Western Australia's Submission to the Commonwealth Grants Commission's 2025 Methodology Review

Fiscal equalisation, supporting principles and assessments guidelines

May 2023

Western Australia's Submission to the Commonwealth Grants Commission's 2025 Methodology Review
Fiscal equalisation, supporting principles and assessments guidelines
© Government of Western Australia 2023

Further information relating to this report may be obtained by emailing igr@treasury.wa.gov.au

Contents

Key points and answers to consulation questions 1
Introduction 3
Horizontal fiscal equalisation principle 4
Existing supporting principles 4
What States do 4
Policy neutrality 6
Practicality 7
Contemporaneity 7
Additional supporting principles 10
Policy consistency 10
Conservatism 11
Uncertainty 11
Discounting 11
Choice of discounting 12
Uncertainty is no different from unreliable data or methods 13
Conclusion 13
Assessment guidelines 14
Materiality thresholds 14

KEY POINTS AND ANSWERS TO CONSULATION QUESTIONS

Western Australia's response to Commonwealth Grants Commission's (CGC's) principles consultation paper comprises Western Australia's March 2023 *Principles of Horizontal Fiscal Equalisation* Occasional Paper and this submission.

Horizontal fiscal equalisation (HFE) principle

Q1. Does the approach to horizontal fiscal equalisation articulated in the 2020 Review remain the appropriate first step in determining GST distribution in accordance with the GST distribution legislation?

We support the existing HFE principle.

- However, as noted in the CGC's paper, it is not possible to accurately quantify HFE.

Existing supporting principles

It would help if the CGC were to give explicit definitions so that each supporting principle could be quoted.

Q2. Does the 'what states do' principle, with assessments based on the weighted average policy of all states, remain appropriate?

The *what States do* supporting principle is generally appropriate.

- However, the HFE principle only requires the assessment of 'same' policies by the States and Territories (States), not 'average' policies.
- Hence, the CGC has considerable room to move on its choice and specification of standards. The CGC should take advantage of this flexibility if its usual approach to the standard proves difficult or incur problems.
- The existence of multiple options for standards demonstrates the inherent uncertainties in the quantification of HFE.

Q3. Does the policy neutrality principle remain appropriate, recognising there are particular circumstances where further consideration should be given to policy neutrality, such as dominant state issues and some instances of state tax reform?

The *policy neutrality* supporting principle remains appropriate, but is not achieved.

There are two main problems with policy neutrality.

- The dominant State problem is best addressed through global revenue assessments.
- The CGC's use of observed revenue bases contravenes the HFE principle as they do not reflect "same effort". This warrants an additional *policy consistency* supporting principle.

Q4. Does the practicality principle remain appropriate for ensuring assessment methods are simple, reliable and fit for purpose?

The *practicality* supporting principle remains appropriate.

- However, there is much judgement in the application of practicality.
- The best way to quality assure methods is through peer review. This is not possible if underlying data cannot be shared among the States.

Q5. Does the 3-year lagged average approach continue to provide the best balance between contemporaneity, predictability and stability in measuring states' fiscal capacities?

Any approach to equalising fiscal capacities will implicitly involve an approach to *contemporaneity*.

- The CGC should reconsider the description of this supporting principle, including referring to predictability and stability, given it now uses these criteria.
- The current lagged three-year average is appropriate for *equalisation over time*. However, if the CGC is keen for *full contemporaneity*, it should consider the use of one-year lagged estimates (for at least the more volatile elements), instead of two-year lagged actual data.

Additional supporting principles

Q6. Do states agree there is no need to introduce any new principles?

We support an additional *policy consistency* supporting principle, as the HFE principle's requirement that States be assessed at same policy has not been addressed in past reviews.

- This would be defined as: *The CGC should calculate revenue bases and expense drivers which reflect the same policies across States (taking into account all policies that could affect the size of these bases and factors).*
- The consultation paper states that it is unlikely to be possible to comply with this supporting principle. We came to the same conclusion. Hence, it should be addressed as a major source of *uncertainty*.

