NSW GOVERNMENT | Treasury

Commonwealth Grants Commission 2020 Review – Significant Changes Since the Draft Report

NSW Treasury Response

January 2020

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1 Introduction and overview

Overview

1.1 NSW Treasury welcomes the opportunity to respond to the Commonwealth Grants Commission (CGC) 2020 Review, *Significant Changes since the Draft Report*.

1.2 This submission comprises four sections:

- **Part one:** Introduction and overview
- **Part two:** Substantive and minor method changes
- **Part three:** Revenue assessments
- **Part four:** Expenditure assessments.

1.3 Following CGC guidance, this submission narrowly targets specific issues and questions relating to individual revenue and expenditure assessments. Arguments and evidence provided by NSW Treasury in our previous Submission are not re-stated below. NSW Treasury will maintain these positions throughout the 2020 Methodology Review (unless otherwise stated).

1.4 NSW Treasury reserves an ongoing right to raise additional issues, new arguments or new data. This reflects the dynamic nature of issues raised throughout the 2020 Review. There could be new or changed methodological approaches, data and other issues raised by the CGC or other states and territories.

1.5 Further information and questions regarding any aspect of this submission may be directed to: Ms Andrée Wheeler, Director, Federal Financial Relations, NSW Treasury (e. ffr@treasury.nsw.gov.au).

CGC methodological review approaches

Data revisions

1.6 The 2020 Review Final Report presents an opportunity for the CGC to set out a consistent approach to data corrections and adjustments.

1.7 Greater clarity and consistency of approach is required going forward because different approaches continue to be adopted by the CGC. This is a significant issue in the 2020 Review because the CGC is extensively revising and adjusting data and making methodological revisions. A consistent approach would help states improve their ability to manage budgets.

1.8 The CGC generally accept prior year data and calculation corrections for each assessment year. However, in the 2019 Update and 2020 Review, the CGC appears to prefer a different approach for the treatment of natural disaster recovery expenditure data. In this instance, it appears the CGC accepts prior year data and calculation corrections for each assessment year and, subject to a materiality threshold, retrospectively offset their historical cumulative impact on GST distributions over the assessment period as part of current relativity calculations.

1.9 NSW Treasury proposes a new approach to minimise the risk of long-term systemic bias in CGC calculations. The CGC should accept prior year data and corrections. These corrections should be filtered for materiality and retrospectively offset the historical cumulative impact on GST distributions through current relativity calculations. However, NSW Treasury acknowledges this could be difficult in practice.

1.10 Going forward, the CGC should consistently adopt one or other approach going forward, including as part of the 2020 Review.

Future review approaches

1.11 NSW Treasury supports the CGC's proposed approach for data driven methodology reviews of individual assessments. Where there are improvements in the quality of data available to the CGC, assessments should be updated on an annually to reflect this. This would not involve changing the overall methodology used by the CGC, but rather ensure that the existing methodology incorporates the best available data.

1.12 NSW Treasury opposes a rolling review approach whereby a select number of assessments would be reviewed on an annual basis. This would lead to inconsistencies between assessments. The current cycle of five-yearly reviews remains appropriate for deciding the comprehensive methods used to determine the distribution of the GST.

2 Substantive and minor method changes

Disaster recovery expenses

2.1 NSW Treasury recommends a 50 per cent discount be applied to state funded local government expenditures on natural disaster recovery. This discount will ensure an appropriate balance between:

- giving effect to the CGC's proposed approach recognising the legitimate expenditure needs of those local governments in states most prone to natural disasters
- confining the principle of horizontal fiscal equalisation (HFE) to the provision of state-like services
- upholding the principle of policy neutrality
- data quality and reliability.

2.2 As part of the 2020 Review, the CGC proposes to include state funded local government expenditure on natural disaster recovery in Other expenses, reflecting the following considerations:

- all states support local governments in natural disaster recovery
- most states require local governments to make a small contribution to fund natural disaster recovery
- that this an unavoidable cost for states.

2.3 The CGC proposes relying on the national average share of gross local government natural disaster expenditure funded by state governments to determine assessed state grant expenditure for each state and territory. This requires collecting gross local government expenditures on natural disaster relief compared with the level of funding support provided by state governments.

Horizontal fiscal equalisation and the provision of state-like services

2.4 The principle of HFE applies specifically to providing state-like services between states and territories. It does not extend to providing municipal services and municipal revenue raising.

2.5 NSW Treasury is concerned that the CGC's proposal to assess state funded local government natural disaster recovery expenditure risks expanding the scope of interstate HFE to encompass local government expenditures in a way that is not supported by the existing legislative framework. This principle is demonstrated by the *Local Government*

(Financial Assistance) Act 1995 (Cth) which provides for Local Government Financial Assistance Grants to be distributed on an equal per capita basis between states.[1]

2.6 In assessing state funding to support local government natural disaster recovery efforts, the CGC must be careful to ensure that it is not a de facto extension of HFE to local governments.

