

Department of Treasury and Finance

The Treasury Building
21 Murray Street HOBART TAS 7000
GPO Box 147 HOBART TAS 7001 Australia
Telephone (03) 6166 4444 Facsimile (03) 6173 0219
Email secretary@treasury.tas.gov.au Web www.treasury.tas.gov.au



Ms Karen Chester
Deputy Chair
Productivity Commission
Level 12
530 Collins Street
MELBOURNE VIC 3000

cc
received 19/11

Dear Ms Chester

Productivity Commission Inquiry into HFE

On behalf of the Tasmanian Government I would again like to thank you for the opportunity to participate in the public hearing on 1 December 2017 and for the invitation to present further information in support of the Government's response to the Commission's Draft Report into HFE.

In particular, the following information is provided in response to some of the issues raised at the hearings and in subsequent submissions:

1. comparing actual and assessed expenditures;
2. the budgetary impact of the Commission's equalisation options;
3. HFE and efficient service delivery;
4. the trade-off between equalisation and efficiency;
5. equalising to various standards;
6. the increased size of the equalisation task;
7. data sharing - a clarification on Tasmania's view; and
8. the issue of VFI.

1. Comparing a State's assessed expenditure with its actual expenditure.

At the hearings, the Commission questioned a number of participants about the significance for State budgets of its recommendation to change the current equalisation standard from the 'same' standard to a 'reasonable' standard.

It also noted that, for a number of States, their actual expenditure was less than the Commonwealth Grants Commission (CGC)'s assessed expenditure. In Tasmania's case, the Commission noted that actual expenditure was around 7 per cent less than assessed expenditure averaged over a six year period.

The Commission infers¹ that there is capacity for the States to absorb a reduction in their GST without impacting service delivery, because some States are spending less than their full GST entitlement, and that the Budget impact of the change would be relatively small. In Tasmania's case,

¹"I'm suggesting that the changes that we're recommending aren't really an Armageddon. Indeed, the Victorian Government would still be able to, given your current track record of what you actually spend on the assessed expenses, the actuals versus the assessed, there wouldn't necessarily be any less services for the Victorian people." Transcript from 17 November 2017 Melbourne hearing, page 18.

the Budget impact would be a 1.3 per cent reduction in total revenue if equalised to the second strongest state, and a 2.8 per cent reduction if equalised to the national average.

I have a number of concerns with this argument, both from a conceptual and a budgetary perspective.

The CGC's assessments are based on a notional average level of service provision, using the average of 'what States do', to determine the average level of service provision. This is then adjusted for specific service delivery cost disabilities. It is not an observable service, rather a mathematical construct developed to give effect to the principle of HFE.

The CGC calculates a GST requirement taking into account specific State demographic, geographical and other non-policy related influences to determine whether a State would need to spend more or less than the national average level of expenditure in order to have the capacity to deliver the national average service level.

As the CGC equalises service delivery expenditure capacity based on the average of what States do, this incorporates the national average level of efficiency in delivering those services. The difference between actual and assessed expenditure could mean that a State is delivering services more or less efficiently than the average level of efficiency. It could therefore be inefficient for a State to increase its actual expenditure to the CGC's assessed level of expenditure if it was able to deliver the services at a lower cost.

State governments are ultimately accountable to their electorates in relation to how they spend government revenue. The specific amounts provided to the States through equalisation should not be used as a measure of what States should spend on particular service areas. It is not the role of the CGC's assessments to be the benchmark for State spending priorities.

The CGC's assessed expenditure is only an assessment. The CGC recommends caution in making comparisons between assessed and actual expenditure and revenue as these concepts are only intended for equalisation purposes to support the equalisation process.

The Assessed Budget

"The data in these tables are for the Commission's calculations only. The actual figures are not necessarily the same as in State budget documents or in Australian Bureau of Statistics (ABS) publications as they have been adjusted for equalisation purposes. Actual amounts for the ACT include municipal transactions.

