Commonwealth Grants Commission — 2020 Review

The Principle of HFE and its Implementation

Submission by the South Australian Department of Treasury and Finance

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INTRODUCTION

South Australia strongly supports the continuation of full horizontal fiscal equalisation (HFE), a principle that seeks to ensure that all Australians, regardless of what state or territory (state) they live in can have access to services and infrastructure of the same standard. This principle is a fundamental strength of the Australian Federation and on this basis, South Australia is strongly opposed to any proposals that would fundamentally weaken HFE.

The principles and economic impacts of HFE are currently being reviewed by the Productivity Commission as part of the *Inquiry into Australia's System of Horizontal Fiscal Equalisation* (the Inquiry). This Inquiry is essentially revisiting issues previously considered in detail by the 2012 GST Distribution Review (the Greiner Review), the final report of which effectively endorsed the prevailing definition of HFE and associated assessment architecture. The principles of HFE were also considered by the Commission in the 2015 Review.

South Australia strongly supports the definition of HFE adopted in the 2010 and 2015 Reviews and believes that the current supporting principles are an appropriate guide to achieving HFE. We see no reason why HFE or the principles underpinning it need to again be investigated so soon after the Greiner and 2015 Reviews. Notwithstanding this, South Australia is actively participating in both the Productivity Commission Inquiry and the Commission's 2020 Review.

This submission responds to the issues raised in Commission Staff Discussion Paper CGC 2017-02-S – *The principle of HFE and its implementation* (the Discussion Paper). This submission also addresses relevant issues raised in the supporting Staff Research Papers on alternative approaches to GST distribution, state mining policies and contemporaneity.[1]

[1] Staff Research Papers CGC 2017-03-S – *Achieving HFE – Other approaches to distributing the GST*; CGC 2017-04-S – *State mining policies*; and CGC 2017-05-S – *Options for improving contemporaneity.*

OBJECTIVE AND DEFINITION OF HFE

- *Do the IGA and the ToR require the Commission to distribute the GST in such a way as to achieve HFE as the sole objective?*
- *Is the aim of HFE to achieve equal fiscal capacities?*
  - *If it is, then, how would different approaches to the achievement of HFE, such as including other desirable policy goals, be implemented consistent with this? How would the definition need to be modified to support them?*
  - *If not, what should HFE be achieving and what changes to the definition would be required?*
- *Are changes to the definition necessary, or are State concerns more about the way HFE and its current definition is implemented?*

Sole objective

The Terms of Reference for the 2020 Review direct the Commission to take into account the *Intergovernmental Agreement on Federal Financial Relations* (the IGA), which provides the basis for the distribution of GST revenue in accordance with HFE.[2] There is no reference in the IGA to the distribution process seeking to achieve other objectives.

South Australia believes that the Terms of Reference make it clear that the Commission's sole objective has to be to recommend a distribution of GST based on HFE.

Aim of HFE

The aim of HFE is first and foremost about equity and is fundamental to ensuring that all states have the capacity to deliver the same level of services and infrastructure. To achieve this equity objective, HFE must be focused on the equalisation of states' fiscal capacities (recognising the average revenue and expenditure policies of states). HFE is not about attempting to correct or respond to states' cyclical budgetary circumstances that incorporate revenue and expenditure policy choices.

It has been suggested that HFE can create disincentives for economic development, tax reform and service delivery efficiency. South Australia is not aware of any evidence that demonstrates that HFE has actually impeded any development or reform process.

The Greiner Review noted (Page 135, Final Report):

> *"…the Panel has formed the view that the current system can and does create perverse incentives in theory, but there is little evidence of those incentives having any effect in the real world. In particular, there is no evidence that HFE acts as a material disincentive to State tax reform.*
>
> *While there may be some merit in addressing perverse incentives on principle alone, after exploring the alternatives, the Panel has concluded that they cannot be meaningfully reduced without significant reductions in equalisation outcomes. As there is little evidence of real world efficiency loss, the Panel is not convinced that this would be a worthwhile trade-off."*

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[2] Clause 26 of the IGA FFR states: *"The Commonwealth will distribute GST payments among the states and territories in accordance with the principle of horizontal fiscal equalisation."*

While equity is the sole objective of HFE, this does not mean that HFE detracts from or is pursued at the expense of efficiency. The Commission's assessments are designed to ensure that, as far as possible, states are equalised to an internal standard reflecting average state policies. Any policy choices by states that are not entirely consistent with efficiency are driven by other considerations. As such, any measures seeking to enhance efficiency in state service delivery should be sought through other instruments and governance arrangements and not through HFE.

