Northern Territory Government

# COMMONWEALTH GRANTS COMMISSION 2015 METHODOLOGY REVIEW

## Northern Territory Supplementary Submission to the Commonwealth Grants Commission – Contemporaneity

November 2014

Department of Treasury and Finance

# Implementing HFE with no lags

The Territory strongly opposes the proposal to implement horizontal fiscal equalisation (HFE) without lags for the following reasons:

- basing the Commission's assessments on projections of states' fiscal circumstances in the grant year would add unnecessary volatility and complexity to the HFE system;
- applying retrospective adjustments to states' GST entitlements when actual data becomes available would create an unacceptable level of uncertainty for states;
- the proposed approach is inconsistent with the guiding principles of 'what states do', policy neutrality and practicality; and
- the proposal would result in potentially significant transitional costs, with no real contemporaneity gains.

1.1 This submission provides the Northern Territory's views on Western Australia's proposal for the Commission to implement HFE with no time lags.

1.2 The proposal is based on the premise that the current approach does not sufficiently respond to changes in state and territory (state) circumstances in the year in which relativities are applied, particularly in relation to volatile revenue sources such as mineral royalties.

1.3 The Territory strongly opposes the proposal to implement HFE without lags, as this approach would add complexity to the Commission's assessments, while exacerbating the volatility of the overall HFE system and reducing its reliability. In addition, the proposal to implement HFE based on projections of state fiscal capacities in the grant year would be inconsistent with the Commission's supporting principle of reflecting what states do.

1.4 The issue of how to produce relativities that best reflect state circumstances in the grant year is not new to the Commission and has been considered in a number of methodology reviews in the past. Historically, the Commission and the majority of states have generally been opposed to the use of data projections in the Commission's assessments on the basis that this would be overly complex, unreliable, and volatile.

1.5 The Territory considers that these concerns remain valid and urges the Commission to continue to base its assessments on the average observed data for the three most recent years, as this is the simplest, most reliable way to reflect states' circumstances in the grant year.

## The Contemporaneity Principle

1.6 The Commission's implementation of HFE is guided by the supporting principles of 'what states do', policy neutrality, practicality and contemporaneity. The Commission describes the contemporaneity principle as meaning that *"as far as possible, the distribution of GST provided to states in a year should reflect state circumstances in that year."*[1]

1.7 In pursuing contemporaneity, it is crucial that the Commission achieves a balance between responsiveness to changes in state circumstances and the stability of states' GST revenue, given the importance of this revenue source to all states.

1.8 Currently, the Commission attempts to achieve this balance by using an average of states' assessed fiscal capacities in the three most recent years for which actual data is available. This approach smooths out the impact of changes in states' revenues and expenditure from year to year. The outcome is a 'lagged' implementation of HFE, where changes in a state's circumstances in a particular year are reflected in future assessments, rather than in the year in which the changes occur.

## Impacts on HFE

### *Volatility*

1.9 Western Australia considers that implementing HFE without lags would improve state budgeting by spreading revenue volatility across states, while eliminating distortions in decision-making caused by time lags. The Territory's view is to the contrary. HFE without lags would exacerbate volatility in two ways: through the use of projections rather than actual data, and the use of one year's worth of data rather than a three-year average.

1.10 Western Australia's proposal entails the use of forward estimates or projections of states' economic, demographic and fiscal circumstances in the grant year, possibly with an adjustment of states' GST entitlements in subsequent years to reflect actual data. The Territory is concerned that this approach would needlessly add complexity and increase the volatility of the GST distribution system, as its reliability would only be as good as the projections used in the assessments. Further, the level of uncertainty that would result from the annual revisions to states' GST revenue is unacceptable, as it would make state budgeting significantly more difficult. States would perpetually be faced with the prospect of potentially large adjustments to their GST revenue shares, arising from differences between

[1] CGC, 2015 Review Draft Report, p.18

projected and actual fiscal capacities in a particular year. These adjustments would significantly increase the complexity of the GST distribution process, and would unfairly advantage states whose GST needs were overestimated, as they would receive a portion of other states' GST revenue entitlements for up to a year, until appropriate adjustments can be made the following financial year.

1.11 The proposal to base the Commission's assessments on the projected fiscal circumstances of states in the grant year also represents a departure from an approach that has been widely accepted by states as an appropriate way of achieving stability in states' GST revenue. Given the significance of GST as a revenue source for the states, any proposals that unnecessarily reduce the stability of states' GST revenue shares must not be pursued.

*Judgement and policy non-neutrality*

1.12 The Territory considers that the use of projections rather than actual data introduces further judgement in the Commission's assessments. Not only would the Commission need to exercise judgement in developing its projections, but the projections would likely be based on states' own budget data. This raises concerns about actual or perceived 'gaming' of the GST distribution system by states through their budget forecasts.

*Complexity*

1.13 A further concern is the magnitude of the additional work the Commission would need to undertake to implement the proposed approach. The Commission would need to develop projections for every type of revenue and expenditure for each state, as well as population projections. To develop realistic projections, the Commission would need to apply different modelling assumptions for each budget item for each state, to capture the differences in state circumstances. It would not be appropriate for the Commission to use broad indicators such as economic growth, as both the Commission and the Review of GST Distribution have previously concluded that broad indicators do not accurately reflect changes in states fiscal capacities from year to year.

## Interaction with Other Guiding Principles

1.14 The Territory is of the view that changing the application of the contemporaneity principle in the manner proposed by Western Australia would not be consistent with the Commission's other guiding principles and would represent an unwarranted expansion of the role of the Commission in the implementation of HFE. For example, basing the Commission's assessments on forecast, rather than actual data would conflict with the principle of 'what states do', and instead reflect 'what the Commission believes states will do'. Further, the proposal raises a range of practicality and policy neutrality concerns as outlined above.

1.15 The Territory acknowledges that the guiding principles of HFE are not always complementary, and in some cases, the pursuit of one guiding principle may be at the expense of another (for example, policy neutrality and ‘what states do’ in the Mining Revenue assessment). However, the Territory considers that currently there are insufficient grounds for the Commission to change the implementation of the contemporaneity principle, particularly as its current application achieves an appropriate balance between reflecting what states do, practicality and policy neutrality.

## Transitional issues

1.16 In the 2010 Review, the Commission’s decision to reduce the number of assessment years from five to three created transitional costs, which were significant for some states. However, the majority of states accepted that shortening the review period was an appropriate way of enhancing the contemporaneity of the Commission’s assessments.

1.17 In the 2015 Review, the proposal to move from the current approach to one based on projections for a single year will likely have significant transitional costs. The Territory is not convinced that the proposed approach would result in sufficient contemporaneity gains to offset the multiple issues that would arise from such a significant change to the form of HFE in Australia.

## Conclusion

1.18 The Territory places great value on the stability of the HFE mechanism. While the current system does not immediately reflect changes in state circumstances, these changes are reflected in the Commission’s assessments over time.

1.19 In the same way a sudden reduction in a state’s fiscal capacity does not immediately result in a higher GST relativity, a sudden increase in fiscal capacity would not immediately result in a lower relativity. However, equalisation is achieved in the long term. This stability is a key feature of the current HFE system and, the Territory considers that rather than being a shortcoming of the system, it is a strength.

1.20 The Territory strongly urges the Commission not to pursue Western Australia’s proposal to change a key tenet of HFE; reflecting what states do. The Territory strongly supports the current HFE methodology and does not consider that the proposed alternate approach would enhance HFE outcomes.