Comparisons between the averages, actual and assessed should be made with caution. In particular, the assessed data reflect only these adjustments to the averages which the Commission could quantify reliably. Not all non-policy influences on State figures have been taken into account."

CGC Report on GST Revenue Sharing Relativities - 2017 Update, Attachment 4 (The Assessed Budget Categories Tables)

Comparing the CGC's assessed expenditure with actual expenditure does not reflect reality, as State Budgets record actual expenditure according to GFS expense categories with actual (not assessed) revenue including actual GST received (albeit that relativities are lagged over two years and averaged over three years).

Annual Financial Statements of State Governments are prepared in accordance with the principles of Australian Accounting Standards and, in particular, AASB 1049 *Whole of Government and General Government Sector Financial Reporting*. This is not the same as the CGC's Adjusted Budget, which is based on actual data for its own budget construct used for HFE purposes to determine what States do.

While the GST provides Tasmania with funding to meet its assessed expenditure, it is on the basis that Tasmania is able to raise revenue at its assessed revenue raising capacity.

Tasmania's actual revenue is less than it is assessed to be able to raise. While for most assessed taxation revenue categories Tasmania's actual revenue is similar to its assessed revenue, in the Other Revenue category, which is over half of Tasmania's own-source revenue, it raises significantly less than it is assessed to be able to raise.

Other Revenue includes revenues for which reliable data could not be found by the CGC to make an assessment, an assessment method could not be developed, or an assessment was not material, and so it is assessed on an equal per capita (EPC) basis. That is, all States are assumed to raise Other Revenue at the national average. In Tasmania's case, this could be overstating its actual revenue raising capacity in this category for a range of reasons, including its weaker tax bases compared to the national average, or the less than average capacity of its citizens to pay.

Table I compares CGC and GFS expenditure and revenue for Tasmania averaged over the period 2010-16. It shows that while the CGC's actual expenditure, including investment, was approximately 8 per cent lower than its assessed expenditure, the CGC's actual revenue also was 9 per cent lower than its assessed revenue. Similarly, although GFS actual expenditure was approximately 1.5 per cent lower than the CGC assessed expenditure, the GFS actual revenue also was approximately 0.2 per cent lower than the CGC's assessed revenue.

Table I - Tasmania: Assessed and Actual Expenditure and Revenue

	Commonwealth Grants Commission Data (2010-16 avg.)		GFS Actual State Budget (2010-16 avg.)
	Assessed Budget (\$M)	Adjusted Budget (Actual Data) (\$M) ²	Actual (\$M)
Assessed Expense Categories	4992	4665	-
Plus Investment	145	48	-
Total Expenditure	5137	4712	5062
Taxation Revenue	897	859	952
Other Revenue	981	830	1076
Commonwealth Grants & Subsidies	932	932	922
GST Requirement ³	2151	1850	2000
Total Revenue	4960	4471	4950
Net Operating Balance	-176	-241	-112

As noted, while not directly comparable, if Tasmania had increased its expenditure in line with the CGC's assessed expenditure, as the Commission is suggesting, Tasmania would have had to fund \$5 137 million, on average, in CGC assessed expenditure (rather than \$5 062 million actually spent) from an average actual GFS revenue of \$4 950 million. This would have increased Tasmania's average

