2025 Methodology Review

Fiscal equalisation, supporting principles and assessment guidelines consultation paper

Tasmanian Government Submission

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Department of Treasury and Finance

Tasmanian Government

Contents

Executive Summary 2
Horizontal Fiscal Equalisation 2
Supporting principles 3
'What states do' 3
Policy neutrality 4
Practicality 5
Contemporaneity 5
Preliminary view on the supporting principles 7
Assessment Guidelines 7
Materiality thresholds 7
Discounting assessments 10

Executive Summary

This submission responds to the Commonwealth Grants Commission (Commission) request for state views on the Commission's consultation paper - *Fiscal equalisation, supporting principles and assessment guidelines consultation paper*.

Tasmania welcomes the opportunity to provide input into the Commission's approach to fiscal equalisation, supporting principles and assessment guidelines for the 2025 Review.

Overall, Tasmania supports the Commission's preliminary view to retain all its principles and assessment guidelines used in the 2020 Review.

While acknowledging it is not a matter for the Commission, Tasmania reiterates its concern at the weakening of horizontal fiscal equalisation (HFE) from the new distribution arrangements as legislated in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of the GST) Act 2018*.

Tasmania's primary concern raised in this submission is in relation to the indexing of assessment driver and data adjustment thresholds. Tasmania has concerns with the Commission's preferred option of indexing thresholds using growth in state government expenditure per capita and would suggest that continuing to use the state price index would be less likely to result in a reduction in HFE.

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?

Tasmania notes that the Commission's preliminary view is that the approach to HFE articulated in the 2020 Review remains appropriate for the first step in determining GST distributions under the new GST distribution arrangements, which is to assess the relative fiscal capacities of each state.

Tasmania supports this continued approach to full HFE and agrees that the assessment of state relative fiscal capacities should continue to be determined 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 state made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

Tasmania notes that alternative approaches to HFE have been considered in previous reviews and inquiries into the distribution of the GST. These approaches have aimed to achieve other objectives and inevitably resulted in a lesser form of HFE.

For the smaller states, fiscal equalisation makes a vital contribution to their economies and their budgets as their GST share represents a higher proportion of Gross State Product (GSP) and general government revenue compared to the larger states. The way the GST is distributed has the potential to significantly impact small state economies and communities, while for the larger states it has a relatively smaller impact.

Since the 2020 Review, all states and territories have begun to transition to new distribution arrangements as legislated in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of the GST) Act 2018*. The application of blended relativities for the third year of a six-year transition to new distribution arrangements will commence in 2023-24. An important measure introduced to support states adversely affected by the new arrangements is to guarantee that they are no worse off during transition compared to the previous arrangement of full HFE. However, the guarantee ceases at the end of the transition period.

Under the new arrangements, there has been a weakening of the GST distribution equalisation system. Equalising to a lesser standard (effectively the state with the second highest fiscal capacity), combined with the application of the GST relativity floor, has increased the GST distributed to Western Australia and reduced the GST distribution to all other states.

Tasmania continues to express its strong support for full equalisation. The aim of HFE is to equalise the capacity of governments to provide services. HFE reflects a belief that all Australians should have access to similar standards of service, regardless of the jurisdiction in which they live. This principle has been widely held over time within the Australian community and has been reflected in the Commission's approach, in one form or another, since its inception.

However, in the absence of this principle, Tasmania has consistently argued a permanent extension to the no-worse-off guarantee and will continue to advocate on this basis.

Tasmania is of the view that the identification and recognition of the drivers of differences in the fiscal capacities of the states will be critical to ensuring state fiscal capacities are equalised to the fullest extent possible under the existing legislation. Given the moderating effect of the 2018 legislated changes, Tasmania would not support any proposed change that threatens to further erode the achievement of HFE.

Supporting Principles

'What states do'

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

Tasmania continues to support the Commission's methods reflecting, as far as practicable, what states collectively do, including the existing approach of basing assessments on the average policies of all states.

Between Methodology Reviews there will inevitably be a range of developments that may increasingly impact on the environment in which states operate, and in turn the methods for determining the distribution of GST revenue. This includes changes to the natural environment, economic, social, and demographic changes, technological and geopolitical shifts and shifts in Commonwealth–state relations.