The CGC should acknowledge the considerable *uncertainty* that arises in seeking to quantify HFE (and that reliable quantification is unachievable). To address this, we support an additional *conservatism* supporting principle.

- This would be defined as: *In the face of uncertainty, the CGC should err on the side of a smaller GST redistribution through discounts towards equal per capita.*

Q9. Does the 2020 Review approach to discounting remain appropriate?

The CGC already implicitly applies *conservatism* through its discounting.

- However, the CGC is inconsistent in its use of discounting. The consultation paper provides a rationale to discount for unreliable data and methods, but not for policy neutrality or general uncertainty. But we believe the logic is flawed.
- The CGC should make broader use of discounting. This would be best achieved through discounting the final (pre-reform relativities) towards one, or introducing a floor on the relativities.

Assessment guidelines

Q7. Do the assessment guidelines, and the Commission's application of those guidelines, remain appropriate?

Apart from the need to update materiality thresholds and the application of discounting, we support the existing assessment guidelines and the CGC's current application of them.

Q8. Should the materiality thresholds be increased broadly in line with state spending per capita (to $45 per capita for assessment of a driver and $15 per capita for a data adjustment)?

We support indexing materiality thresholds, but prefer retaining indexation by the State government price index, for simplicity. The large increase under State spending per capita may be distorted by COVID-19 spending, so it may be premature to lock in such a large increase.

Given the large uncertainties in quantifying HFE, materiality threshold should not be used to judge between different conceptual approaches to HFE.

Introduction

In April 2023, as part of its 2025 Methodology Review, the CGC released its *Fiscal equalisation, supporting principles and assessments guidelines consultation paper* (CGC paper).

Our response to the CGC paper comprises two volumes:

- Western Australia's March 2023 *Principles of Horizontal Fiscal Equalisation* Occasional Paper, which addresses the CGC's principles from a general perspective (WA paper); and
- this submission, which is aimed more directly at the specific questions and analysis in the CGC paper.

Horizontal fiscal equalisation principle

The Western Australian Treasury supports the HFE principle as the basis of determining GST grant shares prior to the application of the floors specified by the GST distribution reforms.

We also support the current wording of this principle, that is:

> *After allowing for material factors affecting revenues and expenditures, each state would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own-sources and operated at the same level of efficiency.*

However, as discussed in the WA paper, we do not believe it is possible to reliably quantify true HFE. The CGC paper also acknowledges this.[1]

Hence, while this principle should be the overriding basis for the CGC's recommendations, the CGC should recognise that this principle can only ever be aspirational. The CGC should, therefore, take caution in redistributing funding according to this principle, and inform governments on the limitations of this principle.

Existing supporting principles

As a general comment, we note that the CGC paper describes each supporting principle, but does not provide an explicit definition for each principle. It would help if the CGC were to give explicit definitions, so that just as the HFE principle is clearly defined, each supporting principle would be clearly defined.

We are also concerned that the CGC paper justifies support for retaining the existing supporting principles based on the CGC's consideration of these in the last two methodology reviews. We found the consideration of the supporting principles in those two reviews as disappointing. We are also aware that new ideas can take time to be developed clearly and be accepted, so hope that the CGC will consider our arguments in this submission on their merits, rather than rely upon conclusions reached in past reviews.

What States do

The *what States do* supporting principle is that CGC methods should, as far as practical, reflect what States collectively do. In practice, the CGC attempts this by using the average of States' policies.

We note that the HFE principle does not require the use of *what States do*. Rather, the HFE principle says that States should be able to provide services at the "same standard", if they

[1] CGC, *Fiscal equalisation, supporting principles and assessments guidelines consultation paper*, April 2023, page 5, paragraph 10.

make the “same effort” to raise revenues and operate at the “same level of efficiency”. It does not state how these “same” policies should be chosen.

Nevertheless, we support the use of what States do as the general approach.

However, we note that average policy can be specified many different ways. For example, it may be interpreted narrowly or broadly, and may use differing concepts, such as legal or economic incidence of taxes.

