Submission to Senate Economics Legislation Committee Inquiry on the provisions of the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018

24 October 2018

VICTORIA
State
Government

The Government of Victoria is pleased to provide this submission to the Economics Legislation Committee Inquiry on the provisions of the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018.

1. Background

Productivity Commission Inquiry

In April 2017 the Commonwealth asked the Productivity Commission (PC) to undertake an inquiry into Australia's system of Horizontal Fiscal Equalisation (HFE). The Inquiry's terms of reference noted that some States and commentators had suggested that Australia's approach to HFE did not sufficiently recognise the differences between the individual circumstances of States and Territories (States) nor States' efforts to manage those circumstances thereby creating disincentives for reform. The inquiry therefore considered the influence that the current system of HFE has on productivity, efficiency, economic growth, the incentives for States to undertake reforms and the States' abilities to prepare and deliver annual budgets.

The PC released its final report on 5 July 2018[1]. The PC broadly accepted the current methodology used by the Commonwealth Grants Commission (CGC) to distribute GST revenue among States. The PC could not find substantial evidence that HFE has impeded productivity, economic growth or influenced State Government policy decision making. It also found that Western Australia's low GST relativity was foreseen and temporary and cautioned against implementing relativity floors.

Despite the findings, the PC Inquiry report recommended to use a different interpretation (or equalisation standard) of HFE; that is to equalise States to the so-called "average" fiscal capacity of all States (if they are below the average) and then pro-rata the remaining funds based on population share

Other key recommendations in the PC Inquiry report were:

- the CGC, whose role it is to determine the relativities on which GST is distributed, should provide "draft rulings" on the HFE implications of a policy change;
- there should be clear guidelines detailing the basis on which Commonwealth payments are to be quarantined from the HFE assessment process;
- the Commonwealth should strengthen the CGC's decision making by providing input to the CGC's five-year methodology review and nominating specific areas of review; and
- the CGC should simplify its assessments by increasing materiality thresholds and aggregating revenue and expenditure categories.

Commonwealth response to Productivity Commission Inquiry report

On 5 July 2018, the Commonwealth released its interim response to the PC's Inquiry Report on HFE[2]. The substantive Commonwealth proposal is to transition Australia's system of HFE (from an "equalise to the strongest" approach) towards equalisation to the "second-strongest" fiscal capacity of all either New South Wales or Victoria. A relativity floor will also be implemented such that States receive at least a certain amount of GST. In addition to this, the Commonwealth proposes to implement several other adjustments to the existing distribution framework consistent with the PC's other recommendations.

The result of the Commonwealth's substantial proposal is that all but the strongest State will have their fiscal capacities equalised. The strongest State will maintain additional fiscal capacity over the rest.

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[1] Productivity Commission, PC Inquiry Report, Horizontal Fiscal Equalisation, No 88, 15 May 2018.
[2] Australian Government, Productivity Commission Inquiry into horizontal fiscal equalisation: Government interim response, July 2018.

The Commonwealth's interim response is based on relativity forecasts published in the PC's Inquiry Report. These forecasts are based on data provided by only some States.

Victoria supports the principles of full HFE

Victoria supports the principle of HFE, a mechanism that gives all Australian States and territories the capacity to fund essential services to a relatively high and equitable standard for the same revenue raising effort.

The PC Inquiry found little convincing evidence to suggest that HFE has been a significant impediment to economic reform, economic growth, or productivity.

