

Victorian Government Submission

to the Productivity Commission Inquiry into
Australia's System of Horizontal Fiscal
Equalisation

D17/226913

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Executive Summary

Victoria supports the principle of horizontal fiscal equalisation (HFE), a mechanism that gives all Australian states and territories (states) the capacity to fund essential services to a relatively high and equitable standard for the same revenue raising effort. This submission takes a principles-based approach.

Victorians have consistently received below our per capita share of Commonwealth-state payments. Since Federation, Victoria has received some \$86 billion less in total Commonwealth payments than if Commonwealth funds were distributed on an equal per capita basis.

Much of this has gone to historically smaller, developing states. Western Australia (WA), for example, has received over \$25 billion more than it would have on a per capita basis. This uneven distribution of funds has been justified based on the need to address inequity for the benefit of all Australians.

While the current HFE system can be improved in some areas, these improvements are mostly technical and administrative in nature, and should be examined as part of the Commonwealth Grants Commission's (CGC) 2020 methodology review process (the 2020 Review). The focus of this submission is on the general intent and impact of the system on economic reform, economic growth, and productivity.

There is little convincing evidence to suggest that HFE has been a significant impediment to economic reform, economic growth, or productivity. It is important that any costs of the system be evaluated in the context of efficiency losses inherent in all redistribution systems.

Victoria considers that the CGC's criteria to determine treatment of mineral resources is appropriate. HFE, economic efficiency, and fiscal discipline would be undermined if concessions are made for mining revenues. High minerals prices during the mining boom increased the fiscal capacities of the mining states. It is entirely in keeping with the intent of HFE that GST revenue to the mining states fell around the time they had high fiscal capacity. The effect of the mining boom on WA's GST distribution, as demonstrated in this submission, was predictable and it was incumbent on the WA Government to manage its finances accordingly. To adjust the system such that WA would receive a windfall gain permanently, at the expense of all other Australians, would fundamentally undermine the principle of equity on which HFE is based.

Victoria therefore rejects intervention by the Commonwealth Government in resources policy through the currently independent assessment of resource revenues by the CGC. Proposals for financial 'penalties' through the GST for states that have a ban on onshore unconventional gas, for example, represent unprecedented Commonwealth government intervention in state policy – which would undermine state accountabilities to their constituents, and may reduce the capacity for sovereign state governments to balance potential economic gains of extracting non-renewable natural resources against other economic and policy considerations. Doing so undermines economic efficiency as it encourages states to consider and implement policies based on short-term financial incentives rather than broader, long-term, economic, social and environmental benefits. It is also unclear why, in this context, the Commonwealth would view 'economic development' through the narrow prism of mining. Victoria undertakes a range of economic development initiatives across

different industries and it would be distortionary to single out any one area of government policy for differential treatment.

HFE has been working as intended in achieving its objective of equalising the states' capacities to deliver essential services to their constituents, 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 ad-hoc 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 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. The current framework should be retained, particularly if no other alternative framework would improve efficiency without significantly undermining the principle of equity that is valued by Australians.

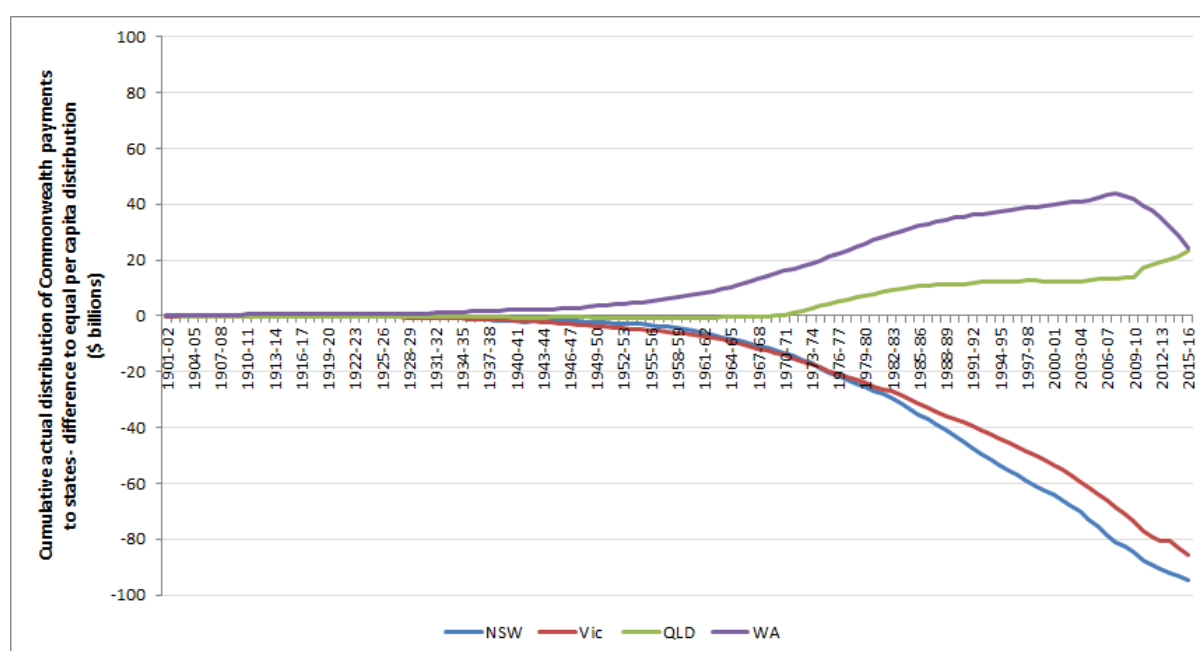
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Introduction

Victorians have consistently received below their per capita share of Commonwealth-state payments. Since Federation, this has meant that Victoria has received some \$86 billion less in total Commonwealth payments than if Commonwealth funds were distributed on an equal per capita basis, as shown in Chart 1, below. On the other hand, Western Australia has received over \$25 billion more than it would have on a per capita basis. Much of this lopsided distribution of funds has been justified based on the need to address inequity between the larger states such as New South Wales and Victoria, and smaller developing states.