To the extent that these have triggered changes in states' behaviour such as in the delivery of services or raising revenue, it is appropriate that the Commission considers these as part of the 2025 Review in consultation with the states.

Determining average policy relies on the judgement of the Commission, particularly if a certain tax is not imposed or service delivered by all states. Using a weighted average ensures that the full range of state expenditures and revenues are captured.

Tasmania believes that the current approach of basing assessments on the average policies of all states, with average policy continuing to be determined using the weighted average approach, where supported by robust data and subject to agreed materiality thresholds, remains appropriate.

Tasmania's consideration of thresholds for materiality are included on page 7 of this submission.

Tasmania notes the Commission's intention to consider significant changes not captured by existing methods that occur between reviews in a future discussion paper.

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?

Tasmania continues to support policy neutrality as a supporting principle. Policy neutrality appropriately ensures that a state's own policy choices do not directly influence the level of GST it receives. It also ensures that Commission methodologies do not influence state decision making in the delivery of services or raising revenue.

Tasmania agrees that further consideration should be given to policy neutrality in particular circumstances such as dominant state issues and some instances of tax reform. However, Tasmania is of the view that any consideration of specific circumstances should be considered in the full context of the new distribution arrangements. Caution should be exercised to ensure policy neutrality adjustments do not further detract from the achievement of HFE or add an additional layer of complexity without a material impact on the distribution of GST.

In its consultation paper, the Commission raised the example of iron ore production in Western Australia. The Commission noted that in the case of iron ore, the policy of Western Australia has a dominant role in determining average state policy, which can raise issues in the event of a change to the mining royalty rate. Placing this example in the context of the new arrangements, in its current position as the fiscally strongest state, a change in the mining royalty rate is unlikely to have a material impact on Western Australia's GST distribution. The 2018 legislated change to equalise to the strongest of New South Wales or Victoria (rather than the fiscally strongest, Western Australia) and the introduction of a relativity floor effectively allows Western Australia to fully retain any additional revenue, including for example revenue generated by a change in the mining royalty rate. In this example, the new distribution arrangements could obviate the need to make arbitrary policy neutrality adjustments, particularly for the mining revenue assessment.

Practicality

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

The Commission's preliminary view is that the current practicality principle remains relevant to ensuring assessment methods are simple, reliable, and fit for purpose while balancing simplicity with the need to capture the major influences on state expenses and revenues. The Commission's approach to practicality is also considered under the assessment guidelines section on discounting assessments and changes to the existing materiality thresholds.

The practicality principle is broadly aligned to the Terms of Reference for the 2025 Review, which require the Commission to aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data.

While there has been a range of significant events since the 2020 Review, in Tasmania's view, there have been no experiences with the application of the assessment methods or other developments that question the suitability of, or have identified potential improvements to, the practicality supporting principle.

Tasmania believes that the existing supporting principle of practicality remains appropriate for ensuring assessment methods are simple, reliable and fit for purpose and should apply in the 2025 Review. However, measures to improve the practicality of assessments should be balanced against the higher order objective of achieving HFE.