South Australia believes that the operation of HFE should not in any way be constrained or modified in order to achieve other policy objectives.

Definition of HFE

The definition of HFE, as adopted in the 2010 Review and retained in the 2015 Review, states that:

> *"State Governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure to the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency."*

The current definition supports a "full" model of equalisation rather than a form of "partial" equalisation. Full equalisation should be the objective as it attempts to replicate how a unitary system of government would treat its citizens in the absence of state and territory borders. As such, it is important that the words 'same standard' be retained in the definition, rather than any alternative concept introduced (e.g. 'comparable', as has been proposed in the past).

The words *'after allowing for material factors'* adequately allow the Commission to resist excessive or inappropriately detailed assessments where required.

South Australia is of the view that proposals for a move away from this definition are likely to be motivated by a desire to reduce the extent of equalisation sought, rather than a genuine aspiration to strengthen HFE. Consistent with our position in the 2015 Review, South Australia sees no need to change the definition of HFE.

SUPPORTING PRINCIPLES

- *Should the Commission continue to adopt supporting principles (or guiding considerations) to assist it in developing methods to give effect to the principle of HFE?*
- *Should HFE continue to be the priority, or are there circumstances under which certain supporting principles should take precedence over HFE?*
- *Should the supporting principles have a pre-determined hierarchy, or should the Commission seek to balance the supporting principles case by case in order to best achieve HFE?*
- *Should any of the 2015 Review supporting principles be removed, or any new supporting principles introduced? For any new principles, what is it that the new principle would achieve, not otherwise achieved?*

The Terms of Reference direct the Commission to consider whether the supporting principles it uses to guide its work remain appropriate, including whether different weights should be given to different supporting principles.

In the 2015 Review, the Commission retained the four supporting principles it adopted in the 2010 Review to help the interpretation of equalisation, namely reflecting what states collectively do; policy neutrality; practicality and contemporaneity.

The Discussion Paper presents the possibility of having first and second order principles with different options within that broad framework. Achievement of HFE must always be the primary objective with the principles supporting this objective. South Australia does not believe that some supporting principles are more important than others, as they are all required for equalisation.

The 'what states do' principle is critical in determining the scope of equalisation; the policy neutrality principle aims to ensure that the equalisation process creates no incentives to choose one policy over another; the practicality principle is necessary to ensure that assessments are based on sound reliable and clear data; and the contemporaneity principle seeks to ensure that the relativities produced by the Commission's assessments reflect, as far as practical, states' circumstances in the application year.[3]

The introduction of fixed weighting would unnecessarily complicate the Commission's methodology and, practically, it would be difficult to get consensus among the states about the appropriate weightings for each supporting principle. In most instances, the Commission's current methodology achieves an appropriate balance between the supporting principles.

South Australia does not support the introduction of any additional supporting principles as this would not add clarity and would instead increase the potential for principles to conflict in their application. We do not consider that there is anything missing in the current principles.

A discussion of the key issues relating to each of the current supporting principles follows.

What states collectively do

- *Is the use of internal standards a sound approach to the achievement of HFE with no further consideration necessary?*
- *Alternatively, are there any circumstances in which it would be appropriate for the Commission to apply an external standard?*

The use of internal standards ensures that the Commission's assessments reflect what states actually do, which largely removes the need for the Commission to make judgements on what states *could* or *should* do. This approach also ensures that the outcomes of the Commission's assessments are such that each state receives a share of GST revenue that would enable it to provide the average standard of services of the type actually provided by states.

The application of any form of external standard would require significant judgement, increase complexity and undermine the achievement of full HFE. The use of external standards has largely been suggested in the past as part of broader proposals seeking to use the GST distribution mechanism as an incentive to achieve particular efficiency goals or policy objectives. There is no evidence to suggest that HFE in its

[3] With regards to contemporaneity, South Australia acknowledges that due to data availability challenges, this principle can only be pursued to a certain extent, meaning the Commission's assessments are only contemporaneous within practical limitations.

current form detracts from efficiency. As previously discussed in this submission, the sole objective of GST distribution should be to achieve HFE. Other policy objectives should be pursued outside the HFE system. .

South Australia does not believe there are any circumstances that warrant the use of external standards.

The use of external standards raises a number of concerns, including impeding states' sovereignty and undermining the untied nature of states' allocations of GST revenues (as prescribed in the IGA). In addition, determining how external standards are derived would be an ongoing area of contention and it would be difficult to achieve agreement on national or state benchmarks that would drive the external standards. As states differ in the scope and quality of services provided, it would be difficult to determine appropriate service delivery baselines without penalising or over-rewarding jurisdictions.