Chart 1: Cumulative distribution of Commonwealth payments to states – difference in payments between equal per capital distribution and actual (2016 dollars)



Source: Commonwealth Budget Papers, Department of Treasury and Finance (Vic) calculations

Victoria acknowledges that the process of GST distribution can be seen as complex and opaque. Unfortunately, the discussion around the distribution of GST funds has, over time, also become highly politicised. This has contributed to public misunderstanding of the objectives, operation, and implications of the current system.

Victoria welcomes the opportunity to contribute to this Inquiry, and to clarify some misconceptions about the current system. Despite Victoria not having benefited financially from HFE, it has undertaken a principles-based approach in preparing this submission in the context of the underlying equity objectives of HFE.

We encourage other jurisdictions to undertake the same principles-based approach and note the need to view GST distribution in the context of Australians' preferences for equity. Further, all jurisdictions agreed to the *Intergovernmental Agreement on Federal Financial Relations 2011*, stipulating that GST funds would be distributed based on the principle of HFE, and that such funds would be provided to states on an untied basis.

1. HFE promotes equitable access to government services across states and long-term social mobility

As defined by the CGC, the principle of HFE refers to the following:

State governments should receive funding from the pool of GST revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

HFE is therefore aimed at allowing state governments across Australia to have the capacity to provide a relatively consistent standard of government services for individuals in their borders with the same revenue raising effort. Crucially, HFE does not impose particular policy choices on states, and each is free to make choices about how it raises revenue and its expenditure priorities – this is in keeping with the desirability of state governments being accountable to their own constituents, rather than to some other external body or mechanism.

State governments are responsible for operating and directly funding basic government services. HFE is a necessary condition to enable individuals across Australia access to relatively equitable level of services, by equalising both benefits and risks of structural factors and cyclical swings in state economies.

Funds distributed through HFE contribute to a more equitable quality of schools, hospitals and transport infrastructure by giving governments the capacity to set tax and expenditure policy around the average level. Crucially, these are the types of government services and infrastructure that are important drivers in promoting equality of opportunity, long-term social mobility, and economic outcomes.

It is clear that these areas of government responsibility are highly valued by Australians, with surveys consistently showing that the majority of Australians want these services to be better funded¹. The objectives of HFE are directly related to supporting these outcomes for all Australians.

¹ Australian National University, *Tax and Equity in Australia: What Australians Want*, 2016.

2. There is little evidence to suggest that HFE poses significant impediments to economic growth, reform, and productivity

Given the above, Victoria fully supports the principle of HFE. The key question then is whether the current mechanism for achieving HFE, through the distribution of GST, is the most appropriate mechanism to realise equity. Victoria considers that the current mechanism does not encourage unnecessary inefficiencies, when free of political interference. It also acts to preserve policy neutrality to ensure that accountability for decision making appropriately remains with sovereign state governments. Given there will likely be an efficiency-equity trade off in any tax and transfer system, any substantive move away from the current system should not only be justified based on the detrimental impacts of the current system, but also provide robust evidence that a different system would be more efficient while retaining a similar degree of equity.

HFE can promote economic efficiency by minimising economically inefficient interstate migration

Conceptually, HFE can promote efficient migration outcomes by giving each state the capacity to fund government services to a similar level. This is because large differences in the level of government services provided by states represent a distortion to market wage and capital return signals which labour and capital owners respond to in their migration and investment decisions.

For example, in a world without HFE, where there are substantial differences in the level of government services offered by states, labour and capital may relocate to fiscally stronger states to take advantage of the higher level of government services offered there, despite being more productive in their existing location.

With HFE in place, fiscally weaker states receive additional GST support, thereby allowing them to offer a comparable level of general government services to other jurisdictions. Labour and capital owners can then make migration and investment decisions based on where they can be most efficient and productive, balanced with other relocation costs.

In this regard, HFE appears to be serving Australia well. The Productivity Commission (PC) examined the issue of labour mobility in its *Geographic Labour Mobility Report*, published in 2014 (the report).

The report notes that “labour appears to be responding to market signals and moving to areas with better employment and income prospects”, and that “these movements...have assisted in meeting labour demand in many parts of the country”. It also notes that the main drivers of inter-regional migration, at an aggregate level, appear to be proximity and economic opportunities.

No evidence that HFE systematically affects state government decisions to undertake policy reform and economic development

There are some views that HFE may create a financial disincentive for states to undertake policy reform or economic development, with the benefits of reforms or development being offset by a lower GST distribution.

This argument over-simplifies the process of policy development undertaken by states, and incorrectly suggests that states only take a simplistic revenue-based approach to reform.

There is little evidence that suggests GST distributions have been a major impediment to reform. Indeed, several jurisdictions have undertaken major tax reforms recently, including South Australia, the Australian Capital Territory, and Victoria. Western Australia, which controls a large share of Australia's iron ore resources, made a series of increases to its royalty rate on iron ore fines between 2010-11 and 2013-14². The *2012 GST Distribution Review* noted that the review panel "doubts that GST share effects are a very powerful factor when states are considering tax reform".

Victoria also highlights that there is a misconception over the impact of HFE on a state government's incentives to undertake economic development. It is sometimes argued that jurisdictions such as the Northern Territory may be discouraged to undertake economic development of remote areas, as it receives GST funds due to the requirement for its government to service these remote communities. The current HFE framework only compensates states for the higher costs incurred by governments in delivering its services to these remote communities – that is, it does not provide additional funding in excess of the cost of compensating for the disability so as to be able to reduce the disability. If such communities were in closer proximity to regional centres and economic opportunities, then it is true that GST compensation for that factor could fall, but only in line with a fall in government service delivery costs, leaving the state government no better or worse off financially. Therefore, the HFE framework has a neutral impact on state government incentives to undertake economic development.

