Western Australia's Second Submission to the

Productivity Commission's Inquiry into Horizontal Fiscal Equalisation

10 November 2017

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Executive Summary

Australia's system of Horizontal Fiscal Equalisation (HFE) must be reformed. The current HFE objective of full equalisation is not achieved, and is indeed unrealistic. Most importantly, the way HFE is practiced distorts economic activity, reducing productivity and economic growth. As a result, the nation is considerably worse off.

It is a system that no longer has any credibility in the eyes of the Western Australian community, who contribute GST revenue with the reasonable expectation that a transparently fair proportion of that revenue will be returned to the State to fund services and infrastructure.

Fundamental reform is needed to address the current system's significant deficiencies and ensure that the arrangements are transparent, fair and efficient. As the Productivity Commission has noted, revising the objective of HFE would increase national productivity.

Ideally, an equal per capita GST distribution would be implemented, with direct Commonwealth assistance for weaker States. However, a dynamic GST relativity floor, such as the Draft Report's suggestion of equalising to the average fiscal capacity of all States, would go a long way towards addressing the system's problems. Reforms to equalise to provide a reasonable (rather than the same) standard of services recognise that extreme situations are where HFE is most damaging to the economy and intractably unachievable.

This reform should be complemented with simplified and more policy neutral assessments to address remaining problems.

Regardless of whether agreement can be reached for fundamental reform, the highly distorting effects of the mining revenue assessment must be addressed. It is a stand-out failing of the HFE process, greater than any other issue. Western Australia regards this as the minimum threshold for meaningful reform.

Reforms to the mining assessment could include discounting, amalgamation of individual mining assessments with a fixed royalty rate, the use of broad indicators or aggregated revenue bases, or a combination of these. Western Australia's dominance of mining activity means that aggregating mining revenue bases alone does not solve the efficiency problem. Increases to a State's mining royalty rates should not reduce its GST share by more than changes to tax policies.

Western Australia has long urged the removal of GST time lags. However, these concerns with GST time lags would be largely mitigated by the proposal to equalise to the average fiscal capacity of all States.

The lack of accountability around the HFE process must be addressed. The Commonwealth needs to give the Commonwealth Grants Commission (CGC) a clear HFE objective. The CGC in turn should be responsible for implementation, not policy. Currently, the CGC's role in developing policy means that it tends to defend the current system rather than act as an independent and objective party.

The importance of the Commonwealth Government providing leadership in fixing the broken HFE system cannot be overstated. Requiring all States and Territories to consent to reform consigns the HFE system to a future of no reform. Where reform is in the national interest, it is the national government that must take responsibility to ensure it is achieved.

As outlined in this submission, there are a number of practical transition mechanisms available to help governments implement reform. Accordingly, the process for reforming the system can and should begin without delay. The longer that reform is delayed, the longer the HFE system will continue to undermine national economic growth and prosperity.

Recommendations

Recommendation 1

The Commonwealth Government should direct the CGC that its HFE objective is to ensure States have the fiscal capacity to provide a reasonable level of services, rather than the same level of services, determined by equalisation to the average fiscal capacity of all States and Territories.

Reasonable equalisation should be pursued to the greatest extent possible consistent with not unduly influencing States' policy choices, not unduly hindering the efficient movement of labour and capital between States, and using transparent methods and reliable evidence.

Recommendation 2

The Commonwealth Government should direct the CGC to implement simpler and more aggregated revenue assessments. Options include:

- *global revenue base indicators; and*
- *aggregating all revenue categories.*

Recommendation 3

The Commonwealth Government should direct the CGC to reform its spending assessments. Options include:

- *simplification and more clearly identifying underlying drivers of cost; and*
- *removing some spending areas where a policy neutral assessment is impossible, and an equal amount of revenue, from the HFE assessments.*

Efficiency cost benchmarks should be avoided unless the revenue assessments are made much more conservative, and if applied, should also apply to socio-economic disadvantage as well.

Recommendation 4

The Commonwealth Government should direct the CGC to:

- *use discounts to ensure States have a sufficient incentive to expand mineral production; and*
- *in the absence of high-level revenue assessments, apply an aggregated assessment of mining with a fixed notional national royalty rate that is below the actual national royalty rate.*

Recommendation 5

The Commonwealth Government should issue clear guidelines to the CGC on how Commonwealth payments should be treated for the purposes of HFE. Recurrent grants should be equalised, but infrastructure payments should be partly or fully quarantined.

Recommendation 6

The Commonwealth Government should direct the CGC to:

- *take steps to improve its accountability and neutrality, as befits an organisation that governments look to for objective and expert advice on contentious matters;*
- *genuinely engage with States in developing its proposed methods for calculating recommended GST shares;*
- *provide draft rulings on HFE impacts of policy changes; and*
- *ensure that issues, decisions, data and calculations are reported in a fully transparent way.*

The Commonwealth Government should require the CGC to refer matters of policy to governments for decision, while concentrating on technical implementation alone.

Recommendation 7

The Commonwealth Government should take on a leadership role in pursuing needed reforms to the system of HFE and ensure that they are undertaken as quickly as possible.

1. Introduction

This submission responds to a number of issues raised in the Productivity Commission's Draft Report on Horizontal Fiscal Equalisation.

The submission outlines Western Australia's views on:

- The *Objective of HFE and Alternative Approaches* – arguing that the current HFE objective of full equalisation is not achieved (and not clearly articulated), rendering the current approach inequitable. Alternative approaches to achieve reasonable rather than full equalisation are presented, along with possible transition arrangements.

- *Methodology Changes to the Current System* – presenting ways to simplify and improve the policy neutrality of the current overly complex HFE methods through aggregation and discounting. Contemporaneity and Commonwealth payments are also discussed.

- *Institutional Reforms* – highlighting that the CGC does not currently act in a neutral manner, lacks accountability and should be made responsible for the technical implementation of HFE, not HFE policy. It also discusses the need for the Commonwealth Government to take a much greater leadership role.

This submission builds on our 28 June 2017 submission, our views from which remain unchanged. Silence on other issues in the Draft Report does not imply concurrence or opposition.

2. Objective of HFE and Alternative Approaches

Key Points

- We agree that there are a number of deficiencies with the current HFE objective. The objective is not achieved and the CGC's interpretation of it is not clearly articulated. The methods are not policy neutral, they change often and randomly over time, they have gaps and they do not cope with extreme circumstances. Hence, the current process is not equitable.
- We agree that HFE has significant potential to distort mineral and energy resources policy, and some tax reforms. But the problems with HFE go further than this. HFE is more broadly a drag on development by short-circuiting the virtuous cycle of growth-funded investment and structural reform leading to more growth. These negative impacts compound over time. In the long run, the Federation is less productive and economic activity more centralised.
- Efficient HFE requires some form of recognition of cost differences.
- We agree that the Commonwealth Government should clearly articulate the HFE principle, and aim for 'reasonable rather than full' equalisation. States should be equalised to the average fiscal capacity of all States and Territories.
- There should be minimal delay in implementing a new approach to HFE. If needed, we support transitional arrangements such as:
  - a 60% floor in 2018-19, an 80% floor in 2019-20 and equalisation to the average from 2020-21, with the Commonwealth Government initially funding the cost of the floor; or
  - phasing-in equalisation to average fiscal capacity commencing at 20% in 2018-19 and rising by 10% increments to 100% in 2026-27, with the Commonwealth funding the full cost of transition over the first three years and phasing out its funding over the next three years.
- Western Australia's support for an equal per capita distribution of GST grants is in the context of additional Commonwealth funding for the fiscally weakest States and broader reform of Commonwealth-State relations.
- Actual spending and revenues are generally not appropriate for determining fiscal capacity, but there are some exceptions.

HFE Deficiencies

We support Draft Finding 2.1 that there are deficiencies with the HFE objective and that HFE "is always to the fiscally strongest State; it provides for limited consideration of efficiency, and it results in a complex system".

More fundamentally, the current HFE objective is not being achieved and the CGC's interpretation of it is not clearly articulated. The methods are not policy neutral, they change often and randomly over time and they have gaps. While there are some equitable aspects of the current process, there are also inequitable aspects.

Hence, a revised HFE objective of providing States with fiscal capacity to provide a reasonable level of services should not be thought of as less equitable than the current system.

When HFE produces modest redistributions among similar jurisdictions, potential errors are less likely and of less concern. However, when there are extreme redistributions among jurisdictions with very different circumstances, errors are more likely and have significant potential equity and efficiency impacts. As such, there is merit in placing a limit on the size of those redistributions.

