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# **Victorian response to the Commonwealth Grants Commission 2025 Methodology Review**

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## Introduction

On 21 April 2023, the Commonwealth Grants Commission (CGC) provided all states and territories (states) a consultation paper on fiscal equalisation, supporting principles and assessment guidelines (the paper), as part of its 2025 Methodology Review (the review). The paper includes an overview of the supporting principles, as well as nine specific questions for the states to address.

The CGC has requested states' responses by 19 May 2023. Victoria's views on the issues raised by the CGC and the principles underlying the GST distribution are provided in this submission.

Victoria reiterates its concern that the starting point for the review is to consider developments since the 2020 Methodology Review, as noted in its submission to the consultation paper on the review workplan. There may be important areas for improvement to the supporting principles or specific assessment topics that do not directly relate to developments since the 2020 Methodology Review.

Victoria supports the majority of the CGC's preliminary positions in the paper. However, Victoria has also made several additional recommendations to emphasise simplicity and consistency in the assessments. The assessments are complex, requiring significant judgement to balance partial or proxy data sources. Victoria suggests the CGC provide further explanation on the uncertainties, trade-offs and judgements inherent in assessments, which can only approximate horizontal fiscal equalisation (HFE).

Victoria recommends a conservative approach with less redistribution where approaches are uncertain, aiming for HFE to be based on the most reliable picture of the assessment years possible. This is within the CGC's remit given the Commission's role in setting the specific standard of equalisation as a first step under the 2018 legislation. Victoria's additional recommendations include consideration of how greater flexibility between methodology reviews could improve the application of several supporting principles, including 'what states do', policy neutrality and contemporaneity.

Victoria agrees with the CGC that the assessments and principles are interrelated. As such, Victoria expects to provide further comments with recommendations for the specific implementation of the supporting principles in its submissions on assessment topics. It is intended that recommendations in this submission are a starting point for more detailed consideration of the unique application of the principles to each category. Noting this, Victoria has made general suggestions below with reference to 2020 Methodology Review assessment methods, which may not apply directly to the details of each assessment category.

## Summary of Victoria's recommendations

### Horizontal fiscal equalisation

- Q1: Victoria supports the 2020 Methodology Review approach to HFE remaining the appropriate first step to determine the GST distribution, even under the current legislation.

### The supporting principles

- Q6: Victoria agrees there is no need to introduce additional new supporting principles, however, suggests the CGC further highlight the simplicity aspect of practicality.
  - Victoria recommends the CGC clearly describe how it has weighed the competing objectives of HFE and the various supporting principles in its public documents on decisions for its assessments.

### What states do

- Q2: Victoria supports the principle that the CGC makes its assessments based on 'what states do' using the current weighted average approach.
  - Victoria supports further consideration of the case for the CGC to have flexibility in its methods between reviews, in cases of significant reforms or economic shocks, to better reflect what states do. Victoria will provide specific comments on this issue in response to the future consultation paper on changes in methods between reviews.

### Policy neutrality

- Q3: Victoria generally supports the principle of policy neutrality. However, while important, it is a supporting principle to achieving HFE and not the primary goal. Achieving policy neutrality is not always possible and should be considered in the context of each assessment. Victoria will respond to the application of policy neutrality as it arises for each assessment category.

### Practicality

- Q4: Practicality remains appropriate, however, as referenced in Q6, the CGC should:
  - elevate simplicity when considering each category and any updates
  - acknowledge that the assessments can only arrive at an approximation of HFE and the extent of uncertainty surrounding its recommendations.

### Contemporaneity

- Q5: Victoria supports the current lagged 3-year assessment approach. Victoria supports the view that HFE is achieved over time, and the CGC's assessments are not required to match the application year.
  - Victoria supports the CGC's view that basing its recommendations on forecasts would be unreliable, add volatility and complexity, and reduce transparency.

### Assessment guidelines

- Q7: The guidelines remain appropriate, however the CGC should:

- clearly explain any changes or rejected proposals against the assessment guidelines and review current drivers against the guidelines
- provide states more information on its decision-making process
- consider engaging periodic external quality assurance review of its calculations.
- Q8: Victoria considers the materiality thresholds should be indexed by the state price index, increasing to \$40 per capita for assessment drivers and \$15 per capita for data adjustments.
  - Victoria considers the CGC should review the materiality of all disabilities and assessments as though they are new proposals and accept modifications or updates to existing methods where they increase HFE, such as the availability of new data.
- Q9: The CGC should:
  - clarify the definition and appropriate application of each discount level
  - consider removing some drivers where a high discount is applied
  - apply discounts to judgement-based estimates.