Significant changes to HFE have potentially major impacts – any evidence supporting such a change must be rigorous and convincing

Any significant deviation from the current HFE system could potentially represent major changes to the amount of GST received by individual states, and so must be supported by robust, data-driven evidence that demonstrates not only a link between HFE and economic underperformance, but that a change would substantially improve performance. Victoria firmly believes that any such deviation would need to be supported by evidence that:

- is data-driven rather than theory and assumptions-driven. Robust empirical models that are based on actual data, and free of unnecessary assumptions of the structure of the economy, would be needed to show that HFE is limiting economic performance. Computable general equilibrium models should not be used to assess the magnitude of any economic costs, given that these models are largely assumptions-driven. These models can show large differences in results, and / or contradictory results, when inputs and assumptions are changed slightly;
- shows any such link between HFE and economic underperformance is causal. Simple correlations mask hidden and confounding factors that could affect economic performance, thereby generating misleading conclusions;
- shows that any link between HFE and economic underperformance is economically significant, where such a link is found. That is, the causal effect of HFE and lower economic growth is substantial and warrants a significant change to the system;
- shows that if any link is found between HFE and lower economic growth, that impact is substantially less efficient than the current Commonwealth tax-transfer system. It is important to highlight that in many cases of taxation and redistribution, there is a trade-off between economic efficiency and the increase in equity from redistribution; and

² Western Australia Government, 2012-13 Budget Fact Sheet – Royalty Rate Analysis, 2012.

- takes into account any required transition and administrative costs resulting from a substantial departure from the existing system.

HFE needs to be viewed in the context of other tax-transfer systems

It is important to reinforce the point that HFE is a system of redistribution. As with other systems of redistribution, there may be an associated economic cost. However, this cost needs to be viewed in the context of society's preferences for equity and social mobility, where government interventions almost always involve a trade-off between equity objectives and economic efficiency to arrive at a socially optimal outcome.

For example, there may be significant economic impediments associated with the Commonwealth tax-transfer system. While governments should always be focused on policy reform and minimising these economic costs, such costs are largely accepted by society, through the political process, as the necessary trade-off for greater equity.

Given this, Victoria highlights that even if a convincing, causal link between HFE and reduced economic performance can be found, any such link needs to be benchmarked against the economic costs of other systems of income / wealth redistribution.

3. The implementation of HFE can be improved, particularly by improving consistency in the system

While Victoria supports the principle of HFE, improvements can be made to the way it is currently implemented. The tradeoff between robust and accurate data, and need for simplicity and contemporaneity has complicated the work of the CGC to achieve the aim of HFE to fully equalise states' fiscal capacities. However, Victoria considers that reaching the appropriate balance in this tradeoff, and other technical issues, are best examined through the existing five-yearly review processes, such as the upcoming 2020 Review.

In the interim, applying the existing methodology is complicated by arbitrary interventions by the Commonwealth, such as the treatment of certain revenue and expenses. These interventions undermine the operation of the framework, lead to inconsistencies that distort incentives and reduce confidence, and should be minimised.

The treatment of revenues and expenditures should be independent and have a consistent policy rationale

The objective of HFE is best served where states' revenue and expenses are comprehensively and reliably measured, such that true fiscal capacity equalisation across the states can occur.

The CGC has developed rigorous criteria for determining the GST impact of funds received by the states from the Commonwealth. However, the Commonwealth Government, from time to time, includes in its terms of reference to the CGC process, a requirement that certain revenue flows from the Commonwealth to the states be excluded from the CGC's assessments.

There may be legitimate reasons for such exclusions. For example, where there is no reliable, policy-neutral approach to objectively assess cost differences between states, or where reliable data is unavailable. Exclusions in these instances may be justified, particularly where a reliable assessment may be developed, and data may become available, in the future. However, such exclusions should be independently and consistently administered by the CGC, given its expertise in this area, and to prevent political decisions from interfering with the independent process.

However, some other exclusions in the past have not been based on any obvious policy rationale. For example, inconsistencies are created through the differential treatment between funding for road and rail infrastructure, or the recent tendency for the Commonwealth to provide investments through equity contributions that are not yet clearly accounted for in the HFE system.

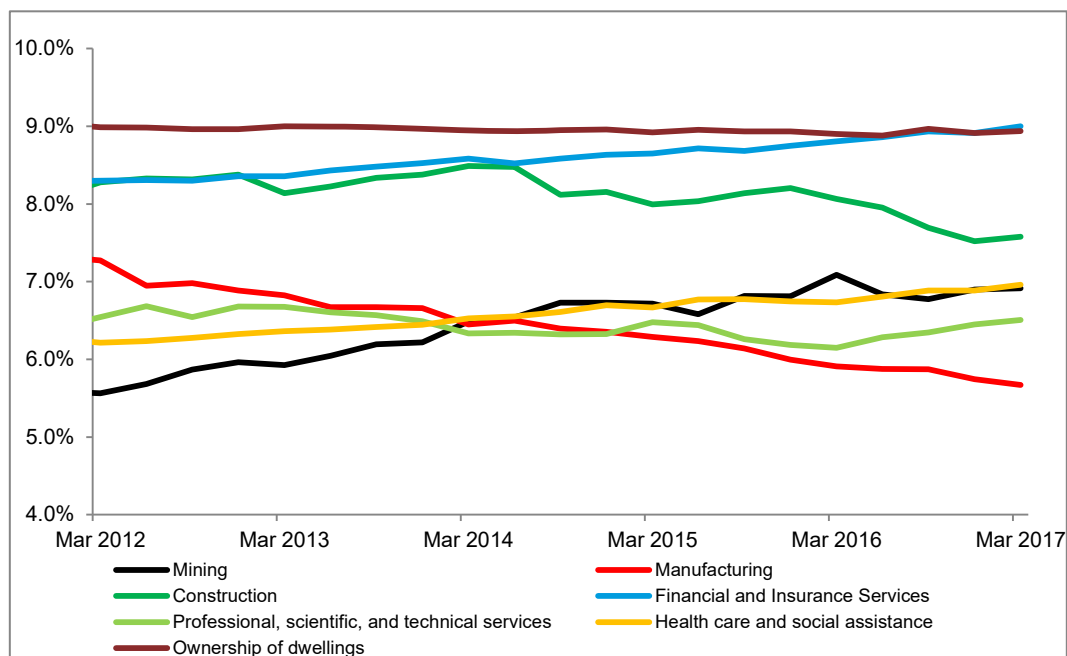
Similarly, mooted Commonwealth interventions to financially penalise states that ban fracking are arbitrary and undermine the efficiency and equity of HFE. Imposition of the Commonwealth's agenda would override Victorian Government decisions on onshore gas. There are no proved and probable onshore gas reserves in Victoria. Gas exploration and mining can have significant economic, social, and environmental impacts on communities. The Victorian Government's ban on onshore unconventional gas exploration and development (including hydraulic fracturing and coal seam gas) has been made in full consideration of the potential benefits and risks. The Victorian Government has decided to keep the moratorium on onshore conventional gas in place until 30 June 2020 to provide sufficient time to undertake the most extensive ever scientific, technical and environmental studies on the risks, benefits and impacts of onshore conventional gas as part of the \$42.5 million Victorian Gas Program.

