NSW Treasury

2025 Review Discussion Paper – Fiscal equalisation and supporting principles

NSW Treasury submission

May 2023

NSW GOVERNMENT

Acknowledgement of Country

We acknowledge that Aboriginal and Torres Strait Islander peoples are the First Peoples and Traditional Custodians of Australia, and the oldest continuing culture in human history.

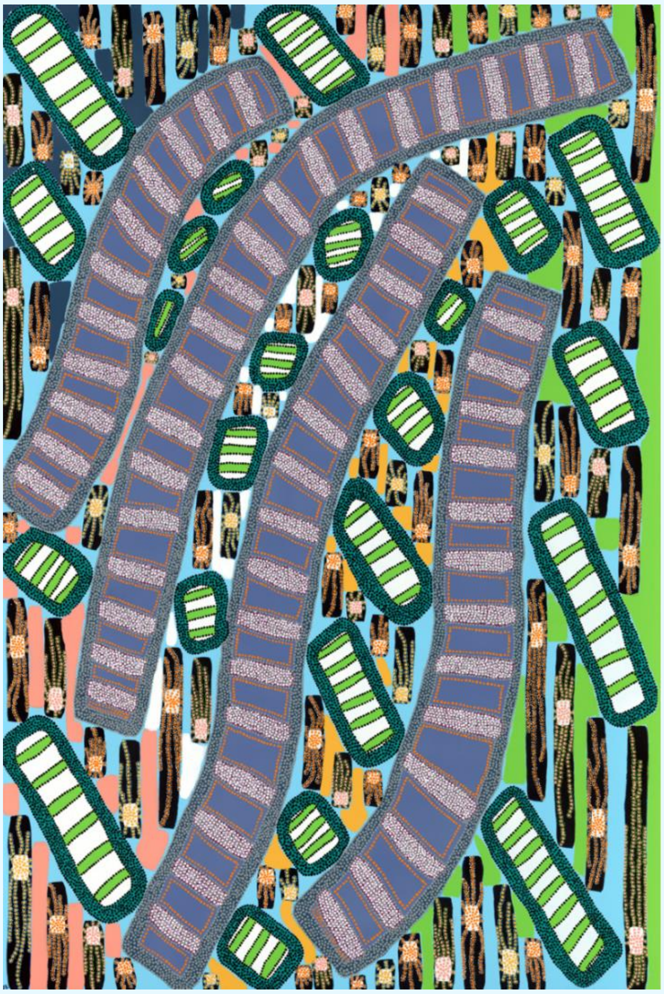
We pay respect to Elders past and present and commit to respecting the lands we walk on, and the communities we walk with.

We celebrate the deep and enduring connection of Aboriginal and Torres Strait Islander peoples to Country and acknowledge their continuing custodianship of the land, seas and sky.

We acknowledge the ongoing stewardship of Aboriginal and Torres Strait Islander peoples, and the important contribution they make to our communities and economies.

We reflect on the continuing impact of government policies and practices, and recognise our responsibility to work together with and for Aboriginal and Torres Strait Islander peoples, families and communities, towards improved economic, social and cultural outcomes.

Artwork:
Regeneration by Josie Rose



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1 Introduction

NSW Treasury welcomes the opportunity to respond to the Commission's Discussion Paper on *Fiscal equalisation, supporting principles and assessment guidelines*.

NSW Treasury recognises the constraints within which the 2025 Review will operate. It will not contemplate wholesale changes to Australia's fiscal equalisation framework, nor will it consider the fairness or effectiveness of the new GST distribution arrangements legislated in 2018. Within those constraints, NSW is broadly supportive of the Commission's preliminary positions.

Nevertheless, the launch of the Review process provides an opportunity to reflect on the effectiveness of the horizontal fiscal equalisation system in a broader context. NSW Treasury believes the system of horizontal fiscal equalisation should aim to achieve the following goals:

- Efficiency – the distribution of GST should not provide disincentives for productivity enhancing reform or improvements in the efficiency of service delivery
- Fairness – the distribution of GST should be fair in the eyes of Australians
- Simplicity – the mechanism should be simple to understand, administer and replicate
- Stability – the distribution of GST should be stable to allow state governments to forecast and budget to provide essential services over time

Regarding efficiency, the current system of equalisation dulls incentives for states to undertake efficiency-enhancing reforms that would generate fiscal benefits, as those benefits may be partially distributed to other states. States are, in effect, compensated for continued underinvestment in important areas linked to their assessed disabilities, as defined by the Commission.

States that deliver poor outcomes and inefficient services may be rewarded with additional GST revenue. That is, a state may be assessed as requiring additional GST so that it is able to provide a similar level of service as stronger states, but there are reduced incentives to actually improve services or invest in efficiency-improving infrastructure as that would reduce future GST revenue.

