Victorian Response to New Issues for the 2021 Update

September 2020

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1. Introduction

The Commonwealth Grants Commission (the Commission) has circulated the 'New Issues for the 2021 Update' staff discussion paper outlining several issues that the Commission considers relevant for the 2021 Update.

Victoria notes that these issues have been identified in the absence of the Terms of Reference (ToR) for the 2021 Update, and that once the ToR is issued, further consultation may be necessary.

Victoria notes that a second new issues paper, considering the treatment of new Commonwealth payments, will be issued in October.

Victoria thanks the Commission for the opportunity to provide comments on its proposed approach to the issues identified.

The issues identified in the New Issues paper are the:

- response by State Governments to the COVID-19 pandemic;
- implementation of the new standard of horizontal fiscal equalisation (HFE);
- use of a new dataset for the non-admitted patient assessment;

- approach to handling revisions to data for stamp duty, land tax and for wage cost assessments;
- approach to deriving consolidated expenses, user charges and investment for urban transport and housing; and
- treatment of concessional loans for natural disaster relief.

The Victorian responses to these issues are presented in the following sections.

2. Response to the COVID-19 pandemic

The New Issues paper seeks to identify whether, and if so to what extent, State Government responses to COVID-19 have resulted in changes to State fiscal capacities that would not otherwise be recognised using the 2020 Review methods.

The New Issues paper states that the 2021 Update is concerned only with COVID-19 related changes and their effects in 2019-20. We note that Victoria accounted for 28 per cent of all COVID-19 cases recorded nationally up to 30 June 2020, slightly greater than the State's population share of 26 per cent.

While Victoria agrees with the recommendation that the Commission only consider issues currently known to be material and affecting 2019–20, there needs to be a comprehensive examination of the expenditure and revenue data to determine the extent of the impact of the responses to COVID-19 in 2019–20 and the materiality of these impacts.

If changes to the Commission's overall approach or methods are required to accommodate responses to COVID-19 then it would be appropriate for the 2021 Update ToR to specify these changes. While Victoria recognises that this issue may be more relevant for the 2022 Update than the 2021 Update, the drivers of COVID-19 related expenses and revenue in 2019-20 need to be compared with the drivers used by the current methodology.

Policy Differences

Victoria considers that there would be little policy differences between the States in 2019-20, although policy differences may be more apparent in 2020-21 (which will be part of the reference period subject to the 2022 Update). Given this, Victoria supports the Commission's proposal to re-assess treatment of COVID-19 responses in future years.

Victoria agrees that for 2019-20, the actual level of economic activity and additional services provided are the best available measure of what has occurred with common State policies.

Method Changes

Victoria considers that some of the effects of COVID-19 on State fiscal capacities may not be captured by 2020 Review methods. For instance, COVID-19 infections seem to be disproportionately located in capital cities which may reflect the contagious nature of this disease in congested settings (for example, in high rise community accommodation). The usual health drivers such as rurality and indigeneity may not be as relevant for COVID-19. Victoria believes that the Commission should investigate the drivers of COVID-19, which are likely to be more relevant for 2020-21.

Revenue issues

The New Issues paper states that the Commission adjusts its revenue assessments when there are State policy differences that materially affect a State's revenue capacity measures. Victoria notes that Commission staff consider that State policy responses to COVID-19 in the assessment period have been broadly comparable. Victoria therefore supports the Commission's proposal not to make adjustments to revenue assessment methods with the exception of any data adjustments needed to ensure data comparability.

Are adjustments required to revenue assessment methods?

While there may be differences between the States in the scope and extent of revenue waivers and deferrals, the current assessment methods should still be appropriate for the 2021 Update. Any differences in State responses are likely to reflect differences in State circumstances and not policy choices.

The treatment to apply to waivers

Victoria considers that waivers and rebates should be considered as being equivalent, as both are related to a particular tax liability. If the Commission is to consider the materiality of rebates, then it should do the same for waivers. However, Victoria would prefer the Commission to consider the materiality of waivers and rebates jointly. Victoria agrees that capturing the effect of waivers and rebates as reduced effective tax rates is the appropriate treatment.

The treatment to apply to deferrals

Victoria agrees with the Commission's proposition that deferrals should be assessed in the year in which the tax liability arose, as this would relate the tax liability to the relevant tax base. If they are assessed in the year the tax is collected, then changes to the tax base could distort the national effective tax rate.