On this basis, we support Draft Recommendation 2.1, that the Commonwealth should clearly articulate the HFE principle, and that it should aim for 'reasonable rather than full' equalisation.

Why HFE is Not Achieved or Clearly Articulated

The CGC's Definition of HFE is Unclear and Does Not Put Policy Neutrality at the Core of HFE

The HFE definition is very broad – it does not provide a process for determining relativities. The CGC has not provided an operational definition of HFE. While it has provided 'supporting principles', it considers these to be 'subordinate' to the HFE definition (despite the absence of an operational definition of HFE), and has only described the principles in vague high level terms.

This allows the CGC to make 'non-recourse' judgements as to how to:

- balance HFE against the principles;
- balance principle against principle; and
- interpret the principles.

The CGC states:

> …The Commission considers that, wherever possible, methods should be chosen having regard to all of the supporting principles. The interaction and subsequent constraints between the supporting principles requires a balancing of competing considerations when determining the choice of methods. This balance may vary with the varying structural elements of the Commission's methodology and with the varying underlying circumstances in each area of assessment. The Commission does not propose to establish any prior ranking or weighting of the supporting principles.[1]

In practice the CGC has interpreted the two major principles ('policy neutrality' and 'what States do') in a narrow way that sets up conflicts between them and does not fully encompass either policy neutrality or what States do. The practicality principle has been interpreted as a support pillar for a narrow 'what States do' perspective rather than as an independent principle.

Methods Remain in Flux

The fact that methods change so often suggests that they cannot be accurate. Since the system of relativities has been implemented, the CGC has held a Review of its methods every three to six years. However, after many Reviews its methods remain in flux, and each Review can easily alter a State's grant share by hundreds of millions of dollars. Significant changes to methods occurred in the two most recent Reviews (2010 and 2015).

- Method changes over time are often random, exemplified by:
  - many changes in the mining assessment, in particular increases and decreases in the number of mineral groups;

1 Commonwealth Grants Commission (2017), *2020 Review: The Principle of HFE and Its Implementation,* Commission Position Paper CGC 2017-2, paragraph 2.2.

- changes in the assessed impact of private health services from an ‘indicator’ approach in the 2004 Review, to a ‘subtraction’ approach in the 2010 Review, to a new ‘indicator’ approach in the 2015 Review; and
- change in the treatment of Fire and Emergency Services Levies from user charges in the 2010 Review to taxes in the 2015 Review.

- Areas of stable methodology can be stable not because the method has broad support, but because an alternative methodology is not apparent (e.g. the assessment of public sector wage costs).

Economic Development Costs Are Not Assessed

The impact of economic development assistance is an intractable area that has led to public dissension among Commissioners[2] and the current view that it is just too difficult [3] (including in relation to the North West Shelf project).

Western Australia has incurred significant costs to improve economic and social infrastructure aimed at facilitating resource and broader economic development. While revenues are equalised, significant costs are not. Hence, States that bear all the risk receive only a fraction of the fiscal benefits. This decreases efficiency and equity.

HFE is Not Delivered Across Time

The CGC does not aim for intertemporal HFE. For example, when the CGC finally introduced an assessment for the impact of population growth on general government infrastructure requirements in 2010, there was no retrospective assessment, nor any assessment of the interest costs arising from the lack of assessment of these costs in the past. This cost Western Australia billions of dollars.

Discounting is Selective and Inconsistent

In acknowledgement that it cannot always reliably undertake assessments, the CGC applies discounts to some assessments. However, as discussed later in this submission, its application of discounting is selective and inconsistent.

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[2] Commonwealth Grants Commission (2004), *Report on State Revenue Sharing Relativities: 2004 Review*, page 61.

[3] Commonwealth Grants Commission (2015), *Report on GST Revenue Sharing Relativities 2015 Review – Volume 1*, page 50.

The Mining Assessments are Unreasonably Affected by Changes in Royalty Rates

The lack of clarity in the operational definition of HFE has led to many incarnations of the mining revenue assessment. Despite this, the current approach still fails to achieve policy neutrality. While changes in any State's tax rates result in GST adjustments of less than 10% of the tax revenue raised, this is not the case with mining revenues.

Western Australia loses more than 10% of any royalty increase for every single mineral other than copper, onshore petroleum and coal. A greater than 10% loss also applies for Queensland royalty increases on coal, bauxite and onshore petroleum, South Australian royalty increases on copper and onshore petroleum, and Northern Territory increases on bauxite and minerals classified by the CGC to its 'other minerals' component.

The following table gives the percentage losses where they exceed 10%.

Table 2.1 – GST Loss of Increased Royalty Rate Revenue in 2015-16 [(a)] (For Losses Exceeding 10%)

	WA	Qld	SA	NT	All Other States
Iron ore	88%				
Coal		39%			
Gold	61%				
Copper			27%		
Bauxite	27%	26%		15%	
Nickel	89%				
Onshore petroleum		12%	49%		
All other onshore minerals [(b)]	13%			15%	

(a) Exact losses vary from year to year. This table uses the CGC's most recent data.

(b) The CGC groups all other onshore minerals into a single component. For example, the 13% loss for Western Australia would apply to all minerals not listed earlier in the table, including diamonds, mineral sands and lithium.

Source: Western Australian Treasury estimates.

It should also be noted that States with less than their population share of a mineral will get a GST gain if they increase their royalty rate (this gain is on top of the increased royalty revenue). Often this GST gain is small, but for States with larger populations it can exceed 10% of the additional royalty revenues. For example, if New South Wales increased its royalty rate on copper (of which it has around 20% of the nation's production) its GST grant would increase by around 12% of the extra copper revenue it raises.

This ultimately reflects the selective application of policy neutrality, and that HFE is therefore not being achieved. Significantly, the CGC has recently admitted that its methods do not achieve policy neutrality.[4]

HFE Does Not Cope with Extreme Circumstances

HFE methods perform poorly in the face of extreme economic circumstances. As highlighted by Western Australia's experience with the iron ore boom, the existing approach to HFE breaks down in these circumstances:

- remote areas across the nation no longer have similar costs (as assumed by the CGC) and capital costs become very high;
- infrastructure spending requirements are no longer well modelled by the CGC's assumptions of mobile and divisible capital and its focus on the general government sector;
- new community needs emerge (e.g. associated with high-income, high-stress occupations such as FIFO workers);
- new economic needs emerge (e.g. modernisation of remote towns and affordable accommodation initiatives to preserve the social fabric and reduce labour costs); and
- there are large risks associated with budget management and planning for the economy.

As Western Australia explained in the 2015 Review, such factors meant that existing HFE methods were arguably understating Western Australia's costs by close to $2 billion per annum.

Revenue Bases Are Not Assessed Based on 'Same Effort'

The CGC's HFE objective says that States must be equalised on the basis of revenue raising capacity at the same effort. However, the CGC uses observed revenue bases to measure revenue raising capacity – it does not adjust these bases for differing State efforts in developing their economies.

[4] Commonwealth Grants Commission (2017), *2020 Review: The Principle of HFE and Its Implementation,* Commission Position Paper CGC 2017-2, pages 16 and 25.

Despite its inability to derive policy neutral revenue bases and its reluctance to discount the observed bases, the CGC has occasionally attempted to make a partial policy neutrality adjustment by accounting for the elasticity of revenue bases to tax rates.

This is problematic for various reasons, including the time lags involved in industry responses to tax rates, the inadvertent penalties or bonuses that are given to States whose GST grants are not accurately determined by the CGC,[5] and the complexity of State influences on their revenue bases.

For example, the mining revenue bases are influenced by:

- royalty rates, allowable deductions and rebates;
- mining bans;
- approval processes and regulation (including their complexity);
- other tax rates and settings;
- provision of services and infrastructure (such as roads, rail and ports);
- support for exploration (such as grants and mapping services);
- facilitation of an appropriately skilled workforce;
- legislative support to increase certainty and reduce sovereign risk (e.g. State Agreement Acts);
- regional development (such as the provision of affordable housing);
- fiscal policies that inspire business confidence; and
- support for other industries, which can either complement or discourage mining (e.g. agriculture, tourism and renewable energy).

A similar list of policy influences could be produced for each State tax base. Land values, for example, are sensitive to State policies on the supply of land, land zoning and planning regulations.