Moreover, absent meaningful methodological changes, the existing arrangements can heavily discourage major efficiency-enhancing tax reform. The disincentive effects are particularly acute for "first-movers". NSW Treasury welcomes the opportunity to comment further on the case for post-review methodology revisions in response to major tax reforms at a later stage of the 2025 Review.

Regarding fairness, many in the general public and key policy makers continue to regard an equal per capita (EPC) distribution as the appropriate standard. Indeed, arguments made by Western Australia that resulted in changes to the methodology in 2018 were underpinned by arguments that its 'fair' share was equal to its population share.

The current system, however, neither commits to full equalisation nor moves to a genuinely EPC model or similar. Instead, current arrangements perpetuate the worst elements of equalisation, being the disincentives for states to undertake efficiency or welfare enhancing reforms, while arbitrarily privileging Western Australia as the current fiscally strongest state.

Current arrangements, based on partial equalisation, entrench unfairness in the system. An equalisation benchmark of the stronger of New South Wales or Victoria alongside an arbitrary relativity floor and record iron ore prices mean that Western Australia – the dominant iron ore producer – has a significantly higher fiscal capacity than all other states. As such, Western Australia can provide greater access to potentially higher quality services and infrastructure to its residents at a lower taxation burden.

As well as driving unintended outcomes and acting as a disincentive to reform, the current system is complex and lacks transparency. Such complexity undermines the stability and predictability of GST distributions. NSW Treasury acknowledges, however, that other elements of the Commission's approach – namely, calculations based on a three-year rolling average with lagged data collection – appropriately support stability and predictability.

NSW Treasury recognises that these matters are largely beyond the scope of the 2025 Review. As such, the rest of this submission assumes no change to the broader policy settings of fiscal equalisation and suggests only marginal adjustments to the Commission's approach where such changes can partly address the concerns raised above.

2 Definition of horizontal fiscal equalisation

Q1: Does the approach to horizontal fiscal equalisation articulated in the 2020 Review remain the appropriate first step in determining GST distribution in accordance with the GST distribution legislation?

NSW Treasury acknowledges that the Terms of Reference for the Review specify that the Commission, in making its recommendations for the distribution of GST, must take into account the *Intergovernmental Agreement on Federal Financial Relations,* which provides that GST revenue will be distributed according to the principle of horizontal fiscal equalisation.

The Commission's approach to achieving horizontal fiscal equalisation is to distribute GST so as to minimise, as far as possible, differences in the fiscal capacities of the states to provide services. In doing so, the Commission assesses states' relative fiscal capacities and determines GST distributions such that:

- after allowing for material factors affecting revenues and expenditures, each state would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own-sources and operated at the same level of efficiency.

This approach articulates an objective to be reached following the distribution of GST. This objective is inconsistent with the new equalisation arrangements agreed in 2018. The Commission should reformulate its approach consistent with the new arrangements, whereby states are equalised to the stronger of New South Wales or Victoria.

NSW Treasury agrees, however, that the process of assessing states' fiscal capacities as articulated and practised in the 2020 Review remains the appropriate first step in determining the GST distribution even under the new arrangements.

NSW Treasury has some concern that the pursuit of full equalisation – that is, distributing GST such that states have the exact same capacity of the stronger of New South Wales or Victoria – limits the Commission's flexibility in applying its guiding assessment principles.

3 Supporting principles

3.1 What states do

Q2: Does the 'what states do' principle, with assessments based on the weighted average policy of all states, remain appropriate?

Absent more meaningful reform to the horizontal fiscal equalisation framework, NSW Treasury broadly supports the 'what states do' principle whereby the Commission bases its assessments on the average policy of all states. However, we note that this can disincentivise reforms to improve economic growth and productivity, or the efficient delivery of government services.

In some cases, NSW Treasury considers the Commission's use of a weighted average approach as a proxy for the average policy of states to be unrealistic and problematic. The weighted average approach is a stylised representation of what constitutes the 'average policy' of states that is divorced from any real policies that can actually be achieved by states.

This is especially relevant with respect to revenue. In its application to revenue assessment categories, the weighted average approach is not representative of the average tax policy, as it fails to take into account the elasticity impacts a state would face if it actually levied the average tax rate.

States with below average tax rates would be expected to have, all else equal, above average per capita tax bases. These states would therefore be assessed as having higher revenue generating capacities. In reality, however, these states could not generate revenue at their assessed levels since any increase in rate up to the average tax rate would, all else equal, see the states' tax bases shrink.

The extent to which this represents a material problem for the Commission's assessments in practice depends on the specific revenue stream. Elasticities vary markedly across different types of taxes. Typically, taxes on transactions (for example, stamp duty on conveyances) will have a relatively higher elasticity than other taxes. The Commission's average tax policy approach is therefore more likely to incorrectly calculate a state's revenue capacity for these taxes.

In the case of major tax reform, the failure of the 'what states do' principle to take account of elasticities can heavily punish any state that substantially deviates from average state policies.