The treatment to apply to JobKeeper payments

Victoria supports the Commission's proposal to not remove JobKeeper payments from its payroll tax base if there is no reliable data available to make such an adjustment. However, Victoria would like the Commission to investigate the data that is available on JobKeeper payments before it decides that an adjustment to the payroll tax base is not practical.

Expense issues

The Commission has observed that States have announced new spending initiatives in response to COVID-19 across all expense categories. In some categories, service delivery arrangements have changed significantly (such as the remote delivery of school education). Similarly, the socio-demographic profile of people targeted by police may have changed.

For most categories, the Commission has concluded that COVID-19 related spending is relatively small, and the drivers of need have not significantly changed. Generally, Commission staff consider that applying the 2020 Review methods to new and existing spending remains appropriate. However, the Commission believes that there are potentially two categories (health and services to industry) where significant additional spending related to COVID-19 has been announced and may result in different needs from those assessed by the 2020 Review methods.

While it may be the case that for most expense categories COVID-19 related spending is relatively small and the drivers of need have not significantly changed, Victoria's view is that this should be examined so that this case can be established. Victoria understands that COVID-19 related expenses can be separately identified in Government Finance Statistics (GFS) data. This would enable the extent of additional expenditure to be quantified. It may be the case that there are other expense categories in addition to health and services to industry that have experienced significant additional spending.

For example, since March 2020, the Victorian Government has announced significant initiatives across a range of sectors that were allocated funding in 2019-20. These programs include:

- accommodation for health care workers, homeless people and victims of domestic violence;
- services to support quarantining of overseas returnees;
- rent relief for commercial tenants in government buildings;
- support for tourism, sport and creative industries;
- IT resourcing to support public sector staff working from home;
- support for police and emergency services response to COVID-19;
- sustainability funding of public transport;
- funding unemployed persons to provide public services such as cleaning public infrastructure and delivering food;
- TAFE and training sector support;
- emergency relief for international students;
- enhanced cleaning of schools; and
- support to schools to deliver online learning.

Health

State budgets

The National Partnership on COVID-19 Response (NPCR) puts in place a 50:50 cost-sharing arrangement for specific COVID-19 related hospital and public health expenditure, apart from the private hospital viability payment which is Commonwealth funded.

The National Health Funding Body has advised the Commission that States have incurred around $1.7 billion in COVID-19 related expenses in 2019-20 that are considered in scope of the NPCR.

The Commission understands that most new spending in 2019-20 relates to the community and other health services component, such as public health expenses associated with responding to the pandemic and running health information campaigns, contact tracing and some testing services. New spending is also expected in the admitted patient and emergency department components, likely in proportion to the incidence of the virus in each State.

Victoria notes that there is reliable data on State health expenditure that has resulted from COVID-19.

Victoria believes that while the NPCR expenditure is reliable and comparable across different States, it does not provide a complete view of the COVID-19 spending as some expenses fall out of the scope of the NPCR.

Due to the requirement to maintain readiness during the pandemic, the Victorian Government has had to support health services with additional funding to continue their operation.

An example is the action of Victorian health services in residential aged care, both in the home and where patients have been transported to a public health service. Under the NPCR, States are responsible for the first three days of responses into aged care, with the Commonwealth responsible thereafter.

Both of these examples are largely a result of particular Victorian circumstances rather than conscious policy choices.

<u>Does the current assessment method capture COVID-19 related drivers?</u>

Victoria considers that the nature of COVID-19 and its responses are not adequately covered by the current assessment methodology. Initial cases of COVID-19 infection were related to returning overseas travellers with subsequent cases clusters of community and workplace transmission. Testing for COVID-19 was not necessarily related to the socio-demographic groups considered in the health assessment.

Accordingly, Victoria supports an actual per capita assessment if this assessment is material and the Commission is satisfied on the reliability of the data from the National Health Funding Body.

Services to industry

<u>State budgets</u>

Analysis by the Commission suggests that States announced COVID-19 related measures of around $4.7 billion to support business and industries during the early months of the pandemic. The issue for the Commission is whether the 2020 Review methods would adequately capture and fairly treat this expenditure. The current method involves splitting GFS data into business development and regulation using a fixed ratio for the duration of the review period, based on State data for earlier years. Commission staff have identified that the Commission could change this ratio by classifying all spending growth as business development.

<u>Does the current assessment method capture COVID-19 related drivers?</u>

Victoria does not consider that changing the split (ratios) between business development and regulation would constitute a method change. The decision to fix the split for the 2020 Review period would have been based on the assumption that there would not be a significant variation over that period. To change this split should be regarded as a data issue rather than a method issue.