Contemporaneity

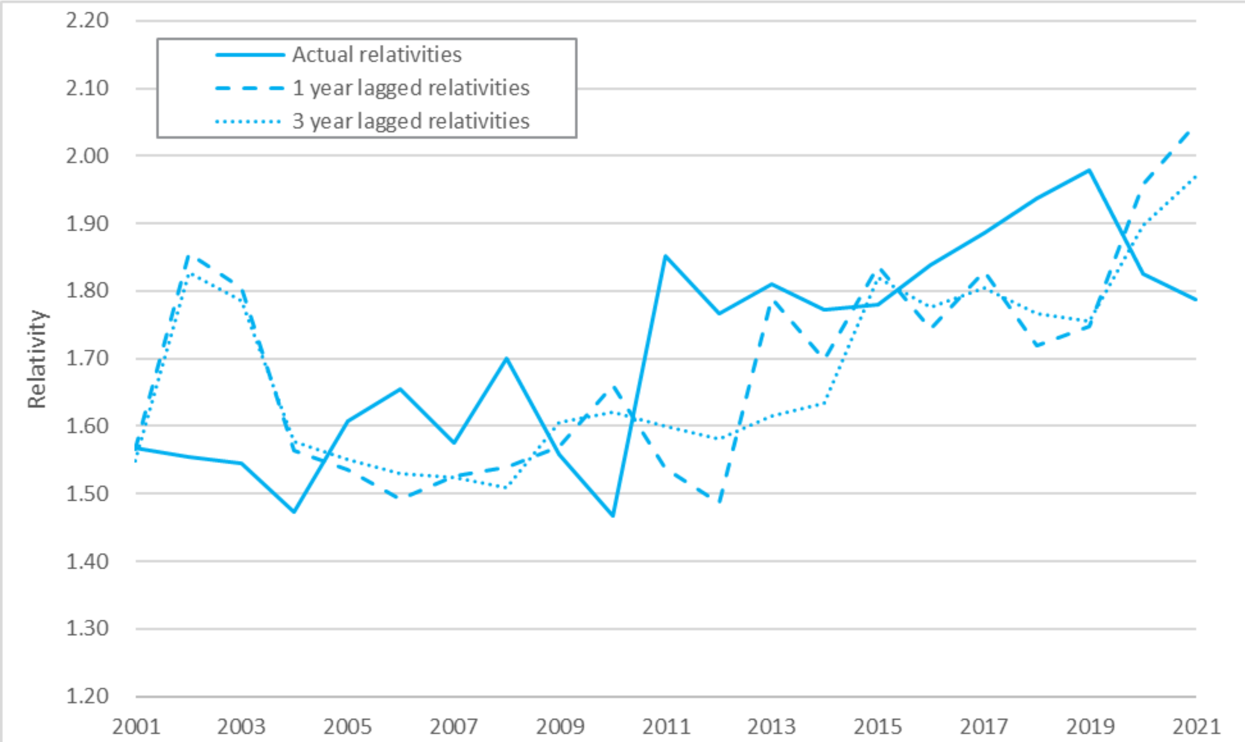
Q5. Does the three-year lagged average approach continue to provide the best balance between contemporaneity, predictability and stability in measuring states' fiscal capacities?

Contemporaneity aims to ensure that the distribution of GST in a year is reflective of state circumstances in that year. Given the absence of robust data in the application year, GST relativities have consistently been determined using historical data. The principle of contemporaneity has been reviewed in the 2010, 2015, and 2020 Reviews. Since the 2010 Review, the assessment period has been the most recent three years for which reliable data are available, with each year receiving equal weight.

Tasmania notes that the Commission's preliminary view is that the three-year lagged moving average continues to provide an appropriate balance between contemporaneity, predictability and smoothing the impact of fiscal shocks. Tasmania supports the Commission's view and the continued use of the three-year lagged moving average.

Using the Commission's data, Tasmania has considered the implications of a one-year assessment period compared to the current three-year assessment period (Figure 1).

Figure 1: Tasmania assessed relativities with different assessment periods



Source: Commission calculation

It is evident from the above comparison, that reducing the number of assessment years included in the moving average will increase the level of volatility in states' shares of GST revenue. In addition, Tasmania is concerned that reducing the number of assessment years would reduce the reliability of internal GST forecasts, as they would become more reliant on forecast relativities as opposed to actual relativities. To provide an example, as of May 2023, actual GST relativities are available for all financial years up to 2021-22. If Tasmania were to undertake modelling to forecast estimated GST revenue for 2024-25 using three-year lagged relativities, it would use actual GST relativities for 2020-21 and 2021-22 combined with a modelled relativity for 2022-23. In contrast, if Tasmania were to undertake modelling to forecast estimated GST revenue for 2024-25 using a one-year lagged relativity, the forecast GST revenue would by fully reliant on a modelled relativity for 2022-23. Modelled relativities are based on forecasts of revenues and expenditures. As the Commission notes in its consultation paper, errors in forecasts have at times been large, particularly for revenue.

If the assessment period were to be shortened, the increased volatility of GST revenue to each state combined with a reduced ability to produce reliable GST forecasts would make the task of state budget management considerably more difficult. This is particularly impactful for smaller states such as Tasmania, for which GST revenue is the largest single source of revenue. In 2022-23, GST revenue represented approximately 40 per cent of Tasmania's Total General Government Sector revenue. Any change in methodology that leads to increased volatility and reduced predictability will have substantial ramifications for Tasmania. Rather than improving management of cyclical cashflows, Tasmania is of the view that a shorter assessment period would be contrary to the principle of practicality.

