Government of **Western Australia**
Department of **Treasury**

Western Australia's Submission to the

Commonwealth Grants Commission's 2020 Methodology Review

The Principle of HFE and its Implementation

July 2017

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Executive Summary

Objective and Definition of HFE

Western Australia considers the concept of horizontal fiscal equalisation (HFE) to be generally reasonable and is comfortable with the CGC's current definition of HFE.

We support a system where financial assistance is available to States with (through no fault of their own) weaker fiscal capacities, so that they can provide an acceptable standard of service to their communities.

However, although the CGC acknowledges that it only achieves proximate equalisation, we argue that even proximate HFE is not achieved under the current implementation principles and methods.

CGC's Supporting Principles

The CGC's current application of its supporting principles erodes the objective of HFE.

- Policy neutrality is central to a GST distribution that reflects States applying the same effort, and not having their decisions distorted. It is therefore integral to fairness and efficiency. HFE cannot exist without it. And yet the CGC regards this principle as second order, ignoring it at times.
- The 'what States do' principle is currently interpreted on a very selective basis. This leads to a micro approach, which increases complexity, and generates false precision and bias. Materiality thresholds embed this detailed approach. These issues lead the CGC away from true HFE.
- The practicality principle overrides HFE rather than guiding sensible responses to the CGC's inability to perfectly assess HFE.
- Contemporaneity is not currently achieved due to the use of average historical assessments, and causes significant budget management difficulties particularly for States facing higher volatility in fiscal capacity, as well as reducing public transparency.

Recommended Principles

Western Australia considers the following principles to be fundamental to HFE. To implement HFE, the CGC would need to uphold these principles in all of its assessments.

- **Policy neutrality**
  - GST grants should not be affected by the revenue or spending mix; and
  - GST grants should not be affected by differences in policies across States that have affected or will affect per capita revenue bases and spending needs.
- **Equity**
  - Underlying disabilities should be recognised, rather than their detailed manifestations.
  - Assessments of drivers of differences in spending and revenue requirements between States should be consistent with policy neutrality.
  - Assessments should be relevant to Australian circumstances to broadly reflect State policies and objectives in providing and funding services.

In addition, the following operational principles can help guide the implementation of HFE.

- **Contemporaneity**
  - HFE should be implemented so that GST grants either:
    - are unaffected by cyclical or transient factors, leaving Sidtates fully accountable to manage budget volatility; or
    - reflect current circumstances, spreading (upside and downside) volatility across States as it occurs.
- **Conservatism**
  - A State's fiscal capacity should be presumed to fully or partly reflect its own effort if there is no or partial evidence to the contrary.
  - That is, when the CGC is unsure how much funding should be redistributed away from a State, the CGC should err on the side of caution.
- **Accountability, simplicity and transparency**
  - High level implementation decisions should reflect a consensus view of Governments or decisions of the Commonwealth Treasurer (where consensus cannot be reached). The CGC should be responsible for implementation, not policy.

  - The CGC's methods should undergo regular peer review, which could possibly be made up of a number of independent experts commissioned to conduct reviews.
  - There needs to be full documentation of data and evidence used by the CGC in reaching its conclusions.
  - Methods should be clearly described and simple.

Implementation Approaches

The following approaches would help operationalise the above recommended principles, and could be adopted to complement each other. They also recognise that HFE is difficult to accurately achieve.

- The sensitivity of assessments to individual State tax rates and tax mixes can be minimised through a **global revenue base** assessment.
  - A **rotating standard** would be much less effective, but if the CGC were to aggregate the mining revenue assessment, it would be worth considering as a second best option.
- **Underlying measures of revenue raising capacity**, such as endowments, could be used for revenue base policy neutrality.
  - In the absence of such measures, practical alternatives include **discounting** of revenues and introducing **GST relativity floors**.
- **Contemporaneous assessments** should be implemented.
  - Ad hoc approaches such as advance grants, data year weights, and time lag growth adjustments are not transparently fair and must be avoided.
- The CGC should **discount** towards no redistribution in response to uncertainty (regardless of whether the uncertainty relates to data quality, data relevance or policy impacts). This would acknowledge that HFE is difficult to accurately achieve, and allow the CGC to work with that constraint rather than butt up against it.
- The complex micro implementation methods should be replaced with **simpler and more comprehensive expense assessments**, which are described clearly and easily understood.
- The CGC's **responsibilities should be limited** to decisions that are technically resolvable. When there is ambiguity in deciding on how to implement HFE on a policy neutral and equitable basis, then the CGC should seek advice from the Commonwealth Treasurer, who should in turn consult State governments.

In addition to the above approaches, other recommendations are for:

- a standard 50% discount to be applied to all Commonwealth infrastructure payments to States in order to allow funding to better reflect the Commonwealth's policy intentions while reducing flows based on political considerations;
- the Assessment Guidelines to be applied consistently between the expenditure and revenue assessments. In effect, the CGC treats interstate differences in per capita tax bases as if they were disabilities, but does not formally identify them as such, nor test their suitability in the same way as it does potential disabilities in expenditure categories; and
- improvements in the way the CGC functions, including greater openness to different views, a preparedness to debate and work with stakeholders, a more critical analytic approach, and using consultancies to improve analytics rather than seeking solutions.

1. HFE – Objective and Definition

Key Points

- Western Australia considers the concept of HFE to be generally reasonable and is comfortable with the current definition of HFE.
- However, the CGC's current methods of implementation erode the objective of HFE.
  - In practice, policy neutrality is sometimes ignored despite it being integral to whether States apply the same effort.
  - The CGC is also excessively reliant on a narrow interpretation of the principle of what States do.
- Recommended implementation principles are policy neutrality, equity, contemporaneity, conservatism, and accountability, simplicity and transparency.
- The CGC should consult with State Treasurers, and seek endorsement from the Commonwealth Treasurer on the choice of implementation principles before commencing the implementation phase. In this way, accountability is preserved.

HFE and its Application

Western Australia considers the concept of horizontal fiscal equalisation (HFE) to be generally reasonable. Western Australia supports a system where financial assistance is available to States with (through no fault of their own) weaker fiscal capacities, so that they can provide an acceptable standard of service to their communities. Western Australia is also comfortable with the current definition of HFE.

As such, we agree with the following statements from the principles discussion paper:

- "…the main task of the Commission [is] to identify factors ('disabilities') affecting State finances that are beyond their direct control and which would cause their fiscal capacities to diverge"[1]; and
- "The 2020 Methodology Review terms of reference do not direct the Commission to review the objective or definition of HFE".[2]

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1 Commonwealth Grants Commission, *2020 Review: The Principle of HFE and its Implementation, CGC 2017-02-S*, page 4, paragraph 13.

2 *Ibid*. page 5, paragraph 20.

Implemented correctly, with full policy neutrality, HFE should drive a process that provides a degree of equity to all citizens of Australia, regardless of the State in which they reside, while not undermining fairness and efficiency. However, achieving this goal requires significant change to the determination of States' GST relativities.

Although the CGC acknowledges that HFE is not completely achieved and that it will always be approximate, it pointlessly strives for precise equalisation wherever possible.[3] This aspiration:

- generates an illusion of comprehensiveness and leads to false precision;
- creates a bias towards assessing categories that have clearer drivers and better data; and
- drives an implementation method that is too complex, causing clashes with its principles (leading to their inconsistent application[4]), and with data constraints (leading to the overuse of judgement).

Western Australia considers that the CGC's excessive reliance on a narrow interpretation of the principle of what States do logically leads to seeking such (unachievable) precision, and the problems it causes. The focus on precision (and its accompanying complexity) is leading the CGC away from true HFE, to a contorted version based on computation.

The major motivation of this approach appears to be from considerations of practicality. But the price of practicality is an outcome that is not demonstrably HFE, so the terms of reference are not achieved.

Much of the discussion paper's approach is devoted to eroding the HFE objective.

- Policy neutrality is relegated to secondary status, yet policy neutrality is fundamental to HFE and to fair outcomes, so it should be the key objective of the CGC. HFE cannot exist without it.
- HFE is about a hypothetical world of 'same effort', yet the CGC assessments are tied in minute detail to 'what States do' in this world.
- 'Fiscal capacities' naturally relate to underlying capacity to pay, yet the CGC prefers legislative tax bases because judgements around underlying capacity to pay are considered more difficult.

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3 *Ibid*. page 4, paragraph 14.

4 For example, the CGC says "…in some circumstances it may not be possible to achieve [Policy Neutrality and Contemporaneity principles] fully, if other criteria are more dominant". *Ibid*. page 13, paragraph 49.

The CGC frequently refers to a State being over- or under-equalised.[5] However, it is false to consider that a movement away from the current distribution as being over- or under-equalised, because HFE is not currently being achieved. It cannot be known whether a movement is towards or away from HFE.

Current CGC Supporting Principles

Policy Neutrality

As policy neutrality is integral to HFE, we cannot understand that the CGC's discussion paper suggests that it is a second-order principle.

Policy neutral assessments ensure that GST grants are not affected by States' revenue or spending mix or by differences in policies across States that have affected or will affect per capita revenue bases and spending needs.

The principle ensures that assessments are implemented in a way that avoids creating disincentives for States to improve their own revenue generation or to make the reforms necessary to improve the operation of their economies. That is, it allows States to make revenue and spending decisions that will lead to the intended outcomes, without being distorted by HFE.

Policy neutral assessments create fair outcomes.

Policy neutrality drives the approach to what States do and practicality, rather than (as the discussion paper seems to suggest) the other way around. Any implementation of 'what States do' and practicality that does not have policy neutrality at its centre is simply not HFE. It may be some form of state welfare, but it is not HFE.

What States Do

This is a relevant principle, but should be incorporated in a broader equity principle (as it is an aspect of equity).

The problem lies in the CGC's narrow implementation of the principle, as for example reflected in its mechanical assessment of revenue capacities, which aims to capture the features of State tax legislation. This approach falls far short of all that States do (see Chapter 3), but appears favoured by the CGC because of its search for precision (which is illusory because it is achieved at the cost of limiting the scope of what States do).

States face inherent endowments and will put in effort to exploit those endowments. As States have differing endowments, they will push in different directions. So, their outcomes will vary, but their overall goals and aspirations will be similar. Finely measuring those approaches will not uncover the essence of what States do.

[5] For example, Commonwealth Grants Commission, *2020 Review: The Principle of HFE and its Implementation, CGC 2017-02-S*, page 35, paragraph 147.

The CGC also needs to pay more attention to the intertemporal aspect of what States do. If some States have done a better job over time in actualising their opportunities, or through investing money to do so, with consequent effects on their fiscal capacity, then these effects need to be adjusted for if a policy neutral outcome is to be achieved in the GST distribution. Similarly, looking forward, HFE must not have the effect of preventing a State from pursuing its opportunities (e.g. by equalising revenues that are required for forward-looking public investment).

Practicality

The practicality principle is an operational directive rather than a core principle.

The practicality principle is inherently ambiguous. It will move assessments in different directions depending on the CGC's guiding approach to HFE.

If a narrow interpretation of policy neutrality and what States do is the guiding approach, then assessments are driven down a particular computational path. However, if a complete view of policy neutrality and what States do is the guiding approach, the practical path will naturally veer towards broad global approaches, and potentially the discounting of revenue capacity if a fully policy neutral revenue base cannot be achieved.

Contemporaneity

This is an operational rather than a defining principle.

The contemporaneity principle, by the CGC's own admission, is not achieved.[6] This does not mean that the principle should be discarded.

GST distributions that are reflective of current circumstances would improve public transparency and aid budget management in the current volatile environment.

There is also an equity issue, as volatility creates complexity and risk, and credit rating agencies are wary of budget improvements predicated on time lag effects. If all States experienced similar volatility, there might be an argument that the effects roughly cancel out over time, providing a reasonable degree of budget certainty. However, when a State is an outlier (e.g. possessing a significant portion of a national revenue base) it will bear a disproportionate share of the risks from volatility.

Hence, as practical and reasonable approaches to contemporaneity exist, it should be an operational objective.

If relativities are determined on a true long-term basis that is unaffected by any cyclical or transient factors, States are faced with a stable and predictable relativity and can be fully accountable to manage budget volatility.

