Australian Government

Commonwealth Grants Commission

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Mr Paul McCullough
Secretary
GST Distribution Review
The Treasury
Langton Crescent
PARKES ACT 2600

By email: gstdistributionreview@treasury.gov.au

Dear Mr McCullough

On behalf of the Commonwealth Grants Commission, which is currently comprised of Chairperson Alan Henderson, Commissioner Glenn Appleyard and Commissioner Greg Smith, I attach a submission to the GST Distribution Review.

Consistent with the approach outlined in the Chairperson's letter of 28 April, 2011 to the Secretary to the Review, the submission is designed to provide factual and background information to the Review on the issues it has identified and does not canvass alternative approaches to equalisation or new methods that may be considered by the Review.

If you have any questions relating to the submission please contact Malcolm Nicholas (02 6229 8886) or Malcolm.Nicholas@cgc.gov.au.

Yours sincerely

John Spasojevic
Secretary

30 August 2011

Enclosure

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Commonwealth Grants Commission

SUBMISSION TO GST DISTRIBUTION REVIEW

August 2011

Introduction

1 The Commonwealth Grants Commission (the Commission) has publicly welcomed this review and stated that it was ready to assist the Panel in its deliberations. However, having regard to the Commission's ongoing need for independence, it intended to limit its input to factual briefing on its methods and the reasons for the approaches taken in developing its recommendations. All correspondence, briefings and material provided to the Review so far are available at http://www.cgc.gov.au/gst_distribution_review.

2 This submission responds to the GST Distribution Review Issues Paper released in July 2011. Many of the issues canvassed in the Issues Paper are long standing and have been considered by the Commission in past methodology reviews. The main purpose of this submission is to set out for background purposes how the Commission has approached these issues in the past in accordance with its terms of reference. It also provides some further data that may assist the Review in its consideration of the issues.

3 Consistent with the approach outlined earlier, this submission has a limited purpose and it does not canvass alternative approaches to equalisation or new methods that may be considered by the Review.

4 For ease of reference, this submission is arranged according to the major issues covered in the Issues Paper.

The Commission's operation

5 The Commission is a statutory body tasked under successive terms of reference from Government with recommending a distribution of GST revenue which achieves the objective stated in the Intergovernmental Agreement (IGA) that GST revenue would be distributed among the States to achieve fiscal equalisation.

6 As far as possible, Commission processes are analytical and data driven. Its advice relies on historical, empirical data on what States do and the circumstances in which they operate. In interpreting the data the Commission benefits from ongoing discussions with State treasuries.

7 The need for reliable, accurate measures of fiscal capacities means the data generally relate to inputs to State services and the activities States tax. Approaches based on estimating fiscal capacities in the year the GST is distributed would be severely hampered by the lack of data that are accurate, reliable and comparable across States. Other approaches such as equalising outcomes instead of capacities were seen as inconsistent with the untied nature of the funds and impracticable given the lack of robust data on outcomes.

8 The methods used to measure fiscal capacities have evolved over time in response to changes in: the scope of State activities, such as the abolition of some State taxes; how States conduct their business, including contracting out and the use of public trading enterprises; arrangements for specific purpose payments (SPPs); economic conditions; and data availability.

9 While the Commission's processes are analytical and data driven, it does exercise judgment in making its recommendations, especially through major methodology reviews. The Commission's use of judgment is informed both by the views of States and by the collective experience of the Commission. In this process it assesses the reasonableness and consistency with the real world of the individual assessment results and the overall recommended GST distribution. This is consistent with terms of reference which ask for the Commission's advice on appropriate relativities.

The Scope of Equalisation

10 The issue of whether the Commission should seek full or partial equalisation has often arisen, most recently during the 2010 Review of methods. Some States have suggested confining equalisation to core government services and recognising only a limited number of cost drivers. However, there has not been unanimity of view among them on either full or partial equalisation. The Commission's most recent conclusions reached during the review were:

> 'Since the IGA makes the GST revenue available to the States to spend according to their priorities, we have no basis for making judgments about whether some areas of State activity are more or less important in determining State fiscal capacity. Nor is there a sound basis for the Commission to make judgments about which cost drivers should or should not be recognised. In the absence of strong reasons, any partial approach could have large effects on the distribution of the GST and the assessed fiscal capacities of the States.'[1]

11 To help inform the Review, Table 1 shows the effect on each State's 2011-12 GST distribution if each category of services, and the related specific purpose payments, were omitted from the measure of State fiscal capacities. Similar information for State taxes and cost drivers is in the 2011 Update Report, Table 7. The effect of a service (or tax) on the GST distribution is determined by both the proportion of State spending (or revenue) it represents and the size of the differences between States in the relative costs of providing it (or the level of taxable activity).