It is unclear why the Commonwealth has specifically chosen the area of onshore gas exploration as a potential point of intervention, other than due to political pressure from interested parties.

For example, Victoria's investments in transport infrastructure and local amenities have made the State a more attractive place to live and work. In turn, this has increased the State's payroll tax and property tax revenue bases. However, the Commonwealth is not proposing to penalise other states which have not provided sufficient investment in their transport networks, despite the fact that doing so would lead to economic gains for those states and increase their revenue capacity.

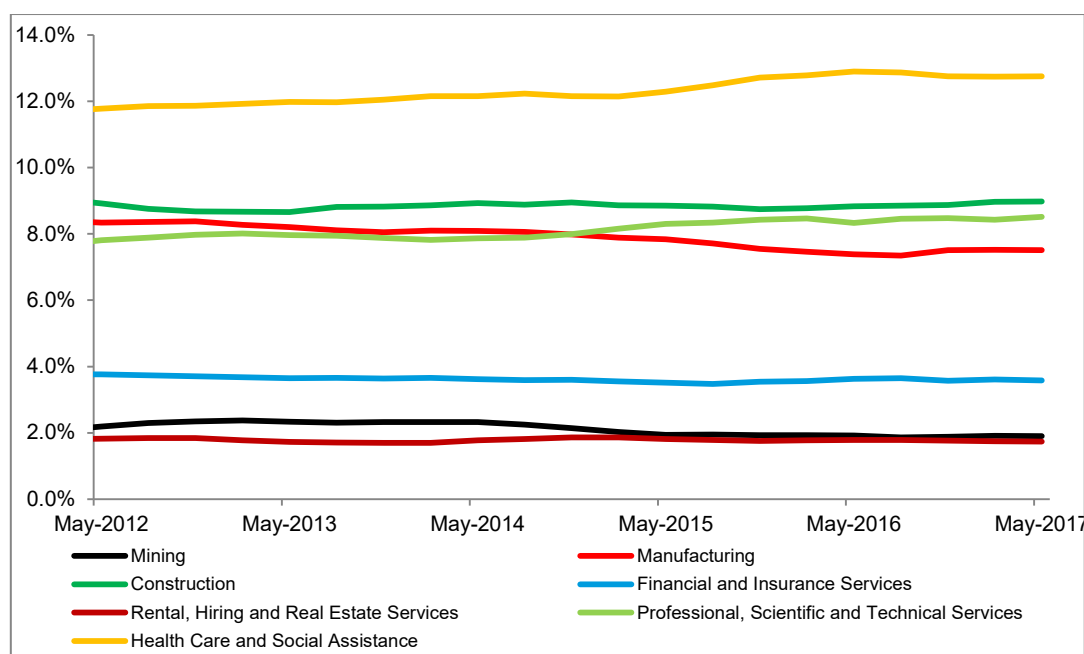
Though the mining industry is perceived to be a significant component of the Australian economy, it remains unclear why this industry (including a particular focus on iron ore) should be preferentially assessed when calculating GST relativities, as has been proposed. Shown in Chart 2, the mining industry was the fifth largest industry by gross value add in the March 2017 quarter, contributing 6.9 per cent of Gross Domestic Product (GDP). This is behind the financial and insurance services (9.0 per cent), ownership of dwellings (8.9 per cent), construction (7.6 per cent), and health care services (7.0 per cent) industries. As shown in Chart 3, the mining industry has been responsible for only 1.9 per cent of employment. This is below the employment share of the financial and insurance services (3.6 per cent), construction (9.0 per cent), and health care services (12.8 per cent) industries, and in line with that of the rental, hiring and real estate industry (1.7 per cent).

Chart 2: Proportion of GDP by industry, seasonally adjusted, March 2012 to March 2017



Source: ABS Cat.5206.0, Department of Treasury and Finance (Vic) calculations

Chart 3: Employment share by industry (12 month moving average) May 2012 to May 2017



Source: ABS Cat.6291.0.55.003, Department of Treasury and Finance (Vic) calculations

Victoria rejects the assertion that states other than Western Australia have failed to invest in ways that enhance Australia's productive capacity, or that the only form of productive investment available to states occurs in the mining industry. As examples, states across Australia have continued to enhance the productive capacity of our nation through investment in the education and health systems, contributing to human capital, while investment in infrastructure has enabled a variety of industries to connect and thrive.

There are a number of equally important revenue and expenditure priorities that have not had the same examination as mining. Pushes for preferential treatment of particular revenue streams are therefore inconsistent and political by their very nature. Victoria encourages the Commonwealth to refrain from making such interventions. Doing so moves the system away from equity objectives, creates economic inefficiencies (through overriding the differing preferences of the states), and incentivises states to lobby for changes to the HFE system for short-term financial gain.

Consistent treatment of state revenue and expense categories helps meet the objective of HFE and promotes economic efficiency

Victoria strongly supports revenue sources being consistently equalised, where possible. Western Australia has argued for a discount to mining revenues on the basis that not doing so creates disincentives for states to develop their economies. On this issue, Victoria does not accept that mining revenue deserves preferential treatment compared to other revenue sources, as outlined above. Further, not only should all revenue sources be considered as part of a states' fiscal capacity without discount, the conceptual economic argument for fully equalising on immobile revenue bases (such as natural endowments in minerals and land) is particularly strong.

Absent the equalisation process, states that have larger immobile revenue bases such as minerals and land are able to raise more revenue from sources such as mineral royalties and land tax. This

allows these states to reduce taxes on more mobile factors and/or increase the level of services, thereby offering a more appealing tax-government services bargain to labour and capital located in other jurisdictions. This has the potential to induce an economically inefficient flow of capital and labour across states as migration may not be towards where those factors of production are the most productive.

