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

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

Flexibility to Consider Method Changes between Reviews

March 2024

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Acknowledgement of Country

This report was prepared by the Department of Treasury (WA Treasury) on the traditional Country of the Wadjuk people of the Noongar Nation.

WA Treasury respectfully acknowledges the Traditional Custodians of Country throughout Western Australia and their continuing connection to Country, Culture and Community.

We pay our respects to all members of Western Australia’s Aboriginal communities and their cultures and to Elders past and present.

We acknowledge and pay tribute to the strength and stewardship of Aboriginal people in sustaining the world's oldest living culture and value the contribution Aboriginal people make to Western Australia's communities and economy.

We recognise our responsibility as an organisation to work with Aboriginal people, families, communities, and organisations to make a difference and to deliver improved economic, social and cultural outcomes for Aboriginal people.

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

KEY POINTS

Issues of concern to Western Australia

Our greatest concern about affording the Commonwealth Grants Commission (CGC) flexibility to change methods between reviews is that methods may be rushed. But we also consider that 'shocks' can often take time to develop, and can take a longer time to understand. Hence, we doubt that such flexibility is needed, as there will always be, and should always be, time for such consideration in a review.

Despite this, we struggle to identify a shock that would impact just one or two States/Territories (States), or where one or two States are impacted to a much greater degree, without being due to policy differences. Existing assessment methods would need to fail to measure the drivers of revenue and expenditure for that shock and the impact would need to be material, after accounting for what would be substantial Commonwealth government involvement to mitigate the shock.

We discuss three possible shocks: a recession, a biosecurity impact, and a pandemic.

- For a recession, we consider that existing methods would appropriately reflect that shock.
- A biosecurity shock is unlikely to be material, due to cost-sharing arrangements.
- The lessons learned from COVID-19 would substantially decrease any differential impact on States from any future pandemic.

CGC consultation paper

Q1. Do States agree that there may be situations, such as a significant unanticipated shock or major policy reform, such that there is a case to extend the circumstances when the Commission may need to consider alternative methods between reviews?

No. We struggle to identify a shock that would impact just one or two States, or where one or two States are impacted to a much greater degree, without being due to policy differences. Hence, we do not see the need for the CGC to have such flexibility.

Q2. Do States agree that the circumstances supporting the case to extend the Commission's flexibility to change methods between reviews should include:

- *major unexpected developments that have a significant impact on state fiscal positions, are not captured in existing assessment methods, and a change in methods is required for the Commission to achieve the objective of fiscal equalisation?*

No. To adequately define 'major' developments and 'significant' impacts is problematic. Further, we cannot envisage a shock that would require a change in methods between reviews.

Q3. Do States agree that any consideration of whether method changes are warranted between reviews be undertaken in consultation with the States and the expectation should be that this flexibility would only be exercised in very limited circumstances?

We disagree that method changes between reviews are warranted, but if considered so, it should be in consultation with States and in very limited circumstances.

Q4. Should the extended flexibility to change assessments between reviews in certain circumstances be operationalised in standing terms of reference for updates?

We disagree that method changes between reviews are warranted, but if considered so, there should be strict guidelines around when it would be appropriate. It should also be written into the CGC's Update Guidelines document. Additionally, there should be direction from the Commonwealth Treasurer, which would best be operationalised in standing terms of reference for updates.

The CGC seeks States' views on it having flexibility to consider method changes between reviews, including the objective, advantages and any challenges arising from such flexibility.

Although the CGC is careful to emphasise that such flexibility would only be used in very limited circumstances, Western Australia is concerned that, over time, such restraint may be compromised.

We are also concerned that such flexibility may lead to rushed changes to methods, before the nature of the shock, or its impact on States is fully understood.

Nevertheless, we believe that such flexibility is not required, that some flexibility can be incorporated into the methods, and that there are other avenues to allow for targeted method changes between reviews. In general, the CGC should develop methods that are sufficiently high level that they can accommodate shocks.

Need for greater flexibility

In the CGC's October 2023 consultation paper (CGC paper), it puts forward arguments for its need to have greater flexibility to change methods between reviews (currently ruled out by successive yearly update terms of reference).