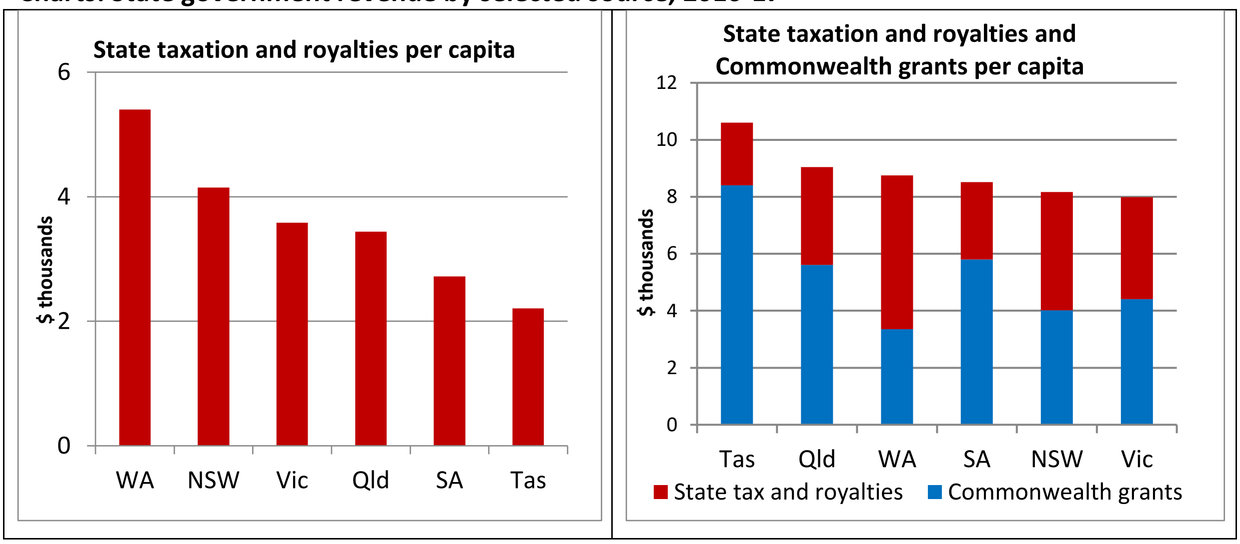
HFE has been working as intended in achieving its objective of equalising the States' capacities to deliver essential services to their citizens, and strikes the right balance between contemporaneous assessment and accuracy based on robust data. Administrative and economic costs of the current system are not substantial, but can be significantly inflated when interventions from the Commonwealth occur, particularly where that is in response to political pressure.

Victoria fully supports the principles of equity and policy neutrality at the heart of the current system. These operate to ensure that all Australians, regardless of State borders, have the capacity to access an equitable level of services, while allowing sovereign State governments the freedom to pursue their own policy agendas and be accountable to their constituents. Victoria maintains that the current framework should be retained, particularly as no alternative framework has been put forward that would improve efficiency without significantly undermining the principle of equity that is valued by Australians.

The fact that Western Australia receives a lower GST share reflects its greater capacity to raise its own revenue. In 2016-17, Western Australia raised $5 400 per head of population, significantly more than any other State shown in the chart below. By comparison, Victoria raised $3 580 per head of population.

When Commonwealth grants are added to State taxation and royalty revenue, Victoria is the lowest ranked per head of population while Western Australia is above the national average.

Charts: State government revenue by selected source, 2016-17[3]



Source: Interstate financial reports and Australian Bureau of Statistics

[3] The charts are an updated version that formed part of the Victorian Treasurer's presentation made at the PC Inquiry hearing on 17 November 2017. The full presentation can be found on the PC's website (Item DR87) at https://www.pc.gov.au/inquiries/completed/horizontal-fiscal-equalisation/submissions#post-draft

Victoria's preference is that the integrity of the current GST distribution system be maintained. As issues arise with a particular State, then the Commonwealth should deal with this outside the GST distribution framework.

Victoria's concerns with the Commonwealth's proposal

Victoria considers the Commonwealth's proposal to be inequitable, as it moves away from the principle of giving each State the potential to fund government services to the same standard. Furthermore, the PC's Inquiry Report on HFE noted that a relativity floor is blunt and arbitrary.

Victoria believes that the main motivation for the PC Inquiry – to boost Western Australia's low GST share – was misguided as that State's share had already recovered from a low of 0.30 in 2015-16 to 0.47 in 2018-19. Over a forty-year period, the mining state's low GST share is both unusual and temporary.

Under the current system, the GST pool is fixed such that if one State were to receive a greater GST entitlement at least one other State would get less GST revenue. The Commonwealth's response had provisions to compensate States that might receive less GST if a new GST distribution framework based on a different standard of HFE were implemented. However, there was uncertainty around the sufficiency of this compensation as the Commonwealth's calculations are extremely sensitive to forecasts of State-level economic circumstances (relativities).

The Commonwealth's response involves transitioning to a new HFE system over eight years from 2019-20 in a way that provided one-off payments to Western Australia and the Northern Territory in some years (to maintain their GST share above a specified floor) and annual top ups to the GST pool from 2021-22. The level of top ups provided were based on modelling which assumed a specified trajectory of GST relativities over a ten-year period.