The Discussion Paper also refers to the potential use of broad indicators and, in particular, a global revenue assessment. South Australia is opposed to the use of broad indicators where they do not reflect what states do. This is consistent with the position adopted by the Commission in the 2015 Review and the findings of the Greiner Review.

The use of broader indicators to measure revenue capacity is likely to create winners and losers without achieving any significant simplification, and at the expense of a less equitable and efficient HFE outcome. For example, such proposals could see the assessment of conveyance duty needs based solely on land values (and disregarding transaction volumes) or assessment of payroll tax needs based on household income data. These approaches would likely produce arbitrary and random changes from the current assessment approach.

- *Should the Commission retain the 2015 Review approach — the 'weighted average' approach — to determine average policy or is there a better alternative?*
- *How might the practical problems arising from the weighted average approach be handled to ensure HFE is achieved?*

South Australia is supportive of using the "weighted average" approach adopted in the 2015 Review to determine what states do. This approach is conceptually simpler than the previous approach which required a majority of states and majority of the base for a service or revenue to become average policy. The shortcomings of the pre-2015 Review approach are well documented, including in the Discussion Paper. Further, we agree with the Commission's view in the 2015 Review that:

> *"… the new approach should be adopted because the Commission is instructed to achieve HFE and all material influences on state fiscal capacities should be recognised. We recognise there was a low risk of missing material influences under the old definition but consider there is little cost associated with providing this new clarity."*[4]

South Australia acknowledges that the weighted average approach may have issues when one state dominates a tax base or provides a unique service, however, no superior approach is apparent.

[4] 2015 Review Final Report, volume 2, p.11

- *Should the fiscal outcome of States the Commission equalises continue to be the same average per capita net financial worth? If not, what fiscal outcome should the Commission equalise?*
- *Given current State circumstances, does the existing scope of equalisation (general government, plus urban transport and public housing PNFCs but excluding local government except for the interactions between it and the State sector) remain appropriate? If not, what activities should the Commission equalise?*

South Australia considers continuation of the current method of equalisation to the same average per capita net financial worth is acceptable. However, as indicated in the 2015 Review, South Australia considers that there is merit in the Greiner Review's recommendation of a simplified and integrated assessment framework to improve the simplicity of the Commission's capital assessments. This would have the potential to achieve greater consistency and transparency by way of uniformly functionalised capital assessments across expenditure categories.

South Australia supports retaining the current scope of equalisation including local government. Consideration should be given to an examination of the range of arrangements emerging for the provision of roads including partly toll funded (private and PNFC) and mooted user charges, and potential changes in Commonwealth financing arrangements to ensure the road assessment methodology is durable for the time being.

- *Should assessments reflect what States do on average?*
- *Should changes be made to the general approaches used by the Commission in the past?*

South Australia accepts that due to data limitations there are some assessments where the relationships between what states do and how the Commission assess state needs is not always direct. South Australia supports such instances being considered in review processes with the Commission exercising its judgement to deliver an outcome most closely aligned with the achievement of HFE.

The Discussion Paper refers to groups that the Commission does not include in any differential assessment. South Australia supports the Commission's position not to include cultural and linguistic diversity (CALD) in any assessment. No conclusive evidence has been presented that demonstrates that having a large CALD population either increases or decreases the overall cost of delivering average state services.

In relation to areas where there is a less direct relationship between what states do and the Commission's assessment approach, we note the following:

Wage cost assessment

South Australia continues to hold the view that private sector wages alone are not a good proxy for movements in public sector wages and that public sector wages are strongly influenced by national, sector-specific labour market pressures. The National Institute of Labour Studies in their 2015 report *Public-private sector wage differentials in Australia: What are the differences by state and how do they impact GST redistribution decisions* (NILS Report) provides support for further review and consideration of the wage cost assessment. We are concerned that the Commission has so far dismissed the findings of this report without clearly outlining the basis for its position.

Population growth as a proxy for capital requirements

South Australia considers that the Commission's use of relative population growth as a proxy for capital requirements results in only a partial (one-sided) recognition of the effects of population growth on states' infrastructure needs. The current approach assumes that high-growth states are automatically faced with above-average infrastructure costs and ignores the positive effects of high population growth on the generation of net worth per capita. South Australia considers that there are grounds for discounting the population growth needs assessment.

Policy neutrality

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

South Australia does not support the equalisation of states based on a rotating average. While, in theory, there may appear to be some policy neutrality gains from assessing each state against a standard that completely excludes its own policies, this needs to be weighed against the significant additional complexity that this approach would create. Essentially, the Commission would need to calculate eight different "standards" for all its assessments.