Preliminary view on the supporting principles

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

The Commission's supporting principles and assessment methods have evolved over many years. As part of every review of its methodology, the Commission has considered whether the existing supporting principles remain appropriate.

It is noted that the Commission's preliminary view is that overall, while aspects of the existing supporting principles could benefit from some elaboration, there are no developments that bring into question the appropriateness of the four existing supporting principles, nor a need to introduce any new principles.

Tasmania continues to support the existing principles as providing an appropriate framework for the Commission's methods and giving effect to the overriding principle of HFE. This includes the Commission using its judgement when applying its guiding principles to determine the most appropriate measure of states' relative fiscal capacities.

In Tasmania's view, there have been no developments since the 2020 Review that would necessitate a change or question the appropriateness of the current principles. The existing supporting principles remain appropriate and should continue to be used for the 2025 Review.

Assessment Guidelines

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

The existing assessment guidelines were developed in the 2015 Review and maintained in the 2020 Review. Tasmania agrees with the Commission that these guidelines remain appropriate and should be maintained for the 2025 Review.

Tasmania's positions on the materiality thresholds and approach discounting referenced in the assessment guidelines are laid out in the sections below.

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)?

Tasmania accepts that the application of indexation to materiality thresholds for drivers used in assessments and data adjustments is warranted given the effect of inflation on the provision of services. Without indexing thresholds, it reduces their real value over time and undermines the purpose of maintaining a consistent level of simplicity in the Commission's methodology. In other words, if the objective is not to erode the value of the thresholds, then the level of simplicity should not change appreciably as a result of increases in materiality thresholds.

In considering materiality thresholds, Tasmania has considered the appropriateness of both the approach to indexation as well as the choice of index.

Approach to indexation

As noted in the Commission's consultation paper, materiality thresholds were significantly increased in the 2015 Review from $10 per capita to $30 per capita for driver assessments and from $3 per capita to $10 per capita for data adjustments. This was in response to the recommendations of the 2012 GST Distribution Review (Carter, Brumby, Greiner) to simplify the Commission's methodology.

The Commission noted in the 2020 Review that in its consideration of materiality thresholds set in 2015, "On balance, the Commission considers the thresholds strike the right balance between achieving HFE and maintaining simplification gains from the previous two methodology reviews".

Further simplification was not pursued using materiality thresholds in the 2020 Review. Rather, a decision was made to maintain their value in real terms by indexing them using the state government price index. Simplification can be achieved by other changes to the Commission's methodology without the need to reduce the number of disability drivers from higher materiality thresholds.

Given that simplification was implemented in the 2015 Review through significant increases in thresholds, and the Commission's intention is to maintain thresholds in real terms, Tasmania contends that the 2015 Review should be established as the base for further indexation. It is noted that the Commission has proposed to index the driver assessment threshold in the 2020 Review ($35 per capita) over 5 years from 2015-16 to 2020-21.

However, the data adjustment threshold is proposed to be indexed over 10 years to 2021-22. It is unclear why it the proposal is to index to 2021-22 and not 2020-21 as is the proposal with the assessment driver threshold. The Commission proposes a $15 per capita data adjustment threshold under the state price index option, which is rounded from the escalated threshold of $12.50 per capita.

As noted, the driver assessment threshold is proposed to be escalated over 5 years from its rounded value at the 2020 Review. While in this case, escalating the driver assessment by the price index over 5 years from $35 per capita (2020 Review) results in the same outcome as escalating it over 10 years from $30 per capita (2015 Review), it is nevertheless important that a common base is used for escalation in the future.

Choice of index

The Commission's proposal to index both thresholds in line with the growth in state spending considers both the growth in service delivery costs as well as the growth in the use of services. That is, the materiality thresholds reflect real per capita growth compared to maintaining thresholds in real terms.

While this would appear reasonable on the grounds that the threshold maintains parity with the value of total services provided by each state that is the basis for assessments, Tasmania has several concerns with this approach.

Figure 2 in the Commission's consultation paper compares nominal growth per capita in state government expenditure and the state government price index. The chart shows that since 2000-01, growth in state spending has grown faster than prices, particularly since 2018-19. The Commission argues that increasing thresholds broadly in line with the growth in state spending per capita would ensure that increases in standards of state services (as opposed to only prices faced by states) do not erode the value of thresholds.

