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Mr Greg Smith
Chairperson
Commonwealth Grants Commission
Phoenix House
86-88 Northbourne Avenue
BRADDON ACT 2612

Dear Mr Smith

ISSUES ARISING FROM 29 OCTOBER 2014 TELEPRESENCE

Thank you for the opportunity to present our views and respond to the Commonwealth Grants Commission's (CGC's) queries at the recent telepresence meeting.

In attachments to this letter, we have sought to:

- document views we expressed on how to make the GST relativities more contemporaneous (Attachment A);
- provide responses to some of the issues raised by the CGC at the telepresence (Attachment B); and
- provide some further reflections and analysis in relation to some of the issues listed in our presentation slides on 'puzzling proposals' (Attachment C).

We welcome opportunities to discuss and clarify these issues with the CGC's staff.

Yours sincerely

Michael Barnes
ACTING UNDER TREASURER

20 November 2014

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IMPLEMENTING CONTEMPORANEITY

Achieving contemporaneity will require the use of forecasts. As there will always be uncertainty in forecasts, we expect that there would also have to be adjustments afterwards for differences between actual outcomes and forecasts. The timing and implementation of these adjustments would depend upon whether the CGC continues to receive terms of reference for annual updates as at present or whether the terms of reference are changed to allow the CGC flexibility to update relativities.

Ultimately, implementing HFE in a contemporaneous manner will involve some volatility in GST relativities. However, this volatility is expected to be small compared to the potentially large budget volatility that occurs in the absence of contemporaneity.

Greater contemporaneity would enhance the operation of HFE, spreading volatility across jurisdictions and ensuring that no one jurisdiction's population and businesses have to bear a disproportionate share of the burden of short-term fiscal savings measures and temporary tax increases.

CURRENT PRACTICE – NO FLEXIBILITY TO UPDATE RELATIVITIES

Using 2015-16 relativities to illustrate, under current practice, the CGC could make recommendations as follows.

- February 2015 – recommendation of 2015-16 relativities based on forecasts.
- February 2016 – adjustment to 2015-16 relativities based on estimated outcomes (to be incorporated in the recommendation of 2016-17 relativities).
- February 2017 – final adjustment to 2015-16 relativities based on actual outcomes (to be incorporated in the recommendation of 2017-18 relativities).

We envisage that the second adjustment would be smaller than the first.

ALTERED TERMS OF REFERENCE

We envisage an improvement to the above proposed arrangements if the CGC reported twice yearly as follows (also illustrated using 2015-16 grants).

- February 2015 – recommendation of 2015-16 relativities based on forecasts.
- August 2015 – revised 2015-16 relativities based on revised forecasts.
- February 2016 – second revision of 2015-16 relativities based on estimated outcomes (recommended 2016-17 relativities would also be reported).
- August 2016 – third revision of 2015-16 relativities based on final or close to final outcomes, which would be used to calculate GST entitlements for 2015-16 (revised 2016-17 relativities would also be reported).

- February 2017 – any final adjustments to 2015-16 relativities based on final outcomes could be added to the second revision of 2016-17 relativities, if material (recommended 2017-18 relativities would also be reported).

Under the above proposal, relativities would be revised a few times within and after the year to which they apply, in the same way that the GST pool and populations are also revised during the year and after the year.

Although the CGC cannot determine its terms of reference, the CGC could recommend changes to its terms of reference (in line with the above) in its 2015 Review report.

ISSUES RAISED BY THE COMMONWEALTH GRANTS COMMISSION

ACHIEVING CONTEMPORANEITY – ARE TRANSITIONAL ARRANGEMENTS NEEDED?

The CGC asked whether transitional arrangements would be needed if it were to move to contemporaneous assessments, noting that Western Australia has benefited from time lags in the past.

We do not believe transitional arrangements are required.