South Australia considers that introduction of such an approach should be contingent on a clear demonstration this method would enhance HFE, and that any equalisation improvements are substantial enough to justify the significant additional complexity.

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

HFE does not create disincentives to reform state taxes, a conclusion supported in the Greiner Review and noted in the *Australia's Future Tax System* review (the Henry Tax Review).

If a state unilaterally reduces reliance on a revenue base in order to exploit an alternative tax base the CGC assessments will be only slightly affected. Any impacts would be the result of the impacts on standard revenue collections, which are likely to be marginal unless a larger state (or a state which dominates a particular revenue assessment) undertook a very large tax mix switch.

A national tax reform initiative could affect the CGC assessments where it results in a tax being abolished and no longer part of the assessment of what states do, and/or a new revenue base being assessed. State GST shares would be altered by this but the effects would be the mirror of the changes in each state's relative revenue raising capacity resulting from the tax mix switch. Ignoring differences in tax effort (which are a policy choice), such a scenario would leave state shares of combined own source tax revenue and GST grants unchanged.

The final report of the Henry Tax Review confirmed HFE's relative neutrality in relation to tax reform. This review highlighted that HFE ensured that states had no incentives to "resist or favour" tax reform proposals on the basis of differing tax capacities.

> *"A change in tax mix adopted by all States will change their relative revenue-raising capacities, therefore affecting the distribution of GST revenue. A change in tax mix might be revenue-neutral to the States in an aggregate sense, but an individual State might have one of their relatively stronger bases replaced with a*

relatively weaker base, such that revenue from their own taxes is lower. However, this loss in revenue could be made up through the HFE process, as the loss of their relatively stronger tax base means that their revenue needs are higher. In theory, if all States apply the same revenue-raising effort, no State would have a financial incentive to resist or favour a revenue-neutral reform of State tax base composition on the basis of the local strength or weakness of particular tax bases.

In practice, however, the States will be affected differently because they apply different policies to their existing tax bases and are likely to continue to do so in regard to tax bases they have access to in the future. The redistribution of GST revenue will not take into account the impact of changes to tax bases on a State where it does not apply the average policy. That is, if a State is raising more than the average revenue off a base that is abolished, HFE will not compensate for revenue lost above the average, just as if a State was making a below-average effort that State would not be penalised. This may cause difficulties for some States, particularly if the States do not have the same ability to raise marginal revenue from the new tax base as they did with the old one."[5]

The above quote highlights the fact that states may still face hurdles in respect of particular tax reform options on account of differences in tax policy (effort) for relevant taxes. This is not, however, a consequence of HFE.

The Henry Tax Review concluded that many state taxes are highly inefficient, including insurance taxes and stamp duties because they are narrowly based transaction taxes, and payroll tax because of the narrowing of the tax base due to the small business tax exemption.

The existence of these taxes in their current form reflects a range of factors, notwithstanding the fact that numerous reviews by economists and other taxation experts have routinely concluded that they have negative efficiency consequences. These factors include:

- community acceptance – for example the relative acceptability of incurring an irregular, albeit large, tax liability when purchasing a property - given that this occurs at a time of liquidity as compared with a regular annual tax impost imposed on the site value of the family home;
- perceived equity motivations (for example, as between small and large businesses);
- revenue issues (for example, the relative stability associated with a sales based royalty regime as compared with the more volatile and unpredictable revenue streams associated with a mineral rent tax); and
- the difficult transitional issues associated with large scale reform, including compensating those who suffer adverse impacts.

As part of its 2015-16 Budget, South Australia announced a major business tax reform package designed to make the state the best place to do business and to encourage investment and job creation. The package, when fully implemented, will see the abolition of stamp duty on non-quoted marketable securities, non-real property transfers, non-residential real property transfers and transfers of units in unit trusts. The package also expanded the stamp duty concession for mining exploration tenements to include retention tenements – a pro-mineral development initiative. This tax reform package will see the abolition of taxes that are commonly acknowledged as being the most inefficient. South Australia will be the first state to abolish duty on

[5] Australia's future tax system, Report to the Treasurer, December 2009, Part Two Volume 2, page 685

the transfer on non-residential property. HFE was absolutely not a factor in developing this reform package.

In its 2012-13 Budget, the ACT Government announced a major tax reform package that when fully implemented will see the abolition of stamp duties on general insurance and life insurance, abolition of conveyance duty and abolition of commercial land tax. Revenue will be replaced through the ACT's general rates system. This reform followed an ACT tax review and the Henry Tax Review. Current HFE arrangements did not obstruct this reform process.