## Horizontal fiscal equalisation

Victoria continues to support the principle of HFE. Victoria supports the CGC's preliminary view that adopting the HFE approach articulated in the 2020 Review remains appropriate for the first step in determining the GST distribution. This includes the definition of HFE used in the 2020 Methodology Review, that states can provide the same level of services and infrastructure, given the same effort and efficiency.

Victoria supports the Commission exercising a degree of judgement to balance the competing aims of HFE and its supporting principles. Achieving HFE should be the primary objective of the GST system, as set in the 1999 Agreement. However, generally Victoria would like to see a reweighting towards the supporting principles, particularly the simplicity aspect of practicality. This is further discussed in the relevant sections of the submission below.

### CGC consultation question

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?

### Victoria's positions:

- Q1: Victoria supports the 2020 Methodology Review approach to HFE remaining the appropriate first step to determine the GST distribution under the current legislation.

## Supporting principles

Victoria supports the CGC using its judgment to balance the competing objectives of HFE and the current supporting principles. However, greater clarity and consistency on how the Commission weighs each principle and HFE to reach its decisions would assist states to understand the CGC's decision making processes and provide transparency for the public. The CGC's descriptions in

previous review reports have not always provided adequate detail on the trade-offs to achieve this. In the absence of this, the way in which one principle is favoured over another, or different judgements have been applied for different assessments, appears inconsistent.

In addition, Victoria considers the CGC could further highlight simplicity, which is discussed below under Practicality.

**CGC consultation question:**

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

**Victoria's positions:**

- Q6: Victoria agrees there is no need to introduce additional new supporting principles, however it suggests the CGC further highlight the simplicity aspect of practicality.
- Victoria recommends the CGC clearly describe how it has weighed the competing objectives of HFE and the various supporting principles in its public documents on decisions for its assessments.

## **‘What states do’**

Victoria supports the principle ‘what states do’, and the CGC’s current weighted average approach.

Victoria supports the CGC’s view that changes to how states deliver services or collect revenues should be reflected in the assessment methods. However, these changes will not necessarily align with the CGC’s timelines for its reviews, to enable changes to its methods where necessary. The treatment of states’ COVID-19 related expenditures on health and business support is a significant example of when the CGC’s methods have been unable to adjust to changing circumstances and so have not reflected ‘what states do’. Victoria supports further consideration of flexibility in the CGC’s methods so they can better reflect what states do. Victoria is additionally open to exploration of broad approaches to assessing expenditure, where this can adequately capture underlying need while delivering a simpler and robust assessment.

While Victoria supports the CGC’s current approach to the principle of ‘what states do’ in general, it notes there can be a trade-off between accurately reflecting what states do, having simple assessments and ensuring policy neutrality.

## **Potential efficiency issues with assessing ‘what states do’**

Victoria remains concerned there may be efficiency effects of the CGC’s assessments, related to the ‘what states do’ principle. This includes how the principle of assessing ‘what states do’ may in certain cases impinge on the principle of policy neutrality or unduly influence state decision making.

As Victoria has previously raised with the CGC, the current approach could have significant impacts for some tax policy reforms. The current methods may penalise states for undertaking efficiency enhancing reforms, to the extent that policy driven changes to their tax mix or bases reduce their GST share. This poses an additional cost and disincentive to reform. Victoria looks forward to continuing engagement with the CGC in the context of revenue assessments, and in the forthcoming consultation paper on the case for changes to methods between reviews, where major policy changes or unanticipated shocks might take place outside of usual review cycles. As part of this, Victoria will further consider the mechanisms for out-of-cycle method changes, including on appropriate safeguards and accountability measures.



**CGC consultation question:**

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

**Victoria's positions:**

- Q2: Victoria supports the principle that the CGC makes its assessments based on 'what states do', using the current weighted average approach.
- Victoria supports further consideration of the case for the CGC to have flexibility in its methods between reviews, in cases of significant reform or economic shocks, to better reflect what states do. Victoria will provide specific comments on this issue in response to the future consultation paper on changes in methods between reviews.