If the CGC were changing from a principle of lagged equalisation to contemporaneous equalisation, then it would be appropriate to consider transitional arrangements. However, the CGC made it clear in its 2010 Review report that one of its principles was contemporaneous equalisation. In the 2015 Review draft report, it has stated that is continuing to have a contemporaneous equalisation principle.

In effect, the CGC has already been making forecasts of the circumstances in the application year – by (with some exceptions) assuming that those circumstances will be the same as the historical data years.

Therefore, what Western Australia is asking is not for a change of principle, but for a method that better implements the existing principle. It is not normally the CGC's practice to transition method corrections or improvements.[1]

Accordingly, whether or not Western Australia or any other State was advantaged by the previous approach to contemporaneity does not appear relevant to the CGC's future approach to contemporaneity. In any case, we do not believe that Western Australia was advantaged. Given the various data and conceptual difficulties, the CGC's relativities are no more than very rough estimates of States' equalisation requirements, and we believe that Western Australia's GST share has been underestimated by over $2 billion per annum by the CGC's 2010 methods, as described in our submissions.

Even if Western Australia were held to be "advantaged" by the past time lags (which is a doubtful proposition), any delay to achieving contemporaneity going forward would constitute a penalty on Western Australia. It would increase the fiscal adjustment that Western Australia needs to undertake, the need for which reflects the 'fiscal illusion' created by past problems with the CGC's methods.

We note also that the CGC has already changed its method in the 2010 Review, when it switched from five-year averaging to three-year averaging. This change cost Western Australia an additional $2 billion over the five years in which the 2010 Review methods applied. Although we asked for transitional assistance during the 2010 Review, the CGC rejected this request.

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[1] We are aware of one previous transitional arrangement, when the CGC switched from cash to accrual accounting for its superannuation assessment. That transitional arrangement was not to address a correction or improvement to methods. Rather it was to transition from a correct cash method to a correct accrual method.

OUTSTANDING MINING RELATED EXPENDITURE DATA REQUEST

We apologise for the confusion in relation to the CGC data request of 3 March 2014 on mining related expenditures.

As we have now explained to the relevant CGC officers, we were not able to directly respond to this data request due to uncertainty about the scope of relevant expenditures (in a State whose business is largely mining) and the inability to apportion costs of regulation, services, and infrastructure spending (both general government and trading enterprises) between mining and non-mining related activity. Our practical response to the data request was to provide very detailed information on the allocation of the State's Royalties for Regions program, much of which is support for the State's mining economy.

ADJUSTING STATE PAYROLL TAX BASES FOR INTERSTATE FIFO WORKERS

We agree that, ideally, data is required to adjust all States' payroll tax bases for interstate FIFO workers. However, in practice, the CGC may need to make judgements, recognising that Western Australia is likely to be most affected by the issue. Our September 2014 submission recommends adjusting Western Australia's payroll tax base down by at least 1% to reflect that perhaps 10% of our FIFO workforce reside in another State.

STATE VS ABS DATA ON VALUE OF MINING PRODUCTION

In our September 2014 submission, we proposed that the CGC use data from our Department of Mines and Petroleum (DMP) rather than from the ABS for the value of production of several minerals, for determining mining revenue bases. The CGC has asked how it would ensure consistency of approach across States.

There were two issues we raised – ABS estimates for manganese and ABS use of metal content for nickel, gold and copper.

Manganese

The issue with manganese is that the ABS does not appear to be providing consistent estimates across States.

The ABS is making an estimate for Western Australia, but appears to be using actual data for the Northern Territory (no other State produces manganese).

In addition, the ABS has titled its manganese values as "manganese ore", but appears to be estimating a concentrate value for Western Australia. Hence, the CGC may wish to consult with the ABS and the Northern Territory to determine whether the ABS is publishing ore values or concentrate values for Northern Territory manganese.

Nickel, gold and copper

The issue with nickel, gold and copper is that the ABS is valuing these minerals at metal content, rather than ore value (to which royalties are generally applied).[2]

Under the 2010 Review methods, this is a significant problem because the inflated metal content values for these minerals are being added to ore values for other minerals.

