

Victoria's Response to 2020 Methodology Review Staff Discussion Paper *The Principle of HFE and its Implementation*

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1. Objective and Definition of HFE and Supporting Principle

Victoria broadly agrees with the 'principle of HFE' articulated in the 2010 and 2015 Reviews, and considers that the objective and definition of HFE is still appropriate for the 2020 Review.

State governments are responsible for operating and directly funding basic government services. The objective of HFE is to provide each state with the capacity to deliver a similar standard of government services. The definition of the 'principle of HFE as articulated' in the 2010 Review, which is that HFE should provide funding to the states from the pool of goods and services tax, such that states are enabled to have the same capacity to deliver services, provided they deliver them at the average level of technical efficiency and make the same effort to raise revenue. Victoria supports both this objective and definition of the principle of HFE.

There is little evidence that suggests HFE has been a major impediment to tax reform in practice. It is important to highlight that any significant deviation from the current HFE system would create considerable uncertainty and could result in major changes to the amount of GST received by individual states, and would have to be supported by robust, data-driven evidence that demonstrates HFE has significant economic costs. Victoria firmly believes that any such significant deviation from the status quo would need to be supported by evidence that shows that HFE is significantly limiting economic performance. Evidence of this should be data-driven rather than theory and assumptions-driven, utilise robust empirical models, and be free of unnecessary assumptions about the structure of the economy.

2. Supporting Principles

Victoria maintains the view that the four current supporting principles are sufficient, and that it is unclear what the nature of additional principles could be if they were introduced. Victoria considers that applying the supporting principles flexibly so that the best HFE outcome can be achieved is the preferable approach. It would be difficult to determine a hierarchy or weighting for these principles, and imposing an arbitrary weighting would not guarantee improved outcomes.

In reference to the consultation questions asked in the staff discussion paper Victoria has the following responses:

- the Commission should use supporting principles (or guiding considerations) to assist it in developing methods to give effect to the principle of HFE and the four current principles are appropriate and sufficient;
- HFE should continue to be the priority, with the supporting principles assisting in the achievement of HFE;
- there does not appear to be any great value in the supporting principles having a pre-determined hierarchy, as the Commission should retain the flexibility to balance the supporting principles case by case in order to best achieve HFE; and
- that the supporting principles from the 2015 Review be retained and no new principles be introduced as the need for changes has not been demonstrated.

3. What States Do

3.1 Internal or external standards

Victoria agrees with the Commission's position that it is not well placed to make normative assessments of state policy or service delivery, and as such, an internal standard based on average state policy (what states do) is a sound methodology rather than an external standard (what states could or should do). Victoria supports the Commission's view that there may be some instances where departure from an internal standard could be warranted to overcome policy neutrality concerns; however Victoria's view is that this would be in extraordinary cases only.

Victoria supports the current model of utilising broad assessments over many narrow and complex assessments, as long as these broad assessments adequately reflect what states do.

3.2 Weighted Averages and Average Policy

The 2015 Review introduced the 'weighted average approach' of what states do. This approach means that even if one state raises revenue from a particular source or provides a particular service then its policy is regarded as being the average state policy. A differential assessment is only made if that policy has a material impact on the GST distribution. By contrast the 2010 Review regarded average state policy to be a revenue source or service that was undertaken by a majority of states and affected the majority of the revenue or service base.

One consultation question the Commission asked is whether it should retain the current weighted average approach (from the 2015 Review). Victoria considers that it is difficult to evaluate the current approach in the absence of information and examples as to how this approach led to different assessments being conducted in comparison with the 2010 Review.

It would appear unlikely, with the notable exception of some mining royalties, that only one or two states raising revenue from a particular source or providing a service would have a material impact on GST distribution. For instance, in the 2015 Review it was found that a differential assessment of the metropolitan improvement levies imposed by Victoria and Western Australia did not have a material impact, nor did the fire services property levies imposed by a number of states.