[5] Where the CGC's methods understate the GST grants to a State that are needed to provide an average standard of services with an average revenue raising effort, that State may have to apply higher tax rates to achieve an average standard of services.

HFE and Efficiency

We agree that HFE creates disincentives for some tax reforms (Draft Finding 4.1) and has pronounced potential to distort State policy for mineral and energy resources (Draft Finding 4.3).

However, the impacts of HFE on efficiency do not end there. HFE has broader effects on the economy, which has consequences for the performance of the economy in the long run.

In the absence of HFE, economic development is self-reinforcing. Some policy or economic circumstance generates a boost to the economy and State revenues. This then opens up opportunities for financing productive investment or making structural economic reforms possible (by compensating losers). As further gains are made, more opportunities open up.

This virtuous cycle of development is short-circuited by the redistribution of the revenue gains from development. The immediately necessary investments and reforms will be prioritised. Significant structural reforms, which typically have high costs (in dollars or vocal losers), and for which the benefits take time to materialise, are less likely to be pursued. The focus shifts to the short-run, lower risk reforms and reliance on the private sector to invest in infrastructure.

To illustrate the potential significant and accumulating impact of these effects, our first submission quoted the empirical work of Twomey and Withers on the superior, long-term economic performance of decentralised federations, the observations of Weingast on the economic development of various regions around the world, and OECD concerns about the impact of HFE on development.

The Productivity Commission has noted concerns of this nature in its Draft Report,[6] but for reasons that are not clear has not seen these broader issues as a concern in Australia,[7] nor cumulative over time.[8] Of its nature, hard evidence in this area is not easy to find, but we consider that there are strong conceptual grounds and sufficient evidence to demonstrate risk.

We ask the Productivity Commission to reconsider these issues.

While HFE modelling in Australia has tended to show negligible impacts, the Productivity Commission has rightly dismissed these exercises, because their assumptions dictate their outcomes.

Migration

Draft Finding 6.1 notes that the GST distribution and net fiscal benefits are unlikely to be a significant driver of interstate movement of people.

As a static analysis, we would not dispute this.

However, the presentation in our first submission of the recent history of migration in Australia was much more concerned with the attractiveness of Sydney and Melbourne to overseas migrants and the lack of responsiveness of interstate migration to emerging economic opportunities.

This is exactly what the Productivity Commission's *Geographic Labour Mobility* report found: "Historically, most immigrants have settled in large 'gateway' cities, such as Sydney and Melbourne";[9] and "In contrast to Queensland, Western Australia has relied much more on overseas migration to meet the labour demands of its strong economy. This could be pointing to the formidable role of distance".[10]

6 For example, "OECD experience provides some evidence that high equalisation tax rates can reduce the incentive for sub-central governments to increase their fiscal base and pursue regional growth", page 168.

7 Draft Finding 4.2 "HFE is unlikely to discourage – nor encourage – States from pursuing growth strategies or addressing their structural disadvantages given the broader and more significant benefits of doing so to the community", page 106.

8 "Some inquiry participants argued that the GST effects of tax reform have no influence at all on State behaviour; others suggested that the effects can be pervasive and accumulate over time … Neither extreme seems plausible", page 100.

9 Productivity Commission (2014), *Geographic Labour Mobility*, page 6.

10 *Ibid*., page 8.

Combined with the short-circuiting of development opportunities, this has consequences for Australia's long-term population distribution and is likely to decrease economic growth.

Cost Equalisation

The Draft Report has flagged some concerns with cost equalisation as a potential source of inefficiency for State governments.[11]

We discuss this in Chapter 3. However, the Productivity Commission should note that recognition of cost differences cannot be entirely removed from equalisation without impairing its efficiency.

As noted by Pincus, if cost allowances for services are removed, costs in the economy need to be recognised in the assessment of revenue capacity:

> …the CGC assumes that, for any given type of wage worker, a higher wage fully represents a higher capacity for tax purposes. But, if the theory of spatial equilibrium has empirical heft, then this is wrong. By imposing a higher burden on the residents of the state with higher nominal wages but not higher real wages for similar people and jobs, the Commission's approach to fiscal equalisation offends the principle of horizontal fiscal equity and distorts the pattern of settlement.[12]

Implementing Reasonable HFE

Appropriate HFE Outcomes

As per Draft Finding 8.5, HFE can be designed to give a range of outcomes. The extent to which an option meets the equity rationale depends on the intended level of equalisation. However, as noted above, a fully reliable assessment will never be achieved.

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[11] See pages 105, 136, 170.

[12] Jonathan Pincus (2011), *Examining Horizontal Fiscal Equalisation in Australia*, Research Paper No. 2011-25, The University of Adelaide School of Economics.

The Productivity Commission has asked what level of fiscal capacity is consistent with 'reasonable' HFE. As examples, it lists three options:

- fiscal capacity of the second strongest State;
- average of the 'donor' States; or
- average fiscal capacity.[13]

All of these help eliminate unjustifiably extreme outcomes and budget management difficulties for outlier donor States.

If GST time lags are not removed, then efficient budget management for States with volatile revenues requires that GST relativities should have longer-term stability and not be affected by economic cycles.

There is a strong case for equalising to average fiscal capacity. This option has the following advantages:

- it minimises disincentives for donor States to grow their economies as each donor State's relativity is relatively unresponsive to changes in its fiscal circumstances. This is superior to the other options, where the incentive impacts are unequal across donor States. For example, under equalisation to the second strongest State there is only one State that has an unresponsive relativity;
- it improves budget management for donor States because of the improved longer-term stability in their GST relativities; and
- it avoids large grant changes when marginal recipient States become marginal donor States, or vice versa.

Transition Arrangements

The Productivity Commission has also asked how to transition to a new HFE objective. The Commission asks if, for example, implementation of a new objective could be considered via the CGC's 2020 Methodology Review.

[13] This option is characterised among other things by States that are donors under the current arrangements all having the same relativity under the new arrangements.

The Draft Report acknowledges that the current system "is now under significant strain" and that "the current HFE system goes too far in the pursuit of equalisation". The justifications to fix the system to avoid such results in the future equally apply in the present.

We agree that the new objective should be reflected in the CGC's annual Update and Method Review terms of reference (Draft Recommendation 2.1). As the CGC process is the subject of the reform, the key elements of the reform should be determined outside the CGC process. The CGC's role should be one of implementation rather than interpretation.

As such, reasonable HFE consistent with Draft Recommendation 2.1 should at least begin to be implemented in the 2018-19 grant year.

Two examples of transition options are as follows, illustrated in Tables 2.2 and 2.3.

1. The Commonwealth Government could introduce a relativity floor that is increased each year until it gives a result consistent with reasonable HFE. The Commonwealth could initially fund the transition.

   A three-year transition could be achieved by setting a relativity floor at 60% in 2018-19, rising to 80% in 2019-20, and fully implementing HFE to average fiscal capacity in 2020-21 (involving an estimated minimum relativity from 2020-21 of 89%).

   The portion of the floor that is funded by the Commonwealth Government could transition from 100% in 2018-19 to 50% in 2019-20 and 0% in 2020-21 (at which stage, the new approach would be totally funded from the GST grant pool).

   While Draft Finding 7.2 rejects the use of a fixed floor (as opposed to the Commission's proposed floating floor) on the basis that it is a band-aid solution, rising floors are nonetheless an appropriate transition mechanism.

2. A nine-year transition could be achieved by setting relativities at a weighted average of 'full HFE' and 'average fiscal capacity', with the weight for 'average fiscal capacity' commencing at 20% in 2018-19 and rising by 10% increments to 100% in 2026-27.

   The Commonwealth Government could fund 100% of the transition costs up to 2020-21, thereafter declining to 67% in 2021-22, 33% in 2022-23 and 0% from 2023-24.

Under this option, no State would be worse off during the current forward estimates period.

Table 2.2 – Impact of Relativity Floor Transition ($m)

	Floor	Cwth Funding %	NSW	Vic	Qld	WA	SA	Tas	NT	ACT	Cwth
2018-19	60%	100%	-	-	-	+1,114	-	-	-	-	-1,114
2019-20	80%	50%	-309	-251	-193	+1,729	-67	-20	-9	-16	-864
2020-21	89%	0%	+1,209	-817	-1,547	+2,050	-533	-158	-75	-128	-
2021-22	89%	0%	+1,366	-157	-1,710	+1,486	-587	-173	-83	-142	-
2022-23	89%	0%	+1,601	-20	-1,764	+1,192	-602	-177	-84	-146	-
2023-24	89%	0%	+1,802	+142	-1,817	+908	-618	-180	-86	-150	-
2024-25	89%	0%	+1,951	+287	-1,888	+719	-639	-185	-89	-156	-
2025-26	89%	0%	+2,173	+458	-1,976	+458	-665	-192	-92	-163	-
2026-27	89%	0%	+2,344	+601	-2,075	+292	-695	-200	-96	-171	-

Source: Western Australian Treasury estimates.