This would be less of a problem under the 2015 Review proposed mineral by mineral assessment, as the CGC intends assessing each of these minerals separately. As Western Australia produces all of the nickel, the valuation point would not matter. However, the ratio of metal content values to ore values may differ among States for gold and copper, in which case using metal content would distort the results.

We suggest that the CGC consult with other States as to whether they have been providing ore values for the latest data year of each annual update. If so, the simple solution would be to use State-provided data from all States for all data years.

HOUSING COST DIFFERENTIAL BETWEEN PERTH AND WA REMOTE AREAS

The CGC suggested that the cost differential between Perth and remote areas of Western Australia is diminishing.

The following charts illustrate that the differential between Perth and Pilbara residential property prices and rents has narrowed over the 18 months, although rents still remain extremely high compared with Perth (140% above Perth levels).

Of course, the CGC is ultimately concerned with how the Western Australian capital city/regional cost differentials compare to other States. We note in this regard that the phenomenon of moderating prices in remote mining areas is not unique to Western Australia, although the driving factors may be different.[3]

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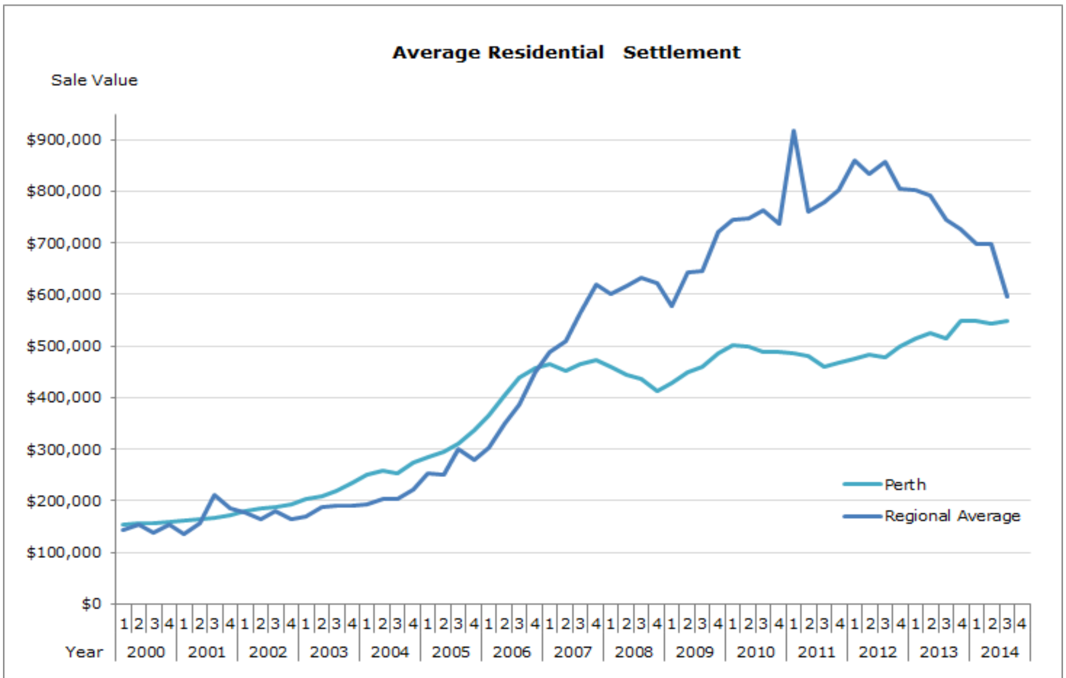
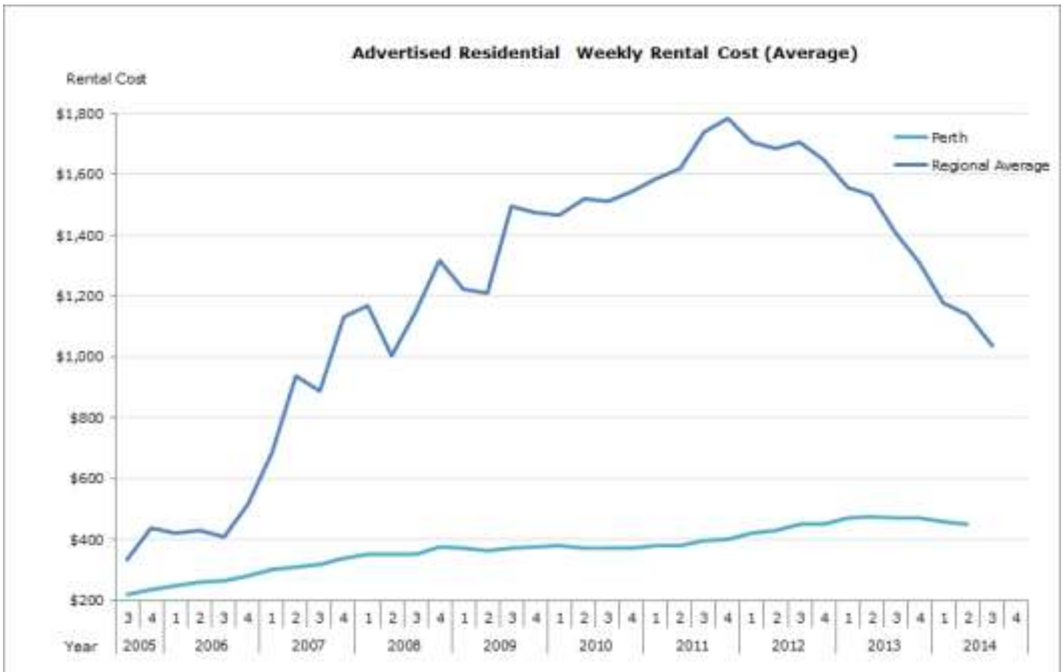
2 The ABS does this for a number of other less significant minerals as well.