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[6] *Ibid*. page 13, paragraph 50.

On the other hand, relativities that aim to capture the detail of States' circumstances must do so concurrently, spreading volatility (ups and downs) across States as it occurs.

Need to Consult Governments

It may be that HFE is too difficult an objective to unambiguously implement. That is, perhaps HFE is not defined in a way that an administrative body such as the CGC could clearly map out an implementation path without making policy judgements.

- If so, the appropriate course of action is to acknowledge this, consult with State Treasurers, and seek resolution from the Commonwealth Treasurer on the choice of principles before commencing the implementation phase.

In this way, accountability is preserved; something that has been notably lacking in the debate over HFE in recent years. The Commonwealth needs to be accountable for giving the CGC a clear task to do, so that the CGC can in turn be accountable for its performance in this task.

A number of requirements of the terms of reference bear on this.

- The CGC should "ensure robust quality assurance processes".[7] This should apply to the principles underlying the CGC's calculations. But only governments can 'quality assure' the principles, as these are inherently normative.
- "The Commission will consult regularly with the Commonwealth and the States…".[8] Seeking advice from the Commonwealth and State Treasurers on the HFE principles is consistent with this.
- "State views should be sought on the importance of each existing principle and any others considered important to the States and the appropriate balance between them."[9] This implies that it is not solely the CGC's prerogative to decide the principles, but should incorporate State consultation. This further implies, in the (likely) event of disagreement among States, that Commonwealth or collective government arbitration would be sought to settle this normative issue.

The esoteric methods used by the CGC and the lack of meaningful quality assurance means it would be difficult for the Commonwealth Treasurer to understand whether the CGC has fulfilled its terms of reference.

7 Terms of Reference for the 2020 Methodology Review, paragraph 7(d).

8 Terms of Reference for the 2020 Methodology Review, paragraph 12.

9 Terms of Reference for the 2020 Methodology Review, paragraph 6.

Recommended Principles

The objective of HFE is well defined, but it is the selected implementation principles that ultimately steer assessments towards that objective. The choice of principles, both overall and for use in certain structural elements,[10] will give that objective form and meaning. The two are inseparable.

Western Australia considers the following principles to be fundamental to HFE. To implement HFE, the CGC would need to uphold these principles in all of its assessments.

- **Policy neutrality**
  - GST grants should not be affected by the revenue or spending mix; and
  - GST grants should not be affected by differences in policies across States that have affected or will affect per capita revenue bases and spending needs.
- **Equity**
  - Underlying disabilities should be recognised, rather than their detailed manifestations.
  - Assessments of drivers of differences in spending and revenue requirements between States should be consistent with policy neutrality.
  - Assessments should be relevant to Australian circumstances to broadly reflect State policies and objectives in providing and funding services.

In addition, the following operational principles can help guide the implementation of HFE to the extent possible.

- **Contemporaneity**
  - HFE should be implemented so that GST grants either:
    - are unaffected by cyclical or transient factors, leaving States fully accountable to manage budget volatility; or
    - reflect current circumstances, spreading (upside and downside) volatility across States as it occurs.
- **Conservatism**
  - A State's fiscal capacity should be presumed to fully or partly reflect its own effort if there is no or partial evidence to the contrary.
  - That is, when the CGC is unsure how much funding should be redistributed away from a State, the CGC should err on the side of caution.

[10] The CGC describes its structural elements as: decisions on scope; decisions on disabilities; and decisions on assessment methods. *Ibid*. page 8, paragraph 30.

- **Accountability, simplicity and transparency**
  - High level implementation decisions should reflect a consensus view of Governments or decisions of the Commonwealth Treasurer (where consensus cannot be reached). The CGC should be responsible for implementation, not policy.
  - The CGC's methods should undergo regular peer review, which could possibly be made up of a number of independent experts commissioned to conduct reviews.
  - There needs to be full documentation of data and evidence used by the CGC in reaching its conclusions.
  - Methods should be clearly described and simple.

2. Current Implementation

Key Points

- The complexity of the CGC's current approach leads to:
  - lack of transparency;
  - greater use of judgement; and
  - illusory comprehensiveness and false precision.
- Despite this complexity, the results produced by the HFE process are questionable and many issues need to be examined.

HFE as currently delivered is excessively complex but produces results which do not demonstrably achieve HFE, even proximately.

Excessive Complexity

The excessive complexity of the CGC's current detailed approach generates the following costs:

- lack of transparency in what the CGC has done;
- greater requirement to use judgement; and
- illusion of comprehensiveness and false precision.

Transparency of CGC Work

The CGC has undoubtedly noticed that many of its critics have an incomplete understanding of its work, either with respect to its broader concepts or in detail. This indicates the extent to which the CGC's work is impenetrable to the public.

However, the CGC's available material is also insufficient for the small number of experts in HFE.

- The CGC's reports, despite their length, fall far short of full documentation of the issues encountered by the CGC and its judgements.
- The CGC's assessments are set out in over two hundred spreadsheets, but 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. for heavy vehicle weights in the Roads assessment and the non-State services factors in the Public Health assessment).

- The CGC also does not share with the States in a timely way the results of its work (for example, the annual regression analysis of wages is performed significantly prior to the reported annual updates, but not shared with States prior to the provision of the reports).

Use of Judgement

Western Australia agrees with the CGC's finding that "judgments on what constitutes the best equalisation outcome must continue to be made".[11]

However, such judgements should be limited to those of a technical nature, rather than policy. The large number of judgements by the CGC reduces transparency and increases the scope for inconsistency (see for example the discussion in Chapter 5).

Judgements at the micro level are particularly problematic as they are necessarily selective. It is not possible to identify, let alone quantify, all micro issues. The result is bias, which is compounded when factors are excluded on the basis of materiality. Micro assessments also make it difficult for observers to assess whether the methods are acceptable or not, as this assessment requires a degree of knowledge that most do not have. The micro approach is also sensitive to distortions in State policy making created by errors in the GST distribution.

A broader assessment methodology also requires use of judgement, but this would be more transparent and comprehensive than a large number of micro judgements.

Illusion of Comprehensiveness and Precision

The detail of the CGC's assessments creates both an illusion of comprehensiveness and false precision.

Due to incompleteness of data and difficult conceptual issues, HFE is not actually comprehensive and cannot be made to be so. The CGC notes that "We accept that there may be some factors impacting on State fiscal capacities which we either do not capture or capture imperfectly. This is because the quality of data varies widely, and in some cases the underlying conceptual case is less clear cut than in others".[12]

One of the CGC's tasks is measuring the extent to which observed spending and revenue bases reflect disabilities beyond States' control, or are influenced by State policies. The complexity of the assessments can create an illusion of precision and obscure that their fundamental aspects have not been addressed, such as policy effects.

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[11] Commonwealth Grants Commission, *2020 Review: The Principle of HFE and Its Implementation: CGC 2017-02-S*, page 8, paragraph 29.

[12] Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities 2015 Review – Volume 1*, page 31.

The focus on exact rather than relevant data also creates a bias in favour of relativities that reflect past data rather than present circumstances. States are not funded for the needs they have in the year in which they receive that funding, making budgets more volatile and reducing the transparency of governments' forward estimates, as these reflect a complex mix of past and current circumstances. Even credit rating agencies don't trust forward estimates that rely on significant GST grant movements.

Questionable Results

The outcome of assessments of HFE not only lacks precision, but cannot be demonstrated to be correct. Broad unresolved issues, and the cumulative effect of specific unresolved issues, render the final result so questionable that it could only be accurate by coincidence.

Despite the long-standing substance of the definition of HFE noted by the CGC,[13] the implementation of HFE is still very far from settled.

There has been much change in the methods implemented over time, such as for wages, royalties, health, services to communities and public transport, and the introduction of assessments for housing, roads and depreciation. Infrastructure growth needs remained unrecognised for all practical purposes until 2010, when an assessment was introduced after more than a decade of debate.

Broad issues include:

- the role of policy neutrality;
- assessment of revenue bases concentrated in one or few States;
- merits of global versus detailed assessments;
- the approach to materiality (see discussion in Chapter 5);
- asymmetrical treatment of economic development initiatives versus the revenue they generate;
- quality assurance of major databases (e.g. IHPA data on hospital activity, ABS Characteristics of Employment survey); and
- lack of recognition of 'disabilities' associated with the dynamics of budgeting (i.e. volatile and uncertain revenue streams, dealing with volatile and uncertain economic growth and putting in place public infrastructure with long lead times for benefits).

[13] Commonwealth Grants Commission, *2020 Review: The Principle of HFE and Its Implementation: CGC 2017-02-S*, page 5, paragraph 20.

Specific issues include:

- mining revenues – the extent to which different minerals should be grouped;
- welfare – the influence of cost of living;
- transport – assumptions behind the current approach;
- wages – conceptual foundations of the model and whether the outcomes are reasonable;
- remoteness – remote areas with different observed costs treated as if they imposed the same costs;
- health – measuring the impact of the private sector;
- roads – relevance of the Commonwealth's national network roads;
- justice – assessment of 'community policing' and an insufficient focus on the drivers of crime;
- schools – the anomaly between the wage-adjusted school resourcing standards and the CGC's own methods;[14]
- services to communities – drivers of water subsidies; and
- services to industry – treatment of business development costs.

[14] Western Australia would be $300 million per year better off if assessments were based on the wage-adjusted school resourcing standards rather than the CGC's own methods.

3. What States Do

Key Points

- What States do is relevant to HFE, but only at a broad level so should be incorporated in a broader equity principle.
  - – The CGC's detailed approach to 'what States do' does not reflect what States do and is not compatible with the policy neutrality objective.
- What States have done and need to do in the future is relevant to HFE in the present.
  - – The failure to recognise this has led to large inequities and a welfare mentality.

'What States do' is relevant to HFE, as HFE must be implemented in the Australian context. We believe that it is a relevant defining principle, although we would prefer to incorporate it in a broader equity principle (as it is an aspect of equity).

This chapter argues that 'what States do' should capture the totality of 'what States do', including the overall intent of State policies rather than just the visible outcomes, and should be measured at a broad level for consistency with policy neutrality.

We acknowledge that intent is not practically observable at the level of detail that the CGC makes its assessments. However, overall intent is discernible, and the assessments should be broadened to this level.

We also argue that the CGC needs to take an intertemporal approach to 'what States do', looking back at what States have done that affects the present, and looking forward to needs that are driving public investment now. While essential to the achievement of HFE, its practical difficulty suggests pragmatic options need to be considered.

What Do States Actually Do?

The comments on 'what States do' in the discussion paper are difficult to interpret, so it is not clear what is intended. One problematic passage is as follows.

> In the 2015 Review, while having a preference for a broad view where possible, the Commission did not take a broad view where this was not consistent with what States did. For example, the Commission observed the bases States actually tax.

> Most often, this was the legislative base, with adjustments to derive average exemptions and thresholds, because this was what States collectively taxed.[15]

While this reflects the CGC's reluctance to capture any more of what States do other than what is in their legislation, it is not clear what issue of 'consistency' is at stake between a broad and narrow perspective.

A second problematic passage is as follows.

> The Commission said it preferred actual measures of what States tax rather than having to make judgements about what States intend to tax, such as would be required if it accepted a 'capacity to pay' approach. It said those judgements are much harder than making decisions on adjustments to legislative tax bases. For these reasons … the Commission did not adopt global or broad indicators of State revenue raising capacity, although some States argued they may be simpler, more policy neutral, remove disincentives to tax reform and better capture the capacity of the community to pay.[16]

This seems to ignore the dictum that "it is better to be roughly right than precisely wrong". If broad indicators are more consistent with policy neutrality and measuring what States 'really' do, then they should have preference over an 'easier' calculation that is further removed from HFE.

The CGC's current assessment of States' revenue capacity does not reflect what States do.

- States do not target levels of revenue for each tax, but an overall revenue target from all sources. What States do **not** do is set a target or optimal amount of revenue to be raised from each tax base.

