Even if all States are better off in the longer term relative to the status quo, it sets in place a system that will entrench a gap between the fiscally strongest State and all other States.

BACKGROUND

On 30 April 2017, the Commonwealth Government Treasurer requested that the PC undertake an inquiry into Australia's system of HFE, which underpins the distribution of GST revenue to the States.

Throughout the inquiry, the Tasmanian Government made a number of submissions supporting the current HFE system, arguing that the PC's proposed alternatives would redirect GST funding to the strongest States and reduce the GST funding to the other States. This would, over time, reduce equity between the States.

On 5 July 2018, the *Final Report* of the PC's inquiry into HFE was tabled in the Commonwealth Parliament.

The Tasmanian Government remains of the view that the current system of HFE is not "broken" and that the PC did not make a convincing case that it needs changing. The PC was unable to demonstrate that HFE had been detrimental to national productivity, efficiency and growth, and its conclusions on these issues were predicated on assertions, not evidence. Despite this, the PC identified a package of changes that it asserted would improve the equity, efficiency, transparency and accountability of the HFE system.

The Tasmanian Government considers that any changes to the current system of HFE are unwarranted and undermine the equitable basis on which the HFE system is built and will lead to growing inequality between the States.

THE COMMONWEALTH GOVERNMENT'S PROPOSAL

On 5 July 2018, the Commonwealth Government released its interim response to the PC's Final Report. The interim response implements a range of measures to change the current system of HFE including a recommendation to equalise to the fiscal capacity of New South Wales or Victoria (whichever is higher) together with a range of measures to transition to the new arrangements.

The Commonwealth Government presented a single scenario to demonstrate that every State would be better off financially (with Western Australia substantially better off) under its proposal.

The changes proposed by the Commonwealth are reflected in the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018.

A number of additional PC recommendations that were accepted by the Commonwealth Government have been referred to Heads of Treasury by the Council of Federal Financial Relations for further consideration.

These are not included as part of the draft Bill and are not addressed in this submission. However, a number of these are of particular concern to the Tasmanian Government and will result in Tasmania being significantly worse off than under the current system.

ANALYSIS OF THE COMMONWEALTH GOVERNMENT'S PROPOSAL

Since the Commonwealth Government released its interim response, the States have been undertaking detailed analysis of the proposal and have been actively engaging with Commonwealth Treasury.

As noted above, the Commonwealth Government's proposal presented one modelled scenario that suggested that all States would be better off under the new arrangements, compared to the current system of full HFE.

However, there are a number of feasible alternate scenarios, based on different assumptions, which would appear to indicate that the proposed changes to the GST distribution may be detrimental to Tasmania's fiscal position.

The PC's "Consensus" Relativity Forecasts

The CGC distributes the GST to the States using a complex formula that aims to equalise the fiscal capacity of the States to the strongest State (currently Western Australia) so that each State has the capacity to provide the 'same' standard of services to its constituents. Each year, the CGC makes recommendations to the Australian Treasurer, in the form of relativities, on how GST Revenue should be distributed between the States to best achieve HFE.

The Commonwealth Government's proposal presented in the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018 is based on moving to a benchmark that would equalise the fiscal capacity of all States to New South Wales or Victoria (whichever is higher) rather than the current approach of equalising to the strongest State.

The assessed financial impacts of the new model are largely predicated on the PC's forecasts of State GST relativities included in its Final Report.

However, the PC failed to take into account that relativities are generally very volatile. For this reason States generally do not forecast relativities beyond the Budget and Forward Estimates period and if they do, they are heavily caveated. GST relativity forecasts over an 8-year period have the potential for a high degree of error.

Notwithstanding this, the PC presented relativity projections for a period of five years beyond the Forward Estimates, to cover the eight-year period 2018-19 to 2026-27.

The PC did not consult with the States on the set of relativities it used in its final report or the methodology that it used to determine these relativities.

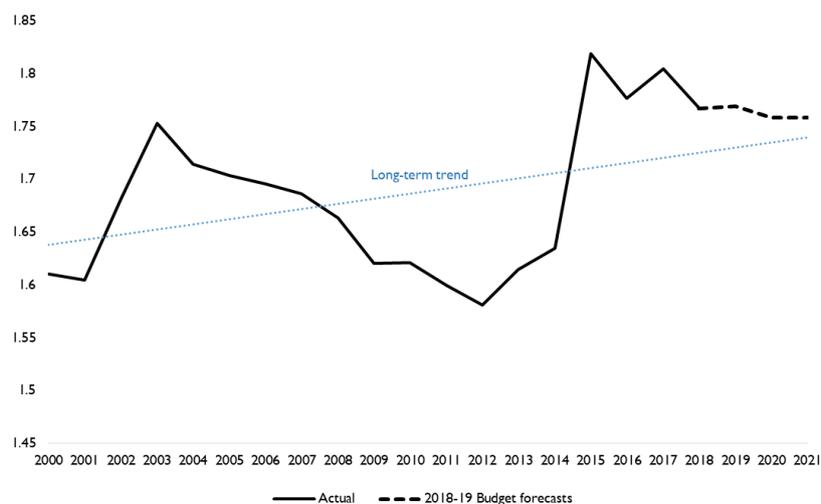
The PC has also assumed that States' relativities trend to their long term average at the end of the Forward Estimates period. This assumption produces an outcome in which Western Australia's relativities to 2026-27 continue to increase. This increase could only occur if Western Australia's mining royalties decline over this period, rather than remaining at near record levels, as they are currently projected to do in the 2018-19 Western Australian State Budget.