In the case of Victoria's provision of protective service officers at railway stations, a full assessment of the GST distributional impact was not undertaken but a judgement call was made that it was unlikely to be material. There did not appear to be any consideration of other revenue sources and services offered by one or two states in the 2015 Review.

It is unclear whether the 2015 Review definition of average state policy did produce outcomes different from those that the 2010 Review definition would have produced. Therefore Victoria is indifferent between the 2010 Review and 2015 Review definitions. However, if the 2015 Review definition is applied consistently it would be expected to require the Commission to undertake a large number of assessments.

3.3 Scope of equalisation

Victoria considers that the Commission should continue to use net financial worth as the fiscal outcome to equalise.

Victoria also considers that the existing scope of equalisation of including general government, urban transport PNFCs and public housing PNFCs but excluding local government except for the interactions between it and the general government sector, is appropriate.

3.4 Disability measurement

Overall Victoria supports the current approach to disability measurement taken by the Commission. There does not appear to be a better alternative to using average state policy in assessments noting that estimates of a disability should be done in a way which minimises capturing of other cost effects.

As noted in the discussion paper, the Commission does not include some population groups in disability loadings for a variety of reasons such as materiality or a lack of data. However in some cases further investigation is warranted for population groups, such as cultural and linguistically diverse groups which may result in higher education or human services costs.

4. Policy Neutrality

The current HFE system does result in some minor incentives that could, conceptually, affect state policy making. However, Victoria agrees with the Commission that in practice there appears to be no significant impact on policy.

There is little evidence that suggests GST distributions have been a major impediment to tax reform. Indeed, several jurisdictions have undertaken major tax reforms recently, including South Australia, the Australian Capital Territory, as well as 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 2013-14¹. 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 supports the Commission's view that the benefits of any move to an external standard are far outweighed by the disadvantages, and that state policy standards should not be set by the Commission.

¹ 2012-13 Budget Fact Sheet – Royalty Rate Analysis, Western Australia Government

5. Practicality

Victoria agrees that the transparent use of data is desirable so that the impact of particular data on assessments can be observed and understood. However, as the Commission has stated, the primary objective is achieving HFE. This implies that if the use of confidential data has a material impact on the distribution of GST then it should be used. Transparency could be improved through the Commission working with relevant states to provide for confidential data to be shared between treasuries.

5.1 Discounting

Discounting assessments results in a proportion of the assessment being an EPC assessment and the remainder being a differential assessment. The extent to which the proportion should be subject to differential assessment to improve the HFE outcome is a difficult judgement to make. In the early sections of this discussion paper it is acknowledged that precise equalisation is not feasible, but rather proximate equalisation is achieved by the Commission's methods.

If proximate equalisation is regarded as being acceptable then the widespread use of discounting should not be required. However, there are circumstances in which discounting is appropriate. Victoria believes that the Commission's existing guidelines for the use of its three levels of discounts are appropriate, particularly in the limitation of the use of discounts to situations in which the Commission is unable to make a suitable assessment due to poor data quality. It could be argued that more levels of discounts might be appropriate, but given that these levels are judgement based it is not clear that more levels would improve the system and produce a better HFE outcome.

There may be a need for the Commission to be more discerning in recognising presumptive cases for a disability in the absence of adequate supporting data. Both partially recognising such a disability and not recognising it could be to the detriment of HFE, but which causes the bigger detriment may not be determinable.

5.2 Materiality thresholds

The values of the three materiality thresholds were tripled in the 2015 Review from their 2010 Review values. Victoria supports the continuation of the 2015 Review thresholds and the issue for the 2020 Review is whether these values should be adjusted to reflect price and wage increases since the 2015 Review.

As the materiality thresholds relate to the amount redistributed, a more appropriate standard for assessing the value of the thresholds is the size of the redistribution task. As Table 1 indicates, the amount of GST redistributed by the revenue and expense assessments has decreased since the 2015 Review. This results in the thresholds representing a greater proportion of the redistribution amounts. On these grounds it could be argued that the materiality thresholds should be reduced rather than increased.