Equalisation on immobile revenue sources reduces the incentive for this inefficient migration by redistributing some revenue to other states (which have weaker immobile revenue bases), and also helps those states reduce their taxes on mobile factors of production or fund a higher level of government services. Hence, there is a strong economic argument that revenue from immobile factors should be fully equalised.

Moreover, comprehensive equalisation of revenue sources is key to achieving the objective of HFE, which seeks to compensate states for factors beyond their control. Given that the location of mineral resources cannot be influenced by any individual or government, and that state boundaries are relatively arbitrary, it is entirely consistent with HFE that mineral royalties revenue is equalised.

4. The current system strikes a balance between predictability and contemporaneity

In delivering the primary objective of HFE, the CGC relies on supporting principles, including to 'deliver relativities that, as far as possible, are appropriate to the application year (contemporaneous relativities)'. Other states have raised concerns that the three year averaging process with a two year lagged period does not accurately reflect current needs of states.

In the *2010 Methodology Review*, following extensive analysis and consultation, the CGC concluded that a lagged three year averaging process, applied across the entire assessment, struck the right balance between minimising volatility and ensuring that GST shares reasonably reflect states' current fiscal capacities. This view was reaffirmed in the *2015 Methodology Review*.

Since that time, state budgetary processes have evolved to incorporate how the GST distribution system currently works. Both a stable system and states having a thorough understanding of that system supports planning of future budgets. This requires that the HFE system remains substantially unchanged.

However, the current system is more than a historical happenstance. It is important to understand the trade-off between data reliability and timeliness in the context of states' role in delivering core government responsibilities such as health and education. Predictability of revenue is key to sound fiscal management, as revenue volatility would force state treasuries to allocate larger contingencies, or undermine confidence in planned investments – both detrimental to the efficient allocation of resources.

This preference for predictability is particularly acute in the context of continual reforms and revisions to Specific Purpose Payments (SPPs) and National Partnership payments (NPs), and is what drives Victoria's specific preference for the status quo: a two year lagged period (to reduce uncertainty that would be introduced by a more contemporaneous approach), and a three year averaging process (to smooth volatilities in any one year).

A two year lag is the best trade-off between timely and reliable data

The first aspect of the supporting principle is that relativities should be contemporaneous 'as far as possible' – that is, as far as reliable data will allow. It is the need for reliable data that leads the CGC to determine GST distribution based on the years for which actual data are available.

As the application year is the forthcoming financial year when the GST relativities are determined, fully meeting this principle would require projections of state finances and circumstances. This approach introduces a number of risks, including to greatly increase the risk of gaming of GST shares by some states by varying their revenue forecasting assumptions.

The key risk, however, is that forecasts of own source revenues in an application year can sometimes be unreliable, often with very large errors. The use of forecasts would therefore likely require a number of consequent revisions and GST adjustments in the future, to address errors and ensure that actual circumstances are reflected. This process would require revisions to the data for at least two years following an application year (i.e. until the final budget outcome is known), thereby introducing additional volatility and uncertainty while providing no additional benefit compared to the current system.

For example, if the 2017-18 application year used estimates for 2017-18 data, this data would be subject to revision until the final budget outcome for that year, provided in late 2018. This would mean data for 2017-18 would continue to be adjusted when used for the 2018 and 2019 Updates – two years on from the application year. Data revisions in this fashion are unpredictable, and would undermine both states' fiscal management capacities in future years, and contemporaneity in that year if revenue is redistributed to account for earlier error.

Given a two year lag means that the most recent actual expenditure and revenue data is used, the current process essentially removes the unnecessary need for revisions and redistributions outlined above through the lag. This means that when data is used, it is far more robust, without needing adjustments in the interim.

Issues relating to revisions and adjustments of data diminish as the lagged period increases, with data more likely to be finalised as time passes. Ultimately, there will be a trade-off between the accuracy of data and the length of the lagged period. Victoria therefore considers the use of as recent as possible historical data as the best trade-off between timely and reliable data. This approach is used by the current methodology, with the two year lag representing the earliest that actual financial data is available through final budget outcomes. For example, relativities for the 2017-18 financial year are provided in early 2017, following the release in late 2016 of the 2015-16 Final Budget Outcome (the most recent assessment year).

A three year averaging process allows for smoothing while being relatively contemporaneous

The second aspect of the supporting principle is that relativities should be appropriate to the application year.

Prior to the *2010 Methodology Review*, HFE was achieved through a five year averaging process. This was in accordance with the idea that any averaging process would smooth the effects of data irregularities and short term events, thereby smoothing a major source of revenue despite volatility in state own-source revenue³.

Compared to a three year average, a five year period further smooths volatilities while also increasing the average age of the data. This increase in the age of the data reduces the degree to which assessments reflect current state circumstances. The CGC has also recently considered a longer averaging period in the context of large and volatile revenues, concluding that it would be at the cost of spike or dip years being included in the equalisation system for a longer period, which some states indicated would be undesirable. The CGC was also equivocal that a longer averaging period would provide an unambiguously improved HFE outcome compared with three year averaging⁴.

On the other hand, use of only the final year of the assessment period would arguably more closely reflect application year circumstances than also including the previous two years. However, this approach would mean that volatilities would not be smoothed, and states would need to be prepared to adjust to much larger movements in revenue – albeit with a two year warning.

³ CGC 2010 Methodology Review, p. 38,

⁴ CGC 2015, GST Shares in the presence of large and volatile state revenues, p.12

On balance, Victoria considers a three year averaging process as the simplest method to reflect application year circumstances while providing a degree of protection from large movements in any one year.

Any change to the averaging period should be undertaken at a time of relative stability of relativities to avoid unnecessarily impacting any one state. In addition, transition costs will need to be addressed if there are changes in the way that more recent or distant years are weighted.

The system readily accounts for large and volatile revenue sources

Victoria notes that there have been a number of booms over time, whether in mining, property or some other revenue base, that have resulted in relatively temporary boosts to revenue to one or a small number of state/s. The current system is capable of smoothing these volatilities, and indeed, this is one outcome of the current operation of the system. Over time, over- or under-estimates are reclaimed as spike or dip years move through the assessment period.