What States actually do when raising taxes is consider the 'best' instrument available, which could include raising taxes on an existing tax base, part of an existing base, or a new tax base. In doing so, States will consider:

- any 'gaps' in the historically determined taxes already in place;
- the existing burdens on taxpayers;
- the ease of implementation; and
- the impact of additional revenue on GST grants.

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15 Commonwealth Grants Commission, *2020 Review: The Principle of HFE and Its Implementation: CGC 2017-02-S*, page 15, paragraph 56.

16 *Ibid*. page 15, paragraph 58.

Existing tax concessions are generally a matter of historical accident. The considerations leading to these concessions cannot easily be unravelled but are relevant in the context of establishing (as the CGC tries to do) ‘what States do’ in setting, say, tax-free thresholds. It matters whether a State sets this threshold to exempt a fixed proportion of the base, or to exempt a minimum tax liability. The CGC always assumes the latter, without evidence.

For all these reasons, assessing States’ revenue raising capacity through individual revenue assessments cannot be said to reflect ‘what States do’. A global revenue base would be a better measure of State revenue raising capacity and more closely reflect what States do in practice.

A Case Study – Land Tax Policy in Western Australia

Western Australia’s land tax policy over the past decade illustrates that State tax bases are simply a means of taxing the capacity to pay of the community.

States often adjust land tax rates when land values rise faster than the community’s capacity to pay land tax.

In every year from 2004-05 to 2008-09 unimproved land values in Western Australia increased and, in response, the State Government decreased tax rates. For example, in 2007-08 the average increase in unimproved land values was 49%, which would have resulted in a 78% increase in land tax revenue. As taxpayer capacity to pay land tax would not have increased by 78% in one year, the State Government adjusted its land tax scale to reduce the effect of the increase on land tax bills.

From 2009-10 to 2012-13 unimproved land values were largely unchanged and the land tax scale was unchanged. In 2013-14 and 2014-15, unimproved land values were lower than forecast and in response the State Government increased land tax rates given its substantial budget pressures.

Other Concerns with the Legal Incidence Approach

In addition to the fact that the legal incidence approach does not reflect what States do in practice, there are multiple other problems with this approach, in contrast to an underlying ‘capacity to pay’ approach.

- It requires data in excess of what is available (e.g. for payroll tax).
- It creates policy neutrality problems with:
  - revenue bases that are concentrated in one or two States;
  - revenue bases that are affected by property prices that are affected by State policies (i.e. land tax and conveyance duty); and
  - the degree of revenue base compliance.

- It assumes that the national average tax structure is an equally rational choice for all States, given a 'standard' policy perspective. However, it is most unlikely that the choices that are rational for one State from a 'standard' policy perspective are equally rational for other States with different economic and social circumstances.

- It makes consideration of policy neutral revenue raising capacity virtually impossible (i.e. the capacity a State has to raise revenues if it makes a decent effort to develop its particular natural advantages). There can be no presumption that the same effort by all States would lead to the existing **national** composition of economic activity.

- The legal incidence approach, by eschewing underlying factors of capacity to pay, is inconsistent with the approach used for expenditures, which looks at underlying demand and cost drivers (albeit there is a debate to be had about the detail of the expense assessments).

What States Do in the Long Term

Fiscal equalisation as presently implemented fundamentally lacks long-term policy neutrality, as the impact on States' economies (and hence revenue capacity) of their past policy choices is not taken into account. There is no assessment with respect to past 'what States do' policy choices, or future 'what States do' long-term planning.

For example, in the 1970s and 1980s Western Australia played a pivotal role in securing the development of the North West Shelf project through financial assistance and infrastructure provision. This has been well documented in previous Western Australian submissions. Woodside Petroleum's CEO, Peter Coleman, has recently corroborated this, stating that the efforts of the Western Australian government in developing the project were 'crucial'.[17]

This project helped to provide the energy needed to develop other State resources and established Western Australia as a prospective location for natural gas development in the face of significant global competition.

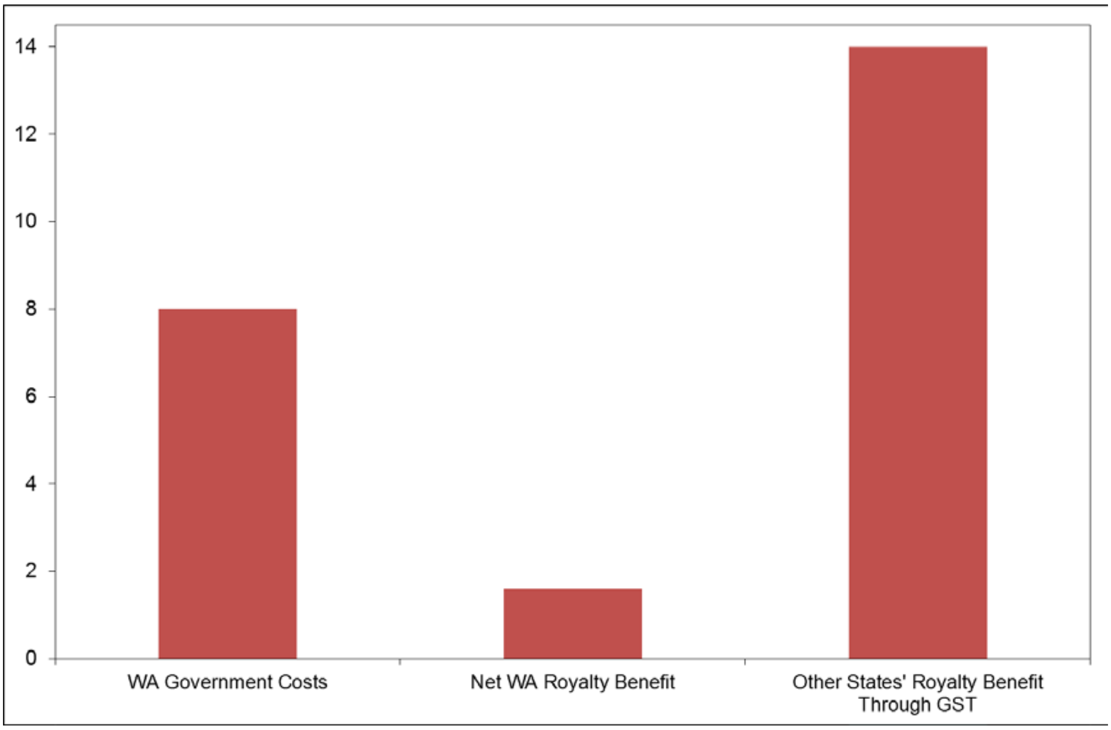
- Western Australian Treasury calculated that in 2010-11 net present value terms, the cost of its commitments to assist the North West Shelf project (e.g. payment of subsidies to the State's power utility to help cover the losses it initially incurred under crucial 'take or pay' gas contracts) is estimated to be around $8 billion. The State negotiated a royalty-sharing arrangement with the Commonwealth that reflected that effort, with the State receiving around two-thirds of royalties.

- However, due to fiscal equalisation, Western Australia loses all but its population share (about 11%) of that royalty stream (without its development costs being reflected in the current HFE methods).

[17] The Australian, *GST Carve-up Must Reward Growth*, 3 July 2017, page 23.

- The aggregate net royalty return to Western Australia is around $1.6 billion (in 2010-11 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 equalisation (see Chart 3.1).

Chart 3.1: 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.

Despite the massive and integral role played by Western Australia to develop the North West Shelf project, it has effectively retained only 7% of the total royalties collected, after the related GST redistribution and the Commonwealth retention of one-third of the royalties.

The CGC's argument in the 2015 Review report, that it cannot know what benefit Western Australia's support really had, is quite irrelevant. States don't know the future and have to make judgements.

At the time that the North West Shelf project was established, the current system of equalisation was in its infancy, and its consequences were unlikely to have been appreciated by State governments. Today they are more likely to have a significant bearing on decision making.

This is not just an argument about the North West Shelf, but initiatives by any State that have enhanced their economic and revenue performance.

The current system also encourages a welfare mentality in mendicant States whereby they can be financially supported by the profits of the industry development carried out (and fully funded) by other States. This is not consistent with the policy neutrality principle, which requires that policy choices not be influenced one way or the other.

Hence the CGC needs to take an intertemporal perspective on 'what States do', not just a snapshot in time. The snapshots are not independent, but inter-related.

We do not underestimate the difficulty of doing this, which is one reason we support approaches such as a discount on revenue redistribution, to give States the capacity to do independently what the HFE process cannot in practice do.

4. Policy Neutrality

Key Points

- The HFE principle mandates policy neutrality.
- The policy neutrality principle requires that:
  - fiscal equalisation should not reflect individual State policies; and.
  - fiscal equalisation should not influence State policies.
- Because policy neutrality is central to HFE, the onus is on the CGC to demonstrate that its assessments are policy neutral.
- Problems with the current implementation of HFE include:
  - reliance on observed revenue bases, which are not policy neutral;
  - assessments reflecting specific tax mixes, rather than the aggregate capacity to raise revenue;
  - an incentive to raise tax rates, rather than expand the revenue base;
  - a high loss of GST grants from increased tax compliance; and
  - State government decisions being influenced by HFE implications.
- The sensitivity of assessments to individual State tax rates and tax mixes can be minimised through a global revenue base assessment.
  - A rotating standard would be much less effective, but if the CGC were to aggregate the mining revenue assessment, it would be worth considering as a second best option.
- For revenue base policy neutrality, the CGC would have to use underlying measures of revenue raising capacity such as endowments.
  - In the absence of such measures, practical alternatives are discussed in the next chapter.

The chapter has four sections which:

- note the centrality of policy neutrality to the HFE principle;
- address the importance of policy neutrality;
- discuss existing problems with implementing the policy neutrality principle; and
- explain how the existing HFE implementation needs to change.

Centrality of Policy Neutrality Principle

The discussion paper says that:[18]

> … equalisation was implemented by methods that … ***are policy neutral***. This principle aims to ensure a State's own policies or choices, in relation to the services it provides, or the revenues it raises, do not directly influence the level of grants it receives. It also aims to ensure the GST distribution methodology creates no incentives or disincentives for States to choose one policy over another.

This principle is embedded in the HFE principle.

Fundamental to the HFE principle is that States' assessments should reflect similar efforts,[19] not their own policies. Further, in the absence of any instructions to the contrary, States must be able to freely elect to pursue similar efforts, and not be incentivised towards or away from any policy.

States are all different, so 'same effort' means that each State makes the same effort to pursue the opportunities available to it to generate and exploit revenue capacity, which will be different opportunities from those available to other States. Policy neutrality is hence quite different from a micro-analysis of 'what States do'. It is this broader perspective of policy neutrality that makes it feasible to aim for no incentives or disincentives. This aim would not be feasible by preserving a micro-analysis of what States do, such as where every revenue source is assessed separately.

The policy neutrality principle is essential to the fairness of HFE. It is also important for the GST distribution to make economic sense.

We note that the significance of the statement that 'a State's own policies … do not directly influence the level of grants it receives' might elude non-HFE experts. It means that the only influence is through the State's impact on the average effort. It would be helpful if this meaning was provided (say in a footnote) when the principle is quoted.

Debate over the Relevance of Policy Neutrality

There is much discussion about how policy neutral the current assessments are, and how much actual influence HFE has on State policies.

Much of this discussion is misguided, as it focuses on particular highly observable matters.

[18] Commonwealth Grants Commission, *2020 Review: The Principle of HFE and Its Implementation: CGC 2017-02-S,* page 9, paragraph 33 (this is a slight elaboration of the principle as specified in Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities 2015 Review – Volume 2 – Assessment of State Fiscal Capacities* page 6, Box 1).

[19] The latest wording of the HFE principle does not specify if this is an internal or external standard.

The reality is that all States at all times have a large menu of initiatives and reform options available to them. No State pursues all its options for betterment. States should (but may not) pursue their major options. Loss or gain in economic performance is something that develops over decades.

One key question is whether some States have done better than others in managing their options over time. We think this is plausibly the case, although as the CGC noted in the 2015 Review, it cannot be strictly proven.