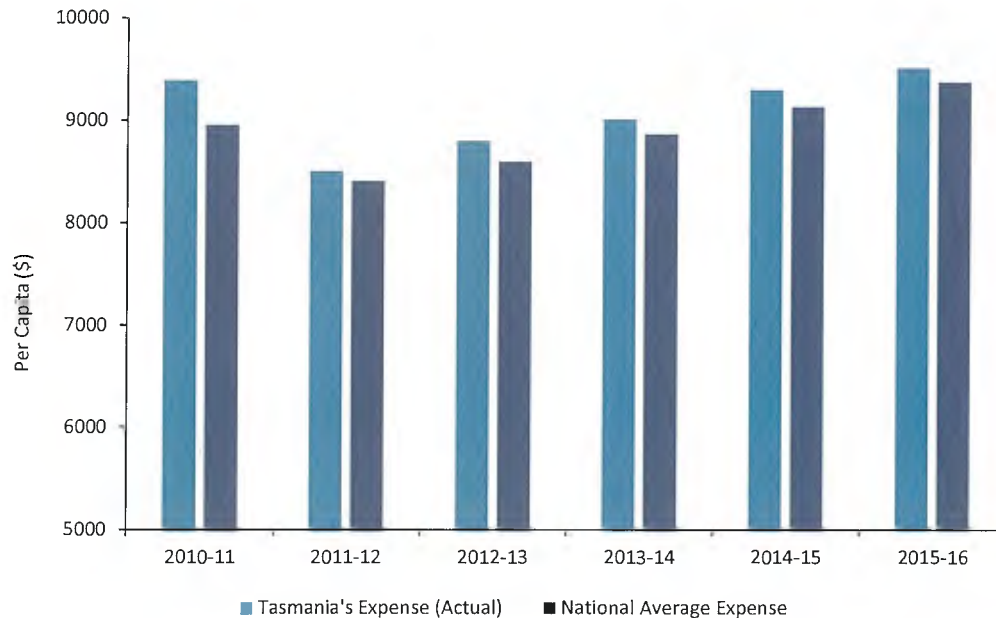
² The CGC's Adjusted Budget is a stylised representation of Actual State Budgets for equalisation purposes. The CGC compiles the Adjusted Budget using data from the ABS GFS data, which is further supplemented with data from the States and other sources to allow the most recently completed financial year to be included. As a result, there will be variations when comparing the data produced by the CGC and ABS GFS data.

³ The GST requirement for the CGC's Assessed and Adjusted Budgets are not equivalent. The Assessed Budget for a given year is the GST requirement based on expenditure and revenue assessments for that year. The Adjusted Budget is the actual GST paid to the State in that year which is determined by the average of the three preceding years relativities lagged by two years. That is, the GST that is paid in the application year relates to assessments of State GST requirements in earlier years.

actual net operating deficit to \$187 million - an additional \$75 million. This would need to have been met by either increasing existing taxes or by finding other new sources of revenue.

It should also be noted that, although Tasmania's actual average expenditure was less than the CGC's average assessed expenditure, actual total spending on a per capita basis was above the national average during the 2010-16 period, as demonstrated in Chart 1 below.

Chart 1 - Total Per Capita Expense Category (average 2010-16)



In addition, from 2010-11 onwards, Tasmania has spent more per capita than the national average on key assessment categories such as total education and health.

2. The impact of equalisation to a reasonable standard is significant

As noted above, the Commission suggested at the hearings that the revenue impact of equalising to the national average or to the second strongest State is relatively small compared to Tasmania's total revenue (equivalent to 1.3 to 2.8 per cent of Tasmania's total revenue). While the Commission may see this reduction as being relatively modest and capable of being transitioned to over a suitable period, the Tasmanian Government has many other financial risks and funding pressures to deal with in addition to its GST revenue that need to be carefully managed in order to meet its fiscal strategy targets.

For example, there is ongoing uncertainty around the direction and/or durability of recent Australian Government funding reforms such as the NDIS and National Health Reform. There is also a trend towards cessation or short-term renewal of critical national partnership agreements. There has been an increasing move towards more prescriptive agreements such as the current education and housing agreements and the Commonwealth Redress Scheme for survivors of institutional child sexual abuse being negotiated to include requirements for matched funding, greater risk sharing arrangements, and more onerous reporting and input controls. This trend is contrary to agreed principles for national funding agreements under the Intergovernmental Agreement on Federal Financial Relations (IGAFFR) and it imposes additional funding risks on the State.