For example, while revenue is increasing rapidly, there is a tendency for the lagged averaging process to underestimate actual revenue in the application year (as it is based on historical data prior to the boom). In these periods, the result is an over-estimate of GST revenue to the state for that application year. Conversely, as the boom weakens and revenue reduces, the tendency is for an under-estimate of GST revenue as assessment is based on previously booming revenues. The incremental impact of up or downswings of economic cycles on GST relativities are broadly estimable given three to five years notice, providing ample opportunity for states to budget accordingly. As an example, Charts 4 to 7 outline WA's forecast of its GST relativities over consecutive budgets from 2010-11, and illustrate that the decline in its relativities were predicted well ahead of time.

While the lagged averaging process is less contemporaneous when dealing with unusually volatile revenues and may produce seemingly counter-intuitive outcomes, a key feature of the approach is that equalisation is achieved over a run of years, rather than in any particular year. HFE is not aimed at achieving a particular desired state budget outcome in the application year, nor to bring all state budgets into alignment in cash terms. Over time, cyclical changes are balanced, and the objective of HFE is achieved irrespective of the amplitude of the cycle.

The exception to the reclamation of over- or under-estimates of GST over time is if there is a structural trend, which would result in a permanent benefit (if an upward trend) or loss (if a negative trend). Since the introduction of the current lagged averaging process, the only observed structural trend has been a broad upward trend in mining revenues. As at 2015, the CGC estimated this change has provided around \$7 billion more in GST revenue to WA than if fully contemporaneous assessments had been in place⁵. Unless iron ore prices revert to levels observed prior to the boom, this will represent a permanent benefit to WA as the lagged approach will not compensate this underestimation of revenues and reclaim previous overprovision of GST revenue.