Another key question is whether all States, and Australia as a whole, have suffered significant damage from the disincentives created by HFE, which we documented in our June 2017 submission to the Productivity Commission HFE inquiry. As that submission argued, plausibly this is the case. We can see much that could be done in Western Australia to assure its future development, but that remains unattainable under the current HFE rules where revenue is equalised regardless of the work done in getting it, or what it might be used for in the future.

All this should be important contextual information for the CGC, but ultimately irrelevant to the CGC, because its methods should be demonstrably and transparently policy neutral. It is not enough for the CGC to presume, in the absence of clear evidence, that policy neutrality is not a concern, as the HFE principle itself requires policy neutrality. The onus is on the CGC to prove that its recommendations are consistent with policy neutrality.

The CGC should aim to ensure that there will be no concern that States are losing revenues they have earned, nor threat to States that want to improve themselves, nor possibility of State tax/royalty rate decisions being contaminated by redistribution issues.

Policy Neutrality Problems with Current HFE Practice

Reliance on Observed Revenue Bases is not Policy Neutral

For most revenue categories (gambling is an important exception), the CGC uses the observed legal incidence revenue base to measure revenue raising capacity.

This ignores policy influences on the revenue bases.

This is a problem for all of those revenue assessments, but particularly for:

- mining revenue – States have put in differing efforts to develop their mining industries, including the regulatory environment, infrastructure, and business assistance. This is discussed in the CGC's *What States Do* paper for mining revenues,[20] which points out that Western Australia scores highest of all States in the Fraser Institute's survey of public policy perception. We have also noted that

[20] Commonwealth Grants Commission, *What States Do – Mining Revenue CGC Staff Research Paper CGC 2016-17-S*, pages 12-14, paragraphs 48-56

Western Australia provided an estimated $8 billion in assistance for the North West Shelf project; and

- property taxes – land values are a function of government policies on releasing land, zoning, provision of infrastructure, and land tax rates. The value of taxable land can also be indirectly impacted by policies to increase economic activity through revenue, expenditure and regulatory decisions that boost employment, population growth, wages growth, and overall consumption of goods and services. Strong economic activity is linked to increasing land values (due to higher returns from holding land).

Tax Mix Matters

States do not think about setting individual taxes in an optimal way and do not target a particular tax mix. Even if they did so, this would vary from State to State reflecting their different economic and social circumstances, which the CGC does not attempt to capture.

Rather, States seek an overall revenue target from the aggregate of all sources. Their major concerns in considering the various alternatives at a point in time are that: the quantum of revenue raised from all their taxes and royalties covers their expenses, that the community broadly sees the distribution of the tax burden as equitable and bearable, and the simplicity and practicality of revenue/relief measures.

State Governments give far greater consideration to these factors than to whether the tax rate or exemption threshold for each tax is optimal. See Chapter 3 for further discussion of these issues.

However, the CGC assesses each State's revenue capacity for individual taxes, not its overall capacity to raise revenues. Therefore, how a State raises its required amount of revenue (its tax mix) affects its GST grant.

So, States could change their mix of taxes, while raising the same amount of total revenue, and receive a different GST grant. Some examples are as follows.

- New South Wales' GST grant would increase by around $240 million per annum if it replaced its stamp duties with an equal amount of land tax revenue. It could increase its GST grant by around $150 million per annum if it doubled its gambling tax revenue and reduced its land tax revenue by the same amount.

- Queensland's GST grant would increase by around $1.4 billion per annum if it were to forgo its coal royalty revenue and replace it with an equal increase in stamp duty revenue.

- At the extreme, Western Australia's GST grant would increase by around $2.8 billion per annum if it relinquished its iron ore royalty revenue in favour of a revenue-neutral increase in its payroll tax revenue.

As a further illustration, should Western Australia want to raise an additional net $1 billion per annum, it would have various taxes or royalties it could choose to increase, but would need to consider the GST impact.[21] If it chose to raise the revenue through an increase in:

- the iron ore royalty rate, it would need to raise over $8 billion in actual revenues to retain $1 billion net of HFE impacts; or
- the transfer duty rate, a highly inefficient tax, it would need to only raise around $950 million in actual revenues to retain $1 billion net of HFE impacts.[22]

The example above demonstrates that the operation of HFE when a revenue base is concentrated in one State has the potential to grossly distort the deadweight losses associated with raising an additional dollar of revenue for the State's budget. Efficient revenue policies should seek to minimise the deadweight losses associated with raising revenue.

States can also be disadvantaged if they forgo certain tax revenue in preference for higher revenue from other sources. For example, because Western Australia restricts gambling, and does not raise revenue from gambling in the same way as some other States, it raises additional revenues from other sources, such as royalties. However, Western Australia effectively loses most of this additional royalty revenue through the HFE process, whereas other States effectively keep all of their gambling revenues.

In summary, assessing different revenue sources individually, instead of considering States' overall capacity to raise revenue, creates incentives for States to make policy decisions based on GST impacts.

There is an Incentive to Increase Tax Rates

The current implementation of HFE can influence the way in which States choose to raise additional revenue to improve its services or infrastructure, or reduce debt.

As States' shares of their revenue bases are generally similar to their population shares (with the exception of royalties), a State's change in a tax rate only affects the national average at the margin, so will have little impact on its GST grant share.

On the other hand, if a State expands its revenue base, its assessed revenue will increase by an amount equivalent to the national average tax rate multiplied by the additional revenue base, and the State will lose all but its population share of this increase in its assessed revenue.[23]

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[21] The losses would occur after a lag. This analysis assumes they are banked from initial revenues to cover later losses.

[22] Western Australia's transfer duty base is lower than its per capita share, so increasing the national average tax rate, increases the GST benefit to Western Australia.

[23] If the State's tax rate differs from the national average, then this increase in revenue base will alter the national average tax rate, but this impact is minor other than for royalties.

Hence, States will always receive more revenue (net of GST redistribution) from increasing tax rates than from an equivalent expansion of the underlying tax base (which would raise revenues by expanding the State's economy), despite the base expansion being better for the economy. The current implementation of HFE therefore incentivises States to increase tax rates above the national average rather than to grow their underlying revenue base.

There is a Disincentive for Tax Compliance

The HFE principle aims to provide States with the grants they would need if they "made the same effort to raise revenue". This should include making the same compliance effort.

However, because the CGC uses observed revenue bases, States' compliance effort will affect their revenue bases.

This is particularly the case for revenue bases which the States report to the CGC. For example, if a State identifies an additional property transfer, then that transfer will be included in that State's data return and result in an increase in measured capacity. This increase will be redistributed among States based on national average tax rates.

- It is possible that this is not a problem when the CGC obtains revenue base data from a third party (such as compensation of employees for payroll tax from the ABS), but only if State tax compliance efforts do not alter businesses' reporting to the third party.

A State can effectively lose the majority of additional revenue raised from increased compliance effort and, in some circumstances (depending on its actual tax rate), can lose more in GST grants than it gains from the increased compliance. This creates a perverse incentive for States to reduce compliance effort in order to reduce their tax base, and increase their GST grant.

- For example, if Western Australia increases its land tax compliance effort, it will result in a GST loss greater than the revenue gained if that compliance activity relates to land with an unimproved value between around $500,000 and $1.5 million. If increased compliance effort in Western Australia identified an additional $10 million worth of property in aggregate with unimproved land values between $900,000 and $1 million, it would raise additional land tax of around $17,500. However, its GST grant would decrease by around $32,000 and it would face the cost of that increased compliance effort.[24]

State Government Decisions Consider HFE

In Western Australia, whenever Treasury provides the Government with advice on a possible revenue measure, it is also asked to include the HFE impact of each option.

[24] This is because Western Australia collects land tax at below the average rate in those value ranges.

The HFE impact is considered up front, when attention should be on whether the option is good policy or not.

This reflects both the large impact that HFE has on the State’s finances, and the sensitivity of HFE to State revenue policies.

Some parties have suggested that because Western Australia increased its iron ore fines royalty rate, despite the prospect of losing more than 100% of the increased royalty revenue in GST grants, State policies are not in practice influenced by HFE. The Discussion Paper suggests that the prospective loss was considered by the Western Australian Government once the decision was made to increase the royalty rate.[25]

In fact, the Western Australian Government had been negotiating royalty rate reform for some time before the CGC published its new methodology (which the CGC had developed at the last minute without consultation). When that methodology came to light, the Government had to consider its position.

In an article in the West Australian newspaper on 9 November 2016,[26] the Hon Christian Porter MP, a former Treasurer of Western Australia, explained that the GST implications were fully understood, but this substantial risk was taken to highlight the flaw in the HFE system and, as Mr Porter explains, was based on the assumption that the Commonwealth would intervene to fix the flaw.

This assumption proved correct, with successive Commonwealth Treasurers directing the CGC on the treatment of iron ore fines over four years from 2011-12 through 2014-15. Further, in 2013, the Hon Wayne Swan, then Commonwealth Treasurer, directed the CGC, through terms of reference for the 2015 Review, to develop a new mining revenue assessment.[27]

This can be contrasted with more recent proposals by Western Australian politicians to alter the iron ore lease rental arrangements.

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[25] Commonwealth Grants Commission, *2020 Review: The Principle of HFE and Its Implementation: CGC 2017-02-S,* pages 25-26, paragraph 104.

[26] Available at: http://christianporter.dss.gov.au/editorials/west-australian-opinion-editorial.

[27] https://cgc.gov.au/index.php?option=com_docman&view=document&Itemid=256&_layout=default&alias=190-r2015-terms-of-reference-pdf&category_slug=terms-of-reference

In particular, in the lead-up to the 2017 Western Australian State election, the Hon Brendan Grylls, the then leader of the WA Nationals Party and member of the State Cabinet, proposed a revenue-raising proposal to increase the lease rental rate paid by selected mining companies from 25 cents per tonne to $5 per tonne. Mr Grylls championed that this would raise $7.2 billion in vital revenue over four years.[28] The idea was rejected by the Liberal Party because the GST losses would amount to 88% of the revenue increase, meaning Western Australian mining companies would be saddled with an increased tax, but the vast majority of the proceeds would flow to the other States through increased GST.

- Concerns about the majority of the additional revenue flowing to the other States were also highlighted in the media campaign by the Chamber of Minerals and Energy of Western Australia.[29]
- Mr Grylls continued the proposal, but based it on seeking a Commonwealth intervention to 'quarantine' the increased revenue from HFE or to impose a floor in the relativities. Either measure would have seen Western Australia effectively retain the increased funding.

The current State Government also floated the prospect of iron ore companies having the option to cash out future lease rental obligations through an up-front payment – but only if the Commonwealth agreed to quarantine this up-front payment.

In both cases, the HFE treatment can be seen as a key factor in State policy as regards the iron ore lease rental.

Solutions

The policy neutrality concerns we have raised earlier in this chapter relate primarily to the revenue assessments. The expenditure assessments do not raise the same level of policy neutrality concerns, although some indicators (e.g. SES indicators) are not strictly policy neutral.

The use of observed revenue bases means that fiscal equalisation reflects individual State policies (both policies that influence the size of the base and compliance efforts).

Also, HFE influences State policies because the assessments are sensitive to changes in individual States' tax rates (particularly royalty rates).

[28] http://www.nationalswa.com/brendon_grylls_appointed_leader_major_policy_platform_announced

[29] The Chamber of Minerals and Energy of Western Australia, *Toxic Tax Must Go As Newspoll Shows Lack of Support for Grylls' Anti-Jobs Mining Tax*, http://www.cmewa.com/news-and-events/latest-news/37-2017/327-toxic-tax-must-go-as-newspoll-shows-lack-of-support-for-grylls'-anti-jobs-mining-tax, 10 February 2017.

Revenue Bases

To fully implement the HFE principle, it is necessary to construct revenue bases that are based on the same policies (including the same compliance effort). The only way that could be done would be to produce revenue bases that reflect underlying unchanging factors that ultimately determine revenue raising capacity (e.g. natural endowments such as land area – mineral reserves would not do, as Geoscience estimates that about 80% of Australia's land area has not been tested for mineral deposits).[30]

In the absence of such measures, it has to be accepted that GST grant shares will never truly reflect HFE. Practical ways of dealing with this are discussed in the next chapter.