Note: Parameters are consistent with the Western Australian 2017-18 Budget. Results are increasingly speculative from 2023-24 onwards and depend on an assumption of only moderate long-term growth in iron ore royalties.

Table 2.3 – Impact of Phase-in to Average Fiscal Capacity ($m)

	Phase in	Cwth Funding %	NSW	Vic	Qld	WA	SA	Tas	NT	ACT	Cwth
2018-19	20%	100%	+168	-	-	+629	-	-	-	-	-797
2019-20	30%	100%	+339	-	-	+717	-	-	-	-	-1,056
2020-21	40%	100%	+483	-	-	+820	-	-	-	-	-1,303
2021-22	50%	67%	+683	-26	-285	+743	-98	-29	-14	-24	-950
2022-23	60%	33%	+961	-8	-705	+715	-241	-71	-34	-58	-559
2023-24	70%	0%	+1,261	+100	-1,272	+636	-432	-126	-60	-105	-
2024-25	80%	0%	+1,561	+230	-1,511	+575	-511	-148	-71	-125	-
2025-26	90%	0%	+1,956	+413	-1,779	+412	-599	-173	-83	-147	-
2026-27	100%	0%	+2,344	+601	-2,075	+292	-695	-200	-96	-171	-

Source: Western Australian Treasury estimates.

Note: Parameters are consistent with the Western Australian 2017-18 Budget. Results are increasingly speculative from 2023-24 onwards and depend on an assumption of only moderate long-term growth in iron ore royalties.

Role of the Commonwealth

As noted by the Productivity Commission in its draft report, the Commonwealth needs to take a leadership role and commit to achieving HFE reform. The Commonwealth should therefore, as soon as possible, direct the CGC to implement reasonable HFE via equalisation to the average fiscal capacity, and with agreed transition arrangements.

As noted later, it is not appropriate for the CGC to be determining the HFE objective, the principles on which it should be achieved, or the transition.

The following recommendation reflects this position and also incorporates the Productivity Commission's views (Draft Finding 2.1) on the appropriate equity, efficiency and transparency goals of HFE, which we support and discuss in further chapters.

Recommendation 1

The Commonwealth Government should direct the CGC that its HFE objective is to ensure States have the fiscal capacity to provide a reasonable level of services, rather than the same level of services, determined by equalisation to the average fiscal capacity of all States and Territories.

Reasonable equalisation should be pursued to the greatest extent possible consistent with not unduly influencing States' policy choices, not unduly hindering the efficient movement of labour and capital between States, and using transparent methods and reliable evidence.

Alternative Approaches

Draft Finding 8.2 rejects an equal per capita distribution of the GST grant pool, on the argument that it does not achieve HFE. We recognise that equity requires some form of additional funding for the fiscally weakest States, which is why we support top-up funding from the Commonwealth in conjunction with an equal per capita GST distribution.

We also accept, consistent with Draft Finding 8.3, that such an arrangement would work best with broader reform of Commonwealth-State relations. We support such broader reforms, and fully support Draft Recommendation 9.3, which calls for reform of the interaction between general and specific purpose payments, and better delineation of responsibilities.

Draft Finding 8.4 rejects the use of actual per capita spending and revenue to determine fiscal capacity. As a general rule, we agree with this finding, as this would give States greater scope to alter their assessments through policy changes. However, we note that there are some circumstances where the use of actual per capita spending and revenue is appropriate.

- For example, the CGC currently assesses spending on native title by an actual per capita approach. This is justified because all States work within the same policy framework set by Commonwealth legislation, and because more general indicators of spending need (such as number of indigenous persons by State) would not capture the actual differences in spending need (which depend upon the relationship of the indigenous population to the land).
- As such, Draft Finding 8.4 should not be interpreted as a blanket prohibition of actual per capita assessments.

3. Methodology Changes to the Current System

Key Points

- The current HFE methodology is overly complex, risks spurious accuracy and fails to meet policy neutrality and therefore its HFE objective.
- Simpler revenue assessments based on broad indicators, or aggregated revenue bases, are ideal for achieving simplification and addressing the shortcomings of the current methodologies.
- Reform of spending assessments should also be considered.
  - However, efficiency 'cost benchmarks' should be avoided unless the revenue assessments are made much more conservative, and if applied, should also apply to socio-economic disadvantage.
- Policy neutrality of revenues must be drastically improved. Mining is a major support to the Australian economy, but the mining assessment is far more sensitive to State policy changes than other assessments. Policy neutrality for mining should be no less than for other sectors.
  - Discounting the revenue base would improve policy neutrality and consistency in the implementation of HFE.
  - Alternatively, in the absence of a higher-level aggregated revenue assessment, mining itself could be assessed on an aggregated basis using a conservative fixed royalty rate.
- The time lags in the GST distribution create genuine budget management difficulties and those States which experience greater impacts from time lags are at a disadvantage relative to other States.
  - For Western Australia, this would be adequately resolved by the Draft Report's proposal to equalise to the average fiscal capacity.
- Most recurrent Commonwealth tied grants are not distributed equitably and should be equalised, but infrastructure grants could justifiably be partially or fully quarantined from the HFE system.

Regardless of whether the HFE objective is reformed as recommended in the preceding chapter, there is a need to improve the transparency and policy neutrality of the CGC's assessments. There is also a need to review how HFE deals with spending areas where reliable equalisation is difficult or impossible to achieve. Reforms here can usefully complement a new HFE objective.

Simplified Revenue Assessments

Western Australia agrees that the CGC should be asked to consider approaches that deliver significant simplification of its methods (Draft Recommendation 7.1).

There is a spectrum of options. This section considers the following options.

- Global revenue base indicator.
- Aggregating all revenue categories.

Global Revenue Base Indicator

As noted in our previous submission to this inquiry and in submissions to the CGC in its Methodology Reviews, of the available options, a global revenue base measure that encompasses all taxes and onshore mining royalties provides the greatest improvement to policy neutrality.

Draft Finding 7.3 suggests broader indicators risk loss of accuracy and may not achieve a 'reasonable' level of equalisation.

However, as discussed in Chapter 2 of this submission, the current methods are not accurate, or even consistent with the HFE objective. The lack of policy neutrality, particularly in the revenue assessments, clearly conflicts with the objective of equalising on the basis of 'same effort'.

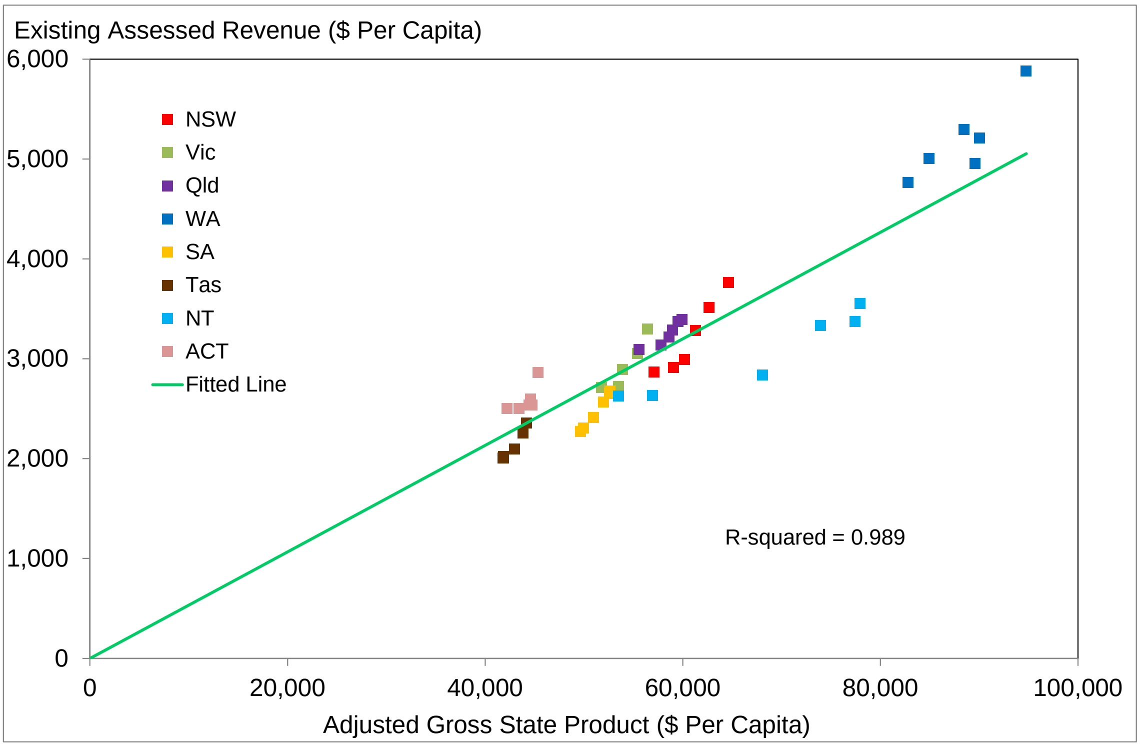
The Draft Report has provided some analysis on the use of Gross State Product (GSP) and Gross Disposable Income (GDI) as broad measures of revenue raising capacity, suggesting these approaches would lead to large HFE movements among States and not appropriately measure the revenue raising capacity of the States.

