
Work Program for the 2020 Methodology Review

Thank you for the opportunity to provide comments on the work program for the 2020 Methodology Review (2020 Review).

Key points:

- **The Commonwealth Grants Commission (CGC) should examine the current definition and application of Horizontal Fiscal Equalisation (HFE) to achieve an equalisation that moves closer to an equal per capita distribution.**
- **Simplicity and transparency; should be added as supporting principles.**
- **For transparency purposes, the HFE supporting principles should be given a hierarchy.**
- **A clean slate review would only be necessary if there was a significant change to the HFE definition or supporting principles.**
- **NSW Treasury supports a continuation of the iterative approach.**
- **NSW Treasury supports State visits by the CGC.**
- **NSW Treasury does not support State led development of aspects of the 2020 Review.**
- **A draft report should be released to the States in early in 2019.**
- **On specific methodology issues, NSW Treasury recommends the cessation of discounting of assessments – where there is a lack of reliable data assessments should not be completed.**

Are the Current Supporting Principles Appropriate

1 Principle of Horizontal Fiscal Equalisation

NSW Treasury notes the CGC's definition of HFE used for the 2015 Review:

*State governments should receive funding from the pool of goods and services tax 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.*¹

NSW Treasury believes that before examining the supporting principles, the CGC should first examine the current definition and application of HFE.

Australia's system of HFE has been extensively examined and reviewed since the establishment of the Commonwealth Grants Commission. The introduction of the Goods and Services Tax (GST) which fixes the pool of funds for distribution has only sharpened the competition between donor states and recipient states. This competition has historically played out in the CGC's own Review/Update processes, other reviews sponsored by the Commonwealth² and the donor States³; and academic papers largely out of public view. The current HFE approach is now very clearly a source of dissatisfaction for the public and accordingly is often in the media accompanied by critical commentary⁴.

NSW has long argued the current system of HFE is flawed. Among its accepted problems are that it is complex and non-transparent, produces often unpredictable and volatile outcomes, is excessively backwards looking, incorporates false precision in equalisation, and provides untied funding for serious disabilities. NSW Treasury believes that the CGC needs to address these issues in a clearer and simpler way than is done currently.

Without a more credible defence of the current system of HFE or reforms that address the problems, there is a risk that adjustments to the CGC's model will be imposed in a haphazard way (a recent example of this is the proposal of a GST floor⁵). NSW Treasury opposes any proposal to tweak the system to suit the purposes of any one or

¹ Commonwealth Grants Commission (CGC), *Report on GST Revenue Sharing Relativities 2015 Review, Volume 1 – Main Report*, Canberra, 2015, para. 3, p. 2.

² The Australian Government, *GST Distribution Review*, Canberra, 2012.

³ Garnaut R, Fitzgerald V, *Review of Commonwealth-State Funding*, Melbourne, 2002.

⁴ Pearson B, "GST carve-up must reward policy that promotes growth" *The Australian*, 16 January 2017, viewed 16 January 2017, <http://www.theaustralian.com.au/business/opinion/gst-carveup-must-reward-policy-that-promotes-growth/news-story/19495970cd84c539f22fac1a43ee044d>

⁵ O'Connor A, "WA Liberal conference: PM commits to GST minimum distribution percentage", ABC, 13 August 2016, viewed 17 January 2017, <http://www.abc.net.au/news/2016-08-13/pm-malcolm-turnbull-commits-to-gst-floor-plan-barnett/7731878>.

two States, as this would undermine the broader acceptability, objectivity and even-handedness of the HFE system as a whole.