Victoria supports the recalculation of the split between business development and regulation expenses for the 2021 Update if it is material.

Victoria agrees with the Commission's conclusion that States' pandemic responses do not warrant a change to the assessment of business development expenses.

The New Issues paper suggests that some of the additional industry support expenditure in response to COVID-19 may have been incurred regardless of the existence of COVID-19. Victoria does not agree with this position and considers that support measures announced in response to COVID-19 clearly represent new expenditure.

3. Implementation of the new HFE arrangements for 2021-22

From 2021-22, legislated changes will see a change to the objective of HFE. The changes will result in a gradual move away from distributing GST revenue using the current arrangements (based on State relative fiscal capacities as measured by the Commission) to new arrangements (equalising to the fiscally stronger of New South Wales or Victoria "second strongest State").

The new HFE arrangements transition from 2021-22, with the new arrangements fully applying in 2026-27. The changes for the 2021 Update are that the recommended relativities for use in distributing general revenue assistance grants for 2021-22 will be a 5/6th to 1/6th blend of the previous and new arrangements, with the grants being a pool comprising GST revenue along with a $600 million top-up (boost) payment.

Giving effect to the new legislation

Victoria notes that, subject to the 2021 Update ToR, the Commission proposes to:

- measure State relative fiscal capacities (as per the previous arrangements);
- from these relative fiscal capacity measures, derive the corresponding standard State capacities (new arrangements); and
- blend the previous and new fiscal capacity measures as prescribed in the legislation.

Victoria notes that this proposal is in accordance with the legislated changes.

Presentation of results

The New Issues paper outlines the additional tables and commentary proposed for inclusion in the 2021 Update report. In particular, the tables would:

- show the capacities derived under both the previous and new arrangements, how those were blended during the transition years, any floor adjustments if required, and hence the recommended relativities to be used in distributing the general revenue assistance grant pool; and
- describe the contribution of each of the change in fiscal capacities, transition blending and floor adjustment, to the change in the grant pool distribution due to the change in relativities from the previous Commission Update.

Victoria supports the additional tables above and the proposed commentary outlined in the New Issues paper. Victoria believes that both the "second strongest State" and "no worse off" calculations should be shown as a final component of the derivation of relativities and that this approach should be reflected in tables and commentary.

4. New data for the non-admitted patient component

For the 2020 Review, the Commission used admitted patient separations as a proxy indicator to measure non-admitted patient service use. During the Review process, Commission staff investigated the potential of using a more appropriate non-admitted patient dataset as a proxy but were (then) advised of adverse data quality issues by the Independent Hospital Pricing Authority (IHPA).

The Commission has received a new non-admitted patient dataset for 2018-19 from the IHPA. The Commission staff propose to recommend that the Commission shift to using this non-admitted patient dataset for the 2021 Update due to improvements in data comprehensiveness and reliability. As only 2018-19 non-admitted data are currently available, staff recommend that this year's data be used for all assessment years (2017-18 to 2019-20 inclusive).

Victoria supports the use of the improved non-admitted patient data for the 2021 Update and future updates. There is a high level of coverage of the non-admitted patient data and it is clear that the current proxy indicator is not an appropriate indicator of non-admitted patient needs and costs.

5. Revisions to stamp duty on conveyance and land tax

In recent years the Commission has found that there has been an increase in the size of the revisions States are making to previously provided conveyancing and land tax data. The concern is that large revisions increase the volatility of State relativities and negatively affect State budget management. Large revisions may also raise concerns over the reliability of State provided data.

Victoria appreciates the work that the Commission staff have undertaken to consult with jurisdictions to gain an understanding of causes for data revisions.

Victoria also notes that the Commission has identified that the deduction of duties from the sale of major State assets from GFS conveyance revenue has been in error as two different tax codes are involved. Victoria considers that the New Issues paper should have provided information on the amounts involved and the estimated GST impact (as was the case for non-admitted patient data). Without this information an assessment of the materiality of this data correction cannot be made. It is also unclear from the New Issues paper whether an adjustment to the tax bases of the affected States is required.

Victoria encourages the Commission to undertake an examination of the ABS GFS data classifications to ensure that no further inappropriate adjustments are made to data.

6. Revised data in wage cost assessments

The Commission has used data from the ABS Characteristics of Employment Survey (CoES) in its wage costs assessment since the 2016 Update. Since the ABS has not previously revised this data, the usual practice for the Commission is to bring in the modelled outcomes for the latest assessment year and retain the outcomes from the previous Update for the earlier years.