Policy neutrality

2.7 The CGC recognises that the level of state support can vary due to differences in the number and severity of disasters and the fiscal capacity of different local governments.

2.8 The CGC's assessment of state funded local government natural disaster recovery expenditure should also acknowledge that differences in state policy necessarily have a large impact on the level of state funded support provided. Investment in local government infrastructure (notably local road networks) may be heavily policy influenced. A broader discretion also exists regarding the level of overall state support provided to local governments which will, in turn, affect the fiscal capacity of different local governments to fund recovery work.

2.9 A further risk to policy neutrality that should be considered by the CGC going forward relates to interactions with the Roads assessment.

2.10 The CGC's proposed approach does not adjust for policy differences between states regarding the scale and extent of different local road networks. The Roads assessment demonstrates significant differences between the assessed and actual road networks for each state. Such differences must be reflected in the assessment of such state funded natural disaster recovery expenditure to ensure consistency of approaches between assessments.

2.11 A further important consideration is that the level of natural disaster recovery expenditure is heavily policy affected by the local government policy decisions, including their level of investment in infrastructure quality and standards, and disaster mitigation. The level of investment (or non-investment) is a key factor that can exacerbate actual disaster costs incurred, especially in relation to local road networks.

2.12 This was a key finding in the 2014 Productivity Commission inquiry into natural disaster funding arrangements which found funding arrangements are heavily weighted towards disaster recovery rather than providing incentives to mitigate against disaster risk.

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[1] See further: Richard Webb, Commonwealth General Purpose Financial Assistance to Local Government, Research Paper 19 2000-01 (https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/rp0001/01RP19 accessed 17 December 2019)

Data quality and reliability

2.13 NSW Treasury also has significant concerns regarding data quality and reliability.

2.14 The CGC proposes to rely primarily on local government data that will be provided to the CGC as part of the 2020 Review. NSW Treasury does not support using this data as part of the assessment, it can be inconsistent between states and could be misreported.

2.15 The CGC's proposed approach could act to incentivise reported local government expenditure data to be grossed up by individual states (at no cost to their state budget) to secure a greater share of GST revenue.

2.16 NSW Treasury also notes New South Wales does not currently collect gross local government expenditure associated with natural disasters and cannot provide this to the CGC as part of the 2020 Review.

2.17 The CGC proposes using Emergency Management Australia (EMA) data to verify correct expenses (including local government expenditure) are being reported and ensure states only report those local government expenditures that are eligible under the Disaster Recovery Funding Arrangements (DRFA[2]). However, EMA data has limited reliability as state reported data is influenced by mandated state recovery thresholds. NSW Treasury notes that these expenses are not reliably or consistently reported to the EMA because this information is not required under Commonwealth reporting guidelines[3].

2.18 States have a discretion to include or exclude those expenditures which relate to those categories and measures that are unlikely to receive Commonwealth reimbursement under a DRFA Determination. In addition, the DRFA requires state audit of those expenses where Commonwealth reimbursement is sought, but no audit is required for unreported expenses. This undermines confidence and assurance placed on reported natural disaster expenses.

2.19 The CGC places significant weight on the DRFA, and variations in reported expenses that fall outside the scope of the DRFA could lead to misreporting of eligible expenses. However, these variations can be significant given Category B (costs of restoration or replacement of essential public assets) is often the largest component in the expense category.

Minor method changes

2.20 NSW Treasury notes the proposed minor method changes to the Mining revenue, Welfare, Electricity and water subsidies and Investment assessments

2.21 NSW Treasury positions with respect to proposed Revenue base adjustments are addressed below.

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[2] https://www.disasterassist.gov.au/Documents/Natural-Disaster-Relief-and-Recovery-Arrangements/NDRRA-determination-2017.PDF

[3] Department of Justice Natural Disaster Relief and Recovery Arrangements Client Service Report for the year ended 30 June 2017 (Unpublished).

3 Revenue assessments

Stamp duty on conveyances

Unit trust adjustments

3.1 The CGC's proposal to remove an adjustment for unit trusts is supported by NSW Treasury. This will mean legislative changes that have reduced differences between states are correctly reflected in the assessment of stamp duty on conveyances.

Elasticity adjustments

3.2 NSW Treasury continues to strongly support an elasticity adjustment for transfer duty. It is irrelevant that an elasticity adjustment is immaterial for the land tax assessment. Socio-demographic and other characteristics are differentially treated between expenditure assessments based on the relevance and materiality of such characteristics on the cost of service delivery. The CGC argues that because elasticity adjustments for some revenue assessments are not material, no elasticity adjustments should be made for any revenue assessment. This argument is not persuasive as it conflicts with the materiality treatment of expenditure assessments.