Given this, and that the HFE principle does not require *what States do*, we consider that the CGC has considerable room to move on its choice and specification of standards. The CGC should take advantage of this flexibility if its usual approach to the standard proves difficult or incur problems.

Furthermore, the concept of “average” State policy becomes problematic when one State dominates the expenditure or revenue raising. This causes significant policy neutrality problems, but even apart from that, it raises conceptual issue of whether an average policy driven by one State can actually be described as an average.

In these cases, it is not clear at all what the other States would do if they faced the circumstances of the dominant State.

- For example, the CGC is implicitly assuming that if other States had similar iron ore production to Western Australia, then they would levy similar royalty rates (despite the other two States that produce iron ore, in small amounts, levying substantially lower iron ore royalty rates than Western Australia).

It also undermines an aim of *what States do* of allowing States to operate at higher or lower standards than the average.

The HFE principle requires equalisation to be calculated on “same” policy, so if a State applies higher than standard effort in raising revenues, the excess must not be equalised away, and if a State applies lower than standard effort in raising revenues, it must not be compensated for the shortfall. The *what States do* supporting principle sets this standard at the average.

However, Western Australia has virtually all of the iron ore production. This means that the average royalty rate used by the CGC is virtually equal to the Western Australian iron ore royalty rate. Any changes to the State’s iron ore royalty rate will cause the “national average” rate to just follow Western Australia’s royalty rate.

Over the period 2010 to 2013, Western Australia made major iron ore royalty rate increases (based on sound policy). Despite this, in 2021-22 only $59 million of Western Australia’s iron ore royalties were recognised as being above the “national average”, and hence not subject to equalisation (this amount is tiny compared to the size of the extra royalty collections from the rate increases). Unlike almost all other revenue sources received by the States, the CGC does not give Western Australia the option of levying a higher-than-average iron ore royalty rate.

This contrasts to Queensland's mining revenues, where Queensland's actual 2021-22 revenues exceeded its assessed revenues by $563 million. As another example, in 2021-22 the ACT collected $224 million more in payroll tax than its assessed revenue (this would be $1.4 billion if the ACT has Western Australia's population). In both cases, these excess amounts are not equalised away.

This also demonstrates that HFE depends so greatly on the standard chosen by the CGC. If, by 1 July 2019, Western Australia had reduced its iron ore royalty rate to match the other iron ore producing States, its 2023 Update pre-reform GST grant (used to calculate the no-worse-off guarantee (NWOG)), would have been $4.2 billion higher. Western Australia's 2023 Update NWOG relativity would have been 0.55 instead of the 0.10 recommended by the CGC.

In our view, these issues are a source of uncertainty, which further support our proposed *conservatism* supporting principle later.

Policy neutrality

The CGC's explanation of its *policy neutrality* supporting principle is that States' policy choices should not directly influence their GST share, and the CGC's assessments should not influence States' policy choices.

These two aspects are essentially just the opposite sides of the same coin – there will be influences on States' policy choices if those policy choices have significant influences on GST shares.

There are two main ways that policy neutrality can be contravened.

- When States dominate a revenue source or expense function, their impact on the national average standard disproportionately influences the assessments.
  - This happens in just a few cases, and the CGC has not adopted any satisfactory solution to it.
  - Although the HFE principle does not explicitly say that States should not be able to influence their assessments, it is a highly desirable outcome
  - The WA paper proposed addressing the dominant-State problem for revenues with global revenue assessment. Alternative solutions are an external standard royalty rate or discounting.

- If States can influence their revenue bases or cost-weighted user populations, then this will influence the assessments.
  - The CGC seeks to address this for expenses by identifying drivers (disabilities), but generally makes no attempt to do so for revenues.
  - The HFE principle requires this to be addressed, as it states that assessments should be based on “same” policies.
  - As this has not been addressed in past reviews, the WA paper proposed an additional *policy consistency* supporting principle (discussed further later in this submission).

In considering solutions to the dominant-State problem, it is worth considering a real-world example. In 2017, the Western Australian Government moved to increase the gold royalty rate. However, the Parliament ceased the move when it became generally understood that the State would lose about 60% of any additional royalties through the GST distribution.