⁵ CGC 2015, GST Shares in the presence of large and volatile state revenues, p.8

Chart 4: WA GST relativities – actuals versus 2010-11 WA Budget forecasts

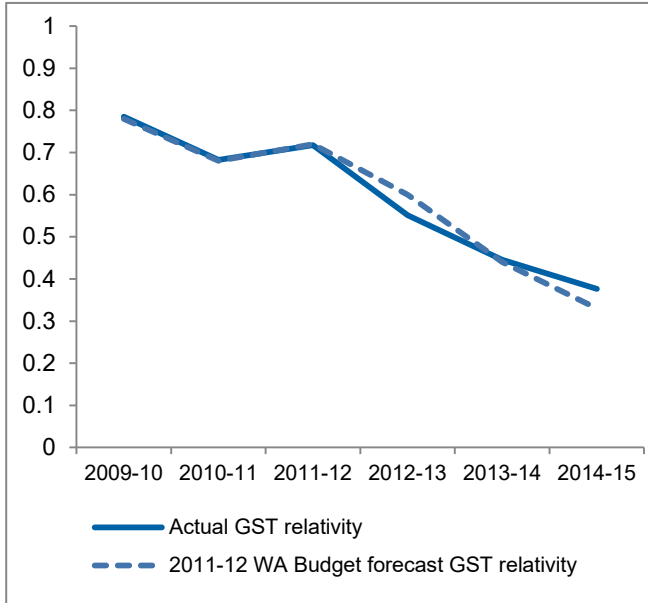


Chart 5: WA GST relativities – actuals versus 2011-12 WA Budget forecasts

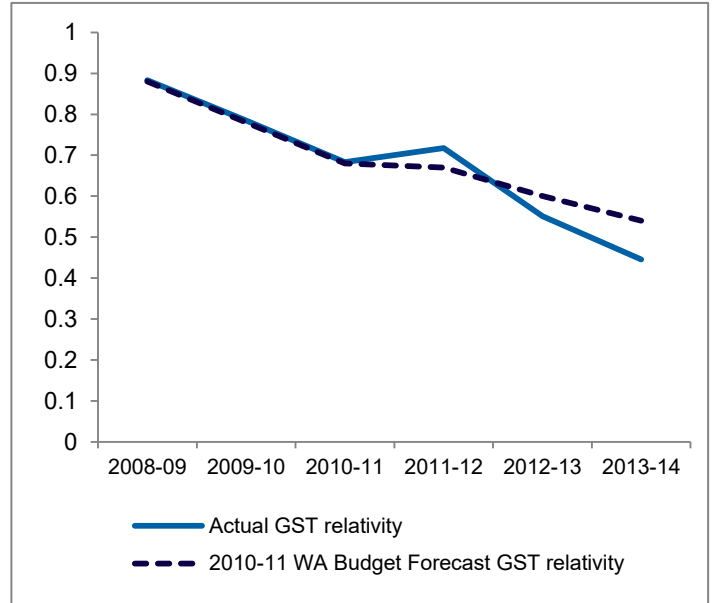


Chart 6: WA GST relativities – actuals versus 2012-13 WA Budget forecasts

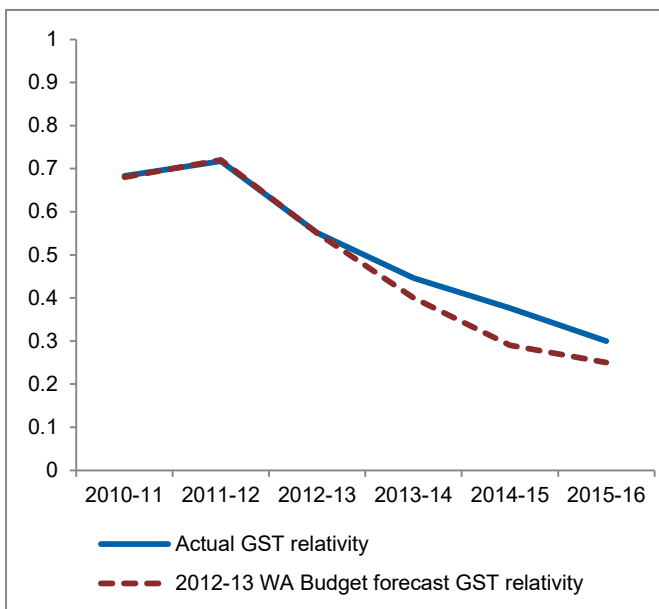
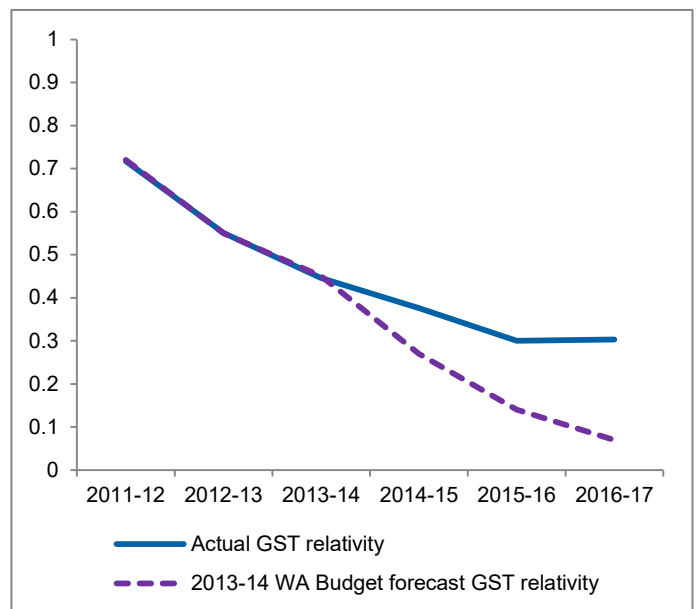


Chart 7: WA GST relativities – actuals versus 2013-14 WA Budget forecasts



Source: Western Australia Budget Papers

It is especially worth noting the wider benefit of the lagged period in providing predictability for all states by protecting all jurisdictions from a volatile outcome in any one or a few state/s, compared to a fully contemporaneous approach. For example, Queensland faced exceptional expenditure requirements to address the impact of a number of flood and cyclone events in 2011 and 2012. While Queensland will be compensated for the additional expenditure requirements by other states through the GST, states do not bear the cost unexpectedly in the year in which the cost occurs. The lag in reacting to volatile changes means that states are able to plan to absorb costs as the relevant year moves through the assessment period. States are well aware of this longstanding aspect of the HFE system and can manage their budgets accordingly.

As part of the *2015 Methodology Review*, the Commonwealth Treasurer specifically sought CGC advice on a possible approach regarding the treatment of GST relativities where a particular revenue source is a large and volatile proportion of state revenue.

Again, the CGC concluded that:

*using three year averaging, applied consistently to all assessments, provides the most reliable, practical and fair outcome consistent with achieving HFE over a run of years (albeit with a lag since reliable data are only available on a historical basis). This approach balances competing considerations of practicality, data reliability, contemporaneity and policy neutrality, and predictably smooths payment flows over time.*⁶

Victoria agrees with the CGC's conclusion that the current three year lagged averaging process provides sufficient ability for states to manage budgets through cycles. Doing so maintains the primacy of having predictable revenue sources, particularly now that the system has been operating for some years.

⁶ CGC letter to the Treasurer, 27 February 2015

5. Significant changes away from the current system may decrease intergovernmental accountability

Questions around accountability have always been difficult in the Federation given the relatively high degree of vertical fiscal imbalance (VFI) that exists. As long as VFI exists, and there are intergovernmental transfers, accountability for outcomes will be difficult to untangle between the Commonwealth and states. Absent any serious re-evaluation of roles and responsibilities in the Federation, questions on accountability must be relative: whether the distribution of GST to achieve HFE blurs accountabilities for outcomes between governments more than achieving it through other intergovernmental transfers.

Examples of other types of intergovernmental transfers that also aim to address equity considerations include negotiations for two funding sources currently under negotiation: Quality Schools funding, and the National Disability Insurance Scheme. Hospital funding is provided on an activity basis, and in part reflects different needs across Australia – that too is also undergoing reforms. It is clear that other intergovernmental transfers are constantly evolving, and are subject to the decisions of government, and the determination of ‘need’ at an individual level differs in each system.

Victoria therefore considers that an independent, holistic assessment of need can operate in parallel with these changing processes to ensure that all relevant revenue and expense disabilities are appropriately accounted for, and are reflective of independent data as far as possible.

Concerns around accountability are exacerbated if jurisdictions are able to shift blame to others for declining outcomes, particularly if it can be linked to a perceived insufficiency of funding. In order to avoid this, it is important that the distribution process is well explained to promote confidence in the system, and does not seek to influence policy explicitly or implicitly through methodology to reduce the perception that policy decisions are outside the control of any one sovereign government. Abiding by these principles will allow better causal linking of accountability for outcomes.

Transparency of the distribution process can be improved

Any distribution of GST will always give rise to blame shifting if a perception exists that the distribution process is unfair – no matter if that process is equal per capita, full, or partial equalisation. Victoria considers that the problem is therefore not best addressed by shifting between systems, but rather to properly explain the existing system.

Further, Victoria considers that, of itself, simplicity does not necessarily improve transparency or accountability. A complex system can be explained and should be evaluated on its merits in achieving the objective sought. Presumably, the system is complex to increase accuracy. If it can be shown that the assessments can be simplified without a substantial loss of accuracy such as to undermine the objective of HFE, then it would be desirable to simplify the assessments. However, transparency can be improved through other mechanisms to promote public understanding and confidence.

On this issue, Victoria acknowledges the importance of gaining public understanding and confidence in the HFE system. This can be partly achieved by giving the public more digestible information on how the current system operates to achieve its objectives. The CGC, being an independent body and having expertise in the current system, would be the ideal entity to lead in this role. To further promote transparency, the data used in calculating GST relativities and the

explicit methodology can be made available to the public. While there may be some privacy and commercial-in-confidence limitations on the release of sensitive data, Victoria would be willing to work with the CGC and other jurisdictions to overcome some of these issues.

Untied grants and the principle of policy neutrality promote accountability and economic efficiency

Victoria understands that there is a view that the provision of funding to compensate for assessed disabilities should lead to an improvement of those disability factors over time – non-achievement of outcomes would therefore imply that funding has been misallocated, and conditions on the receipt of revenue may be desirable. Firstly, Victoria reiterates that funding is not redistributed in excess of the cost of compensating for the disability so as to be able to reduce the disability. Secondly, disability factors are those that are assessed to be due to ‘circumstances beyond the control of individual states that require a state to spend more per capita than other states to provide the average level of service’, and are therefore by definition not those that are able to be affected by specific policy choices in the short term.