Western Australia agrees that broad indicators need to reflect States' fiscal capacities. Hence, a revenue base that is based on GSP needs adjustments to ensure the measure is suitably reflective of States' revenue raising capacities.

For example, we have proposed to the CGC a GSP measure that excludes half of general government final consumption expenditure and an estimate of total offshore mining gross operating surplus / gross mixed income. These two adjustments would account for a significant portion of GSP that does not contribute to States' underlying revenue raising capacities (particularly for the Northern Territory, which has a relatively high government presence, and Western Australia, which has a large share of offshore economic activity).

This measure gives a very good fit to the CGC's existing assessments of revenue capacity (R-squared of 0.989 for the data years 2010-11 to 2015-16).

Chart 3.1: Adjusted GSP Compared to the CGC's Existing Revenue Assessments



Source: Calculated by Western Australian Treasury.

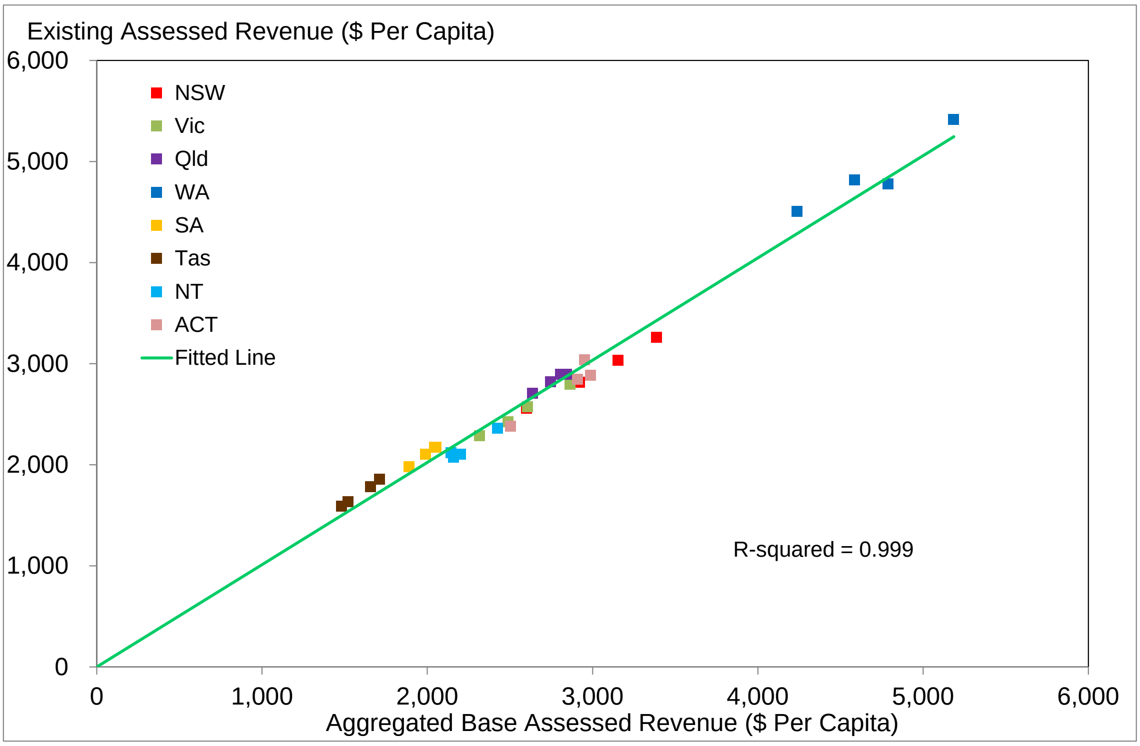
Aggregating All Revenue Categories

In response to the CGC's concerns that a broad GSP revenue measure may not be clearly reflective of what States do, we have also proposed aggregating the existing revenue bases that the CGC currently assesses.

This measure would be the sum of individual revenue bases, which include all taxes that are currently assessed differentially and all onshore mining royalties. Adjustments to some of the revenue bases would be required, but this would be straightforward. For example, the assessed revenue base for motor taxes, currently the number of vehicles, would need to be converted to a dollar value. Furthermore, as land values and vehicle values are stocks, rather than flows, annual tax rates on these bases would need to be reduced to ensure they are not as high as one-off taxes on flows such as wages, property transfers and mineral production.

This measure also provides a similarly appropriate fit to the existing assessments (R-squared of 0.999 for the data years 2012-13 to 2015-16).

Chart 3.2: Aggregated Revenue Bases Compared to the CGC's Existing Revenue Assessments



Source: Calculated by Western Australian Treasury.

Analysis of Simplified Revenue Measures

Both the GSP-based and aggregated tax base measures warrant serious consideration, as they exhibit genuine simplification, remove the sensitivity of the mining revenue assessments to royalty rates and remove disincentives to alter the tax mix (except where a tax is abolished nationally).

- A broad GSP-based measure has the added advantage that the revenue base is not sensitive to State compliance efforts, but the aggregated tax base measure more closely reflects what States actually do.
- The GST impacts among States (summarised in the table below) are modest compared to the analysis provided in Table 7.3 in the Draft Report.

Table 3.1: GST impact for Simplified Revenue Measures for 2015-16 Data Year

	NSW $m	Vic $m	Qld $m	WA $m	SA $m	Tas $m	ACT $m	NT $m
Adjusted GSP Measure								
2015-16	+368	+332	-230	+339	-594	-92	+102	-225
Aggregated Revenue Bases Measure								
2015-16	-984	-427	+422	+696	+222	+75	-24	+21

Recommendation 2

The Commonwealth Government should direct the CGC to implement simpler and more aggregated revenue assessments. Options include:

- *global revenue base indicators; and*
- *aggregating all revenue categories.*

Simplified Spending Assessments

Reform of spending assessments should be considered.

For a number of spending areas the distinction between the influence of policy and disabilities is hard to delineate. State government policies can significantly impact the spending requirements for public transport, urban roads, housing, services to industry and services to communities. Many such policies may impede or promote economic development. As such they are difficult to assess on a policy neutral basis.

These spending areas, and an equivalent amount of revenues, could be removed from the HFE assessments. Revenues would be excluded by reducing the revenue from each tax and royalty by the same proportion.

- This would improve policy neutrality on the expense side and therefore would improve efficiency and reduce disincentives for States to improve service delivery in certain areas.
- Revenue policy neutrality would also be improved.
- Arguably there is no loss in accuracy as the current accuracy of these assessments is questionable.

Another potential reform worth consideration is adopting broader assessments of State services that are relatively homogeneous among States such as health, education, welfare and justice services. These could conceivably be assessed using relevant broad indicators.

Clearly, loadings for structural disadvantages such as indigeneity, population characteristics (e.g. age) and remoteness would continue to be necessary, but these could be applied at a broad level, rather than using the detailed disability assessments that currently exist. The idea is not to introduce conservatism in the assessments, but more clearly identify the key cost drivers and hence improve the assessments.

In this regard, the spending assessments are currently far more conservative and policy neutral than the revenue assessments. On the expenditure side, discounts are used, factors are not assessed where sufficient data is unavailable, and the assessments are based on a rigorous policy neutral approach and policy neutral data.