The specific problem of sensitivity of assessments to compliance effort may be ameliorated by using third party data on revenue bases (though this does not tackle the broader issue of the State efforts that have impacted on these revenue bases).

Tax Rates Mix

The sensitivity to tax rates is amenable to partial solution by introducing a rotating standard (with amalgamation of minerals), and a full solution by introducing a global revenue base measure.

Rotating Standard

The Discussion Paper[31] suggests the option of a rotating standard, instead of an eight-State standard (each State would in turn be the standard policy for each other State, and that State's policy would carry a population share weight). The CGC used this approach prior to the 1993 Review, with each State contributing to the standard in proportion to its population share, rather than its revenue base share.

This proposal is consistent with the HFE principle, which demonstrates that the principle does not always have to be interpreted as currently.

It gives needs that do not sum to zero, but a simple solution to this would be to distribute this 'gap' equal per capita.

A rotating standard will not remove all influence of each State's tax rate on its assessment, but it may reduce it. There are also difficulties in using a rotating standard for mining revenues where revenue bases are concentrated in one or two States, as the results for those States can become highly sensitive to the royalty rates of States with a small amount of production. However, if the CGC were to decide to amalgamate all onshore minerals into a single component, a rotating standard would usefully reduce the sensitivity of Western Australia's assessment to changes in its royalty rate from about 40-50% to about 10%.

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[30] http://www.ga.gov.au/scientific-topics/minerals/unlocking-resource-potential

[31] Commonwealth Grants Commission, *2020 Review: The Principle of HFE and Its Implementation: CGC 2017-02-S,* page 25, paragraph 99.

In this context, we would consider a rotating standard to be worth consideration, although it would be a second best option compared to a global revenue assessment.

Global Revenue Bases

A global revenue base, provided it encompasses both mining royalties and taxes, would result in minimal sensitivity to changes in individual States' tax rates. It would also address the concerns about tax mix that we raised earlier in this submission, and would probably reduce the more extreme sensitivities to changes in compliance effort.

During the 2015 Review, we proposed a global revenue base measure that would encompass all taxes and onshore mining royalties. The revenue base would be Gross State Product, less half of general government final consumption expenditure and an estimate of total offshore mining gross operating surplus/gross mixed income.

- This gives a good fit to the existing assessments (R-squared of 0.996 for the data years 2010-11 to 2015-16).

We continue to consider this to be a good proposal. We are puzzled by the suggestion in the Discussion Paper that this might have little relevance to mining royalties,[32] as Gross State Product includes the value of mineral production.

However, in response to CGC concerns about this measure not adequately reflecting what States do, we now propose an alternative global revenue base measure, which is to develop a revenue base by aggregating the existing revenue bases that the CGC assesses.

This measure would cover all taxes that are not assessed equal per capita[33] and all onshore mining royalties. The revenue base would be the sum of the individual revenue bases, subject to the following.

- The motor taxes revenue bases of number of light and heavy vehicles would need to be converted to a dollar value.
- Because the land values and vehicle numbers/values are stocks, rather than flows, their values would need to be amortised over time (say 10% of the value would be included in the aggregate revenue base).

This measure also gives a good fit for the existing assessments (slope of 0.987 and R-squared of 0.999 for the data years 2012-13 to 2015-16).[34]

Chart 4.1 shows the relationship between assessed revenue for the 2017 Update and assessed revenue under amalgamated revenue bases.

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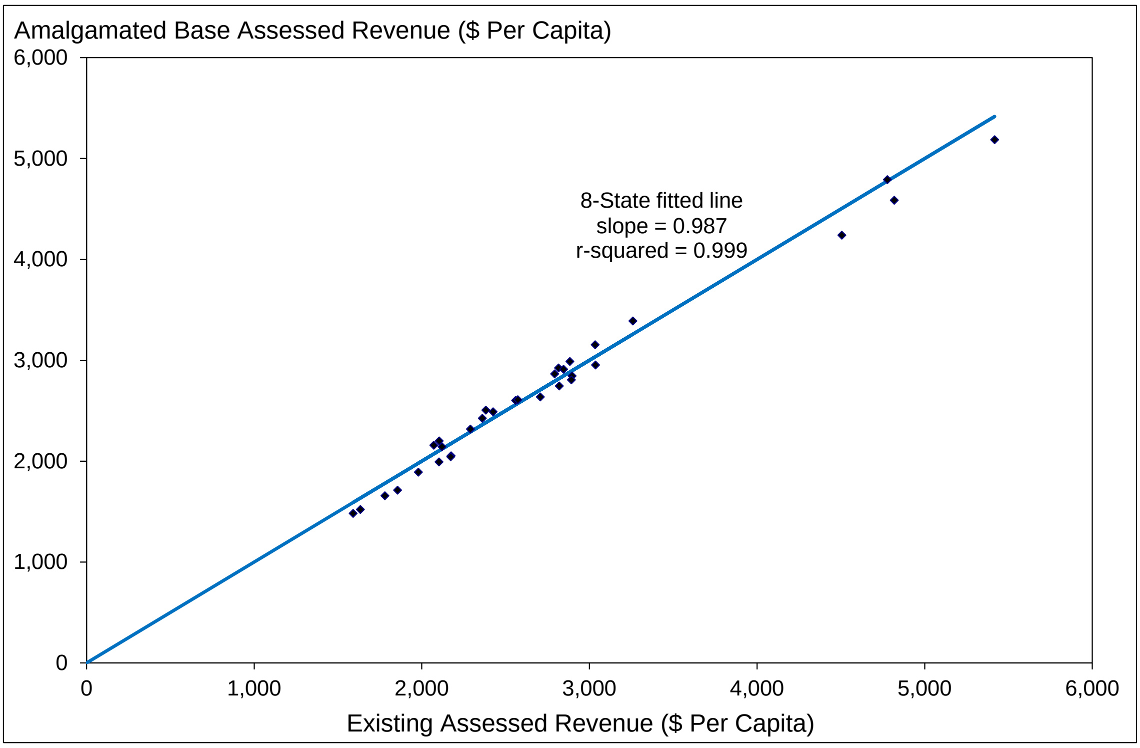
32 *Ibid*, page 26, paragraph 107.

33 Additional taxes could be included in the global assessment if the CGC were to develop a revenue base measure for them.

34 For this analysis, we used the average vehicle values from the latest Western Australian data return for motor vehicle stamp duties and an amortisation factor of 10% for land values and vehicle values.

Chart 4.1: Assessed Revenue[(a)] - Amalgamated Revenue Bases Versus Existing [(a)(b)]



Source: Calculated by Western Australian Treasury from CGC data.

(a) Assessed revenue for total differentially assessed taxes and onshore mining royalties. Covers each State and each of the four data years 2012-13 to 2015-16.

(b) Amalgamated revenue bases convert vehicle numbers to values using average vehicle values from Western Australia's latest motor vehicle stamp duty data return and amortise land and vehicle values at 10%.

5. Practicality

Key Points

- Practicality should be a response to the inability to perfectly assess HFE, rather than a set of rules that override HFE.
- The CGC's current rationale for discounting is both unclear and inconsistently implemented.
- The CGC should adopt a 'conservatism' principle under which it discounts towards no redistribution in response to uncertainty (regardless of whether the uncertainty relates to data quality, data relevance or policy impacts).
- Discounting of revenue assessments would also improve policy neutrality and account for unrecognised expenditure needs.
- Materiality thresholds presume a micro approach to assessments. A better way to simplify would be undertake assessments in a different manner, rather than just cutting out parts.
- Assessments should be based on data that States can review.

The HFE principle makes no reference to practicality.

The assessments have to be practical, or it would not be possible to produce a result. However, practicality should be a response to the inability to perfectly assess HFE. It should not be a set of rules that override HFE.

Hence, practicality is genuinely subsidiary to other principles.

The CGC's terms of reference require it to implement HFE. If practicality prevents this from being possible, then the CGC should report that it is unable to comply with its terms of reference. The Commonwealth Treasurer would then discuss the way forward with the Council on Federal Financial Relations and direct the CGC on the approach it should take in response.

Practicality should also reflect procedures that are applied with consistency and transparency. Two major examples we consider below are discounting and materiality.

Discounting

Current Implementation of Discounting

The CGC does not currently have a clear rationale for discounting.

The discussion paper notes that:

> When developing assessments, sometimes data are incomplete, dated, unreliable, not fully fit for purpose or a combination of all these.[35]
>
> In the 2015 Review the Commission considered a better HFE outcome was achieved by recognising the disability, but discounting its impact on the GST distribution to reflect the confidence it had in the data.[36]
>
> [The CGC] did not use [discounting] to introduce conservative bias or to allow unreliable assessments, but to achieve its best estimate of HFE where it had concerns about data.[37]
>
> The Commission also said it should not discount otherwise reliable assessments because of possible policy neutrality or general uncertainty, … While the Commission agreed that, conceptually, differences in tax rates or State development policies may affect the observed [revenue] bases, it did not consider discounting them necessarily moved assessments in an appropriate direction in terms of HFE.[38]

The problems with this rationale are as follows.

- Discounting will always introduce a bias if the best available data is being used.
- It is not clear, if there is "general uncertainty", how the assessment is "otherwise reliable".
- There is no rationale for singling out policy neutrality for different treatment from other sources of reliability. As discussed in the previous chapter, the HFE principle requires revenue bases that are policy neutral. Observed revenue bases are not policy neutral revenue bases, and their fitness for purpose needs to be demonstrated.
- The concern about discounting not necessarily moving assessments in an appropriate direction is equally valid for all uses of discounting, including when there are concerns about the data.

Furthermore, the CGC's implementation of discounting often does not appear to match its described rule.

35 Commonwealth Grants Commission, *2020 Review: The Principle of HFE and its Implementation, CGC 2017-02-S*, page 28, paragraph 116.

36 *Ibid*. page 28, paragraph 118.

37 *Ibid*. page 29, paragraph 119.

38 *Ibid*. page 29, paragraph 121.

Examples of the CGC's decisions being inconsistent with its rule of not discounting for policy or general uncertainty are as follows.

- Gambling – the CGC has not used gambling activity as the base, including because a level of discount for policy differences would be warranted "given the lack of data quantifying the nature and impact of **policy differences** affecting the level of gambling activity" (but no discount was applied for policy differences in respect of other revenue bases).[39]

- National parks and wildlife – the assessment is discounted by 100% because of "**uncertainties** surrounding the **policy influences** on the number and size of national parks and the difficulty of obtaining reliable data to measure cost influences".[40]

- Wage costs – the assessment is discounted because of "some **uncertainty** in the data".[41]

- Regional costs – the assessment is discounted, when extrapolated from schools and police to other functions, because extrapolation "opens the assessment to a degree of **uncertainty**".[42]

- Interstate non-wage costs – the assessment of electricity costs is discounted by 100% because the CGC is not confident that it can "reliably isolate the impact of State **policy** on them".[43]

- Service delivery scale – the assessment is discounted, when extrapolated from police to child welfare, because the extrapolation "results in increased **uncertainty**".[44]

- Net borrowing – the assessment is discounted to allow for the remaining **uncertainty**.[45]

Appropriate Rationales for Discounting

Discounting is appropriate when:

- other information suggests a systematic bias in the assessments that can be ameliorated by discounting towards an alternative measure (but discounting will not, for example, ameliorate bias towards understatement of disabilities); or

- other criteria come into play.

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39 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities 2015 Review – Volume 2 – Assessment of State Fiscal Capacities*, page 122, paragraph 11 (emphasis added).

40 *Ibid*. page 400, paragraph 44 (emphasis added).

41 *Ibid*. page 455, *Summary of the Assessment* (emphasis added).

42 *Ibid*. page 487, paragraph 35 (emphasis added).

43 *Ibid*. page 492, paragraph 65 (emphasis added).

44 *Ibid*. page 503, paragraph 27 (emphasis added).

45 *Ibid*. pages 555-556, paragraph 19 (emphasis added).

Appropriate criteria include the following.

Conservatism

When the CGC is unsure how much funding should be redistributed away from a State, the CGC should err on the side of caution. A State's fiscal capacity should be presumed to fully or partly reflect its own effort if there is no or partial evidence to the contrary.[46] We believe that the CGC should adopt this as an additional operational principle.