- This demonstrates that merely merging the mining revenue components into a single royalty assessment would not be sufficient to achieve policy neutrality. This is why we have proposed a global revenue assessment covering both taxes and royalties.
- A global revenue assessment would still reflect *what States do* overall, but on a broader basis, using the flexibility that we suggested above. It would allow States differing tax and royalty mixes.

Practicality

The *practicality* supporting principle covers simplicity, reliability, and fitness for purpose. It is required to meet the HFE principle and the terms of reference.

However, as discussed in the WA paper, there is much judgement in the application of practicality.

Also, for a method to be fit for purpose, it should be quality assured. The best way to achieve quality assurance of a method is to subject it to peer review. This is only possible when the data underlying methods can be shared among the States. The CGC should consider discounting methods when the drivers are overly dependent on confidential data, given this introduces uncertainty as to the reliability of the methods.

We discuss *materiality* and *discounting* later.

Contemporaneity

The contemporaneity principle is that, to the extent reliable data will allow, the distribution of GST provided to States in a year should reflect State circumstances in that year.

Any approach to equalising fiscal capacities will implicitly involve an approach to contemporaneity.

The CGC's supporting principle appears to describe fully contemporaneous assessments, as opposed to lagged assessments (where equalisation is achieved over time).

- However, after presenting full contemporaneity as its supporting principle, the CGC paper then uses the criteria of predictability and stability (which are not part of the HFE principle nor embodied in any supporting principles) to effectively support equalisation over time. This appears to negate the principle.
- If predictability and stability are desired outcomes, the CGC should write them into the contemporaneity principle, preferably with an explicit definition.

The CGC uses lagged three-year averaging as its solution to contemporaneity, which is appropriate if the CGC is seeking equalisation over time.

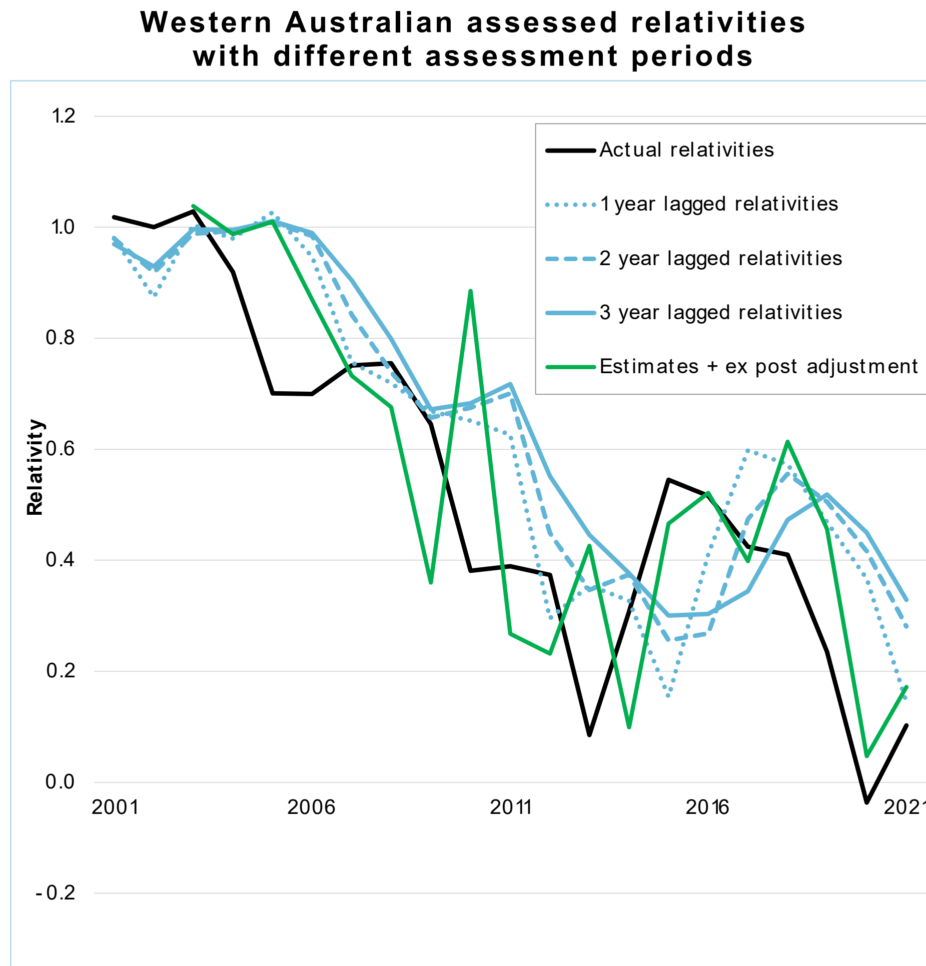
If the CGC seeks fully contemporaneous assessments, then it must assume the lagged three-year average is a reasonable projection of the grant year. This clearly involves a degree of unreliability. The CGC has previously rejected the use of forecasts, due to their unreliability, but it is in essence using its own forecasts (the data may be a reliable measure of what happened in the assessment years, but that does not mean it is a reliable measure of what will happen in the grant year). Any decision about reliability should ask the question as to whether using forecasts (with ex post adjustments) gives a more or less reliable result than using historical years as the forecast.