The Productivity Commission's suggested cost benchmark for efficient service delivery would not address the expenditure/revenue assessment imbalance, and would worsen it unless major changes were made to the revenue assessments to make them more conservative. Moreover, cost benchmarks that were not also applied to socio-economic disadvantage would distort the expenditure assessments in favour of less policy neutral elements.

Recommendation 3

The Commonwealth Government should direct the CGC to reform its spending assessments. Options include:

- *simplification and more clearly identifying underlying drivers of cost; and*
- *removing some spending areas where a policy neutral assessment is impossible, and an equal amount of revenue, from the HFE assessments.*

Efficiency cost benchmarks should be avoided unless the revenue assessments are made much more conservative, and if applied, should also apply to socio-economic disadvantage as well.

Mining and Discounting

HFE has more than just the *potential* to distort State mining and resources policy (Draft Finding 4.3). There is evidence of this actually occurring. For example, GST losses have been a factor in recent debates in Western Australia over proposed royalty rate changes for iron ore and gold.[14] For an outlier with high mining revenues like Western Australia, the current assessment distorts decision making and influences State policy.

We agree that HFE should not be reformed to explicitly add incentives for resource exploration (Draft Finding 4.3). However, it is essential that current disincentives for economic development be addressed.

We disagree that a discount would be inequitable and argue that discounting the mining revenue assessments is essential for improving policy neutrality and the consistency of HFE.

The CGC claims to discount where data are not fully fit-for-purpose. The lack of policy neutrality of actual revenue data means that such data is not fit-for-purpose, and thus a discount would be appropriate.

[14] http://www.abc.net.au/news/2017-09-12/gold-royalty-rate-rise-sends-more-money-east-gst/8904180
https://thewest.com.au/news/wa/gold-miners-warn-on-royalties-ng-b88579636z
http://www.theaustralian.com.au/news/wa-would-be-better-off-without-royalties-minerals-council/news-story/393335e19340add1bdd12b9b73e4d822

The Draft Report has indicated acceptance of the CGC's use of discounting to address data quality issues. Applying a discount to revenues would address the uncertainty in how State policies influence State economies and revenue bases, and improve consistency in the implementation of HFE.

Reasons for Discounting the Mining Assessment

There are a number of reasons for discounting the mining revenue assessments if the aim is 'full equalisation' (some of which also justify discounting all revenues). These reasons are set out below.

Notably, the Draft Report's proposal to equalise to the average fiscal capacity, if adopted, would largely address many of these issues for the donor States.

CGC Assessments Are Highly Sensitive to Changes in Royalty Rates

Changes in tax rates generally have little impact on the CGC's tax assessments, but changes in royalty rates can have very large impacts on the mining revenue assessments when a State dominates the revenue base. For example, about 88% of the revenue from an increase in Western Australia's iron ore royalty rate would be offset by a loss of GST revenue. Even if all onshore mining were aggregated into a single assessment, Western Australia would still lose about 40-50% of any royalty rate increase.

Hence, there is an incentive to raise tax rates rather than royalty rates. This incentive can be reduced by discounting. (An alternative is a global revenue base indicator or aggregating revenue bases.)

Observed Revenue Bases Are Not Policy Neutral

States have put in differing efforts to develop their mining industries, including through the regulatory environment, infrastructure policy and investment, and other assistance. Hence, data on actual mining production is not 'fit-for-purpose' if the objective is policy-neutral assessments of mining royalties.

While the distribution of natural resource endowments is not policy influenced, these endowments have to be identified and developed. As Geoscience Australia has noted, Australia's resource endowments are still poorly understood.[15]

15 http://www.ga.gov.au/scientific-topics/minerals/unlocking-resource-potential

Intergenerational Risk

Intergenerational risk arises in the following ways.

- Equalisation of royalties has led to mining revenues being treated as a revenue source on par with other taxes. However, States should be able to invest the proceeds from their finite resource royalties for the benefit of future generations. This is not the result when States lose their royalty income. States that receive royalties from other States do not see it as coming from a finite resource and have no incentive to invest these for the future.

- While the current HFE system redistributes Western Australia's high royalties, there is no guarantee that HFE will exist in the future to support Western Australia when its royalties are gone and other States exploit their mineral reserves.

Equalisation of Mining Revenues is a Disincentive to Mining Development

The HFE process equalises mining-related revenue, but it does not equalise all mining-related expenditure.

Mining development can involve significant costs in terms of infrastructure provision, community opposition, environmental impacts and forgone alternative land uses. Gaps in the CGC's recognition of mining-related expenditures include:

- common user infrastructure investments in 'frontier' development regions (that cannot realistically be fully cost-recovered);

- improving the amenity of cities and availability of residential land in remote areas to reduce long-term labour costs;

- FIFO-related health, welfare and justice costs;

- differences in labour cost pressures in remote areas across different States; and

- the challenges of delivering growth infrastructure for general government services efficiently across the State in a high growth, but volatile and uncertain, economic and population growth environment.

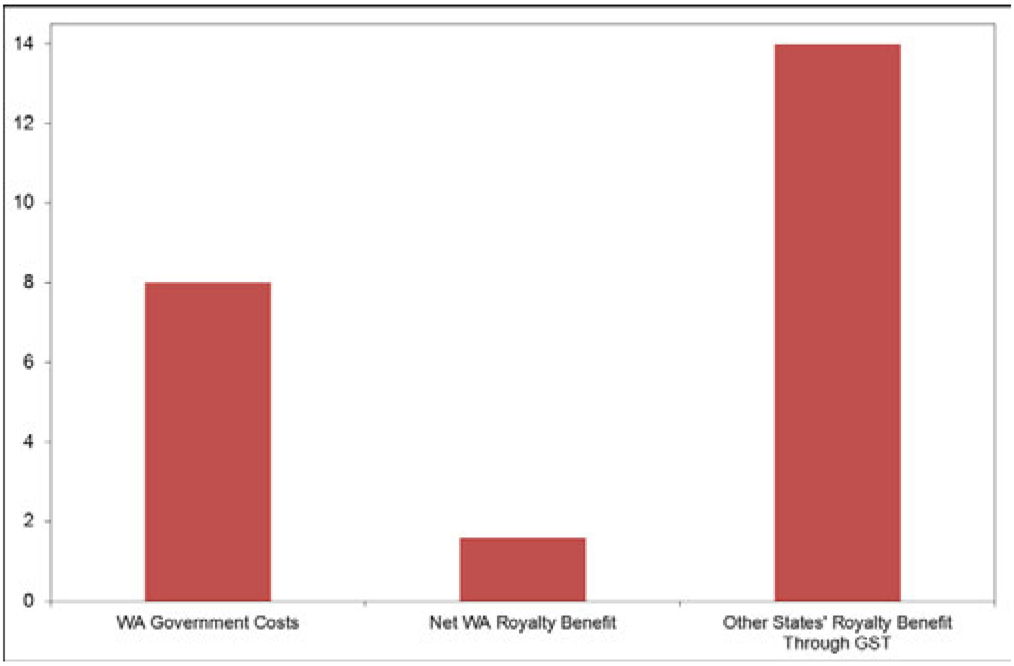
Historically, Western Australia has been significantly disadvantaged by deficiencies in the CGC's assessments.

- An assessment for infrastructure growth pressures (worth hundreds of millions of dollars per annum to Western Australia) was not put in place until 2010.

- Western Australia provided an estimated $8 billion in present value terms of subsidies and net infrastructure assistance for the North West Shelf project (excluding flow-on infrastructure expenditure from economic and population growth such as schools, roads, etc) which has not been recognised by the CGC. Granting the CGC's view that it is impossible to know how the world would have looked if Western Australia had not made these commitments, States do not have the luxury to forgo opportunities on this basis. The CGC has been supplied with ample evidence of the reasonableness of Western Australia's provision of support to the project so that it would go ahead in the face of caution by overseas gas buyers and project financiers.

  - The aggregate net royalty return to Western Australia to 2015-16 is around $1.6 billion (in net present value terms). Other States (who shared none of the costs or risks) effectively received the remaining royalty stream of around $14 billion courtesy of HFE.

Chart 3.3: Costs and Royalties from the Start of the North West Shelf Project to 2015-16 (2010-11 Net Present Value Terms)



Source: Calculated by Western Australian Treasury.