This is appropriate when:

- there is uncertainty as to whether the assessment matches true HFE; and
- the direction of the errors is unknown.

The reason for the errors is irrelevant – only that their direction is unknown. For example, because observed revenue bases differ from average policy revenue bases, there will be differences between the CGC's current revenue assessments and true HFE. Unless the direction of those differences are known (which generally they are not), discounting is equally valid here as in cases of data uncertainty due to ABS sampling errors.

In some cases, discounting towards equal per capita may achieve or approximate this conservatism (e.g. discounting mining revenues). However, currently most instances of discounting do not consistently reduce the redistribution of GST grants away from donor States.

- It may be more appropriate to discount the final relativities.
  - This need not be by a fixed percentage (which would make a discount far higher per capita for the Northern Territory than for other States).
- An alternative approach is to set a floor for GST relativities that would provide an overall limit to the redistribution from any State.

Influence on State Policies - Incentives

As discussed in a Chapter 4, fiscal equalisation should not influence State policies.[47]

Chapter 4 recommends using a global revenue base assessment to minimise the sensitivity of revenue assessments to each State's tax rates.[48]

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[46] See further our comments in the Policy Neutrality chapter, in the section on *Debate over the Relevance of Policy Neutrality*.

[47] Fiscal equalisation should also not reflect individual State policies. That aspect of policy neutrality is already covered by the discussion of conservatism above.

[48] Under conservatism, discounting would also be relevant to a global revenue base assessment to reflect the uncertainty that each State's global revenue base reflects the standard policy.

Another approach would be to discount the revenue assessments. This would also reduce the sensitivity of those assessments to States' development policies and compliance efforts, and would also be warranted on the principle of conservatism.

Unrecognised Needs

It has been very difficult for the CGC to assess needs for expenditures made by States to develop their economies, and hence their revenue bases.

In this case, equity requires the CGC to not fully assess the resulting revenues.

At the very least, expenditures towards generating revenues should be netted off the standard tax rate for those revenue assessments.

Other unassessed needs include risks associated with volatility and uncertainty in mining dependent economies.

Where there is a potential offsetting relationship between revenue capacity and some unrecognised needs, the case for discounting the revenue capacity is strengthened.

Materiality

Materiality is a legitimate goal.

However, we consider that the materiality guidelines, which reflect an approach of 'slicing' out small components, are unsuited to the achievement of HFE, and are not implemented consistently or transparently.

The guidelines are unsuited to the achievement of HFE because they depend on a micro approach to the assessments, which does not well capture the objectives of policy neutrality or what States do. These objectives require broader capacity measures, as argued in previous chapters.

Even if one takes the micro approach as given (which we do not), the implementation of the materiality guidelines seems problematic.

In an ad hoc way, the CGC recognises that not all the small components can be regarded as independent, and assesses the materiality of some of these in a grouped fashion. But all revenue bases are treated as independent, when they are clearly not.

The materiality guidelines have a semblance of working only because (by chance) there are States with extreme disabilities, so most assessments are untouched. However, as States continue to develop novel tax approaches, a greater proportion of tax capacity will escape the HFE net.

If all States had more moderate disabilities, then they could all be assessed as having equal per capita GST entitlements, even if the cumulative impact of those disabilities came to many multiples of the $30 per capita materiality threshold.

The implementation of materiality thresholds is inconsistent in other ways.

The CGC chooses to ignore materiality thresholds at times (e.g. retaining details in expenditure and revenue assessments). The CGC does not always split the remote and non-remote regions, despite the split being material when taken over all expenditure categories. The land tax and conveyance duty value ranges are split quite finely, yet the CGC limits the number of age bands in expenditure assessments.

The implementation of materiality is also non-transparent because it is often not evidenced that a split is immaterial.

With all this in mind, we do not support any increases in the existing materiality thresholds. Even indexing them would send a signal that somehow they are any more than a judgement.

Rather than using materiality thresholds, the CGC should be aiming for inherently simpler and more transparent ways to undertake assessments that properly focus on policy neutrality and what States do.

Confidentiality

The assessments should not be based on data that cannot be shared among State Treasuries.

Clause 12 of the 2020 Review terms of reference requires the CGC to consult with the States. It is not possible for the States to comment on assessments that are driven by confidential data.

An example of this in the 2015 Review was the urban transport assessments, which were driven by the shape of the curve fitted to States' data. This shape was particularly sensitive to the Sydney data point, yet New South Wales refused to let other States have access to its data.

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.

6. Contemporaneity

Key Points

- It is feasible to achieve far better contemporaneity, so this should be done to improve budgeting processes, public transparency and equity between States with greater and less volatility.
- Ad hoc approaches such as advance grants, data year weights, and time lag growth adjustments are not transparently fair and must be avoided.
- Western Australia recommends HFE be implemented such that grants either:
  - are unaffected by cyclical or transient factors, leaving States fully accountable to manage budget volatility; or
  - truly reflect current circumstances, equitably spreading volatility across States as it occurs.
- If the former is not practical, then Western Australia prefers the use of forecasts (potentially updated during the financial year) followed by a final correction in the following year to reflect final outcomes.
  - Options involving longer time lags, including longer averaging periods, a one-year lagged model, and the absorption approach, are inferior as they add volatility without improving contemporaneity and budget management.
- The use of backcasting should be limited and must allow for a mechanism to correct for errors.

Contemporaneity is not currently achieved due to the use of average historical assessments, and causes significant budget management difficulties.

Budget Management Difficulties and Transparency

The problem occurs as the use of old data means that GST impacts of changed fiscal circumstances occur with a time lag and mainly beyond the forward estimates period, but governments generally focus on the forward estimates period and the operating surpluses. The public and commentators cannot easily disentangle the mix of past and current influences in the forward estimates, and hence cannot hold governments and the CGC accountable.

For example, during the period of high iron ore prices up to 2013, the Western Australian Budget forecast large operating surpluses throughout the forward estimates, but these largely reflected the HFE time lags. Consideration of the later impact of the time lags tended to be discounted due to the substantial uncertainties in any forecasts beyond the forward estimates period.

When the iron ore price fell abruptly, Western Australia’s GST grant share was still declining, exacerbating the fall in revenue. If there had been no time lags, both the increase and the decrease in iron ore royalty revenue would have been largely offset by GST grant changes at the time these were occurring. GST relativities would have been more volatile but this is necessary to cancel out the volatility in other revenue and ensure much more stable budgets.

Additionally, HFE time lags arguably lead to more extreme fiscal policies by State governments.

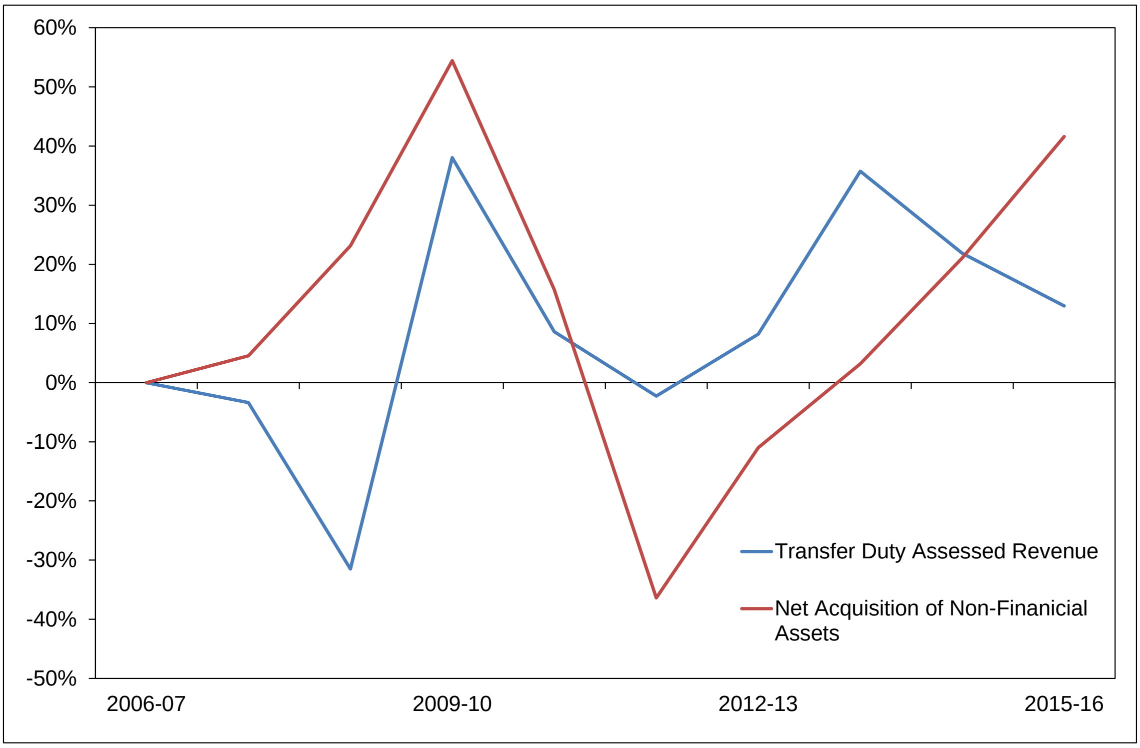
For example, when land tax collections have grown strongly, the time lags have hidden the GST impact. This was a contributing factor to the Western Australian Government cutting land tax rates and/or increasing land tax thresholds in the majority of years from 1995-96 to 2008-09, leading to lower than otherwise land tax collections. In recent years, when time lags have reduced Western Australia’s overall revenues, land tax rates were increased (bringing Western Australia up to national average land tax effort).

As another example, Western Australia did not increase electricity prices for eight consecutive years (2001-02 to 2008-09). The latter half of this period was when Western Australia had begun to benefit from time lags in the HFE treatment of the mining boom. When taxation revenue fell in 2009-10, without an immediate offsetting GST impact, electricity prices were increased by 23% (and by 16% in 2010-11).

It is likely that other States are also affected in this way.

For example, Chart 6.1 compares New South Wales’ growth in assessed stamp duty on property transfers with growth in net acquisition of non-financial assets, over the last decade. This shows some correlation between strong growth in transfer duty and strong growth in asset purchases.

Chart 6.1: New South Wales Growth in Transfer Duty Assessed Revenue and Net Acquisition of Non-Financial Assets



Source: CGC assessed transfer duty and ABS net acquisition of non-financial assets.

The discussion paper suggests that there is no issue with contemporaneity and governments can simply manage their volatile budgets through banking surpluses, borrowing or more effectively managing expenditure.

This ignores the transparency and accountability issues discussed above. Putting these issues aside, in theory, when a State's revenues fall, it could borrow to cover the shortfall while it waits for the GST benefits to flow. However, time lags mean there are inherently more variables and therefore more uncertainty and risks in GST forecasts, which have to be factored into the budget process. As well, restrictions on their credit rating (credit rating agencies are wary of budget improvements predicated on time lag effects) may make this borrowing more expensive. These additional risks will be faced by States with more volatile revenues, undermining equity.

Mechanisms available to adjust down expenditure quickly are more limited and more costly for the community (limited to reductions in service volumes, transfer payments, or cancellation of smaller capital projects) while the jurisdictions without the volatile revenues have the lead time to consider a wider range of options (for example, service redesign) or implement cost reduction programs. Again, equity is undermined.

If all States experienced similar volatility, there might be an argument that the effects roughly cancel out over time, providing a reasonable degree of budget certainty. However, when a State is an outlier (e.g. possessing a significant portion of a national revenue base) it will bear a disproportionate share of the risks from volatility.

Hence equity considerations point strongly to a contemporaneous approach.

Another reason for adopting a contemporaneous approach is that the time lags have been a significant source of debate in the past, with various ad hoc solutions being proposed. Going into the mining boom, other States were quite vocal about how the circumstances of Western Australia and Queensland had improved ahead of their relativities declining.

- It was this concern that led the CGC to implement a contemporaneity principle in the 2010 Review, in order to justify changing from a lagged five-year average to a lagged three-year average. In practice, a three-year lagged average fails at improving contemporaneity.