In addition to the practical difficulties of linking funding for HFE purposes to the improvement of outcomes, Victoria considers it is critical that funding for HFE remains untied so that state governments are clearly accountable for outcomes. Accountability of state governments’ use of GST funds currently exists through the state political process. This is an economically efficient method of accountability, given that it allows state-specific preferences to be accounted for in the use of GST funds. For example, Tasmanians may prefer a higher level of hospital services relative to school services, compared to, say, South Australians. This preference can be expressed and satisfied through the state political process, which is essentially a mechanism for aggregating individual preferences at the state level. A Commonwealth-imposed accountability framework, or other input controls, are unlikely to account for differences in the preferences for various government services across the states, thereby creating an economically inferior outcome and exacerbating the blame game.

Finally, not only would the imposition of input controls on funding for HFE purposes confuse accountabilities, there is evidence that shows there are efficiency concerns in countries where equalisation grants are tied, and sub-national governments ‘perform public services under explicit financial control of the central government’⁷. Tying the spending of revenue to certain input controls reduces choice for state governments. This outcome may distort the efficient allocation of resources as it is not clear why a central government would be any better placed to determine policy priorities for the constituents of a state than that state government. The OECD has suggested that if a ‘central government is to retain control over the proper use of equalisation funds, it can do better through appropriate public service regulation such as minimum standards or output and performance indicators, while leaving operation and management of fiscal resources at the discretion of local and regional governments’⁸.

Similarly, Victoria emphasises the importance of policy neutrality as a principle of GST distribution. The CGC currently uses national average policy as a baseline against which state-specific expenditures and revenue raising efforts are compared. This baseline policy is then applied to each state’s revenue base or expenditure area to determine GST distribution. Conceptually, there may be some risks to policy neutrality, where larger states may be able to influence this baseline

⁷ OECD, *Fiscal Equalisation*, 2008, p.15.

⁸ OECD, *Fiscal Equalisation*, 2008, pp. 15-16.

through a policy change, thereby affecting GST distribution. However, as highlighted earlier, there is little evidence that state governments game this to increase their GST share.

Victoria is cautious of any proposal to introduce an externally-determined baseline, such as an 'efficient price' for government services. It is unclear how such an objective baseline could be reliably determined, taking into account unavoidable cost differences between states and discounting any state policy effects on costs and demand. It will also likely add to complexity, particularly if such an approach is intended to cover the vast majority of expense categories.

There is also a risk that, where a flawed 'efficient price' is used, it could potentially undermine state governments' obligations to their constituents to provide the desired level and quality of services.

Instead, the current system that assesses what states do (rather than what states *should* do) provides appropriate space for governments to undertake policy decision making and reform based on the economic and social merits. Both these principles work together to promote efficiency and accountability. States may still choose to provide services at different levels, presumably as a reflection of the preferences of their constituents. A sovereign elected state government should have the right to increase or reduce their level of service delivery to the extent supported by their constituents. In so doing, state governments remain accountable for outcomes in their jurisdiction, rather than to another level of government, thus avoiding potentially further blurring accountabilities and exacerbating the blame shifting that can occur in the Federation.

HFE in other parts of the world

Australia is unique among the world's federal systems in fully equalising fiscal capacities among its sub-national jurisdictions. Canada and Germany, for example, largely equalise revenue capacities without substantially adjusting for expense needs and costs.

Conceptually, the policy goal of HFE is better achieved if all government revenue and expenses are fully accounted for. For example, it is just as legitimate to compensate one state for not having access to valuable underground minerals, as it is to compensate another state for having higher expense needs due to its geographic nature or demographic make-up. Both revenue capacity and expense needs combine to define a jurisdiction's fiscal capacity. There is no clear policy rationale, at the conceptual level, for partial equalisation.

Victoria acknowledges, however, there may be some issues involved in equalising expenditures. Given the wide range of government expenditure areas and the lack of data in some of these areas, equalisation of expenditures can introduce apparent complexity and potentially create inconsistent and arbitrary outcomes.

However, there may be other ways to address these issues without undermining fiscal equalisation. This submission has already canvassed the possibility of instilling greater transparency in the system to counter the perception of complexity. It has also noted the need to establish a robust, permanent framework for determining which types of expense and revenue categories are equalised to reduce inconsistencies and arbitrariness in the system. Moreover, where an appropriate methodology for a particular expense category has not yet been developed, or for which data is not yet available, it does not preclude an appropriate assessment methodology or data source being developed in the future.

6. Administrative Issues

The administration costs of HFE are relatively low

Despite the detailed way in which some revenue and expenses are assessed and the associated data and expertise required, the administration cost of the current HFE framework is relatively low.

The Victorian Department of Treasury and Finance allocates around 4.0 full-time equivalent (FTE) staff to the role of advising on HFE issues and estimating and forecasting GST relativities. At the Commonwealth level, the CGC employs around 25 FTE and has a budget of around \$5.5 million per year⁹. This is a small amount relative to the amount of funds redistributed.

Governance of the CGC

Victoria understands there may be some concerns that the CGC, an unelected body, has the capacity to influence the distribution of a substantial amount of revenue. However, its role is set in legislation under the *Commonwealth Grants Commission Act 1973*.

Given the size of revenues in question, Victoria considers it is desirable that an independent body develops methodology that is subject to periodic review, collates data, and provides recommendations.

Relativities are ultimately the decision of the Commonwealth Treasurer: the CGC, like other independent statutory government bodies, responds to requests from the Commonwealth Government. It does so by making recommendations in consultation with states, and based on data provided by them and independent statistical sources. The Commonwealth Government alone issues the terms of reference for the CGC's advice, and is at liberty not to accept that advice if it so chooses. However, the importance of the CGC lies in their independence, given the distribution of the GST pool is a zero sum game. Provision of independent advice on relativities supports the agreed goals of HFE.

⁹ 2015-16 Annual Report, Commonwealth Grants Commission, 2016