The preferred solution NSW has suggested over a sustained period of time in submissions to CGC methodology reviews and the GST Distribution Review is to fundamentally change the system to a simpler one: an equal per capita (EPC) distribution of GST revenue among the States supplemented by top-up payments from the Commonwealth Government to the smaller States to explicitly address disabilities. In the absence of the above approach, NSW believes the CGC should take steps to reform the HFE definition to shift the redistribution closer to an EPC outcome with some top-up payments to smaller States to be funded from the GST pool. Or in terms of the 2002 Garnaut Review:

Untied grants funded by the GST would be allocated on a simple basis of equal per capita, with an element of horizontal fiscal equalisation. The element of horizontal fiscal equalisation – favouring the smaller States – would be much closer to that originally applied by the Commonwealth Grants Commission.⁶

In the 2015 Review the CGC concluded that ‘an equal per capita (EPC) GST distribution would not be consistent with HFE.’ This conclusion ignores other Commonwealth Government payments to the States. The specific purpose payments (SPPs), national partnership payments (NPPs) and other Commonwealth payments already contribute to equalisation. The current system of HFE adds complexity and volatility above and beyond what is necessary.

In its role as advisor to the Commonwealth and State Governments, the CGC could take a more holistic view of Federal Financial Relations and support a discussion to improve the HFE system.

2 Current Supporting Principles

The current Supporting Principles are defined such that equalisation will be implemented by methods that:

- reflect what States collectively do;
- are policy neutral;
- are practical; and
- deliver relativities that are appropriate to the application year (contemporaneous relativities).⁷

⁶ Garnaut R, Fitzgerald V, *Review of Commonwealth-State Funding*, Melbourne, 2002, p. 191.

⁷ CGC, *Report on GST Revenue Sharing Relativities 2015 Review, Volume 2 – Assessment of State Fiscal Capacities*, 2015, Box 1, p. 6.

NSW Treasury is concerned by the CGC's view that in deciding the inevitable trade-offs between principles the Commission 'has not set rules for how it would decide the appropriate approach in any such cases, nor has it established a hierarchy among the principles. As required, judgment is used to devise the best overall equalisation result.'⁸

We consider such an approach can accentuate the lack of transparency and consistency that are the cause of many current misgivings with HFE. An example of the issues that can arise with the use of "judgment" is the Mining Revenue assessment.

Given the very unequal distribution of mineral resources across the States it is difficult to arrive at an assessment method that is policy-neutral. States dominating the production of some minerals can heavily influence the 'averages' against which royalty raising capacities are based, even when minerals are grouped to dilute the dominance of those States.

A grouping approach, with one group covering all minerals, would provide the most policy neutral outcome. However, the CGC has an assessment method that puts an equalisation principle first by retaining a mineral by mineral assessment which assesses the seven minerals that generate most royalty revenue separately and the remaining minerals together. The CGC recognises that this has the potential to make the assessment less policy-neutral since changes in State policies may have a larger impact on their GST payments share than under alternative assessment methods that use groups of minerals or minerals as one group.

The CGC notes that 'If we do observe a significant change in behaviour which raises policy neutrality concerns, we will revisit the assessment in a future update.'⁹ We note that there have been past examples where the CGC was not inclined to address policy neutrality concerns. For example in the 2015 Draft Review, the CGC considered phasing in Western Australia's decision to raise the effective royalty rate on iron ore fines which had been previously excluded by terms of reference, based on the practicality supporting principle. This would have significantly reduced WA's assessed fiscal capacity compared to their actual fiscal capacity and in effect acted to discount WA's policy change.

If the CGC wishes to stay within the current HFE framework, NSW Treasury believes that the supporting principles of simplicity and transparency are necessary for the process of HFE to be more easily understood and its outcomes more readily accepted.

NSW Treasury does not believe that a system of weights could be practically implemented for supporting principles. A more workable approach would be a hierarchy of first order/tier and second order/tier supporting principles with a discussion of why

⁸ CGC, *Report on GST Revenue Sharing Relativities 2015 Review, Volume 1 – Main Report*, Canberra, 2015, ch. 1, para. 37, p. 30.

⁹ CGC, *Report on GST Revenue Sharing Relativities 2015 Review, Volume 1 – Main Report*, Canberra, 2015, ch. 2, para. 9, p. 37.

different principles are given priority which would assist consistency, and reduce the role of seemingly arbitrary judgement.

Review of Methods

1 Review of Methods Dependant on Principles

As discussed previously, NSW would prefer a fundamental redefinition of HFE, but without changes to the HFE principles it is unlikely that a clean slate review will deliver substantially different assessments. If the principles are largely unchanged, the CGC should focus on improving the current assessments and working through new issues with the States.