The recent mining boom was not the first boom, nor will it be the last, so issues relating to contemporaneity are likely to repeat unless contemporaneity is addressed.

In summary, contemporaneity will achieve benefits in terms of improved budgeting, transparency and equity between States with more and less volatile revenues.

Contemporaneity is also quite achievable (see below).

Why would a system be intentionally maintained so as to create unneeded complexity in managing and interpreting budgets?

The case for achieving contemporaneity is solid.

Implementing Contemporaneity

Ideally contemporaneity should be implemented such that either:

- GST grants should be unaffected by cyclical or transient factors, leaving States fully accountable to manage budget volatility; or

- GST grants should reflect current circumstances, spreading volatility across States as it occurs.

The former can be achieved if HFE is implemented through the use of policy neutral indicators of long-term revenue capacity, which would provide States with very stable GST grants and hence the capacity for managing their budget volatility.

It is important to note this 'timeless' concept of contemporarily, based on policy neutral indicators, is entirely different to using a longer average period, as advocated by some parties.

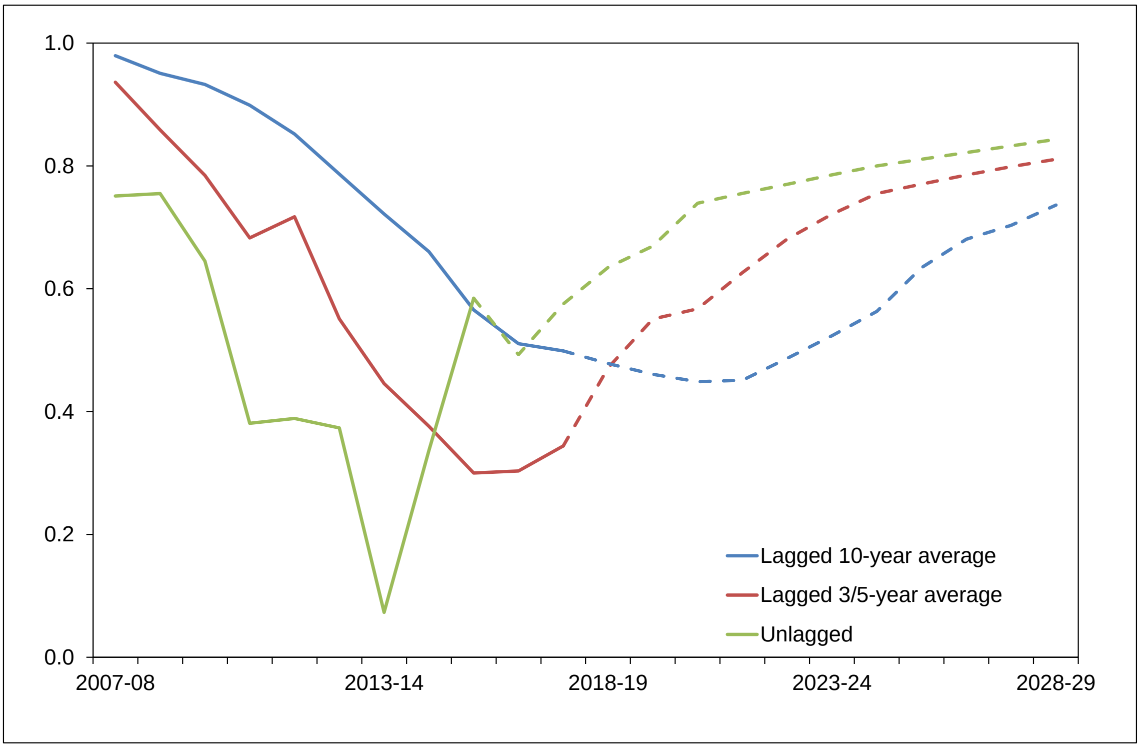
The idea behind a longer data period is not to have GST grants offset movements in own source revenues (which would occur with fully contemporaneous relativities). Rather, it is to remove volatility from GST grants, so States only face volatility in their own source revenues, which they can manage as it occurs (without the risk of it being exacerbated by movements in GST grants).

Stable GST grants could be a reasonable approach to addressing budget management and would also have the additional benefit of addressing some policy neutrality concerns, as relativities would be less responsive to State actions.

However, a lagged ten-year average would not sufficiently achieve stable GST relativities, does not achieve contemporaneity, and fails to improve budget management over the medium to long term.

Chart 6.2 compares Western Australia's relativity under a lagged ten-year average with the lagged average that the CGC has been recommending (three- or five-year average) and unlagged relativities. This chart includes extended forecasts to show the flow through of the end of the mining boom into the lagged ten-year average relativities, but forecasts beyond 2019-20 should be treated with considerable caution.

Chart 6.2: Western Australian Relativities



Notes: Projections are shown by dashed lines.

Earlier relativities have been put on a GST only basis (whereas the CGC recommendations applied to a combined pool of GST and health care grants prior to 2009-10).

Forecasts beyond 2019-20 should be treated with considerable caution.

Source: CGC and Western Australian Treasury.

As shown by Chart 6.2, ten-year average relativities would still have had a substantial fall, from 98% in 2007-08 to 44.9% in 2020-21 (not much above the three-year average of 29.9% in 2015-16), followed by a substantial rise.

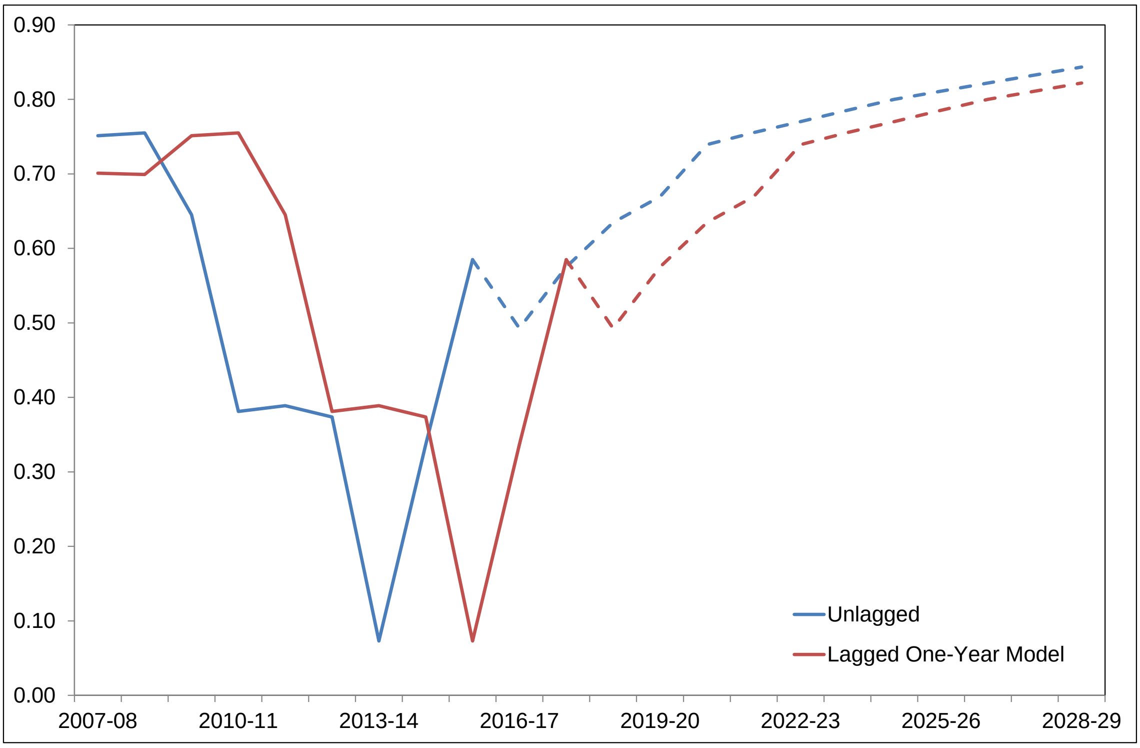
In Western Australia's case, a ten-year average would give results further from unlagged than the current arrangements for all years in Chart 6.2, except for the four years 2015-16 to 2018-19. A ten-year average could have:

- further distorted policy decisions by giving a greater illusion of revenues and surpluses arising from the time lags during the mining revenue boom; and
- resulted in a much more drawn-out process whereby the State faced very low GST grants in the face of economic hardship after the mining boom.

In contrast, other options aim to shorten the time lag to varying degrees including using only the latest available year of data and giving more weighting to the more recent data years. Western Australia does not support these options as they do not meaningfully address contemporaneity and budget management concerns.

For example, Chart 6.3 compares Western Australia's relativity under the CGC's proposed one-year model (lagged latest data year) and unlagged relativities.

Chart 6.3: Western Australia's Relativity – One-Year Model With Two-Year Lag



Notes: Projections are shown by dashed lines.

Source: CGC and the Western Australian Treasury.

While a one-year model has the benefit of not relying on estimates, the above chart shows volatility is increased without improvements to contemporaneity as it is not reflective of circumstances in the application year.

- In particular, years that relate to the collapse of iron ore prices (2013-14, and 2015-16 when the 2013-14 data year applies) are clearly not representative of circumstances in the year, and produces a worse result than methods that use longer lags.

Therefore, if HFE is not based on policy neutral indicators with 'timeless' relativities, then contemporaneity can only be achieved through the use of estimates on a fully unlagged basis.

This can be readily achieved through the use of forward estimates (which could be updated during the financial year) followed by a final correction in the following year to reflect final outcomes. Updating the estimates during the financial year would require some changes to the terms of reference. In the absence of these changes, the CGC could still determine an estimated contemporaneous relativity for the forthcoming year, with corrections incorporated in the relativities for the following two updates. This would still achieve much better contemporaneity than the current three-year average (see below).

The CGC's proposed absorption approach would produce essentially the same result for the selected volatile revenues/expenses that would be encompassed by this approach. However, assessments of GST relativities are considered superior for transparency reasons, particularly for the public and other non-HFE experts. For example, if only mining revenues were treated by absorption then:

- Western Australia could be reported as having a relativity above 1.00, which may misleadingly suggest it is receiving an above population share of the GST and cause public confusion; and
- it would appear the CGC would be 'directly' taking away States' royalties and encroaching on State sovereign rights.
  - Royalties are the price paid to extract ores owned by the people of the State. This option could make it appear as if the royalties instead belong to the people of Australia.

Another problem with the absorption approach is that it has unneeded messiness by distinguishing between volatile and non-volatile budget components, and the boundary between these is vague. If volatile budget components can be included in a contemporaneity approach, then non-volatile components can be as well.

Contemporaneity, including through an absorption approach, has been previously criticised on the basis that it would promote volatility of the GST.

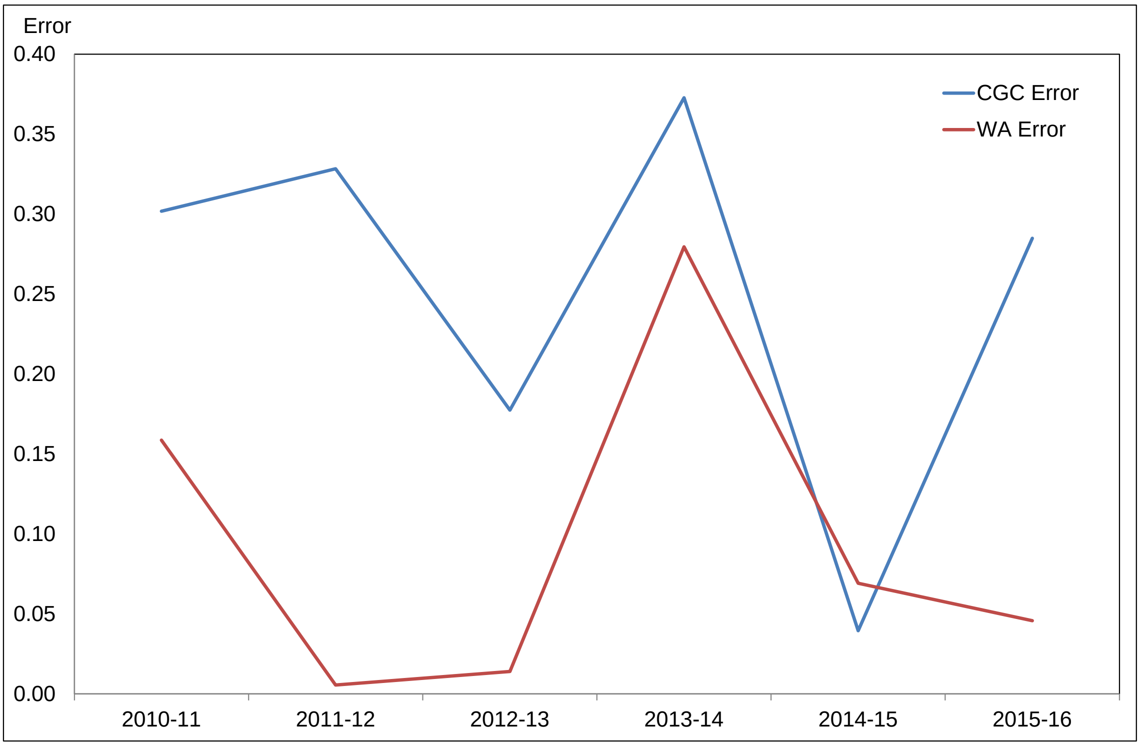
However, contemporaneity acts to stabilise States' total annual budgets, which is important for transparency and budget management, as discussed above.