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[1] Further discussion is in the Commission's Report on GST Revenue Sharing Relativities – 2010 Review, Chapter 3, paragraphs 6 to 21.

Table 1 Effect on GST distribution of omitting services and associated SPPs (a)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Schools Education	82.1	826.8	-308.9	-310.8	73.8	-100.8	31.3	-293.6	1 014.0
Post-Secondary Education	35.2	54.0	8.8	-49.4	25.5	2.9	-29.6	-47.5	126.5
Admitted Patients	6.1	381.4	30.1	-70.0	-130.8	-71.5	68.2	-213.6	485.8
Community and Other Health	558.2	259.1	-78.9	-449.9	47.9	-67.6	-52.2	-216.6	865.2
Welfare and Housing	95.3	418.1	-34.8	-16.0	-115.0	-90.8	66.2	-323.0	579.7
Services to Communities	184.4	293.5	-101.4	-209.3	40.3	42.4	36.0	-285.9	596.6
Justice Services	171.7	593.6	-110.7	-193.7	31.3	-39.6	-1.2	-451.4	796.6
Roads	249.2	240.9	-115.1	-234.8	-67.0	4.5	36.3	-114.1	531.0
Transport Services	-258.4	-95.2	161.9	16.6	56.6	80.7	17.2	20.6	353.6
Services to Industry	127.3	57.2	16.8	-99.3	-39.0	-30.3	0.2	-33.0	201.6
Other Expenses	159.1	234.2	39.1	-76.9	1.9	-73.8	-109.1	-174.5	434.3

(a) The effects are based on an estimated 2011-12 GST pool of $50 000 million. Each row shows the effect on each State's GST if the measured fiscal capacities were not affected by spending on the service (including depreciation costs) and any associated specific purpose payments and national partnership payments received from the Commonwealth. The effects of several services can be derived by summing the effects of each.
(b) The sum of the positive (or negative) items in the row.
Source: Commission calculation.

Efficiency issues

12 A distinction needs to be made between the possible efficiency implications of equalisation and those of the Commission's methods for implementing equalisation. Both sets of issues have been considered many times in the past and both are raised in the Review's Issues Paper. This submission addresses only the effects of the Commission's methods and processes for achieving equalisation.

13 Successive Commissions have consistently sought methods designed to avoid or minimise grant design inefficiency, which occurs if the methods it adopts lead States to adopt policies in the hope of increasing their share of the GST. As the Commission has stated 'It would undermine confidence in equalisation if States were able to manipulate it to their own advantage.'[2]

14 To do this, fiscal capacities are measured on the basis that all States apply the same set of policies and, as far as possible, allow for only the effects of factors which are outside the control of individual States.

15 The potential for each State's policies and changes in them to affect their GST shares are minimised by averaging, across States and over several years of historical data.

[2] Report on General Revenue Grant Relativities, 1999, Chapter 2, paragraph 35.

The lags mean several years elapse before any increases in revenue might occur in response to a State's policy choice. Other means of mitigating policy effects include adopting as broad as possible groupings of services and cost drivers and explicit adjustments to remove any major identified policy effects from data.

16 Unless the Commission measured State fiscal capacities using independent, externally chosen policies governing revenue and spending and ignored what States were actually doing, there will always be some scope for States to affect the average policy observed by the Commission and so, in that limited degree, the GST distribution.

17 Some States have argued that equalisation reduces their incentives to adopt policies designed to grow their economies because much of the benefits to their budgets are redistributed to the other States. If this is so, it is an outcome of the policy of equalising State fiscal capacities. As such, it is not considered in this submission.

18 The Commission is aware that tax policies, especially tax rates, may affect the size of a tax base and that State tax rates differ across States and from the average. In this context, there may be a conceptual case for building tax elasticity effects into the measures of relative revenue raising capacity.[3] This would require adjusting the actual level of taxable activity in each State for its responses to the State's above or below average tax rates. Elasticity adjustments were made for State business franchise fees prior to their abolition and for mining royalties up to 2004. However, they were not extended to other taxes or continued beyond 2004 due to a lack of reliable data to measure them. Consequently, under current methods, revenue capacities are measured using data on the observed level of activity in each State.