Note: Costs do not include flow-on infrastructure demands from economic and population growth such as schools and roads.

Unequal treatment of revenue and development expenditure may apply to other areas of economic activity. The issues are, however, most significant for mining due to the disparity of mining activity across States.

To accommodate all areas of economic activity, a discount could be applied across all revenues, similar to the proposal in the previous section to exclude development-sensitive expenditure areas and associated revenues from HFE.

Response to the Productivity Commission's Objections to Discounting

The Draft Report raises several objections to a permanent discounting factor (page 147).

"Mining Revenue is a Prime Example of a Source-based Advantage and Should Be Included in the Equalisation Process"

- We agree, but it has to be done fairly. The literature on HFE generally takes a very simplistic approach in analysing the efficiency of resource allocation. The computable general equilibrium (CGE) models of HFE impacts are usually eternal, and mining royalties are essentially treated as a location-based windfall.
- In the real world, minerals are a limited resource, so intergenerational issues such as those discussed above must be considered. Exhaustion or devaluation of minerals creates adjustment costs.[16]
- In the real world, mining has development costs and negative impacts. It also has economic volatility costs (for communities and governments alike).
- Discounts do not need to be towards an equal per capita distribution, they could be partly towards a land area distribution.[17]

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[16] There is a view that Western Australia's iron ore resources are large enough that exhaustion is unlikely in the foreseeable future. However iron ore is not a homogeneous product and changes in customer preferences (for different types of ore), the level of overall demand, technological change and the development of competing products (e.g. other iron ore mines or scrap) all have the potential to impact on the economically recoverable reserves in Western Australia.

[17] Discounting to land area means that the assessment would be a weighted average of value of production and land area shares (with the discount rate determining the weights). Discounting to equal per capita involves a weighted average of value of production and population shares.

"[A Mining Discount] Would Open Up the Prospect of Other Discounts in a Range of Areas"

- Discounts are already a feature of HFE, sometimes explicit (e.g. the discount applied to wage assessments), but often disguised (e.g. non-assessment of a cost disability, or assessment using a conservative approach).
- An alternative to individual discounts would be a generic discount that could take several forms, including a discount to all revenues, a discount to GST relativities, or a discount to the redistribution of State revenues (benchmarked against what they would be if the GST were distributed on an equal per capita basis).
  - As noted above, discounts do potentially create winners and losers, but so does not discounting.

"Permanent Discounts Should Also Not Be Introduced… Where Jurisdictions Have Managed the Fiscal Returns of Buoyant Conditions in a Less Than Ideal Way Over Time"

- We do not argue for a discount on this basis.

Alternative Approach to Mining Assessments

A global or aggregated revenue assessment offers the best opportunity to achieve policy neutrality in the mining assessments with respect to royalty rate policies (although this does not address the lack of policy neutrality of the mining revenue base).

In the absence of a global assessment, the sensitivity to royalty rate changes could be reduced in other ways.

The CGC has acknowledged this problem and suggested limiting the GST impact of future State royalty rate increases to 50%. However, this threshold is far higher than the maximum 10% redistribution in relation to tax rate changes. It is also asymmetric with respect to past and future rate increases, and it raises questions about what threshold (if any) should apply if rates are reduced. As a proposal, it is a good first step, but more needs to be done.

An approach that is more generally consistent with HFE would be aggregating all minerals into a single mining revenue category. Such an aggregation is not intrinsically unreasonable, as the current mineral-by-mineral assessment already often compares minerals of different royalty capacity across States.

- For example, Western Australia dominates iron ore production with 98.5% of the national value of production, and ultimately determines the national royalty rate. However, this means that other iron ore-producing States are assessed at the Western Australian rate, regardless of their ability to sustain that rate. Similarly, all coal is assessed as having the capacity to sustain the average rate across all open cut and underground operations.

- Aggregating across all minerals arguably will not increase these problems of differences in capacity, and has the advantage of reducing the dominant States' influence on the national average royalty rate for particular minerals.

However, this would still result in a GST grant impact of around 40% of revenues from a royalty rate change in Western Australia. This is four times the maximum impact for any State for any tax assessment. If policy neutrality is to be seriously addressed, the HFE process should aim for no more than a 10% impact.

One way of achieving this would be to choose and apply a fixed notional national royalty rate to the aggregated production base, that could in practice be applied to most minerals (i.e. including those with both high and low profits). Such a rate would be below the national average royalty rate. This would ensure that States could not affect the national rate through an increase in royalty rate or increase in production, leading to greater stability and policy neutrality in the mining assessment.

Recommendation 4

The Commonwealth Government should direct the CGC to:

- *use discounts to ensure States have a sufficient incentive to expand mineral production; and*

- *in the absence of high-level revenue assessments, apply an aggregated assessment of mining with a fixed notional national royalty rate that is below the actual national royalty rate.*

Contemporaneity

The draft report has understated the problems with the lack of contemporaneity in the HFE system.

Draft Finding 5.1 correctly notes that there are key features of the HFE system that detract from its contemporaneity and that can exacerbate the fiscal impact of economic cycles when States experience large economic shocks. This is not just a hypothetical scenario – Western Australia has had to deal with this first hand. It is a real problem.

The lack of contemporaneity currently disguises the real GST grants and underlying budget position of all States which, in turn, distorts policy decisions.

Draft Finding 5.1 also states that 'offsetting cyclical factors is not the primary objective of HFE'. However, fiscal equity *is* the primary objective of HFE. Overall State revenue volatility has severe fiscal impacts on a State, in particular due to the uncertainty this creates for budget management, which in turn results in suboptimal decisions and a reduced ability to plan for the future. It is not fiscally equitable to have one jurisdiction bear all the volatility of a revenue source, and in effect have to budget on a more conservative basis, when other States share the funding from that revenue source. A system that aims for equity must not institutionalise inequity.

The Draft Report's suggestion for equalisation to the average State fiscal capacity would help to stabilise Western Australia's GST relativity in the longer term, and hence help to address the contemporaneity problem for Western Australia.

Treatment of Commonwealth Payments

In principle, we agree that the Commonwealth needs to develop clear guidelines detailing the basis on which Commonwealth payments are to be quarantined from HFE (Draft Recommendation 7.2).

However, in practice, there are difficulties with this approach as the Commonwealth is unlikely to hold itself to overly prescriptive guidelines. In addition, it is unlikely that a prescriptive set of guidelines could accommodate the many circumstances in which Commonwealth grants are provided.

It is appropriate for most recurrent Commonwealth payments to be equalised as they are often not equitably distributed, the reasons for departing from equity are often not obvious, and, as all States receive these payments, equalisation usually has only a moderate impact.

There is a stronger case for infrastructure payments to be partly or fully quarantined, as they are project-specific and the public would generally question the logic of making a payment for a project, but then equalising the payment. In addition, infrastructure spending needs across States are lumpy and reflect different cycles across States.

Recommendation 5

The Commonwealth Government should issue clear guidelines to the CGC on how Commonwealth payments should be treated for the purposes of HFE. Recurrent grants should be equalised, but infrastructure payments should be partly or fully quarantined.

4. Institutional Reforms

Key Points

- The CGC should provide a strong, neutral voice on matters related to HFE. Unfortunately, the CGC tends to defend the current HFE process, rather than objectively assessing its process in a neutral fashion.
- The CGC has too much scope for normative judgements, without recourse from the States.
  - This reduces transparency and increases inconsistency.
- The CGC should be responsible for implementation, not policy. Policy decisions should be made collectively by governments or, if this is not possible, by the Commonwealth Treasurer, and prior to implementation.
- The CGC's reports currently fail to properly document all of the data and evidence used, and frequently do not respond to State arguments.
  - The CGC's 2015 Review Final Report gave no serious response to many of Western Australia's arguments, and in some cases did not even acknowledge that the arguments were made.
  - To date, this has not improved in the 2020 Review.
- A close look at the CGC's methods suggests inconsistencies of approach. However, the CGC has appeared reluctant to address these matters.
- The CGC's assessments should be based on data that can be shared among State Treasuries.
  - If this is not possible, the CGC should undertake and publish greater quality assurance including State-by-State analysis of national data collections;
- The CGC should provide draft rulings on HFE impacts of policy changes.
- The Commonwealth Government should take on a much greater leadership role, including in clearly specifying the objective of HFE.

Accountability

We agree, in principle, that the CGC should provide a strong neutral voice in discussions on the HFE system (Draft Recommendation 9.1).