3 The Australian reported that “Homes valued around a million Australian dollars [in Moranbah, Queensland] are now lucky to get a bite at half that price”, reflecting mine closures and staff layoffs (Mining towns ‘dying a slow death’, 9 June 2014).



Source: *Pilbara Residential Housing and Land Snapshot September quarter 2014, REIWA market update September quarter 2014*



Source: *Pilbara Residential Housing and Land Snapshot September quarter 2014*

The Western Australian experience partly reflects a cyclical adjustment in the Pilbara as mining investment activity declines after a period of record growth. Over time, residential supply and demand will again come into equilibrium.

The reduced gap between Pilbara and Perth house prices potentially also reflects differences in the Perth and Pilbara property cycles.

However, another important factor is the Royalties for Regions program, which (in line with the Government's objectives) has helped to normalise Pilbara housing costs through increasing housing supply and improving the amenity of the towns to encourage more permanent populations. In the absence of this investment, mining companies may have made greater use of work-arounds (FIFO and work camps) that would have cushioned the towns from supply/demand adjustments and left prices high.

As a result of its efforts to increase land supply and affordable housing in these communities, the Western Australian Government has explicitly sought to engineer a situation in which the value of land and property it owns has fallen.

In our view, the implications for the CGC's assessments are:

- the need to recognise Western Australia's higher remote area housing costs (relative to the capital city) compared to other States;
- the need to use average costs over an appropriate time period to exclude cyclical volatility; and
- the need to recognise the Western Australian Government's spending programs that have assisted the normalisation of prices in the Pilbara and have reduced the Government's capital values.

FURTHER COMMENTS ON THE 'PUZZLING PROPOSALS'

TAX THRESHOLD ADJUSTMENTS IN HFE

We believe that the CGC's tax threshold and progressivity adjustments are giving significance to essentially random government decisions in relation to their taxes.