19 It is sometimes said that equalisation reduces the incentives of States to improve their service delivery efficiency. This is unlikely to be significant, since the GST shares are based on average expenses, adjusted for factors beyond a State's control. Those calculations are not affected by interstate differences in service delivery efficiency. Each State's actual efficiency is reflected in the average expenses, but they are equalised to the average efficiency. States that are more efficient than the average keep the benefits of that extra efficiency to use as they see fit, while less efficient States bear the costs.

20 If a State makes some new efficiency savings, they will reduce the national average spending on the service, which would increase the GST shares of States with below average relative costs and reduce them for States with above average relative costs. The potential effects can be illustrated by simple examples, which ignore the lags in the equalisation process. The first line of Table 2 shows how each State's GST would be affected if efficiency improvements reduced national spending by $100 million in the Services to communities category — the category where relative costs differ the

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3 These matters are discussed in the Commission's Report on Research in Progress, Elasticity and mobility adjustments in revenue assessments, 1996.

most.[4] The second line in the table shows the net effect on each State's budget if it was the State which made the efficiency improvement.

Table 2 Effects of a $100 million efficiency saving in Services to communities

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Effect on GST	3.4	4.8	-1.2	-3.1	-0.5	0.6	0.6	-4.4	0
Net budget saving (a)	103.4	104.8	98.8	96.9	99.5	99.4	100.6	95.6	100.0

(a) Assumes the State made the $100 million efficiency saving (it is $100 m + the GST effect).
Source Commission calculation.

21 Table 3 shows the effects of a $100 million efficiency saving in schools education.[5]

Table 3 Effects of a $100 million efficiency saving in Schools education

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Effect on GST	0.4	1 9	- 0.7	- 0.7	0.1	- 0.3	0.03	- 0.7	0
Net budget saving (a)	100.4	101.9	99.3	99.3	100.1	99.7	100.0	99.3	100.0

(a) Assumes the State made the $100 million efficiency saving (it is $100 m + the GST effect).
Source: Commission calculation.

22 The tables show that in the service with the largest cost variations, the Northern Territory would retain about 96% of its efficiency saving and Victoria would receive a 5% supplement. In a less extreme case, the Northern Territory retains 99% of its efficiency saving and Victoria's savings are supplemented by 2%.

Equity issues

23 The methods developed by the Commission in a review, and implemented in following Updates are designed to equalise the fiscal capacities of the States to deliver equal services with equal taxes. Its advice relies on historical, empirical data on what States do and the circumstances in which they operate.

24 In the course of reviews the Commission has considered, in response to State proposals and the views of commentators, whether measures of fiscal capacity should go beyond the observed average policy of States to address purported policy

4 It costs 5.3 times the average per capita amount to provide the average community services in the Northern Territory but 0.8 of the average in Victoria and 0.7 of the average in the ACT.

5 It costs 1.7 times the average per capita amount to provide average school services in the Northern Territory but 0.9 of the average in Victoria.

failures or create scope for State policy initiatives. The Commission has concluded that to do so would be equivalent to it deciding what constitutes good State policy, a role it considers beyond its mandate.

25 Even if directed by terms of reference, going beyond observed State policy in calculating fiscal capacities would be difficult.

26 For example, the Commission's methods measure what States do on average and reflect the fact that on average States spend different amounts to provide services in different regions. Measuring fiscal capacity so as to provide States with the capacity to deliver the same standard of service in all regions would require data on current service levels by region and the potential spending required to equalise those service levels across State regions. Since the necessary data and information are unavailable, implementing such an approach would be very judgmental.

27 Similarly, to ameliorate any general shortcoming of governments in addressing particular social problems within the equalisation process would require the clear exposition of those shortcomings in terms of reference and reliable, externally sourced estimates of the funding required to address them.

28 The current IGA states the GST revenue is untied. So while changing measures of fiscal capacity as illustrated in paragraph 26 would change the distribution of GST revenue, it could not ensure the desired policy outcomes would be achieved.

Simplicity issues

29 Simplicity and ease of understanding are desirable features in the design of any public policy.

30 Concern is frequently expressed about the complexity of the policy of fiscal equalisation and in particular, the Commission's methods for achieving it. However to a significant extent, the complexity of the system reflects the complex range of factors that bear on the costs of delivering services to residents living in very different circumstances (such as big cities and small remote communities) and the implications of very different economies and resource endowments for revenue raising capacities.