Practicality

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

South Australia supports the Commission using the most reliable, fit-for-purpose data in its assessments. While it is desirable that the Commission's methods and the data used should be completely transparent, this is not always possible due to the confidential nature of some of the data required to develop robust assessments. South Australia considers that the Commission should continue to use confidential data where this will facilitate equalisation.

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

South Australia is comfortable with the current levels of discounting and generally supports the Commission using its discretion to determine the levels of the discounts applied in specific cases. However, South Australia urges the Commission to revisit the discounts applied in the Land Tax and Wage Costs assessments.

Land Tax

In the 2015 Review, the Commission applied a 25 per cent discount to the income producing component of the Land Tax assessment, reflecting its concerns about the reliability and comparability of state data on land values. A key concern related to the reliability of Queensland's data on the distribution of its taxable land holdings by value.

In the 2017 Update, Queensland provided new data based on a revised distribution of land values, which Commission staff considered to be more representative of Queensland's property market and derived through an approach that is more consistent with that used by other states to estimate their value distributions.[6]

Given that the Commission now has more reliable data on which to base the Land Tax assessment, South Australia considers that a 25 per cent discount is no longer warranted. The Commission should review the discount in light of the improved data with a view to removing or reducing the discount.

Wage Costs

As indicated earlier in this submission, South Australia continues to have concerns about the lack of a compelling conceptual case to support the current Wage Costs

[6] Commission Staff Discussion Paper CGC 2017-01-S, *An additional new issue for the 2017 Update – Land tax assessment*

assessment and considers that there is sufficient evidence for the Commission to increase the current 12.5% discount applied to this assessment.

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

South Australia has no concerns about the current materiality thresholds, however, we support the Commission using its discretion to determine whether there is a compelling case to increase them. We trust that, consistent with usual practice, states will be given an opportunity to review any proposed changes.

- *Is the Commission's current approach to quality control an acceptable way to ensure 'robust quality assurance processes'?*
- *Are there any new risks that the Commission should take into account from a State perspective?*

South Australia has no concerns with the Commission's 2015 Review Quality Assurance (QA) Strategic Plan and is comfortable with the plan being carried over into the 2020 Review.

Contemporaneity

- *Should the Commission maintain the aim of achieving a GST distribution relevant to the application year, or should the aim be varied to achieve equalisation over time using historical assessments?*
- *Does the current three year lagged average approach present undue difficulties to managing your State's cyclical cash flows?*
  - *If so, which of the approaches discussed would result in an improvement to cyclical cash flow management and why, noting the concerns about using reliable and consistent data, the unreliability of forward estimates and the risk of policy contamination through the different budgeting practices of the States (with the consequent likelihood of increasing complexity through a completions type process)?*
  - *If none of the proposed approaches appeals, what approach would your State propose and why?*
- *Under any contemporaneous approach, should backcasting in its current limited form continue? If so, can/should backcasting be expanded to cover a wider range of Commonwealth payments or other volatile revenues?*

South Australia supports the Commission's current approach to contemporaneity and continues to believe that three year averaging is a practical, reliable and stable assessment approach. However, it is recognised that this approach will not produce a fully contemporaneous outcome in the application year, particularly if there is a sudden large change in states' fiscal capacities.

In the 2015 Review, the Commission was asked to consider the treatment of large and volatile revenue sources, provide advice on a possible approach that would mitigate the negative effects of revenue volatility and ensure that states' shares of GST for a year are appropriate for their fiscal circumstances in that year. This was effectively a review of the contemporaneity supporting principle.

A number of options for improving the contemporaneity of the Commission's assessments were suggested in the 2015 Review, including changing the averaging period, applying weightings to the assessment years to give greater weight to the more recent years, basing the assessments on forecasts of state circumstances in the application year, removing iron ore royalties from the mining revenue assessment, and adjusting state GST entitlements to provide additional support to states affected by large and volatile revenues, with this additional funding repaid in subsequent years.

HFE is first and foremost about the equalisation of states' fiscal capacities (recognising the average revenue and expenditure policies of states). HFE is not about attempting to correct or respond to states' cyclical budgetary circumstances that incorporate revenue and expenditure policy choices.

Notwithstanding the main objective of HFE, the Commission's assessment method is well established and understood by state Treasury officials and the estimated GST impacts of changes in states' circumstances are incorporated into states' GST revenue forecasts.

Concerns have been raised about the predictability of relativity changes from one year to the next but the current three year averaging approach does moderate sudden changes in states' circumstances.

Changes in GST relativities are usually the mirror of changes in state circumstances, albeit with a lag. South Australia accepts that, as with any other budget item, no state can predict its future GST revenue with absolute accuracy. However, states are able to anticipate the trajectory of their GST shares into the future by taking into account observed and expected changes in revenue and expenditure patterns.