## Policy neutrality

Some policy influences are inherent in the CGC's assessment methods, particularly as states' demographics vary greatly and there is an unequal distribution of revenue sources and expenses. States with high concentrations of revenues or high expense groups will have greater impact on average policy through the CGC's approach to the principle of 'what states do'. For example, this may be the case for states with high concentrations of remote and very remote residents skewing the national average policy for spending on those groups.

Achieving policy neutrality is not always possible and should be considered in the context of each assessment. As noted by the CGC, this dominance issue is also present in the mining revenue assessment, where WA raises the majority of mining royalty revenue. The CGC noted in its research paper on Fiscal Equalisation and Mining Booms that "under the new arrangements, a state will not have the same capacity to influence its GST distribution." Victoria will provide further information on this issue in its response to the mining revenue assessment.

**CGC consultation question:**

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?

**Victoria's positions:**

- Q3: Victoria generally supports the principle of policy neutrality. However, while important, it is a supporting principle to achieving HFE and not the primary goal. Achieving policy neutrality is not always possible and should be considered in the context of each assessment. Victoria will respond to the application of the principle as it arises for each category.

## Practicality

The practicality principle outlined by the CGC states that assessments should be as simple as possible while being conceptually sound and reflecting the major influences on state expenses and revenues. It is also supported by materiality and reliability criteria covered under the assessment guidelines.

The current CGC assessments are highly complex, creating a significant barrier to understanding for the public and decision makers. Only a few specialists across Australia understand the details of the GST distribution. Funding of this significance and magnitude should be accessible and predictable. Victoria suggests simplicity should be elevated as a principle and considered more prominently across all categories.

Given the number of assumptions, the extent of judgement used, weak statistical outcomes, lagged and proxy data, the current presentation of the assessment methods and relativities in some cases provides an unreasonable sense of precision in achieving HFE. Generally, the CGC could be clearer in its communications of the uncertainties and judgement involved in its assessments, including that it only arrives at an approximation of HFE.

**CGC consultation question:**

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

**Victoria's positions:**

- Q4: Practicality remains appropriate, however, as referenced in Q6, the CGC should:
  - elevate simplicity when considering each category and any updates
  - acknowledge that the assessments can only arrive at an approximation of HFE and the extent of uncertainty surrounding its recommendations.

## Contemporaneity

Victoria supports the CGC's preliminary view that the 3-year moving average continues to be the appropriate basis for calculating the relativities. Victoria's position is that achieving contemporaneous relativities for the application year is not realistic. A moderate lag, which achieves HFE in the short term rather than in each application year, provides for greater reliability and predictability. Overall, Victoria considers the principle of contemporaneity to be less critical than the other principles and achieving HFE.

Victoria does not support shortening the averaging period from 3 to 2 years and does not agree that its goal should not be to produce an accurate reflection of assessment year fiscal capabilities.

Averaging over a three-year period is preferred as some data are not available in the final year of the assessment. Shortening the averaging period to two years would reduce the overall accuracy of the relativities by weighting more towards proxy data that do not reflect the assessment years. Victoria's preference is for the most accurate calculations of assessment year relativities.

A lag also improves the predictability and stability of GST relativities, which Victoria prefers to making the relativities more contemporaneous. Greater predictability assists states to manage expected revenues for their budgets. The assessment is also currently based on the Australian Bureau of Statistics (ABS) Government Finance Statistics data, which Victoria supports as a consistent source for states' finances. The assessments must be lagged to use this key data source, as the ABS source data from states' end of year reporting (only released after the completion of the financial year in question, often several months later).

Victoria supports the CGC view that basing its recommendations on forecasts would be unreliable, add volatility and complexity, and reduce transparency. States are familiar with the difficulties in

accurately forecasting the GST relativities. There are many detailed inputs that change each year, in addition to CGC decisions on new issues that are not known until the relativities are released.

While Victoria's position is that the relativities should aim to achieve equalisation over time, Victoria rejects the statement that approximate fiscal equalisation would be achieved over time in relation to impacts of the COVID-19 pandemic. This would only be the case if the CGC's methods accurately reflected the fiscal impacts of COVID-19, which they do not, as the CGC has stated in its 2022 and 2023 Update reports.

**CGC consultation question:**

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

**Victoria's positions:**

- Q5: Victoria supports the lagged 3-year assessment approach. Victoria supports the view that HFE that is achieved over time, and the CGC's assessments are not required to match the application year.
- Victoria supports the CGC's view that basing its recommendations on forecasts would be unreliable, add volatility and complexity, and reduced transparency.