There are, of course, the ongoing funding pressures on the State Budget for increased spending on services in key areas of health and education. There are also risks that budgeted own-source revenue is not realised because of changes in economic conditions. A reduction in Tasmania's GST share would compound these financial risks.

Successive Tasmanian Governments have adopted fiscal strategies aimed at balancing their operating budgets. A permanent reduction in Tasmania's GST distribution is likely to increase the risk of running unsustainable deficits.

This risk would be further exacerbated over the medium term as the Government needs to carefully manage borrowing costs and provide funding flexibility to offset the increasing emerging cash cost of the unfunded defined benefits superannuation liability.

3. Does HFE encourage inefficient service delivery?

The question of whether HFE encourages inefficient service delivery has been raised again in the recent paper prepared for the New South Wales Government by Fahrer and Fitzgerald⁴ that was submitted to the Commission following the Melbourne public hearings.

As discussed earlier, the CGC does not equalise expenditure based on the individual efficiency of State governments. Its methodology distributes the GST based on the average of what States do. The CGC then makes disability adjustments on factors that are beyond the control of Governments, such as the number of people in various age groups that are the heaviest users of hospital services, the number of school students in each jurisdiction, indigeneity and so on.

No adjustment is made in relation to how efficiently a State delivers a service. If a State is able to deliver the average level of service at a cost below the national average, its funding from the GST would only be affected by the marginal impact it would have on the average national standard.

Therefore, any reforms that States make to their service delivery systems will not materially affect those assessments or HFE transfers. If a State has above average efficiency in delivering a particular service, it will benefit from the difference between the national average and its actual expenditure. Conversely, if it is less efficient than the national average then it bears that cost. States therefore continue to have the incentive to reduce costs, as they will retain the benefit of greater budget flexibility and will not be discouraged, by the equalisation process, from improving efficiency.

It would appear that the Fahrer-Fitzgerald paper fails to recognise these policy principles in its criticisms of the HFE process. The theme of the Fahrer-Fitzgerald paper appears to be that all States should conform to assessed patterns of expenditure and that, by doing so, disabilities will be eliminated in the long-term. If that was the reality, there would be no levels of disparity between States, particularly those that match their expenditure levels with their assessed expenditure levels. Some service cost disabilities experienced by particular States are determined by issues that are outside their control such as socio-demographic, geographic/regional and remoteness, and scale disabilities, and these are hardly capable of being eliminated by additional expenditure.

Fahrer-Fitzgerald also presume that lower levels of expenditure are a sign of lower effort. As mentioned previously, those lower levels of expenditure may, in fact, be due to a State providing a service on a more efficient basis.

⁴ Fahrer J and Fitzgerald V. Aspects of Australia's System of HFE. November 2017.

It is noted that the Commission was not persuaded by these arguments and, in its Draft Report, made the following finding:

DRAFT FINDING 4.2

Changes in State service delivery policies can impact on GST payments, but the impacts are mostly trivial. HFE is unlikely to discourage - nor encourage - States from pursuing growth strategies or addressing their structural disadvantages given the broader and more significant benefits of doing so to the community.

4. Trade-off between equalisation and efficiency

The Commission discussed hypothetical cameos in its Draft Report and at the hearings to demonstrate that the current system of full HFE can act as a barrier to efficient tax reform, such as moving away from conveyance duty on property to a broad based land tax, and that this is a weakness in the current system of HFE. The Commission concludes that this is the case because, as HFE equalises to the strongest State, there is little ‘wriggle room’⁵ for trading off equity for efficiency.

This trade-off is already considered by the CGC and is examined as part of periodic reviews of its methodology, including its supporting principles. Policy neutrality is one of the CGC’s supporting principles and it recognises that sometimes it can be in conflict with equity when a State’s policy changes directly and materially impacts its GST share.