Even using forward estimates to determine GST relativities on an unlagged basis should promote much better revenue stability than the CGC's current practice, which is effectively a forecasting method in its own right. For example it is forecasting the 2017-18 circumstances as reflecting the circumstances in the three years to 2015-16.

Chart 6.4 shows that Western Australia's Mid-year Review estimates of its unlagged GST relativity for the coming financial year have been a better estimator than the CGC's lagged three-year average. For example:

- In its December 2014 Mid-year Review, Western Australia's forecast of its unlagged GST relativity for 2015-16 was 0.539 and the actual 2015-16 data year relativity was 0.585 (a difference of 0.046).
- In comparison, in its February 2015 Update, the CGC recommended a GST relativity of 0.300 for 2015-16 (based on its forecast based on three previous years of data) (a difference of 0.285 compared to the actual data year relativity).

Chart 6.4: Forecasting Error of Unlagged GST Relativity[49]



Source: CGC and the Western Australian Treasury.

49 The unlagged GST relativity for a year is measured as the latest data year relativity calculated by the CGC for that year.

Corrections throughout the year, while not essential, are desirable as it should result in estimates that are close to the final outcome, limiting the size of the final correction in the following year, and acts to reduce any potential for gaming.

- Gaming concerns raised by other parties are overly exaggerated as the correction payment, along with any revisions within the year, would address these concerns and estimates could be achieved though consensus and/or consultation with States.

Backcasting

There is no need to consider backcasting under a fully contemporaneous approach, or where HFE is implemented on the basis of policy neutral indicators.

If backcasting must be used then the following principles could be used to guide their implementation.

- Backcasting should only be used in a limited capacity; otherwise it suggests there are issues with the current assessment approach, and it should probably be replaced with a more contemporaneous assessment instead of adjusting through backcasting.
- A mechanism to correct for errors must be available to allow for incorrect backcasting assumptions; otherwise States suffer windfall gains and losses.
- Careful consideration must be given to the technical implementation of backcasting. For example, changing population shares between the backcasted data and the data years the data is applied to should be accounted for.

7. Other Considerations

Key Points

- A standard 50% discount should be applied to all Commonwealth infrastructure payments to States.
  – This would allow funding to better reflect the Commonwealth's funding intentions while reducing flows based on political considerations.
- We consider that the GST distribution methodology lacks meaningful quality assurance. The CGC process falls short on:
  – transparent reporting of decisions;
  – consultation with States and reporting of significant changes following draft reports; and
  – independent expert review of the methods.
- The Assessment Guidelines are applied inconsistently in that for expenditures a disability is only adopted if it is shown to not be policy influenced, but for revenues the revenue base is adopted without modification unless the policy influences can be demonstrated.

Commonwealth Payments

The current assessment for Commonwealth infrastructure payments calls for rationalisation.

At present, there is a chaotic mix of full Commonwealth quarantining, 50% Commonwealth quarantining, 50% discounting and full equalisation being applied, on an essentially ad hoc basis. There is no fairness in this.

'National interest' justifications are not based on any transparent case for national interest. The CGC uses the Commonwealth's national network classification to apply its 50% discount, which has no consistent national interest basis.

Full exclusion of all these Commonwealth payments would provide consistency, but would not be consistent with HFE, as Commonwealth distributions generally reflect neither general needs nor national interest considerations very well. We have provided some evidence on this matter in our recent submission to the Productivity Commission review of HFE.

We believe a default minimum 50% discount applied by the CGC to all Commonwealth infrastructure payments represents a suitable compromise approach.[50] It would reduce pressures for States to seek quarantining and on the Commonwealth to grant quarantining. It would simplify the assessment and remove subjectivity around 'national interest' issues. The approach also recognises that there may be circumstances where full exclusion from the assessments is appropriate.

Lack of Meaningful Quality Assurance of Methods

The quality assurance (QA) of principles has been discussed in Chapter 1.

There are a number of quality assurance issues in relation to methods.

- Reporting decisions in a transparent way so that stakeholders can understand clearly what the CGC has done and why.
  - This is an objective of the CGC's QA process, but is not being achieved. To illustrate the problem, the CGC's introduction of a new health assessment that cost Western Australia over $200 million per annum in the 2015 Review did not have a clear supporting case for change; the conceptual validity of the new method (which Western Australia had questioned) was not established; material issues that had been raised were not laid out and systematically responded to; and there was no discussion of the losses and gains in the quality of outcomes from changing the method.
- Consultation with States.
  - What has been missing in recent years is active open engagement on issues of contention. The CGC and staff now tend to receive views or present them but not debate them.
  - Staff are now very conscious about not being seen to question positions that the organisation has taken, or even to question draft positions.
- Method consultancies.
  - States are now often surprised to see proposals for consultancies that pre-empt discussions on what issues might benefit from consultancies.
  - There appears to be much randomness about the topics chosen for consultancies – they can be very specific (including investigating a particular topic to the exclusion of other related topics) or very broad.
  - Consultancies are inherently subject to transparency risk, because the client will wish to deliver a product that the employer wants, and the employer has chosen the client. Yet QA on consultancies is rudimentary.

[50] The Commonwealth can still elect to fully quarantine payments.

- QA processes.
  - The CGC uses consultants to review and validate its processes. While these have a value, they cannot rate the quality of research, decision-making and documentation.
  - Much of what the CGC does is of a research nature. In academic fields, research publications are critically assessed by peers, there is competing research, and the 'truth' (i.e. academic consensus) gradually emerges (sometimes) from all this debate.
  - However, the CGC can only debate issues within itself or with States. This is helpful to some extent, but it is not adequate. Internal QA processes are at risk of being self-validating. Decisions rest in the hands of the CGC (a small body) rather than academic consensus. States' views have much value, but States have resource limitations and they are not independent commentators.
  - There is no independent technical review of the CGC's methods, by experts who have a good understanding of what the potential issues might be, and can critically assess whether there are gaps in the scope of issues considered, how they are considered, and the quality and relevance of data and methods in relation to the desired objective. Simpler and more transparent approaches to HFE would aid greatly in such reviews.

Solutions

We believe the solutions are partly cultural and partly formal.

Cultural issues are:

- a genuinely open view to issues, rather than defending 'lines';
- a commitment to full and timely consultation, active debate, and working with stakeholders on their issues; and
- engaging in and inviting debate on its methods and processes with experts and other interested members of the community.

Formal issues are:

- a transparent process. Data and methods should be well documented. Issues, reasoning and decisions should also be carefully documented. Gaps in the analysis, if they exist, should be highlighted to assist future debate;
- a quality analytic process. The CGC should work through issues and develop methods in a systematic and reasoned way, looking for flaws rather than committing to and defending positions prematurely. It should be alert to the strengths and weaknesses of data and methods. It should seek help and validation from States where possible, and use consultancies to assist on analytics in preference to conclusions;

- accountability to the terms of reference. The CGC is not a political body. If there is ambiguity in its terms of reference, or a question about achievability, these are normative matters that need to be agreed with the Commonwealth Treasurer in a timely way; and
- independent external review of methods by academics and other experts. To achieve meaningful quality assurance, the CGC's methods need to be reviewed by suitably-qualified external people. We have noted above what this involves.

Assessment Guidelines

We do not think the Assessment Guidelines are applied consistently between the expenditure and revenue assessments.

The Assessment Guidelines state that one of the conditions for including a disability in a category is that a presumptive case for it is established[51]. It also states that where there is a case for a disability but the CGC is unable to make a suitable assessment of its impact, its options are to discount its impact or make no assessment.[52]

However, the CGC also states that "Revenue assessments aim to measure the revenue each State would raise if it applied the Australian average tax rates to its tax bases",[53] rather than "Revenue assessments aim to measure the revenue each State would raise, if it applied the Australian average tax rates to its populations, with those populations being weighted by identified revenue disabilities".

In effect, the CGC treats interstate differences in per capita tax bases as if they were disabilities,[54] but does not formally identify them as such, nor test their suitability in the same way as it does potential disabilities in expenditure categories. No presumptive case for a disability for tax bases has been made, let alone that it should be applied without a discount. Indeed, the CGC's discussion paper section on disabilities refers to tax bases as if they were self-evidently exogenous.[55]

To be consistent at the macro level, relativities should be calculated with a degree of consistency between the revenue and expenditure assessments. Otherwise, there is potential for systematic bias.

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[51] Commonwealth Grants Commission, *2020 Review: The Principle of HFE and Its Implementation: CGC 2017-02-S*, page 49.

[52] *Ibid*.

[53] *Ibid*. page 46.

[54] "We often refer to such non-policy influenced differences among the States as 'disabilities' which generate different State needs for GST. They mean States need more or less than the average per capita amounts of GST." Commonwealth Grants Commission, *2015 Review Report – Volume 2 – Assessment of State Fiscal Capacities*, page 3.

[55] "For revenue assessments, it can often do this [reflect what States do] easily. Many revenue assessments use the base that States actually tax, and apply actual (national average) tax rates to that base." Commonwealth Grants Commission, *2020 Review: The Principle of HFE and Its Implementation: CGC 2017-02-S*, page 22.

The CGC considers that the implicit disability it assesses for each revenue category should not be discounted for the potential impacts of State policies on tax bases except to the extent to which these impacts can be proven. In other words, its starting point is the disability. By contrast, in the expenditure area, it appears more willing to calculate "what the fiscal capacities of the States would be if the policy differences were removed".[56]

Examples of the CGC's recognition of the potential impact of State policy in assessments of expenditure categories are:

- the location and/or degree of provision of private health facilities;[57]
- the age profile of the public housing stock;[58]
- projects funded in each State under the Sustainable Rural Water Use and Infrastructure Program;[59]
- differences in electricity supply costs to capital cities;[60]
- provision of community amenities;[61]
- road lengths;[62]
- use of rail in public transport;[63]
- assessment of national parks and wildlife services;[64] and
- cost of borrowing.[65]

We are not aware of any case being made that differences in per capita tax bases are not amenable to being influenced by policies on tax rates, regulation, industry development, infrastructure, education or training.

But the CGC has admitted that because of just one issue, that of different policies on fracking and coal seam gas, "it is difficult for the Commission to determine from observed activity what a policy neutral revenue base for the States with bans would be".[66] Even a nominal consistency with expenditure assessments would, in these circumstances, require discounting of the apparent disability.

56 Commonwealth Grants Commission, *2015 Review Report - Volume 1*, page 76.
57 *Ibid*. Volume 2, page 186.
58 *Ibid*. page 271.
59 *Ibid*. page 283.
60 *Ibid*. page 292.
61 *Ibid*. page 294.
62 *Ibid*. page 337.
63 *Ibid*. page 361.
64 *Ibid*. page 400.
65 *Ibid*.
66 Commonwealth Grants Commission, *2020 Review: The Principle of HFE and Its Implementation: CGC 2017-02-S*, page 27.