Table 1: GST redistributed by the revenue and expenses assessments (\$ per capita)

Assessment	2015 Review	2016 Update	2017 Update
Revenue	320	316	274
Expenses	336	332	288

Source: CGC review and update reports.

Victoria considers that, in order not to further complicate the review task, the materiality thresholds should remain at the 2015 Review levels.

5.3 Quality assurance

Victoria considers that a quality assurance (QA) process is critical for the validity of the review processes and the assessment methodologies. It is difficult to comment further on the QA process for the 2020 Review until the draft plan is received.

6. Contemporaneity

The Commission faces a difficult task in determining the relativities to ensure HFE in the application year. When the Commission recommends its relativities, the application year is in the future, and there are no actual data available. The Commission trades off contemporaneity with data availability and quality by using the actual data rather than forecasts. This means that the latest data used is from two financial years prior to the application year. The Commission calculates relativities for assessment years (the most recent years for which data are available). The application year relativity is calculated as the simple average of the latest three assessment year relativities. This approach has been used since the 2010 Review.

Victoria considers that using forecasts to determine application year relativities would introduce unwarranted uncertainty and volatility. Equalisation over time produces predictable results for budget management.

Table 2 presents a number of alternatives for determining application year relativities, and estimated relativities for Victoria. Comparison between alternatives is imperfect as the time periods considered involve three different assessment methodologies and two averaging periods. The weighted average approach places more weight on the more recent assessment year relativities. However, using a weighted average rather than a simple average tends to produce relativities that are further from the assessment year relativity for the application years. Similarly, using only the relativity from the most recent assessment year tends not to produce more accurate relativities than the current method, as outlined in the table below.

The current method produces relativities that are too high in some years and too low in others but balance is achieved over time. This outcome supports the Commission's objective that equalisation is achieved over time. Victoria supports retaining the current method as it would be difficult to develop a more contemporaneous method without introducing additional uncertainty and volatility.

Table 2: Alternative derivations of application year relativities, Victoria

Year	GST Relativity	Weighted average ¹	Last assessment year ²	Actual assessment year ³
2011–12	0.9048	0.9362	0.9333	0.9290
2012–13	0.9211	0.9429	0.9624	0.8869
2013–14	0.9040	0.9054	0.8999	0.8917
2014–15	0.8828	0.8280	0.8660	0.9738
2015–16	0.8925	0.8833	0.8640	0.9317
2016–17	0.9097	0.9257	0.9782	na
2017–18	0.9324	0.9363	0.9317	na

1. Weights of 0.2,0.3 and 0.5 for the three most recent assessment years.
2. GST relativity set to last assessment year relativity.
3. Annual relativity for specified year from most recent update/review.

While the current methodology can produce pro-cyclical outcomes for two to three years, for example both own-source revenues and GST growing at low rates, these outcomes are known and predictable. States should be able to incorporate the implications of the current determination of application year relativities into their financial management.

Victoria understands that the Commission backcasts application year distributions of other Commonwealth payments to the assessment years in an attempt to make relativities more contemporaneous. However, Commonwealth payments, in total, are relatively small in comparison to expenses and own-source revenues so it is unclear the extent to which contemporaneity is improved. There is an element of uncertainty as to whether forecast application year distribution of payments are actually realised.

On balance, Victoria is uncertain about whether backcasting of Commonwealth payments achieves a better equalisation. Not backcasting Commonwealth payments would simplify the GST distribution system with minimal impact on contemporaneity.

Victoria does not support backcasting any additional items (i.e. beyond Commonwealth payments). In the past, the Commission has assessed revenue based on states' intended policies but these policies have subsequently been amended prior to being implemented or withdrawn, demonstrating that backcasting is fraught with problems, for example, state deferrals of changes to the tax mix following the introduction of the GST.

7. Treatment of Other Commonwealth Payments

Victoria supports the continuation of the current treatment of other Commonwealth payments, but considers that the treatment of government schools could be revised given the changes in government schools funding since 2015. While the 2015 Review terms of reference sought that schools funding be thoroughly reviewed, no such request has been outlined in the 2020 Review terms of reference.

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