In addition, while projecting an increase in Western Australia's relativity, the PC has not projected a corresponding decline in other States' relativities. This outcome is not possible under the GST distribution methodology and the assumption would appear to distort the 'zero sum' outcome of the GST methodology whereby any financial distribution to one State must be offset by a redistribution away from other States.

Variability in Relativities

As mentioned above, relativities are generally volatile. Chart I illustrates the high level of historical variability in Tasmania's annual GST relativities. This variability can be driven by Tasmanian-specific factors such as growing own-source revenue, or by external factors such as high iron royalties in other States during the mining boom.

Chart I: Variability in Tasmanian GST relativities



However, the PC's relativity projections for Tasmania used in the Commonwealth's modelling are extremely stable, with an average annual variability of only 0.5 per cent.

By comparison, historical actual average annual variability for Tasmania's relativity is 2.2 per cent, with variations of up to 11.3 per cent. Annual variability has exceeded one per cent in 13 out of 18 years and two per cent in 8 out of 18 years. The average annual change in Tasmania's actual relativity over three years is 5.0 per cent. Forecasts also become progressively less accurate over the out years.

Given this, the stable long term relativity projections relied on by the Commonwealth are highly unlikely to reflect actual future outcomes.

Alternative Scenario Analysis

Given concerns about the PC's relativity forecasts, the Department of Treasury and Finance (Treasury) developed a number of alternative relativity scenarios to illustrate the range of outcomes that could result from the Commonwealth's proposal. These are outlined in the document entitled "Productivity Commission Inquiry into Horizontal Fiscal Equalisation, Commonwealth Government Response: Department of Treasury and Finance Analysis" available at <https://www.treasury.tas.gov.au/gst-distribution-to-tasmania/publications>.

These alternate scenarios demonstrate that there are a number of feasible scenarios, based on different assumptions and more realistic relativities, which would appear to indicate that the proposed changes to the GST distribution may be detrimental to Tasmania's and other States' fiscal positions. For instance, a scenario which reflects a return to 10-year average relativities would leave all States substantially worse off over the transition period, with the exception of Western Australia and the Northern Territory.

Scenario analysis undertaken by other State Treasuries is consistent with the outcomes in the Treasury modelling and demonstrates that there is significant variation in outcomes depending on the scenario modelled.

While modelling undertaken by the States focussed on the transition period through to 2026-27, the risks of the Commonwealth's proposal have been given effect through this Bill in perpetuity.

This legislation will also ensure that Western Australia has a greater permanent and increasing fiscal capacity than any other jurisdiction which will enable it to deliver a higher standard of services and/or lower taxes to its constituents relative to all other jurisdictions. Even if other States are better off in the longer term relative to the status quo, it sets in place a system that will entrench a gap between the fiscally strongest State and all other States.

NO WORSE OFF GUARANTEE

Given significant concerns associated with the Commonwealth's proposal, a letter from the Board of Treasurers signed by all State Treasurers was sent to the former Commonwealth Treasurer on 10 August 2018 seeking a binding guarantee that no State would be worse off under the proposed system compared to the current system in perpetuity.

It was considered that a formal guarantee from the Commonwealth Government would provide a greater level of confidence that States will not be negatively impacted by the proposal and will embed in legislation the former Treasurer's commitment that all States will be better off.

The Tasmanian Government welcomes the Commonwealth Government's decision to include a limited guarantee in the Bill to ensure that each State will get funding at least equal to the better of the current distribution system or the updated distribution system during the transition period until 2026-27.

However, as noted above, the risks associated with the Commonwealth's proposal will exist in perpetuity and are not only restricted to the transition period. On this basis, the Tasmanian Government continues to support a guarantee in perpetuity.

The Tasmanian Government also welcomes the involvement of the CGC as an independent, expert arbiter in the annual assessment process. Consistent with current practice, it would expect that this process will be undertaken in an open, transparent manner with the CGC's calculations of entitlements for additional financial assistance under the guarantee for a payment year shared with jurisdictions in a timely manner as part of the Commonwealth Government's consultation process.

REVIEW OF THE OPERATION OF THE ACT

The Bill includes a requirement for the Treasurer to refer to the PC for inquiry, a review into the operation of the Bill, assessing whether the updated system is operating efficiently, effectively and as intended. In undertaking its inquiry, the PC is required to focus on the fiscal implications for each State and Territory arising from the reforms. No further information is provided as to what will be considered by the PC as part of this review.

Given the ongoing risks associated with the changes to HFE detailed in the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018, the Tasmanian Government welcomes a comprehensive review of the operations of the revised system of HFE.

However, as noted above, the Tasmanian Government expressed significant concerns with the PC's recent analysis of the current HFE system. Notwithstanding that the PC was unable to demonstrate that the current system was detrimental to national productivity, efficiency and growth, it recommended a broad ranging suite of reforms that would benefit one State at the expense of all other States.

Given its demonstrated knowledge and evidence-based approach, the Tasmanian Government considers that the CGC is better placed to undertake the review proposed to be undertaken by the PC by December 2026 to assess whether the updated system is working to ensure that all Australians are treated equally no matter where they live and ensure that all States have the capacity to deliver a similar standard of services to their residents and that the tax burden is similar on all taxpayers.