31 Experience suggests there are at least two broad approaches to achieving greater simplicity:

- mandating the level of disaggregation of services and revenues with broader indicators of revenue bases and spending needs and/or
- imposing strong evidentiary standards and materiality thresholds for data used in measuring fiscal capacities.

32 Reflecting the focus on simplification in the terms of reference for the Commission's 2010 Review of methods, the Commission began that review with a clean slate. Consistent with the first approach to simplification, it proposed measuring fiscal

capacities using a few categories based on broad views of what States do, the types of costs incurred and the factors affecting them.

33 However, research and State views indicated a very high level of aggregation of categories could unduly limit the achievement of equalisation. For example, the factors affecting health and welfare services were considered to be too disparate, and too numerous, to include in a single assessment. The main users of hospital inpatient services and the unit costs of delivering them differ markedly from those of community health, housing and welfare services and other community services. Similarly, the factors affecting roads and other transport services differ greatly from each other and those affecting other general services.

34 Proceeding on the basis of very broad categories would have led to obscure comparisons which may not have reliably captured State fiscal capacities or may have been so complex as to hinder understanding. The categories adopted in the 2010 Review reflected these considerations.

35 The Commission also began by considering broad indicators of service use (such as school aged people and people in receipt of Commonwealth income support). However, research and State views indicated capturing the main cost drivers often required more than one indicator or required an indicator to be disaggregated because there are material differences in:

- the use of services by different groups of people in the population
- the cost of providing a unit of service to people in some groups and
- the proportion of State populations in those groups.

36 The assessments, therefore, continue to be based on national profiles of service use by relevant groups in the population.

37 The second approach to simplification was found in 2010 to be both more productive and more readily accepted by States. The strict reliability and materiality guidelines (as set out in Attachment A of the 2010 Review Report) were aimed at ensuring the assessments allowed for only those factors which had a material effect on the GST distribution and which were measured using conceptually rigorous methods and quality data that were fit for the purpose. The guidelines led to considerable simplification by reducing the detail in the assessments. They also provided greater confidence in the outcomes because the assessments were more reliable.

38 The Commission suggested maintaining and strengthening the guidelines would be an important step in facilitating further simplification. The materiality thresholds should be at least indexed for future reviews to reflect movements in price levels to prevent their impact being progressively reduced. Without major changes in economic activity and data availability, small increases in the materiality thresholds would lead to

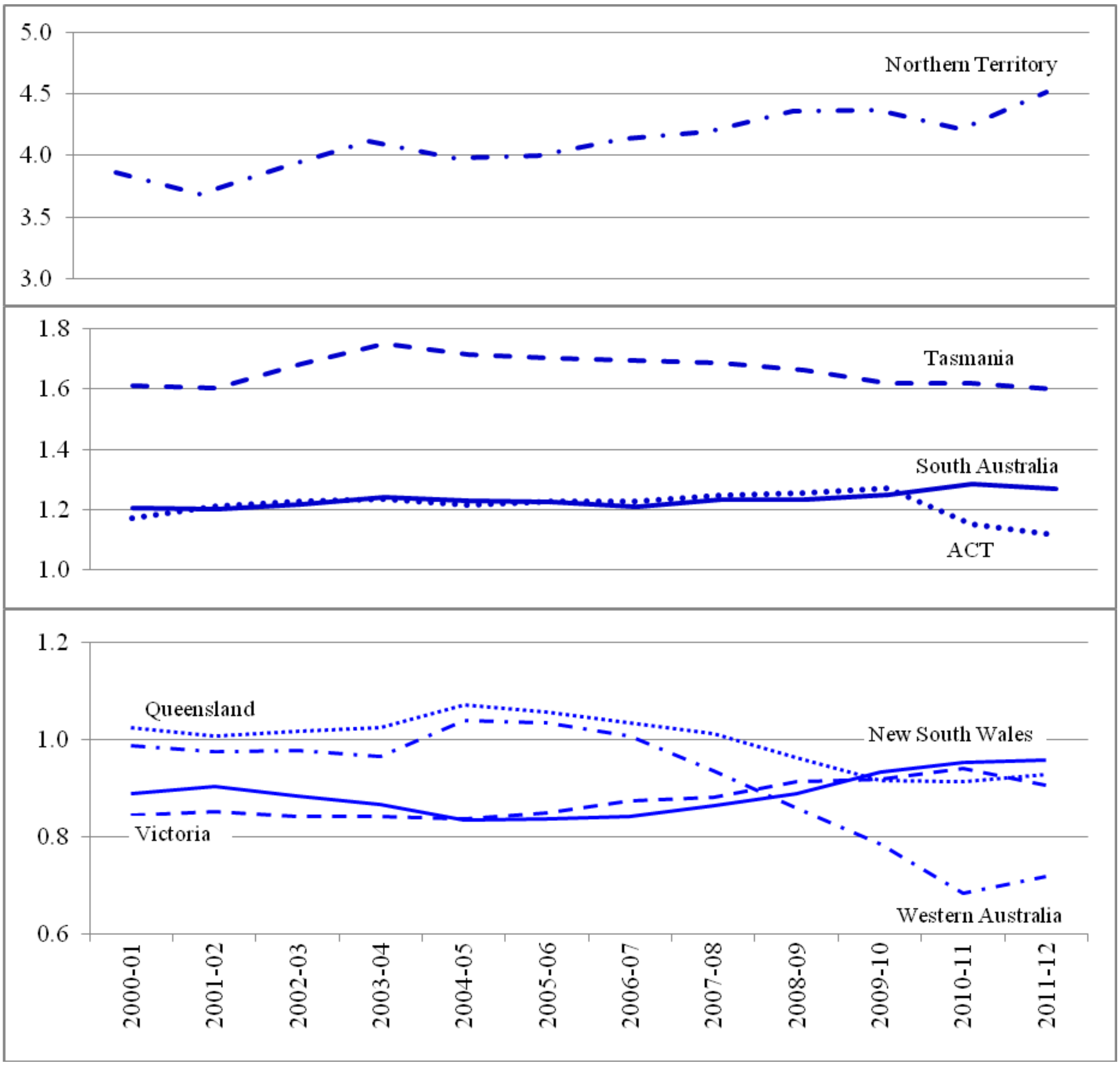
further simplification by removing assessments of revenue raising capacity for insurance taxes and the effects of cultural and linguistic diversity on costs.