3.3 In the case of the ACT, a reduction in their stamp duty rates will see an expansion in the value of liable transactions, with both the number of transactions, and the value of individual transactions (that is, property prices) increasing. This results in a reduction of GST revenue to the ACT. Conversely, an offsetting increase in land tax will depress land values will lead to an increase in their GST revenue.

3.4 Prima facie, it appears the effects of a stamp duty and land tax swap are offset. However, this does not negate the need for an elasticity adjustment. This is demonstrated in the following example.

3.5 Consider a scenario involving one state which has both a flat rate comprehensive stamp duty and land tax. Assume the state then determines to abolish stamp duty, exactly replacing the revenue (in present value terms) through an increase in the land tax rate. This policy action will not change property values, because the present value of taxes is unchanged. However, the abolition of stamp duty would lead to a large increase in transaction volumes, increasing the stamp duty assessment, and thus reducing GST revenue to that state. In this example, horizontal fiscal equalisation outcomes would be improved if an elasticity factor is applied to offset the increase in transaction volumes and likely impacts on GST distributions neutralised.

3.6 The ANU Crawford School Tax and Transfer Policy Institute in their report, *State tax elasticities of revenue bases* (2019), estimates elasticity impacts for transaction values. This impact should be split between the value of individual transactions and the volume of transactions, with the latter being applied to the assessment of stamp duty revenue. Davidoff and Leigh have estimated the relevant elasticity.[4]

Land tax

The ACT adjustment

3.7 NSW Treasury recommends that the adjustment made to the ACT's share of land holdings should be equal to the revenue effects experienced.

3.8 The impact of aggregation policies on land tax revenue is to increase overall land tax revenue. This is highlighted by New South Wales, Western Australian and South Australian data.

3.9 For New South Wales, aggregation increases the value of taxable land holdings and the collection of land tax by around 22 and 33 per cent respectively in 2018-19. For Western Australia this impact was more than 50 per cent, and greater than 30 per cent for South Australia.

3.10 This means the CGC's proposed 10 per cent adjustment to the ACT's land holding is significantly understated. However, the CGC does not propose to apply a similar adjustment to the value of the ACT land tax base because:

"The progressivity of States' rates of land tax means aggregation has a greater effect on State revenues than States' land holdings. Thus, the ACT adjustment should be less than the revenue effects experienced by these two States."[5]

3.11 NSW Treasury acknowledges that states' land tax data demonstrates that the progressivity of states' land tax rates means aggregation necessarily has a greater effect on state revenues than states' land holdings. However, the CGC's proposed adjustment to the value of the ACT's taxable land holdings is problematic. The proposed adjustment will give rise to an inconsistency within the CGC's assessment methodology. This is demonstrated by the following example.

3.12 Where a state provides their taxable land holdings data without aggregation (see Table 1) an adjustment is needed to quantify the value of aggregation:

- if the adjustment is made on the effect of aggregation on the state's taxable land holdings above the threshold, then no adjustment would be applied as the threshold is effectively zero, but
- if the adjustment is made on the revenue effect, then a 29 per cent adjustment would be applied – this better reflects the progressivity of states' rates of land tax, and the adjustment is applied uniformly at a value range level.

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[4] Davidoff and Leigh, "How do Stamp Duties Affect the Housing Market, *Economic Record*, 2013.

[5] CGC 2020 Review, *Significant Changes Since the Draft Report*, November 2019, paragraph 39.

Table 1: Land tax values – no aggregation

Value range ($m)	Marginal tax rate (%)	Taxable land holdings ($m)	Land tax payable ($m)
0 to 0.5	1.0	300	3
0.5 plus	2.0	200	4
Total	***1.4***	***500***	***7***

Table 2: Land tax values – aggregation

Value range ($m)	Marginal tax rate (%)	Taxable land holdings ($m)	Land tax payable ($m)
0 to 0.5	1.0	100	1
0.5 plus	2.0	400	8
Total	***1.8***	***500***	***9***

Table 3: Land tax values – no aggregation, revenue effects adjusted for aggregation

Value range ($m)	Marginal tax rate (%)	Taxable land holdings ($m)	Land tax payable ($m)
0 to 0.5	1.0	386	4
0.5 plus	2.0	257	5
Total	***1.4***	***643***	***9***

3.13 This example highlights that the most appropriate adjustment captures the revenue effect and will ensure that the state's assessed revenue set out in Table 3 is equal to what it would have been with state provided aggregated data.