However, the CGC does not presently conduct itself in a 'neutral' fashion. The CGC tends to defend the existing HFE process, instead of providing an objective assessment of its processes and methods. Its decision-making and reporting processes lack accountability.

What is HFE?

As noted in Chapter 2, there is no operational definition of the HFE principle, yet HFE has primacy over the supporting principles, which are themselves vaguely defined and (as interpreted by the CGC) often conflicting.

The problems this creates for accountability are legion.

The CGC has, in effect, large scope to make normative judgements. The CGC adjudicates among competing principles without criteria and the States have no effective recourse. For example, policy neutrality is central to a GST distribution that reflects States applying the same effort, and yet the CGC regards this as a 'subsidiary principle' weighing it against another of its subsidiary principles 'what States do' (which is defined in a very narrow way).

Western Australia agrees that judgements on what constitutes the best equalisation outcome must continue to be made. However, policy judgements should be made by governments, while the CGC should make judgements about technical implementation. At the very least the CGC should be making it clear what operational definition of HFE it is delivering. The CGC has not done this, either in past Reviews or in its recently released principles paper for the 2020 Review.

Transparent Implementation of HFE

The CGC's implementation decisions often suggest a lack of systematic approach, or at least a lack of systematic reporting.

The current implementation of discounting shows no obvious consistency.

The CGC also has materiality guidelines which are implemented under a mix of conventions that often seem to result in different treatments for issues (such as whether an adjustment or a more detailed assessment is made) that should be treated similarly. The underlying problem is that the CGC has sought to implement and increase materiality thresholds without changing the very detailed and narrow 'what States do' perspective it has historically used. The outcomes are therefore arbitrary and ultimately inequitable.

The CGC's implementation guidelines lack clarity. For example, the version proposed in the CGC's recent position paper on HFE principles indicates that "Separate assessments will be made when they are materially different from other assessments or if the assessment is easier to understand". This means there is no systematic requirement to test materiality.

The CGC currently reports its decisions and reasoning at a high level that often gives little insight into whether it has understood and taken into account all the information and reasoned arguments put to it, and how it has balanced these.

It is difficult to tell to what extent this is a reporting issue as opposed to an issue with the CGC's analytical processes. However, it is possible that erosion in reporting standards, and the simultaneous erosion in the general level of HFE expertise across States, is reducing pressure on the CGC and leading to erosion in analytical standards.

The CGC does not provide information on the weaknesses of its decisions or alternative views that might reasonably be taken.

Following are some examples of Western Australian arguments to which the CGC 2015 Review Final Report either did not acknowledge or respond to.

- *Discounting* – Selective discounting of 'unreliable' factors risks biased HFE outcomes (hence the CGC should discount all unreliable factors).

- *Materiality* – Using materiality thresholds to eliminate sub-components of particular disability assessments (e.g. public hospital age groups) raises implementation and consistency issues.

- *Mining Revenue* – Current revenues should be adjusted for the cost of reasonably justifiable past State initiatives such as assistance to the North West Shelf project, regardless of whether the actual impact on revenues can be determined.

- *Private Sector Impact on Health Services* – Multiple conceptual and data reasons why the CGC's proposed new assessment will not work. The CGC supported its new methodology that took $200 million per annum from Western Australia with virtually no reference to Western Australia's arguments.
- *Roads* – Discounting National Network Roads for national interests, while not recognising national interest issues in other State activities, is selective.
- *Economic Development* – A practical policy-neutral way of assessing this.
- *Remote Area Costs* – Rental data shows different staff accommodation costs across different States in remote areas.

The CGC also did not provide full transparency on its positions of not addressing contemporaneity by highlighting Western Australia's $7 billion gain from GST time lags, but not Western Australia's multi-billion loss from infrastructure growth needs before 2010.

With respect to the 2020 Review, the CGC's principles position paper[18] has not acknowledged or addressed any of the arguments raised by Western Australia in relation to discounting or materiality.

Data Availability

We agree that the CGC needs to make available State-provided data, and calculations on these data (Draft Recommendation 9.2). This should apply to all data, including from Commonwealth sources. Where it is not practicable to supply data, and the CGC cannot avoid the problem by using alternative methods, the CGC needs to undertake greater quality assurance.

The methods currently used by the CGC are complex, often rely on very specific data collections, and require copious judgement. Although the CGC's assessments are set out in over two hundred spreadsheets, they are marred by confidentiality requirements (e.g. natural disasters) and often by the CGC's provision of derived data, rather than the underlying data (e.g. heavy vehicle weights for roads).

[18] Commonwealth Grants Commission (2017), *2020 Review: The Principle of HFE and Its Implementation,* Commission Position Paper CGC 2017-2.

For example, in the 2015 Review a more considered approach would have been desirable for the urban transport assessments. These were proposed to be assessed using a curve fitted to data on the population size of urban centres and States' data on net urban operating expenses. Not all States could provide open access to their data. This made it very difficult to independently assess the quality of the proposed approach.

The CGC makes use of some large databases (e.g. for health and schools) without documenting data quality issues or providing analysis that could aid in understanding the quality of the database (e.g. national regression analyses and national segmentation are done, but not on a State-by-State basis).

In addition to the CGC making data more available, if a State is presenting evidence, then the onus should be on that State to provide it to other States so it can be reviewed, or to find another way to pursue its case that does not rely on confidential data.

The CGC's Consultations with Governments

We agree that the CGC should enhance its formal interactions with the State and Commonwealth Governments (Draft Recommendation 9.1).

It also needs to enhance its working relationship with governments, including provision of draft rulings on the potential HFE implications of a policy change.

Over the course of the 2015 Review, Western Australia considers that the CGC made little attempt to engage genuinely with the States. Interaction was primarily through the formal channels of Commission papers and State submissions. Bilateral visits from staff, while welcome, occurred late in the process, and staff did not always seem aware of the arguments in our previous submissions. This lack of genuine engagement carries a high likelihood of issues being lost, misunderstood or inappropriately prioritised.

In 2016 and early 2017, Western Australia noted an improvement in the level of engagement between CGC staff and the State, including a willingness to meet with Treasury staff to explain their positions in the 2015 Review. This was very welcome.

However, since the 2020 Review formally commenced there has been a reversion to the previous style of consultation. This is characterised by formal meetings between the CGC and all States, but with the CGC staff predominantly informing States what work they have decided to conduct, with limited opportunities for that work to be shaped by State knowledge or insights. The CGC is also engaging private consultants with minimal State consultation on the scope of the work.

Role of the CGC

The CGC's current role involves both interpreting the generic HFE principle (i.e. how it will be implemented) and actually implementing it. This requires a mix of normative (essentially policy) judgements about principles, and judgements about technical implementation.

It is not considered appropriate that issues that are ultimately matters of opinion should be determined by an unelected administrative body. Judgements on principles should be made by governments. The CGC's responsibilities should be limited to decisions that are technically resolvable.

When there is ambiguity in deciding how to implement HFE on a policy neutral and equitable basis, the CGC should seek advice from the Commonwealth Treasurer, who should in turn consult State governments. This would allow alternate views to be considered, and would make the CGC more accountable.

Recommendation 6

The Commonwealth Government should direct the CGC to:

- *take steps to improve its accountability and neutrality, as befits an organisation that governments look to for objective and expert advice on contentious matters;*
- *genuinely engage with States in developing its proposed methods for calculating recommended GST shares;*
- *provide draft rulings on HFE impacts of policy changes; and*
- *ensure that issues, decisions, data and calculations are reported in a fully transparent way.*

The Commonwealth Government should require the CGC to refer matters of policy to governments for decision, while concentrating on technical implementation alone.

Leadership is Required by the Commonwealth Government

We agree with the Draft Report that the "Commonwealth Government should take on a greater leadership role in specifying the [HFE] objective, and reflecting it in the terms of reference it issues to the CGC for its yearly updates and five-yearly methodology reviews" (page 17).

The Commonwealth needs to be accountable for giving the CGC a clear task, so that the CGC can in turn be accountable for its performance in this task.

More generally, the Commonwealth Government needs to show greater leadership when it comes to reform. The importance of this cannot be overstated. Requiring all States and Territories to consent to reform consigns the HFE system to a future of no reform. Where reform is in the national interest, it is the national government that must take responsibility to ensure it is achieved.

Recommendation 7

The Commonwealth Government should take on a leadership role in pursuing needed reforms to the system of HFE and ensure that they are undertaken as quickly as possible.