In this respect, Figure 1 of the CGC paper (giving different options for calculating Western Australia's relativity over time) is an incomplete analysis. It does not provide the relativities that would have been produced if forecasts had been used.

We have attempted such analysis, focusing just on Western Australian iron ore royalty collections, as these are by far the most volatile aspect of the CGC's assessments.

- Our analysis shows that using forecasts of the grant year in Western Australia's Mid-year Reviews (the latest official forecasts available at the time of each annual update) would not improve the HFE assessment of circumstances in the grant year.
- However, we found that estimates of the year in progress could be used to reduce the two-year time lag to a one-year time lag.
  - We took the CGC's "1 year lagged relativities" and replaced the impact of Western Australia's iron ore royalty collections with an impact based on the Mid-year Review estimates for the year in progress (plus an ex post adjustment for the difference between the previous year estimate and the actual outcome).
  - The result is the green line in the following Figure 1.

Figure 1



With a few notable exceptions, this use of estimates performs comparatively well. Also, although it does not match actual relativities in the same year, it adjusts for this in the following year, whereas the CGC's current approach takes four years to pick up States' grant-year circumstances.

Hence, we present this as an option that the CGC could consider. We will provide the CGC and other States with our calculations.

We note that equalisation over time will produce more predictable and stable GST grants, but full contemporaneity would make total State revenues (including GST) more predictable and stable.

Additional supporting principles

As discussed in the WA paper, we propose two additional supporting principles of *policy consistency* and *conservatism*.

Policy consistency

We support an additional *policy consistency* supporting principle, as the HFE principle's requirement that States be assessed at same policy has not been addressed in past reviews.

This would be defined as:

> *The CGC should calculate revenue bases and expense drivers which reflect the same policies across States (taking into account all policies that could affect the size of these bases and factors).*

The CGC paper states that:[2]

> *While there will inevitably be a range of different policies affecting a state's revenue capacity, it is unlikely to be possible to identify, and make reliable adjustments for, such differences.*

This was the same conclusion we came to in the WA paper, that true HFE is unquantifiable.

The HFE principle explicitly requires an assessment of revenues under "same effort". We are under no illusion that this is achievable – but the CGC's terms of reference require it to try. To the extent that this is not possible, the CGC should be advising the Federal Treasurer that its recommended relativities have a significant degree of unreliability.

Further unreliability arises from the difficulty of identifying "same" policies when:

- a State dominates the revenue bases, so there is no way of knowing what other States' policies would be if they had a comparable revenue base (this relates to the philosophical issue discussed above under *what States do*, rather than the dominant State problem discussed above under *policy neutrality*); or
- when States have differing revenue base mixes, and tailor their policies to those mixes, so their policies are not comparable.