Responsiveness, predictability and stability issues

39 The GST distributions recommended by the Commission respond, albeit with a lag driven by data availability, to measured changes in: State circumstances affecting their relative revenue raising capacities and the spending required to deliver the average level of services; and the distribution of SPPs between the States.

40 Figure 1 indicates there have been noticeable changes in the recommended GST distribution since 2000-01.

Figure 1 Change in recommended relativities for distributing the GST



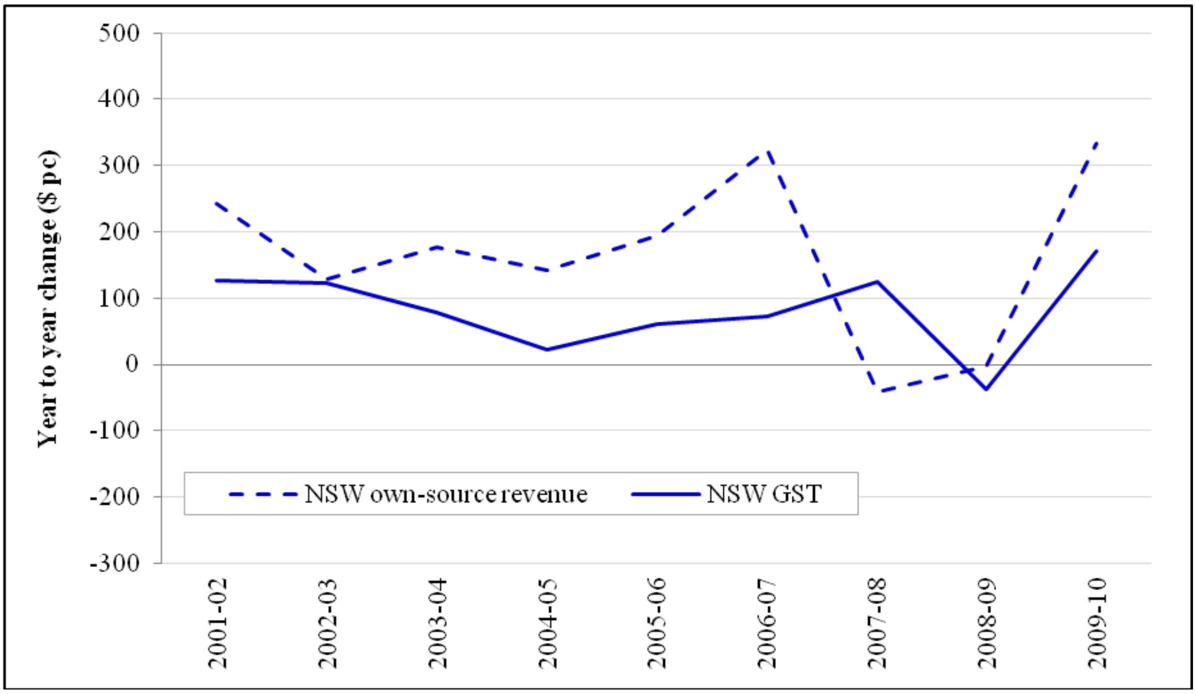
Source: Commonwealth Grants Commission, Report on GST Revenue Sharing relativities — 2011 Update, Figure 6-1.