In the case of payroll tax, the tax threshold adjustment costs Western Australia over $200 million per annum. If the CGC were consistent with practice elsewhere, the average tax rate would be calculated for a range of payroll values, but the CGC has instead opted for a single payroll threshold.

It is also difficult to understand why government tax concessions for the small to medium size business sector (or keeping land values affordable) count as a revenue disability.

From the available evidence, we can conclude that all States give away a proportion of the revenue base at the lower end. Most States also give the benefit of the threshold to companies with payrolls in excess of the threshold. We are not aware of evidence that the level of this give away reflects States intentionally targeting a threshold business size.

THE NEW PUBLIC HEALTH MODEL

The CGC has not provided any robust reason for changing the current public health assessment.

The CGC draft report cited data complexities as a primary reason for abandoning the subtraction model.

However, the methodology proposed in the draft report resolves none of these issues, and by splitting one category into three makes them harder to address. As illustrated through examples that have been provided to CGC staff (who agree with our conclusion), determining the aggregate level of substitutable private sector health services remains critical for an assessment of States' health spending needs. Using "indicators" such as bulk billed GP benefits, without regard to total private substitutable spending, will not suffice.

Moreover, as we will illustrate in further examples to be provided to CGC staff, the proposed 'substitutability' measures for private vs public services are irrelevant to the correct assessment of needs under the CGC's proposed new model. What is relevant is the relative size of substitutable private services compared to total State services.

The CGC's new model has many more conceptual 'moving' parts to quantify, leading to higher complexity and extreme data problems.

- The three new categories each require an assessment of 'standard' regional/remote non-State services impacts, as well as an assessment of the State specific non-State services impacts.
- There is little or no data to support these assessments.

We understand that the CGC is using consultants to assist it, but we have no information on their terms of reference or the briefing they have been provided. We ask for close consultation with States on this assessment in the remaining time.

LAND TAX – EMERGENCY SERVICE LEVIES AND METROPOLITAN IMPROVEMENT LEVIES

Our submission has highlighted the variable characteristics of emergency service levies and metropolitan improvement levies (including geographical distinctions, fixed charges, use of unimproved or capital improved values, and land value thresholds). In Western Australia they are not levied on site values, the CGC's proposed measure of the revenue base.

We do not believe it is coherent to assess some land taxes using a general indicator (as is proposed in this case) and other land taxes on a fairly rigorous legal incidence basis.

If the CGC persists with legal incidence as its usual approach then, at a minimum, the final report should clarify why the CGC considers that a general indicator reflects the legal incidence of these levies.

REGIONAL COSTS

We are concerned that the CGC has been focussed on technical changes in the remoteness indexes (which are essentially arbitrary measures), rather than considering the actual distribution of costs in the regions. These costs, especially accommodation costs, depend on the economic conditions in regions such as the Pilbara, as much as on distances from towns of chosen sizes.

We sought advice from the ABS as to whether their 2009 Survey of Education and Training data (used by the CGC to determine interstate wage cost differences) included employer-provided accommodation subsidies (and some other subsidies). Their advice implied that such subsidies were unlikely to be included. Accordingly, the costs of employer-provided accommodation need to be reflected in the CGC's regional cost assessment.

Another consequence of the technical changes in remoteness indexes has been to give Tasmania and the Northern Territory an arbitrary (unevidenced) allowance for interstate non-wage costs because Hobart and Darwin would now be classified as regional. An assessment for Western Australia was discontinued, because of data challenges.

In a calculation we will shortly provide to CGC staff, we estimate that Western Australia's "needs" (i.e. above-average costs) in relation to electricity, rent, interstate freight and interstate travel exceed $150 million per annum.

Category specific weightings for wages and regional costs

The CGC's assessments show surprisingly low proportions of expenses affected by wages and regional costs in some categories. We are reviewing the CGC's methodology to ensure that the assessed proportions properly capture embedded costs in contracted out services, purchases of goods and services and grants (for example, concessions for energy, local government rates and water include embedded wage and regional costs).[4]

NATIONAL INTEREST ISSUES IN HFE

We are concerned at the inconsistent recognition of 'national needs' (cross-State benefits) in the HFE process.