The Victorian Department of Treasury and Finance (DTF) undertook research to demonstrate that forecasts of relativities are likely to vary from actual relativities. The analysis[4] undertaken shows that most States could get less GST in future years compared to the current distribution method based on several scenarios. Therefore, the use of forecasts to determine the compensation required for States may still result in a negative financial outcome for an individual State.

This work was independently verified by Deloitte Access Economics (Deloitte) who found that alternative scenarios could see some States worse off in dollar terms under the proposed HFE system. The Deloitte report[5] (attached) noted the Commonwealth's modelling is based on comparing the outcomes for each State under a "central case" set of projections. Under that set of projections, the Commonwealth's proposed system would leave no State "worse off". Deloitte observed that this approach does not account for the significant uncertainty surrounding this central case due to that inherent uncertainty in forecasting, which increases over time.

Given the risks to the States' revenue bases, Victoria and other States sought a guarantee that they will be no worse off under any new arrangements. Arising from the Board of Treasurers' meeting on 3 August 2018, all State Treasurers signed a letter to the former Commonwealth Treasurer seeking a such a guarantee. Victoria and other States could receive less GST under the new methodology in future years depending on the economic and fiscal outcomes over coming years.

The Commonwealth called a special Council on Federal Financial Relations (CFFR) meeting on 3 October 2018 seeking agreement on its proposed changes to the GST distribution framework. At a media conference following the meeting, most States rejected the Commonwealth's approach and sought a binding guarantee.

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[4] Department of Treasury and Finance, Victoria, Effect on GST revenue using alternative scenarios transitioning to a new standard of Horizontal Fiscal Equalisation, September 2018.

[5] Deloitte Access Economics, Report on the Victorian DTF's analysis of the new Horizontal Fiscal Equalisation Standard, 17 October 2018.

2. Draft legislation

The Commonwealth wrote to States on 18 October 2018 proposing a "sensible compromise" to guarantee that no State will be worse off under the new (proposed) system during the transition period when compared to the current system (the "no worse off guarantee"). While Victoria welcomes that some elements of the no worse off guarantee have been included into the Bill, it does not provide the level of certainty that Victoria requires. Victoria's key concerns are that:

- the Bill does not ensure that no State will be worse off beyond the transition period (i.e. 2026-27);
- the Bill allows too much discretion by the Commonwealth Treasurer in determining whether and the extent to which any State is to receive additional financial assistance under the no worse off guarantee, including setting terms of reference for the CGC and whether they consider the CGC's reports relevant;
- there is uncertainty around the purpose and use of the proposed PC review to be submitted by 2026;
- clarity is required regarding the stage at which the CGC is to adopt the new standard of HFE; and
- there is uncertainty in respect to the source of additional financial assistance to compensate a State if its GST under the new (proposed) system is less than the current system.

These concerns are discussed in further detail below.

No guarantee that States will be no worse off beyond the transition period

The Bill in its current form only provides for the no worse off guarantee to apply during the transition period. Victoria notes that beyond this transition period, the proposed GST distribution system represents a significant risk to State budgets. Although the Commonwealth will increase the funds available for distribution through its 'pool top-up payments', there is a risk that most of these funds will be distributed to Western Australia, leaving other States worse off in some years after the transition period.

Analysis conducted by DTF shows that the Commonwealth's projections of future GST distribution allocations are highly sensitive to changes in economic circumstances. As shown in DTF's analysis, the magnitude of these changes (in relation to the GST distribution allocations) is particularly significant in the final years of the transition period. This is true not only because modelling the economy over a long-term horizon is an inherently difficult task, but also as a result of transitioning fully to the new GST distribution system. This analysis has been verified by Deloitte, who (in its report) has stated that "while any base case projections may reflect a view, based on current information, of the most likely path of future outcomes, actual outcomes are likely to differ, possibly substantially, from those base case projections".

As implied by DTF's analysis, without a guarantee that is enforced in perpetuity, as a result of enacting the Bill most States may be financially worse off beyond the transition period, possibly substantially so.

Recommendation 1: That the Bill should be amended to extend the no worse off guarantee in perpetuity.

Level of discretion maintained by the Commonwealth Treasurer in "no worse off" payments

Victoria notes that the Bill[6] gives the Treasurer significant discretion in determining whether a State is to receive a payment under the no worse off guarantee. In particular:

[6] Proposed sections 5(2), (3) and (4) of the Federal Financial Relations Act 2009 (clause 3 of the Bill).