Paragraph 7 of the CGC paper states that methodology reviews are to ensure methods appropriately capture changes in what States do. However, they are also an important opportunity to improve methods. To develop a method can take a long time, and in some cases *should* take time, to properly develop. Sometimes there is insufficient time during a review to properly hone a method, and it carries over to the next review. The development of the capital assessments is a good example.

Our greatest concern about affording the CGC such flexibility is that methods will be rushed. But we also consider that ‘shocks’ can often take time to develop, and can take a longer time to understand. Hence, we doubt that such flexibility is needed. Consider that:

- major policy initiatives are not (and should not be) rolled out quickly.[1] There would be time for a State to flag such policy changes with plenty of time for discussion through a review;
- even with an external shock (such as a pandemic) it takes time to understand the drivers and whether State policies are aligned, and there are lags in the data. For example, COVID-19 evolved over the years and State’s adapted as they learned from it; and
- due to this evolution and increasing understanding, changes to methods in reaction to the shock should not be undertaken quickly.

Paragraph 13 of the CGC paper discusses New South Wales’ proposed property tax. Even though this was announced in 2021 (so early in the period constrained to 2020 Review methods), New South Wales stated there was unlikely to be any material impact until after 2025. Hence, there was plenty of time to consider the issue in the 2025 Review.

Further, New South Wales sought assurance that the CGC would seek to mitigate any unintended GST impact, to give its Cabinet confidence to pass the tax reform. This was a more urgent issue but did not require any method changes, just a discussion about if and how the CGC would react. At an all-States workshop in May 2021, the CGC essentially gave New South Wales that assurance, under the principle of policy neutrality.[2]

Therefore, we do not see this example, nor any similar example, as a reason to afford the CGC flexibility to change methods between reviews.

Shock examples

CGC reviews are typically every five years. Unless the shock occurred immediately after the completion of a review (as happened with COVID-19), the time remaining to completion of the next review will likely be sufficient. This is because it can take a while to understand the impact of the shock and even longer to identify drivers. Then, suitable methods would need to be developed to accommodate the shock. Further, CGC assessments are lagged two years. As noted, it would also likely be beneficial to allow time so that inferior methods are not imposed rashly.

1 We consider a major policy initiative to be where significant reforms are undertaken, that change the nature of a State’s service delivery or the structure of its revenues, so that CGC methods no longer reflect what States do. The latter is much more likely than the former.

2 At the NSW Treasury Workshop on 4 May 2021, the CGC presentation stated (in relation to the proposed NSW reforms), “Policy neutrality says the consequences of its policy choice should be mitigated”, and the subsequent discussion augmented this.

In addition, under the CGC's Contemporaneity principle, States' fiscal positions in a grant year should reflect the GST distribution in that year. This is a difficult requirement, given that the GST distribution is based on average conditions spanning four to two years prior. A short-lived shock would have run its course before being fully understood, and before data has been collected to measure its impact. A long-lived shock (creating some form of structural break) would lend itself to assessment in a review, with methods applying following the review (and with safeguards built into the methods should the shock dissipate).

Despite this, we struggle to identify a shock that would impact just one or two States, or where one or two States are impacted to a much greater degree, without being due to policy differences. Existing assessment methods would need to fail to measure the drivers of revenue and expenditure for that shock and the impact would need to be material, after accounting for what would be substantial Commonwealth government involvement to mitigate the shock.

We discuss three possible shocks below: a recession, a biosecurity impact, and a pandemic.

Recession shock

For a recession to occur in one or a few States only, or to impact one or a few States materially more, it would need to occur from a shock to an industry that occurs in one or a few States only. A general macroeconomic shock will largely impact all States similarly.

We could only identify mining as an industry whose distribution across States is sufficiently skewed to enable such a shock.

- Iron ore is a critical industry to Western Australia, contributing 47% to its economy. A shock to this industry would heavily impact the Western Australian economy and likely send it into recession.
- Although Queensland is also regarded as a mining State, its entire mining industry contributes only 16% to its economy. Coal is the largest component of Queensland's mining industry, but represents just 11% of its economy. A shock is unlikely to affect Queensland's entire mining industry, but if it were to occur, a sizeable shock could send it into recession.
- No other State has a mining industry sufficiently large.