---

2 CGC, *Fiscal equalisation, supporting principles and assessments guidelines consultation paper*, April 2023, page 14, paragraph 49.

Conservatism

Uncertainty

As the WA paper discussed, there are many sources of uncertainty in the CGC's assessments.

These include:

- inability to obtain policy consistent revenue bases (discussed above);
- ongoing changes in methods in methodology reviews;[3]
- options for the choice of standards (discussed above);
- assessments that are difficult to quantify, sometimes despite a valid conceptual case (e.g., water quality, isolation, economic development); and
- data that are unreliable or not fully fit for purpose.

The WA paper quantified the potential impacts of these uncertainties, showing that these impacts are potentially very large. In particular, the 2010 Review method changes for the Northern Territory were almost identical (in per capita terms) to the estimated benefit to Western Australia from the GST distribution reforms in the 2022-23 grant year.[4]

- Other States have suggested that Western Australia is getting a windfall gain from the reforms, because it is getting more than HFE dictates. However, this example shows that HFE is not reliable enough to justify this claim.

Discounting

Our conclusion from considering *uncertainty* is that the CGC should be advising the Federal Treasurer of the substantial uncertainties in the quantification of HFE. This could involve error bounds, but we concluded (in the WA paper) that this would not be helpful to the Federal Treasurer. Hence, we propose a new *conservatism* supporting principle, defined as:

> *In the face of uncertainty, the CGC should err on the side of a smaller GST redistribution through discounts towards equal per capita.*

The CGC already implicitly applies this supporting principle, albeit selectively, in its application of discounting.

The CGC paper contrasts discounting for data and method reliability (which the CGC does) and discounting for policy neutrality and general uncertainty (which the CGC does not do). However, this distinction is flawed for the following two reasons.

---

3 This does not mean that method changes are inappropriate. It merely shows that methods are highly uncertain.

4 Since that paper was drafted, the CGC has released its 2023 Update, which shows a higher benefit from the reforms for Western Australia in the 2023-24 grant year. However, we expect the average benefit for Western Australia over time to remain lower than the 2010 Review method changes for the Northern Territory.

- For discounting for data and method reliability, the CGC paper[5] presents the choice between a discounted assessment and no assessment. However, for discounting for policy neutrality and general uncertainty, the CGC paper[6] instead compares between a discounted assessment and an undiscounted assessment.
- The distinction between data and method reliability, and general uncertainty is spurious, as uncertainty arises due to data and method unreliability.[7]

Choice of discounting

The CGC has compared only two discounting options for each of data and method reliability, and policy neutrality and general uncertainty (which differ). However, we want to take a step back and consider all the options prior to determining which are reasonable and which are unreasonable. On this basis, the CGC always has the choice between no assessment, an undiscounted assessment and a discounted assessment. We illustrate this by assuming that the data and method give a HFE result of +$100 million for one State.

If the data and method are irrelevant to HFE, then the CGC would not use them, so it would choose no assessment. If the data and method are relevant and totally reliable, then it would choose an undiscounted assessment, where +$100 million would precisely reflect HFE.

However, if the data or method are only somewhat reliable, then the CGC might consider HFE to be in the range of +$75 million to +$125 million.

- This does not mean that HFE differs from +$100 million. Generally, around +$100 million would still be the most likely value of HFE.
- There is no reason to believe that HFE is more likely to be +$75 million than +$125 million, unless there are other data or another method that provides further information.[8] For the purpose of this illustration, we assume the CGC has not identified other data or another method.

If the data or method are quite unreliable, then the CGC might consider HFE to be in the range of +$50 million to +$150 million. If they are very unreliable, the range might become from equal per capita to +$200 million. Even then, HFE is most likely to be around +$100 million, and is no more likely to be around equal per capita than around +$200 million.

However, for each of the above degrees of unreliability, the CGC would always choose the lower end of the bound (+$75 million, +$50 million, and equal per capita), by discounting by

---

5 CGC, *Fiscal equalisation, supporting principles and assessments guidelines consultation paper*, April 2023, page 18, paragraph 65.