The CGC has grappled with this issue, particularly since the impact on iron ore royalties from the mining boom. The CGC tries to balance policy neutrality against other supporting principles and its overriding principle of HFE. In the case of the 2015 Methodology Review, it erred on the side of equity.

For the 2015 Review, we have decided to adopt a mineral by mineral approach. We have done this because we consider this achieves equalisation more accurately. We acknowledge that this has the potential to make the assessment less policy neutral because changes in State policies may have a larger impact on their shares of GST.

However, we consider that the goal of policy neutrality is subsidiary to the requirement to achieve equalisation. We also consider that while it is theoretically possible for changes in State policies to affect GST shares, in practice we do not observe that States adopt policies for this purpose. If we do observe a significant change in behaviour which raises policy neutrality concerns, we will revisit the assessment in a future update.

CGC Methodology Review 2015 final report page 37. Emphasis by Tasmania.

The CGC is again considering this issue and, for the 2020 Methodology Review, it is proposing to trade-off equity in order to improve policy neutrality. In its 2020 Review Position Paper, *The Principle of HFE and its Implementation*, the CGC is examining the option of allowing a State to keep half the revenue from a tax or royalty rate change that would impact its own GST share where it is the dominant State for that revenue source. In this situation, less GST revenue would be redistributed from the stronger State to the weaker States compared to a situation where this measure was not taken. As a result, the stronger State would become fiscally stronger because it would retain a greater share of GST while retaining half of the higher royalty revenue. This would result in less than full HFE, and thus there is a trade-off in favour of policy neutrality at the expense of equity.

⁵ “...that’s where we’re coming from, that perhaps there is - you can make a little bit more of a trade-off between equalisation and efficiency. Because the CGC do have efficiency as one of their subsidiary principles, but when you’re equalising to the highest and it’s such a high bar at the moment with WA there’s just no wriggle room for efficiency.” Transcript from Adelaide hearing 21 November 2017, page 217.

The Commission's recommendations to equalise to the average, or to the second strongest State, effectively places a dynamic floor under Western Australia's relativity. This also appears to address policy neutrality issues by limiting the GST impacts of changing mining royalty tax rates. It is unclear whether the Commission supports the CGC's proposal and whether this measure should be implemented in addition to its own recommendation.

Given that the CGC is already proposing methodology changes to address policy neutrality in the 2020 Methodology Review, the Commission's recommendations in the Draft Report may need to be re-visited to ensure they do not pre-empt measures being actively considered by the CGC that will be extensively debated by the States in consultations during the 2020 Review.

Policy neutrality is only an issue if a State was able to either 'game the system' by adopting policies that would increase its share of GST or consciously refrain from adopting them because it would reduce its GST share. As noted in many submissions to the Commission's Inquiry, while it is theoretically possible that this could occur, there is no evidence that it actually has.

At the Tasmanian hearing, the Commission acknowledged that these potential disincentives are likely to be less significant for the smaller States that do not materially affect the national average, and that the larger States are more likely to face a material change to their GST share from such reform. Notwithstanding that many of the submissions to the Draft Report argue there is no evidence that HFE has been a barrier to tax reform, the Commission's partial equalisation solution to address this problem, in effect, penalises the smaller States which do not face such a disincentive to tax reform.

5. Is the Commission proposal to equalise to a 'reasonable' standard simply a return to an earlier standard used by the CGC?

During the hearings the Commission observed that the CGC's current definition of HFE to equalise to the 'same' standard had evolved from an earlier definition of 'not appreciably different'. By inference, the Commission's recommendation to equalise to the national average or to the second strongest State is a return to a form of equalisation used by the CGC that is less than full HFE. It should be noted that the concept of equalising to the 'same' capacity was introduced into the CGC's definition of HFE in the 1990s and has therefore been the known methodology for over 20 years during negotiations by State and Territory Governments on a number of successive intergovernmental agreements, including the Intergovernmental Agreement on the Reform of Commonwealth - State Financial Relations and the IGAFRR.