However, a mining shock that leads to a recession in a State would mainly impact the Commonwealth. Its revenues would undergo reduced income and company taxes, and its expenditures would experience higher welfare payments. There would be minimal impact on State expenditure. The primary impact would be to reduce the State's royalty collections, but also reduce payroll taxes and transfer duties.

- The assessment of a State's royalty collections is based on the value of production of its minerals, and the shock would have reduced that value of production, so existing methods would reflect the shock (over time).

- The payroll tax assessment is based on employee compensation, which would be reduced from the shock, so existing methods would reflect the shock.
- The transfer duty assessment is based on the value of property transferred, which would be reduced. Again, existing methods would reflect the shock.

Hence, we conclude that a recession shock does not require the CGC to have flexibility to change methods between reviews. Besides, Western Australia had five quarters of negative State final demand growth in late 2015 and early 2016, that can be regarded as a recession shock. At the time, it suffered very low GST shares through a lagged response to earlier strong mining years. There was no consideration of changing methods at the time.

Biosecurity shock

A biosecurity event in one or a few States is a credible risk, and one that concerns all States and the Commonwealth. All States have teams and procedures in place to deal with biosecurity threats.

Should a large, isolated biosecurity event occur, it would have little impact on State government revenue, because farmers do not generally pay land tax or payroll tax. However, there would be State expenses, which would take the form of direct emergency response to contain the event, including quarantining, transportation (e.g. of affected livestock), contact tracing, public information communications, and indirect support for impacted businesses (usually in the form of grants, waivers, or concessional loans).

The CGC’s Services to Industry assessment is designed to pick up direct biosecurity expenditure in the Agriculture industry regulation component. Support for impacted businesses is assessed equal per capita (EPC) as business development. However, any increased expenditure by one State would add to the national expense total, and be split into Regulation or Business Development according to the fixed 50:50 ratio. So, half the increase in national spending would have no impact on the GST distribution, and the affected State would gain or lose GST for the other half, depending on its population share and relative value of production in the sector. Depending on the State, this gain or loss in GST would be a small fraction of the expense incurred.

Hence, should one State incur a material biosecurity cost, the existing methods would only partially compensate the State.

However, should the State be compensated? If methods were allowed to be changed, the CGC may treat the shock expenditure as APC, where the State would effectively only incur its population share of its increased expenses. But two aspects must be considered: whether the State’s policy caused the shock; and whether the impact is material.

A significant differential biosecurity shock in a State could be the result of the State’s policy. For example, if a State became inattentive in its administration of agricultural biosecurity precautions, which results in an incident that devastates its major agricultural product, should the CGC account for that in its methods? We would argue that the shock is the result of a policy decision, which should not be compensated through the GST distribution.

But, importantly, shocks such as these are covered by cost-sharing agreements between the Commonwealth and the States.

The *Intergovernmental Agreement on Biosecurity* 2019 (IGAB) tasks the Commonwealth with the responsibility for matters relating to the national border including development and enforcement of quarantine and responding to and controlling detections, providing national leadership for strategic biosecurity issues, and providing legislative, capacity and capability support to States. The first principle of the IGAB is that biosecurity is a shared responsibility.

Following the IGAB, three agreements have been recently developed. Through these agreements, if a serious outbreak occurs in one State, all (or most) States will fund its eradication (because no State wants it to spread).

- The *National Environmental Biosecurity Response Agreement* 2021 (NEBRA) commits 50% of any cost to the Commonwealth from an environmental biosecurity event.
  - The States pay the other 50% roughly according to their population shares.
- The *Emergency Plant Pest Response Deed* 2024 (EPPRD) commits the Commonwealth to 50% of the government portion of costs from a crop biosecurity event.
  - Under this agreement, there are four event categories.

    Category 1 is where the event would cause major environmental damage. Eradication costs are covered 50% by the Commonwealth and 50% by States according to their population shares.