## Assessment guidelines

The assessment guidelines consider whether:

- a case for drivers is established, conceptually and with sufficient empirical evidence
- a reliable method is devised that is conceptually rigorous and implementable
- data are available that are fit for purpose and of suitable quality.

Victoria notes that there are instances where the CGC will accept the application of a driver on a conceptual basis, but not have full supporting evidence, or will conclude that there is no conceptual basis, having considered supporting evidence provided by states. Consistent and transparent explanations would ensure states understand and accept that equivalent standards of analysis and data apply to all proposals.

Victoria considers it is appropriate for the CGC to communicate how any proposed or recommended change to the method meets each element of the assessment guidelines. Further information on the process of CGC decision making (for example, a timeline of Commission decision making meetings and outcomes of decisions as they are made), or periodic external review of calculations could also increase states' engagement and confidence in these processes.

### **CGC consultation question**

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

#### **Victoria's positions:**

- Q7: The guidelines remain appropriate, however the CGC should:
  - clearly describe any changes or rejected proposals against the assessment guidelines and review current drivers against the guidelines
  - provide states more information on its decision-making process
  - consider engaging an external quality assurance review of its calculations.

## **Materiality**

Materiality means assessments will only be made where there is a sufficiently large impact on the GST distribution.

Victoria considers an equivalent threshold of impact and evidence should be applied to new proposals for changes to the assessment methods and underlying current assessments. Victoria would like to see, as part of the review, a full assessment of all disabilities and assessments individually to meet the materiality thresholds.

Proposals for modifications and updates to existing methods should be considered for their impact across the assessment methods in totality, rather than incrementally. For example, if a driver is proposed that is near to but below the materiality threshold in three separate assessment categories, but is above in aggregate, Victoria considers there is a case it should be included in the assessments.

Victoria would value additional reasoning for the base amounts used in the materiality thresholds. A rationale for the selection of these dollar values, and how they best represent a material change to a component or category, would aid states' common understanding of the practical balance of different principles, including simplicity.

Victoria considers that the CGC's proposed increase to the materiality threshold for assessment drivers from \$35 to \$45 per capita is too high and that the threshold should only be increased to \$40 per capita. Victoria supports the increase following the State and Local Government Final Consumption Expenditure chain price index (state price index), as was the case for the 2020 Methodology Review. Victoria considers growth in this price index better reflects the aim of adjusting the nominal thresholds for changes in prices over time. For data adjustments, Victoria considers that \$15 is appropriate. Going forward the CGC should index the drivers using the state price index.

### **CGC consultation question**

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)?

#### **Victoria's positions:**

- Q8: Victoria considers that materiality thresholds should be indexed to the state price index and increased to \$40 per capita for assessment drivers and \$15 per capita for data adjustments.
- Victoria considers the CGC should review the materiality of all disabilities and assessments as though they are new proposals and accept modifications or updates to existing methods where they increase HFE, such as the availability of new data.

### **Discounting assessments**

Victoria does not find the current practice of discounting assessments appropriate, transparent, or fit for purpose. The CGC should clarify the definitions of each discount, when they are used, and how the application achieves the required accuracy and confidence in assessments and disabilities.

Victoria considers there are some instances where discounts should be applied and are not, particularly where the data are subject to large revisions or significant variation between years. For example, in the non-government schools assessment, regression coefficients that determine the additional costs associated with regional and remote areas vary by over 40 per cent between years. Conceptually, the cost of non-government education for a regional student would not vary by 40 per cent between years. This points to concerns with both the quality of the data, and the methodology. It is unclear why this has not been discounted to account for the lack of reliability of the data and method. The CGC should reconsider all disabilities and components of the GST method against its discounting framework.

Where a high discount is applied, this raises concerns with the appropriateness of the data or method. It is unclear why a disability should be applied if there are significant concerns with either of these points. Victoria would like to see more assessments or disabilities that are significantly discounted not made at all.

The CGC does not discount judgement-based estimates that purportedly incorporate relevant information and weighting according to reliability. The CGC should clearly outline the elements of the assessment that are judgement-based and how these are already weighted. Regardless, judgement-based estimates are more prone to human error or bias and Victoria considers there is a greater case these should be further discounted from the original judgement as appropriate.

**CGC consultation question:**

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

**Victoria's positions:**

- Q9: The CGC should:
  - clarify the definition and appropriate application of each discount level
  - consider removing some drivers where a high discount is applied
  - apply discounts to judgement-based estimates.