6 CGC, *Fiscal equalisation, supporting principles and assessments guidelines consultation paper*, April 2023, page 19, paragraph 69.

7 To clarify, we argue that discounting is the appropriate response to uncertainty caused by lack of policy consistency, but not for the dominant State problem for policy neutrality. Our preferred solution for the dominant State problem is a global revenue assessment, rather than discounting. However, as noted in the WA paper, if discounting is done to address uncertainty, then it will also partially mitigate the dominant State problem.

8 In which case a blended assessment would be appropriate.

25%, 50% and 100% respectively. This shows that the CGC has a preference for discounting towards equal per capita, consistent with our proposed *conservatism* supporting principle.

Importantly, the above illustration is equally valid if we replace reference to “data and method unreliability” with reference to “uncertainty in the results of the assessment”. The above illustration can support the CGC’s conclusion that it should not discount for uncertainty, but in that case, it would not discount for data or method unreliability either.

The CGC paper states that to “discount for differences in development policies would assume that in all cases, States with above average revenue raising capacity are in this position because of greater, or more effective, historical State development policies”. While we would not necessarily agree this in *all* cases, the CGC’s assumption is that it is true in no cases. Our proposed *conservatism* principle accommodates the possibility that this is true to some degree (which is arguably plausible). Hence, an element of partial discounting is appropriate.

Uncertainty is no different from unreliable data or methods

A major source of uncertainty is due to lack of policy consistency. Lack of policy consistency arises in the revenue assessments as the CGC uses observed revenue bases, rather than policy consistent revenue bases. This is a case of using data that are not fit for purpose, due to the absence of data that are fit for purpose. It is inherently a data reliability problem, and so not distinguishable from other data reliability problems. We also note that the CGC does discount for policy consistency in the case of gambling tax.

Likewise, we earlier discussed how there are choices for the standard, and in some cases, it is questionable how equitable the existing standards are. Hence, there is uncertainty in these case as to whether the appropriate standard has been chosen. This uncertainty is effectively unreliable methods.

Conclusion

Based on the above discussion, we reach the conclusion that the CGC should be using discounting far more often.

In the WA paper, we pointed out that discounting individual assessments can actually result in larger GST redistributions. Hence, we consider that the CGC should instead discount the final (pre-reform relativities) towards one. The size of this discount would be informed by the magnitude and intention of the potential assessment-by-assessment discounts.

An alternative, bearing in mind that an excess GST redistribution away from a State is a greater problem than an excess GST redistribution towards from a State, would be for the CGC to introduce a floor on the relativities.

It should be noted that although our proposals would involve the CGC in some respects moving towards the arrangements mandated by the GST distribution reform legislation (which are outside the scope of the 2025 Review), we think it is important that the reasons for the

2018 reforms be recognised in the underlying calculation of HFE. This would take the attempted application of the HFE principle (which is inside the scope of the 2025 Review) to its logical conclusion.

Assessment guidelines

Apart from discounting (discussed above) and materiality thresholds (discussed below), we support the existing assessment guidelines and the CGC's current application of them.

Materiality thresholds

While the CGC is taking a detailed approach to quantifying HFE, materiality thresholds are a useful tool to guard against increasing complexity. They should not be too large, as there is a risk of bias if they rule out including a range of drivers that work in the same direction. However, it makes sense to index them over time, so that their impact does not diminish.

For simplicity, we would prefer to continue to use the State government price index that has been used over the past decade. We are also concerned about the size of jump in the $35 per capita materiality threshold under State expenditure per capita (about 30%). It is possible that this index may be distorted by COVID-19 spending, so it may be premature to lock in such a large increase.

We note that the chosen thresholds are rounded to the nearest five dollars per capita. For simplicity, this is appropriate. However, the indexation should continue to apply to the same base year (e.g., over ten years for this review and over fifteen years for the next review), so that rounding errors do not accumulate.

As discussed in our principles occasional paper, there are large variations in how HFE could be quantified, so the current small materiality thresholds should not be used to judge whether a different approach to HFE still achieves HFE or not, as long as there is an underlying logic to the approach taken.