3.14 NSW Treasury recommends that an adjustment of 33 per cent is applied to the value of the ACT's taxable land holdings. This is the most conceptually rigorous approach given it accounts for the effect of aggregation on the value of land above the threshold, as well as the progressivity of states' rates of land tax above the threshold.

3.15 This approach is also preferable as the practical effect of the CGC's proposed ACT adjustment of 10 per cent is to create a perverse incentive for states to provide the CGC with land tax data that omits the effect of aggregation of the rateable land tax base. This would benefit states like New South Wales where aggregation significantly increases the value of the state's assessable land tax base and redistributes GST revenues to other states.

Mining revenue

Backdated royalty revenue

3.16 The CGC must include backdated royalty recovery revenue from within the assessment period as part of each state's royalty tax base. This is because enforcement activity to recover backdated royalty revenue represents average state policy and is material. It is inconsistent with the principle of horizontal fiscal equalisation that such revenue should be excluded from a state's revenue assessment, and materially benefit the affected state.

3.17 As outlined in the NSW Treasury response to the Draft Report, the settlement of $250 million between BHP and Western Australia for the back payment of royalty revenues falls within the assessment period for the 2020 Review and must be assessed to ensure consistent treatment of royalty revenues, as well as to ensure such states do not derive an unfair windfall. [6]

Supplementary Terms of Reference

3.18 Changes proposed to the CGC's assessment of mining revenues in its Draft Report are consistent with the Supplementary Terms of Reference in the 2020 Review (which directs no change in the assessment methodology of the Mining revenue assessment).

3.19 Changes in the materiality of individual mineral assessments (namely, lithium) and the inclusion of non-royalty mining related revenues are consistent with the structure of the mining revenue assessment methodology set out in the 2015 Review.

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[6] ABC News, *Disputed BHP royalties to help fund new King Edward Memorial Hospital in Perth*, 28 June 2019: https://www.abc.net.au/news/2019-06-28/bhp-royalties-to-fund-king-edwards-memorial-hospital-replacement/11259878 (accessed on 30 September 2019).

4 Expenditure assessments

Schools education

4.1 The CGC should take into account Students with a Disability (SWD) as a cost driver in the Schools education assessment. The CGC proposes to omit SWD even though the underlying cost data, the Nationally Consistent Collection of Data on School Students with a Disability (NCCD) forms part of the Commonwealth's School Resourcing Standard (SRS). The SRS is used to determine public funding allocation between states under the *Australian Education Act 2013* (Cth) and the related National Education Reform Agreement.

4.2 NSW Treasury has provided the CGC with detailed data demonstrating how the presence, and prevalence of SWD drives the allocation of funding based on student age and supports required.

4.3 It is anomalous that the CGC does not utilise these loadings as part of its specification of the Schools education regression based on its own assessment the NCCD lacks sufficient reliability.

4.4 In the event the NCCD is not incorporated into the CGC's 2020 Review Schools education assessment methodology, this presents an area for further consideration by the CGC. Including nationally consistent data will improve the robustness and accuracy of the Schools education assessment and ensure actual underlying drivers of cost are taken into account by the CGC in determining each state's relative GST requirement.

Roads

4.5 The CGC should rely wholly upon National Transport Commission (NTC) data as the basis for allocation of investment between urban and rural roads.

4.6 At present the CGC estimates the relative shares of urban and rural road investment costs by applying a 33 per cent weight to NTC-provided data (rural roads account for 43 per cent of costs) and a 67 per cent weight to state-provided data (rural roads account for 54 per cent of costs). The outcome is anomalous and represents a departure from what states do.

4.7 This approach should be revisited. In addition, any departure from the urban and rural road investment allocation shown in NTC data requires clearer, and more persuasive evidence-based justification.

Services to Industry

4.8 NSW Treasury remains concerned that CGC judgment regarding the materiality of disabilities is influencing the order in which disabilities are calculated by the CGC. This appears to be a key factor in the CGC's conclusion that a disability to take into account the number of businesses, as well as the absolute size of the industry regulated, is not supported based on materiality grounds.

4.9 NSW Treasury recommends that the CGC reconsider its decision to remove the number of businesses regulated as a disability component.

4.10 As outlined in the NSW Treasury response to the Draft Report, the number of businesses in a state has a key bearing on the size and complexity, and therefore the cost, of the regulatory task for states. For example, the cost associated with regulating 100 firms each with an individual turnover of $1 million is generally significantly higher than the cost of regulating one business with a turnover of $100 million.

4.11 Available data indicates there are significant differences in the level of economic output per firm between states which, intuitively, suggests that the size and complexity of the regulatory task varies with it and will have a direct bearing on the costs incurred by states.