NSW Treasury would prefer the CGC to include the suggested supporting principles of simplicity and transparency; and give them a high priority (i.e. they should be a 'first tier' principle).

NSW Treasury believes that the CGC will need consult with the States to quickly establish the HFE principles in order to complete a detailed work plan.

2 Iterative Review Process

NSW Treasury supports a continuation of the iterative approach.

For the 2015 Review the iterative approach worked relatively well in cases where there were no major changes to assessments during the review period. This allowed the development of assessments beginning with broad principles and then working through to more detailed matters of data and implementation. However, where there were major late changes, such as to Schools education funding, the iterative approach did not prove as effective.

NSW Treasury believes that the risk of late changes could be managed by delivering the draft report early in 2019 and carefully managing the consultation process with the States to avoid confusion if there are any major policy changes announced in the 2019-20 Commonwealth Budget.

3 State Visits by the CGC

For the 2015 Review some of the CGC papers were not sufficiently detailed for NSW Treasury to fully understand the information. An example of this was the new approach to 'average policy' in the 2015 Review Draft Report. NSW Treasury sought further explanation in its bi-lateral meeting with the Commission. In general, bi-lateral meetings with the CGC were often the most effective way to explain our case and gain a more detailed understanding of CGC views and proposals.

The three year timeframe for the 2020 Review will allow the CGC to more deeply consult with the States on technical matters. NSW Treasury would like to see the CGC spend more time consulting with subject matter experts within major State departments

such as health, transport and education as well as relevant experts outside of government.

Note: NSW Treasury is supportive of the use of consultants to provide independent expertise. However, advice from any consultant is highly dependent on the scope of work being sought and the specific questions a consultant is asked to provide advice on. Involving States in the early stages to help determine these details could increase the effectiveness of the use of consultants.

The timing of the visits would depend on the purpose. Meetings with the States to discuss technical matters would need to begin early in the review process. The three year timeframe for the review could provide some scope for changes to data collection to improve assessments. Where data problems exist it would be useful to identify them early and consult with the States on the best way to manage them. Outside of State visits, the CGC could consider reviving the data working party to look into detailed data issues that require specific focus.

Higher level meetings between State representatives and the CGC would be more appropriate later in the review process to work through the CGC views and proposals.

4 State Led Development

NSW Treasury does not believe that States taking a lead role in some instances would result in an improved review.

There is no reason to believe that a State acting in good faith would produce a substantially better piece of work than the CGC, yet the zero-sum nature of the HFE process would always create the suspicion of bad faith amongst other States. The review of HFE being carried out by a disinterested party increases confidence.

5 Draft Report

As discussed above, NSW Treasury supports an iterative review process and believes that the draft report will form a key part of the 2020 Review.

Traditionally the CGC has released the draft report in June of the year before the final report, which coincides with the release of Commonwealth Budget but inevitably does not contain the new policy measures. NSW Treasury believes that a better strategy would be to release the draft report earlier in 2019 in order to allow the States to process the draft report before the new policy measures are released in the Commonwealth Budget. Once the States have assessed the new policy measures they could provide feedback to the CGC on what changes, if any, are needed to the draft report.

Other Methodology Issues for the CGC to explore

1 Discounting

NSW Treasury considers discounting is arbitrary and is therefore inappropriate. We consider that if there is sufficient uncertainty in an assessment to render its results less than fully acceptable the assessment should not be included.

However, if discounting is to be used it is important that it is consistently applied. Based on the reasoning provided by the CGC in the 2015 Review and 2016 Update, NSW Treasury is not convinced that this is currently the case. A comparison of the data used and the application of discounting in the interstate wages and administrative scale assessments is a case in point. NSW Treasury considers the data on which the administrative scale costs assessment is based to be far less reliable than that underlying the interstate wage costs assessment, and the consequent uncertainty in the assessment to be far greater than the low, 12.5 per cent discount for the uncertainty in the interstate wages assessment.