A range of factors influence the movements in relativities in annual updates, in particular:

- revenue updates reflecting differential emerging growth in revenue raising capacity between jurisdictions, particularly in relation to royalties and conveyance duty;
- emerging state shares of impacting Commonwealth grants; and
- data updates (for example the Characteristics of Employment data underpinning the wage costs assessment).

The first two sources of change in relativities should be able to be anticipated by state Treasuries because they are observable from published documents including Budget documents released prior to the Commission's annual update reports. The impact of data updates and other assessment factors may be less readily anticipated by state Treasuries, however, we note that the Commission does endeavour to notify the states of emerging developments.

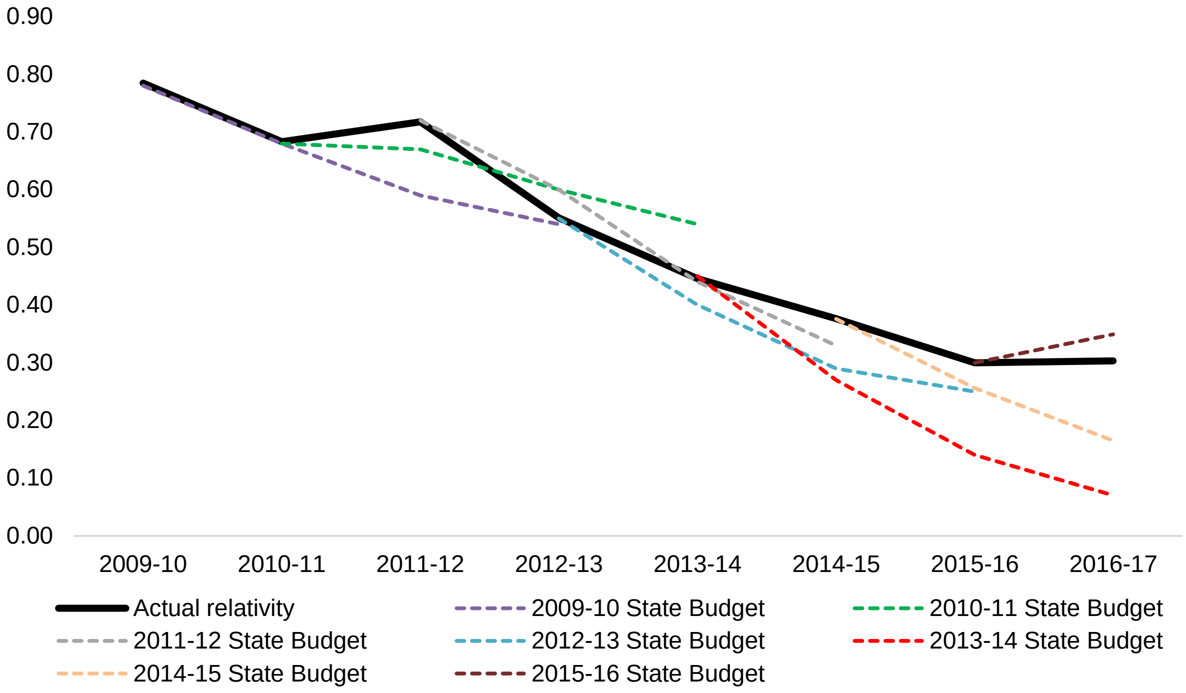
States, including those that rely on large and volatile revenues, generally take these considerations into account when forecasting relativities as part of the budget development process. For example, in its 2013-14 State Budget, Western Australia predicted the impact of its significantly above-average capacity to raise mining revenue on its future GST grants:

> *Overall, GST grants are forecast to decline from $2.9 billion in 2012-13 to just $500 million in 2016-17, mainly due to the significant increase in Western Australia's mining royalties in recent years and the full 'equalisation' of these royalties over time by the CGC (i.e. with lags).*
> *Western Australia's projections of its GST share over the forward estimates*

period differ significantly from those published by the Commonwealth, due to our more detailed forecasting methodology and associated differences in assumptions made.[7]

While Western Australia's GST forecasts appear, in hindsight, to be rather conservative (for example, Western Australia's GST share in 2016-17 will likely be around $2 billion rather than $500 million), that state clearly anticipated the trajectory of its GST relativities over time, as shown in Figure 1.