- an assessment of the GST that a State would have otherwise been entitled to if the Bill had not been enacted, is based on "the Minister's opinion"; and
- in forming this opinion, the Minister must only "have regard to any report of the Commonwealth Grants Commission that the Minister considers relevant".

The Bill does not include any mechanism for the Commonwealth Treasurer to frame terms of reference for the CGC to ensure that the CGC transparently reports on payments which should be made under the no worse off guarantee, consistent with other provisions of the Bill.[7]

Recommendation 2: That the Bill should be amended to:

- require the Commonwealth Treasurer to refer the matter to the CGC if a State considers that it should receive additional financial assistance under the no worse off guarantee;
- specify that the terms of reference for the CGC are to calculate the amount of GST the State would have been entitled to using the approach the CGC adopted under the previous (i.e. current) system; and
- restrict the Commonwealth Treasurer's ability to make payments under the no worse off guarantee based on relativities other than those recommended by the CGC.

The PC review

The Bill legislates that in 2026, the PC must submit a report on "whether the amendments by this Act are operating efficiently, effectively and as intended". The Bill does not however, discuss how the "intent" is defined, nor how "efficiently" and "effectively" will be measured. Noting that these terms may be better defined when the terms of reference are issued to the PC, Victoria considers that the aims of the PC review are unclear in this context. Furthermore, given the concern of States that the new distribution methodology inhibits equity, the legislation should mandate that the PC examine the equity of the new methodology compared to the current methodology.

Victoria also considers that there is no indication – in the Bill or otherwise – as to how the recommendations of the PC's report will be applied by the Commonwealth Treasurer. Without an indication as to what actions will be taken as a result of the recommendations, the value of this aspect of the Bill is unclear, particularly given that there is no guarantee that States will be better off beyond 2026-27. Victoria also considers that the Bill should ensure that all States are engaged during this review process.

Recommendation 3: That the Bill should be amended to specify the aims of the PC report, include equity as a key topic of inquiry, require engagement with all jurisdictions and outline action that is required by the Commonwealth as a result of the report's recommendations.

The extent to which the CGC's methodology is altered

Victoria considers that the expanded role of the CGC in relation to the new equalisation standard is unclear. It is Victoria's understanding that the Commonwealth has proposed a change to the equalisation standard rather than the CGC's individual assessments. However, section 1.53 of the Bill's Explanatory Memorandum States that the CGC will need "to make necessary adjustments to its principles, categories and methods of assessment (within the horizontal fiscal equalisation system) to make an appropriate and even transition from the old equalisation standard to the new equalisation standard".

Adjustments to the CGC's principles, categories and methods of assessments typically occur once every five years through the CGC's extensive and consultative review process. Changes to these aspects of the CGC's methodology represents a significant shift away from their current methodology, in addition to a change in the equalisation standard.

[7] Proposed section 16AB(2) and (3) of the Commonwealth Grants Commission Act 1973 (clause 1 of the Bill).

Although the current phrasing may be attributed to the way in which the existing legislation is constructed, Victoria considers that further clarification is required to ensure the Bill only facilitates a change in the equalisation standard rather than methodology changes at the category and assessment level.

Recommendation 4: That the Explanatory Memorandum should be amended to stipulate that the CGC will continue its assessment and review methodology as it does currently, altering only the equalisation standard used (to the stronger of New South Wales and Victoria).

Source of additional financial assistance to ensure no State is worse off

Victoria considers that neither the Bill nor the Explanatory Memorandum explicitly specifies the source of additional financial assistance provided to ensure no State is worse off. Although Victoria does not seek to prescribe a specific funding source that the Commonwealth can use, this funding should not reduce payments to States via a reduction in the GST pool or reduce tied funding that jurisdictions might have otherwise received.

Victoria also notes that there is no provision in the Bill to ensure that the CGC excludes these "no worse off" payments from its calculation of a jurisdiction's revenue in any given year. Should these payments be included, it would reduce the amount of GST a jurisdiction would receive in subsequent years.

Recommendation 5: That the Bill should be amended to specify that additional financial assistance paid to jurisdictions to ensure no State is worse off, should not be sourced from funds that would have otherwise been granted in the form of tied or untied grants.

Attachments

Department of Treasury and Finance, Victoria, Effect on GST revenue using alternative scenarios transitioning to a new standard of Horizontal Fiscal Equalisation, September 2018.

Deloitte Access Economics, Report on the Victorian DTF's analysis of the new Horizontal Fiscal Equalisation Standard, 17 October 2018.