41 Those changes show a substantial increase in Western Australia's fiscal capacity and a lesser increase in Queensland's capacity. The changes reflect the effects of strong mining and property markets on State revenue raising capacities and, more recently, changes in relative wages bearing on service delivery cost. In coming years, the GST distribution can be expected to respond to the impact of the early 2011 natural disasters on State finances with the result that part of the burden will be shared among the States.

42 The recommended GST shares change from year to year in response to changes in the relative fiscal capacities of the States so that the objective embedded in the IGA of fiscal equalisation is achieved. If constraints were placed on annual changes in GST shares, States would not have the fiscal capacity to provide the same level of services. If State economic, social or demographic conditions are volatile then GST shares are also volatile to preserve fiscal equality. For example, if a State's capacity rises (or falls) due to changes in its tax revenue, the resulting changes in GST shares will, subject to the lags in the process, partly offset the tax changes — the GST distribution process helps reduce volatility in total revenues. However, some volatility is moved to the other States.

43 The year to year changes in the per capita GST received by the States, which reflect changes in both the amount of GST available for distribution and the recommended State shares of it, have generally been less than that for State own tax revenue, especially for the more populous States. Figure 2 illustrates this using data for New South Wales.

Figure 2 Year to year changes in GST and own revenue — New South Wales



Source: Commission calculation.

44 Because the recommended GST shares significantly affect the revenue States have to deliver services, they should reflect, as closely as possible, conditions in the year they are used to distribute the GST revenue. However, in the absence of reliable, detailed forecasts of State finances and economic conditions, historical data are used. In addition, to reduce volatility in the assessments, the recommended shares are based on an average of conditions and policies in several recent financial years.

45 Using data averaged over several years produces less volatile GST shares, by smoothing the effects of short term fluctuations, but using averages over long periods can lead to recommendations that are further removed from current conditions. Between 1991 and 2010, a 5-year averaging period was used which produced substantial smoothing and resulted in the GST distributions reflecting conditions that existed between 2 and 6 years previously. Following discussion with heads of treasuries during the 2010 Review, the averaging period was reduced to 3 years (which reduced the average age of the data from 4 to 3 years) to better balance the competing needs of capturing current developments and reducing volatility.

46 The measures of State fiscal capacities and the resulting recommended GST shares are determined by the availability, timeliness and accuracy of data on State finances, economic conditions and demography. Because more reliable data that are subject to fewer revisions would lead to more stable recommendations, the Commission devotes much effort to working with the States and other major data providers, such as the ABS and AIHW, to improve the quality of their data.

47 More frequent availability of major data sets such as the ABS Survey of Education and Training may help reduce volatility in GST shares. The SET, which is conducted every four years, is used to measure the effects of differences in wage levels on State spending. Use of data from the 2009 survey, which showed relative wage levels had changed significantly since the 2005 survey, was a major reason for the changes in recommended GST shares in the 2011 Update.

48 The use of an averaging process to reduce volatility and improve predictability means the recommended GST shares are based on measures of fiscal capacity that differ from those in the year they are implemented. If economic conditions are stable, or changes moderate, that divergence is small and with cyclical activity offsetting, albeit with a lag. However, if there is a major shock to the fiscal capacities of some States, the divergence may be large. If some States are growing rapidly, the lags imply the recommended GST shares may be more than is required to equalise capacities in the year the GST is distributed. But, if there is a rapid slowdown, the lags may yield GST shares that are too small to equalise State capacities for several years. Nevertheless, States have seen and experienced many economic cycles and they are aware of the effects of the lags in the Commission's procedures. They thus have scope to adopt fiscal strategies which manage the outcomes and timing effects on their budgets.