Such needs have been recognised by the CGC itself in relation to national network roads, and are implicitly recognised through the Commonwealth Treasurer's directions, such as his intended instruction to quarantine Asset Recycling Initiative funds. However, these are very particular national needs, and others go unaddressed.

We consider that the CGC needs to pay more attention to the following national needs.

- As noted by the OECD,[5] HFE can exacerbate the very differentials that it seeks to equalise. The CGC needs to implement HFE in a manner that avoids this problem.

- The efficiency of the federation depends on mobile labour and capital being able to move to more productive regions. States play a key role in enabling this movement through the appropriate provision of common user infrastructure and services. HFE needs to allow States the capacity to provide such infrastructure and services.

  - Under the current implementation of HFE, a 100% tax applies on above-average revenue capacity but States' efforts are not standardised. In addition, the assessed expenditure requirements are limited by the availability of data and understanding of expenditure drivers. The net outcome is far from the underlying intent of HFE.

  - Twomey and Withers suggest that Australia's per capita GDP could be 10% higher with best practice decentralisation.[6]

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4 For example, local governments are mainly equalised only within States rather than across States, so that higher costs experienced in Western Australia are reflected in the 50% rate concessions.

5 *Fiscal Federalism 2014: Making Decentralisation Work*, OECD Publishing, 2013, page 111.

- The Commonwealth has not addressed the gaps in HFE from its own resources, due to political constraints.

'Previously Unequalised Expenditures' and WA Assistance for the North West Shelf Project

We are concerned at the lack of transparency in the draft report on the CGC's position on previously unequalised infrastructure expenditure, such as Western Australia's assistance for the North West Shelf project.

The draft report states that "Queensland and Western Australia have asked that the equalisation process recognise they incurred costs in developing their mining industries which were not recognised at the time. The Commission has considered mining development expenditures in previous reviews but States were unable to identify expenses on mining or mining related activities which warranted a material assessment in addition to category specific assessments like infrastructure assessment. As such we do not accept there have been previously unequalised expenditures" (page 68).

This is an important issue for Western Australia but the CGC's response is essentially unintelligible. For example:

- there was no significant assessment of infrastructure prior to the 2010 Review;
- it is not clear how or whether the CGC is distinguishing between possible shortfalls in past equalisation of expenditures (which should be based on standard policy) and differences in State policies; and
- it is not clear whether the CGC is saying that (a) there were no material shortfalls in past equalisation of expenditures, or differences in State policies; or (b) such equalisation shortfalls or policy differences had no material impact on the mining revenue bases.

Equally importantly, we do not understand (and CGC staff have not been able to explain) the lack of specific comment in this context on Western Australia's submissions documenting how the CGC is still equalising revenues from the North West Shelf project which are a result of the State's unequalised past efforts. We consider that the CGC should only equalise the net revenues from the North West Shelf, that is the revenues net of an amortisation of the government assistance.

We understand that the CGC may have consulted with some persons regarding whether or not the North West Shelf project would have proceeded in the absence of the Western Australian assistance. As it has not documented these discussions, we are unable to comment on the expertise of such persons or the content of their advice.

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[6] Anne Twomey & Glenn Withers, *Federalist Paper I Australia's Federal Future: Delivering Growth and Prosperity, A Report for the Council for the Australian Federation*, April 2007, page 42.

In any case, we do not consider it to be the CGC's role to 'second guess' past actions by States that were reasonable at the time. The Western Australian Government and relevant industry players believed that the assistance it provided was necessary to get the North West Shelf project established. We have documented this in our submissions.

Therefore, we consider the CGC should either assess the revenues net of the assistance, or treat the revenues as the result of above average effort (and so not equalise them).