While the CGC's definition of HFE refers to equalisation to the 'same' standard, in practice it does not equalise to this standard precisely. The CGC applies materiality tests and discounts to its assessments where its methodology and data have reliability concerns, and, where no reliable assessment can be made for a number of service expenditure and revenue measures, it is treated on an EPC basis rather than being differentially assessed.

The Commission's proposal to equalise to a 'reasonable' standard is arguably a greater departure from 'not appreciably different', as the impacts of such a change would result in significant, rather than 'not appreciably different' equalisation outcomes for the States.

In the CGC's submission to the 2012 GST Distribution Review interim report, it noted that the evolution of its definition to equalise to the 'same' standard was made to avoid having to make judgements about what is an appropriate lesser standard, and that this is a decision for the Commonwealth Government to make.

6. Has the equalisation task become too great?

The Commission has acknowledged that HFE works very effectively in achieving equity and it does not dispute that this should be the objective of HFE. However, the Commission argues that, because Western Australia is an outlier in terms of its significantly greater fiscal strength compared to other States, HFE has had to work harder and has a larger equalisation task.

While the amount of GST redistributed has grown, particularly since the mining boom, the total amount to be redistributed from an equal per capita distribution in 2017-18 is \$7.9 billion representing only 12.7 per cent of the total GST pool. As a proportion of total GFS State revenue it is even smaller (3.5 per cent).

It is questionable whether this is a problem that needs fixing. The HFE process operates to even out changes in economic circumstances. Often these circumstances are not large in comparison to the size of the pool, and although the recent mining boom has been an exceptional case it is unlikely to be an outlier so significant that it warrants a major change to the current system of HFE.

7. Data sharing

The Commission made the comment at the Tasmanian hearing that Tasmania does not support its recommendation to make the CGC's data and calculations publicly available.

This comment is not totally correct and needs clarification. Tasmania's submission stated that:

Tasmania has some concerns with this Draft Recommendation.

While in principle Tasmania supports greater public access and transparency to the CGC's data and calculation methods, because of its complexity it also presents a risk of increasing the misunderstanding of how HFE works. Any increase in the availability of data should be considered carefully and accompanied with detailed explanation and guidance notes to users to mitigate the incorrect use and interpretation of the information.

Tasmania is not opposed to the Commission's recommendation. It simply highlighted some concerns about how it might be implemented.

8. Is VFI the real problem here?

While this is an issue that is outside the Terms of Reference for the Commission, it has observed that even the strongest State, Western Australia, is unable to meet its expenditure needs without additional assistance from the Commonwealth Government and that this shortfall is a result of Vertical Fiscal Imbalance (VFI).

It is true that, because of the current level of VFI, all States' expenditures are greater than their GST shares and own-source revenues, and that additional Commonwealth funding is required. However, if VFI was significantly reduced through the transfer or provision of greater taxing powers for the States and/or transfer of State funding responsibilities to the Commonwealth, there would still be some States that would have less capacity to raise revenue, or face higher costs, compared to other States. HFE would still be required.

A reduction in VFI would not change Tasmania's relative fiscal disadvantage and, arguably, it could worsen it as its capacity to raise new taxes in lieu of Commonwealth grants is limited by its lower incomes, smaller mineral endowments, lower population growth and lower economic activity compared to stronger States.


The level of VFI will affect the degree to which HFE is distributed, but it does not eliminate the need for HFE and so a certain level of VFI is necessary for this purpose.

The CGC equalises the GST to give States the fiscal capacity to meet assessed expenses, taking into consideration other Commonwealth transfers. If those Commonwealth transfers were reduced because of a reduction in VFI, the CGC would still need to apply equalisation to that new situation.

Thank you again for the opportunity to provide additional comment and clarification on some of the issues raised during the Tasmanian hearing and in subsequent discussions.

Yours sincerely

Tony Ferrall
Secretary

 January 2018