Tasmania contends that a significant driver of the growth in government spending in recent years has been due to the impacts of COVID-19. States have responded to the impacts of the pandemic with a broad range of new and increased expenditure measures such as income and business support, vaccinations, and other health responses. Tasmania argues that much of this growth was in response to an economic and health shock rather than a desire to increase state service standards to that higher level.

Indexing materiality and data adjustment thresholds by the growth in state spending per capita over the five years to 2020-21 as proposed by the Commission would capture most of this exceptional growth caused by the pandemic. This growth is likely to moderate over time as the impact of the pandemic passes.

Additionally, Tasmania raises a potential issue that for some specific assessment categories real per capita growth can be lower than average real per capita growth. This could arise because the growth in the quantity of services can vary between sectors. As a result, the increase in the materiality threshold could result in an assessment driver no longer being material for an assessment category that has not grown by the same extent. In this case simplification has occurred because the materiality threshold grew faster than the redistribution impact of the disability driver for that assessment.

Finally, Tasmania questions whether it is appropriate to escalate thresholds that apply to both revenue and expenditure driver assessments that are solely based on the growth in state spending per capita for indexing thresholds and apply it to driver assessments for revenue categories.

In conclusion, Tasmania is concerned that the Commission's preferred option may over time introduce further simplification rather than maintaining it at current levels.

There is a tradeoff between simplification and the achievement of HFE. Simplification will result in fewer assessment drivers available to achieve HFE and a greater proportion of assessments treated equal per capita.

In its Final Report in the 2018 inquiry into Horizontal Fiscal Equalisation, the Productivity Commission recommended that the CGC be directed to use significantly higher materiality thresholds to secure greater efficiency and simplify the HFE system. In an April 2018 Staff Research Paper, the CGC considered the effects of raising materiality thresholds. If thresholds were raised to $100 per capita, seven of the 25 expense drivers and three of the seven revenue drivers would have been removed. At the time, these changes were considered to disproportionally affect the least populous states. The biggest effects on GST distribution were on Western Australia ($121 per capita), the ACT (-$126 per capita) and the Northern Territory (-$190 per capita). If the thresholds were raised to $200 per capita, a further six expense drivers and another revenue driver would have been removed and the effects on GST distribution were large for all states.

It is therefore important that the method of indexation does not result in any further simplification. On this basis, Tasmania has concerns with the Commission's preferred option and would suggest that continuing to use the state price index would be less likely to result in a reduction in HFE.

Discounting assessments

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

The current approach to discounting assessments was adopted in the 2015 Review and maintained in the 2020 Review. The Commission applies discounting at four levels: low (12.5 per cent); medium (25 per cent); high (50 per cent), and no assessment (100 per cent). The Commission uses its judgement on a case-by-case basis, with higher discounts applied when the Commission has greater concerns with the underlying data or assessment method.

Tasmania understands that circumstances for discounting may relate to:

- data which are incomplete, dated, unreliable, or not fully fit for purpose;
- concerns about the suitability of proxies; or
- concerns with the assessment method used to measure a driver.

It is also Tasmania's understanding that the Commission does not discount:

- to address policy neutrality concerns;
- to address general uncertainty;
- as a means of more actively encouraging efficiency;
- judgement-based estimates; or
- where the Commission considers discounting towards an equal per capita assessment does not provide the best measure of fiscal capacities (e.g. the urban transport assessment).

It is noted that the Commission's preliminary position is to retain the 2020 Review discounting framework as it considers this allows it to better capture states' fiscal capacities while recognising the limitations of the data and methods in some circumstances.

Tasmania supports the continuation of the Commission's approach to discounting and believes the current levels of discount remain appropriate. Consistent with past submissions, Tasmania supports the Commission's continued use of judgement in the application of discounting and believes that when applied consistently, this approach will help to enhance equalisation outcomes.

It is Tasmania's understanding that the specific application of discounts within individual assessments will be considered later in the process of the 2025 Review, as part of the consultation on those assessments.

Tasmania welcomes further consultation between the Commission and the states with regard to reviewing assessments that have previously been discounted, and in considering where new discounts may be appropriate, for example with the inclusion of a new dataset.