Figure 1: Western Australia's forecast and actual GST relativities over time



Source: Western Australian State Budgets 2009-10 to 2015-16, Commonwealth Final Budget Outcomes 2009-10 to 2015-16, Commonwealth 2017-18 Budget

Similarly, with the recent decline in its revenue raising capacity, Western Australia has started to factor in an increase in its relativity going forward. The change in Western Australia's fiscal capacity will affect all states and the majority of states appear to have factored this into their latest Budget forecasts.

The three-year averaging approach assists, and does not hinder, the development of realistic GST estimates over a budget cycle as it stabilises GST shares from one year to the next, even in times of revenue or expenditure volatility. This is because a significant change in revenues or expenses in a particular year would only affect the relativities incrementally over a number of years rather than in a single "big hit" in a particular year.

In recent years a big source of forecasting error in GST revenue has been changes in the size of the total GST pool for distribution, rather than changes in relativities. For example between the 2016-17 Commonwealth Budget and 2017-18 Commonwealth Budget, Commonwealth estimates for the total GST pool were revised down by around $7.5 billion over the four years to 2019-20.

It is widely acknowledged that the lag in the Commission's assessments means that the relativities used to distribute GST revenue in a particular year may not

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[7] Western Australian 2013-14 State Budget, Paper No.3, p.96

necessarily reflect state circumstances in that year. However, from a budget development perspective, the stability of GST revenue from one year to the next could be viewed as more pertinent than the extent to which the GST relativities accurately reflect fiscal capacities in a given year. This is especially important when a large and unexpected change in revenue or expenses in one state has the potential to significantly affect other states' GST revenues, as the Commission noted in the 2015 Review:

> *The three year lagged approach also assists States with budget management, in that any State's GST revenue is not immediately subject to volatile outcomes in other States. For example, while the equalisation system will see Queensland compensated by the other States for expenses incurred in addressing natural disasters, States do not bear this cost unexpectedly in the year in which the disasters occur. States can plan to absorb those costs through reductions in GST revenue as the relevant year moves through the equalisation system. States are well aware of this longstanding aspect of the HFE system and manage their budgets accordingly.*[8]

Clarification of the contemporaneity supporting principle

The discussion above leads to the question of whether the current supporting principle should be altered to reflect the fact that the use of lagged data is a reality (and the most reliable approach) and that as a result, gaps between GST payments and GST requirements in a particular year will always exist.

The current contemporaneity principle aims to:

> *Deliver relativities that, as far as possible, are appropriate to the application year*.

Of course, it is not possible to produce relativities that are perfectly contemporaneous ahead of the actual application year. The contemporaneity supporting principle could move the focus away from the unachievable "appropriate to the application year" to:

> *Deliver annual relativities for an application based on the most recent actual data.*

This definition recognises the limitation on achieving full contemporaneity but still maintains a requirement on the Commission to base its assessments on the most accurate and up-to-date actual data.

ALTERNATIVE APPROACHES TO APPLYING THE CONTEMPORANEITY PRINCIPLE

Commission Staff Research Paper CGC 2017-05-S discusses the following options for improving contemporaneity:

- A one-year model, where assessments are based on only the most recently completed financial year;
- Adopting a later reporting date, which would allow the Commission to incorporate more up-to-date data for the final assessment year;
- Use of projections or forecasts of fiscal capacities in the application year;

[8] Commonwealth Grants Commission, 2015, *Response to Commonwealth Treasurer – GST shares in the presence of large and volatile state revenues*, pp.4-5

- Applying a different treatment to volatile revenues (for example, treatment by absorption); and
- An advance and completion (or completion only) method to correct for differences between GST payments and GST requirements.

South Australia appreciates the work Commission Staff have undertaken in investigating each of these methods and quantifying the potential contemporaneity gains (and losses) for each state under each method. This work is especially valuable as it clearly demonstrates the difficulties of attempting to genuinely improve contemporaneity (as opposed to proposals put forward by some states with the aim of improving their own GST outcomes).

South Australia notes that none of the options investigated by Commission Staff eliminated the gap between GST payments and GST requirements. In fact, no method would even reduce the gap for all states – each alternative produced winners and losers.

As indicated earlier, South Australia acknowledges that the Commission's assessments do not always produce contemporaneous relativities. However, we are of the view that the current approach should only be changed where it can be demonstrated that a particular alternative would be more reliable and robust. In principle, we are open to the consideration of alternative methods, however, we note that none of the options considered so far are demonstrably better than the current method.

TREATMENT OF OTHER COMMONWEALTH PAYMENTS TO STATES

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

South Australia supports the Commission's current approach to assessing Commonwealth payments to the states. The Commission should retain its discretion in determining the treatment of each payment in a manner that most closely achieves HFE.