3.2 Policy neutrality

Q3: Does the policy neutrality principle remain appropriate, recognising there are particular circumstances where further consideration should be given to policy neutrality, such as dominant state issues and some instances of state tax reform?

Conceptually, the Commission's stance that a state's policy choices should not directly influence its GST share, and its assessments should not create incentives or disincentives for states to choose one policy over another, is supported. The system should also, as far as possible, be free from gaming behaviour.

Achieving policy neutrality, however, can be problematic. There is unavoidable tension between the principles of 'policy neutrality' and 'what states do', since 'what states do' will affect their assessed fiscal capacities. There are instances where a state's policy choices will result in it losing significant GST revenue, thus seriously curtailing the benefits of potentially difficult reform and distorting decision-making processes.

These effects are pronounced where a single state dominates a tax base, such as with some minerals, or where a state seeks to make efficiency-generating tax reforms, as discussed above.

These issues will be further explored in a separate paper.

3.3 Practicality

Q4: Does the practicality principle remain appropriate for ensuring assessment methods are simple, reliable and fit for purpose?

NSW Treasury supports the principle of practicality. It is critical that the Commission's methods are simple and reliable as this supports transparency of the system.

3.4 Contemporaneity

Q5: Does the 3-year lagged average approach continue to provide the best balance between contemporaneity, predictability and stability in measuring states' fiscal capacities?

NSW Treasury considers that the current three year assessment period with a two year lag strikes an appropriate balance between contemporaneity and budget stability and predictability.

For these reasons, we would not support the introduction of projections or forecasts to reduce the lag. While technically feasible, they would introduce a new and undesirable source of uncertainty, volatility and complexity due to the need to make continued corrections. A forecasting approach also introduces significant potential for gaming behaviours, above and beyond any existing incentives.

NSW Treasury acknowledges that, in the case of a significant minerals boom, the three-year lagged approach will result in over- and under-estimates of states' assessed fiscal capacities, depending on the stage of the cycle. In practice, however, the 'smoothing' effect of the three-year lagged approach could be beneficial. In this case, NSW Treasury considers the benefit of the year-on-year stability to be greater than the benefit of contemporaneity. The task of horizontal equalisation is ultimately achieved over time.

In these circumstances, states can also act to smooth the Commission's temporary over- and under-estimates of their fiscal capacities through their own budgeting processes. The temporal impact of the Commission's approach is, to an appreciable degree, predictable.

Since the 2020 Review, the experience of the COVID-19 pandemic has demonstrated issues with the contemporaneity principle. NSW Treasury considers this to be an extreme outlier event, however, and does not support revising the contemporaneity principle in response. Instead, NSW Treasury supports the Commission's intention to consider whether it should be given the power to revise methods between reviews in response to major events or otherwise justifiable circumstances. NSW Treasury will engage more fully with this matter through the appropriate submission.

3.5 Additional principles

Q6. Do states agree there is no need to introduce any new principles?

As per the introduction to this submission, NSW Treasury is broadly concerned with the efficiency and fairness of the current horizontal fiscal equalisation system. These arrangements discourage efficiency enhancing reforms, especially in relation to major tax reforms. Under current arrangements, states are disincentivised from addressing their fiscal disabilities.

Those issues are, however, largely beyond the scope of the Review. Assuming no changes to the overarching framework of fiscal equalisation or to the new arrangements legislated in 2018, NSW Treasury does not see any need to introduce a new principle to guide the Commission's assessments.

4 Assessment guidelines

Q7: Do the assessment guidelines, and the Commission's application of those guidelines, remain appropriate?

Refer comments below

4.1 Materiality thresholds

Q8: Should the materiality thresholds be increased broadly in line with state spending per capita (to $45 per capita for assessment of a driver and $15 per capita for a data adjustment)?

NSW Treasury supports increasing materiality thresholds over time, so as to not erode the real value of the thresholds as prices increase.

NSW Treasury's preference would be to increase the materiality threshold in line with the State and Local Government Final Consumption Expenditure chain price index. This would maintain the real value of the existing thresholds.

4.2 Discounting assessments

Q9: Does the 2020 Review approach to discounting remain appropriate?

NSW Treasury is concerned that discounting is arbitrary and often without genuine basis.

For example, the Commission applies a discount where it considers data to be unreliable. However, as the discounting is only ever in one direction, moving closer to equal per capita, it could in fact be moving further away from true equalisation.

If discounting is to be used, it is important that it is consistently applied. For example, for the administrative scale assessment there is significant use of discretion on the part of the Commission and the use of outdated data, and yet no discount is applied. Conversely, the wage costs assessment, which similarly is neither robust nor stable, is discounted by 12.5%.

NSW Treasury suggests that those assessments that have a discount applied should be given greater attention by the Commission in order to improve the assessments. For example, increasing efforts to ensure more reliable data is collected from the states. In the long run, this would lead to the removal of discounts and minimise the subjectivity involved in applying them.

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