As the Commission has become aware that the ABS has revised data from this survey, the New Issues paper proposes that the revised data be used in the calculation of wage costs modelled outcomes for prior years.

A table provided to States by Commission staff shows that the effect of revising wage costs modelled outcomes on the 2020-21 GST allocation is to redistribute $200 million across States, with Victoria losing $94 million.

Victoria notes that the ToR from previous Updates state that the Commission should use, where possible, the latest available data. We support the Commission applying the latest available data to its assessments which may include revised data.

Victoria agrees that the Commission use the modelled outcomes based on revised CoES data for 2017-18 and 2018-19.

7. Changes to the compilation of the adjusted budget

Commission staff have reviewed the approach taken in the 2020 Review to deriving consolidated expenses, user charges and investment for urban transport and housing.

Following discussions with the ABS, the Commission proposes that user charges, expenses and investment for the urban transport and housing assessments be based on ABS GFS data for the non-financial public sector (NFPS) for the first two assessment years (NFPS data are not available with respect of the final assessment year). In the 2020 Review, the consolidation was made by the Commission using the ABS State general government sector and public non-financial corporations sector data. This change will simplify the adjusted budget calculations and improve the reliability of the data.

Victoria supports the proposal to use NFPS data to estimate user charges, expenses and investment for housing and urban transport for the first two assessment years if this will simplify the adjusted budget calculations and improve the reliability of the data. Victoria notes that no change is proposed to the method of obtaining data for the last assessment year, but that increased checking of the data will occur.

Detailed analysis undertaken for the New Issues paper indicates that the majority of transactions in COFOG-A category *1132 Urban water transport freight services* relate to port services and not urban transport. Therefore, the Commission proposes to reclassify this COFOG-A from the urban transport component to non-urban transport component.

Victoria notes the Commission’s intention but considers that the New Issues paper should have provided information on the amounts involved and the estimated GST impact so that an assessment of the materiality of this data adjustment can be made. It is not clear from the New Issues paper if these expenses were included in the regression model for urban transport expenses. If they were then the model should be re-estimated to examine whether there are statistically significant changes to the regression coefficients.

The New Issues paper notes that Victoria's general government subsidies to V/Line are recorded as urban transport by Victoria and the ABS. However, the Commission considers V/Line services to be non-urban transport. From this update onwards, the Commission proposes that the subsidies to V/Line are included in the non-urban transport expenses component.

Victoria notes that the New Issues paper is mistaken in the belief that V/Line services are exclusively non-urban transport. V/Line provides a mix of urban and non-urban transport services and Victoria will obtain the data required to illustrate the split and make this available to the Commission.

In the NFPS data, all Queensland Rail (QR) expenses and user charges (urban and non-urban) are classified as urban transport. Non-urban rail passenger transport expenses can be identified from the ABS GFS general government data and the State unit record data. From this update onwards, the Commission proposes to use these two datasets to identify QR non-urban rail passenger transport expenses and reallocate them to the non-urban transport component. The non-urban transport share of QR user charges could not be identified but the amount is likely to be relatively small. Therefore, the Commission does not intend to make an adjustment to the user charges.

Victoria notes that it is proposed to split QR expenses into urban transport and non-urban transport expenses, but not to split user charges due to lack of data. If user charges represent fares paid by travellers, then net non-urban transport expenses could be overstated and net urban transport expenses understated. Victoria would prefer that the outcome of discussions between Commission staff and Queensland officials be presented to the other States before forming a view on this proposal.

Victoria is concerned that the Commission did not identify these issues relating to the classification of urban and non-urban transport at the time of undertaking the 2020 Review.

8. Assessing loans under natural disaster relief expenses

The natural disaster relief expenses assessment recognises the net costs States incur due to natural disasters. The assessment should apply a consistent treatment to the various types of assistance (grants, concessional loans and interest rate subsidies) provided by States to individuals, businesses, community organisations and local governments as well as to the different forms of reimbursement provided by the Commonwealth (grants and concessional loans).

Previous assessments inflated the value of concessional loan expenses relative to interest rate subsidies because loan values were used in the assessment. Commission staff propose to correct this by including in the assessment only the net cost to States of providing concessional loans, that is, a State's interest rate subsidies on loans.

Victoria supports the recommendations for assessing loans under natural disaster relief expenses presented in the New Issues paper.

Treasury and Finance