Given the heterogeneity of Commonwealth payments and the wide range of service delivery areas that they cover, it is unlikely that treating all these payments in the same way (i.e. all or none impacting on relativities) would be consistent with HFE. Notwithstanding this, if a uniform treatment were to be applied for simplicity, it would make more sense from an equalisation perspective for all payments to be treated as impacting, rather than not. However, South Australia maintains that simplicity should not be pursued at the expense of equalisation.

ASSESSMENT GUIDELINES

- *Are changes needed to the assessment guidelines?*

South Australia is broadly comfortable with the assessment guidelines adopted by the Commission in the 2015 Review. Our concerns with the Commission's approach to assessing interstate wage costs and the discounts applied in the Land Tax and Wage Costs assessments have been detailed earlier in this submission.

ACHIEVING HFE – OTHER APPROACHES TO DISTRIBUTING THE GST

Staff Research Paper CGC 2017-03-S considers and analyses the following alternative approaches to distributing GST revenue:

- An equal per capita (EPC) distribution
- A partial EPC distribution
- An actual per capita (APC) distribution.

The Greiner Review considered a number of different equalisation approaches and classified them into two broad categories – proposals that do “less” equalisation and proposals that perform equalisation in a less precise or more general way. This classification approach correctly highlights that all alternatives to the current arrangements result in outcomes that will compromise the achievement of full equalisation.

South Australia does not support any of the above approaches, on the basis that they would not be consistent with the HFE objective agreed to by the Commonwealth and all states in the IGA. All these methods would leave some states without the fiscal capacity to provide their citizens with the average standard of services. South Australia firmly supports the continuation of the current form of HFE.

Relativity floor

A further alternative distribution mechanism that has been proposed recently is the introduction of a relativity floor, to ensure that no state’s relativity may fall below a set level. Similar to the alternative methods highlighted above, a relativity floor would be inconsistent with HFE and would compromise the capacity of all other states to provide the average standard of services to their residents. Again, the flaws of this proposal are well documented, not least among them the arbitrary nature of picking a “floor” with no conceptual basis.

It is well known that these alternatives to HFE have arisen in response to recent changes in Western Australia’s GST relativity, following the significant increase in its fiscal capacity during the mining boom. While there may be a case for investigating robust ways of improving the contemporaneity of the GST relativities, there certainly is no case for dispensing with HFE altogether. Further, as has been noted by the Commission and a number of states, it is important to note that while the lag in the Commission’s assessments has meant that Western Australia’s relativities did not immediately reflect the decline in its fiscal capacity in recent years, Western Australia benefitted from the lag at the beginning of the mining boom. For that state to now push for fundamental changes to the system because it no longer benefits from the lag is disingenuous.

STATE MINING POLICIES

Staff Research Paper CGC 2017-04-S discusses key issues relating to the Mining Revenue assessment, particularly the challenges of attempting to balance policy neutrality and reflecting what states do, as well as changes in state mining policies since the 2015 Review. The Staff Research Paper also notes that the Commission may revisit the following issues in constructing average policy on which to base its assessments:

- when a state dominates a tax base (as is the case with Western Australia and iron ore); and
- when a state prohibits a tax base being accessed (as with the case with a number of states and coal seam gas).

The first issue was a key topic of consideration in the 2015 Review. South Australia acknowledges that the assessment of mining revenue capacity is made difficult by the trade-off between policy neutrality and reflecting what states do, which is accentuated in many cases by the domination of the respective mining tax bases by one or two states. However, South Australia is not aware of an alternative approach that would better achieve HFE. The current mineral-by-mineral assessment is the most appropriate approach, as it best reflects what states do.

The second issue has grown in prominence since the 2015 Review, mainly due to some states' decisions to ban coal seam gas exploration and mining. We note that there are also bans on uranium mining in most jurisdictions. Currently, states are assessed to have no capacity in relation to any banned mining activity, which is consistent with a view that bans on environmental grounds are average state policy. South Australia considers that any move away from the current approach should be supported by clear evidence that this is no longer the case.

The State Mining Policy staff research paper suggests that options for assessing average policy where exploration of a mineral is banned in a state could include estimating the capacity foregone by states that ban mining activity; continuing to assess no capacity for the state that bans the mining of a particular mineral; or assessing no capacity for any state for the banned mineral.

South Australia notes that a key strength of the current mining revenue assessment is that it is based on observed levels of production and policy decisions.

Alternative estimates of revenue capacity would need to take into account factors such as extraction costs, commodity market conditions and other commercial and economic factors. Just because it is known that there is a resource deposit in a particular area, does not mean that it would be economically feasible to extract that resource. We are not aware of any reliable source of information for such an assessment.