    Category 2 is where the event would cause significant losses. Eradication costs are covered 20% by industry and 80% by government. Half of the government cost is paid by the Commonwealth and half by States (40% of the total cost) according to their share of the value of production of the affected crop.

    Category 3 and Category 4 are for lesser shocks and are paid increasingly by industry.
- The *Emergency Animal Disease Response Agreement* 2022 (EADRA) commits the Commonwealth to 50% of the government portion of costs from a livestock biosecurity event.
  - This agreement also has four categories with similar definitions and cost-sharing arrangements to the EPPRD.

Under these agreements, if the incident is considered nationally significant, technically feasible to eradicate, and cost beneficial to do so, the cost-sharing arrangements take effect.

Under the NEBRA, or a Category 1 event under the EADRA or EPPRD, eradication of the outbreak is financed on, or near to, an EPC basis, with little or no differential impact between States. Hence, it would not be material.

Under the EADRA or EPPRD, a Category 3 or Category 4 event would not be material, as States are paying 25% and 10% respectively of the cost of a more minor event.[3, 4]

Hence, only a Category 2 event under the EADRA or EPPRD is relevant.

Table 1 shows a selection of agricultural products where States produce far in excess of their population share. It uses the latest data to test the level of national cost of a biosecurity shock that would be material for at least one State.[5]

Table 1

Required biosecurity event material cost

By commodity, 2021-22 State shares

Commodity	State	Share	Required cost ($m)
Wheat	WA	36%	900
Barley	WA	40%	800
Canola	WA	43%	750
Sugar cane	QLD	95%	750
Cotton	NSW	70%	1,800
Wine grapes	SA	54%	400
Bananas	QLD	96%	700
Apples	VIC	52%	1,800
Apples	TAS	9%	700
Sheep and lambs	WA	18%	1,800
Dairy cattle	VIC	60%	1,500
Dairy cattle	TAS	14%	400
Beef cattle	QLD	49%	1,400
Beef cattle	NT	7%	700
Poultry	QLD	31%	2,200

Note: Based on a Category 2 event under the EADRA or EPPRD, where States contribute 40% of the total cost, according to production share. 'Share' is the State's share of national production, where crop and fruit shares are by weight and livestock shares are by number. Only shares that substantially exceed the State's population share are listed. The 'Required cost' is the rounded minimum national cost for which the cost to the State listed will be material ($40 per capita). Shares are based on 2021-22 data, which will vary by year.

Source. Australian Bureau of Statistics (2021-22), Agricultural Commodities, Australia; WA Treasury calculations.

3 Industry pays 50% and 80% respectively and the Commonwealth covers half of the non-industry cost.

4 For example, costs for the recent lumpy skin disease outbreak in Western Australia and the Northern Territory is classified Category 3, covered 50% by industry and 50% by government, of which the Commonwealth pays half. So, the States incur only 25% of the total cost.

5 Due to cost sharing arrangements, it is irrelevant whether the shock hits one, several, or all States. We have calculated the minimum value required for the shock to be material at $40 per capita in any State, given its share of the production of the affected commodity. In practice, this State will be one whose production share substantially exceeds its population share.

Western Australia spends less than $100 million per year on all aspects of its biosecurity, with around 470 full-time equivalent employees. Table 1 shows that the smallest estimate required to be material would be $400 million per annum nationally from a shock to wine grapes for South Australia, and $400 million for Tasmania from a dairy cattle event. The next smallest estimate, for beef cattle and apples, would need to be $700 million per annum for the Northern Territory and Tasmania, respectively.

To put this in perspective, the current outbreak of fire ants in south-east Queensland, a major biosecurity event, is estimated to cost $596 million nationally over 10 years under the draft *National Red Imported Fire Ant Eradication Program Response Plan 2023-2027*.

Hence, it is highly unlikely any biosecurity shock would be material. Therefore, there is no need for the CGC to have flexibility to change methods between reviews for such shocks.

Pandemic shock

We continue to firmly argue that different State policies contributed to most of the differential impact of COVID-19, as argued with evidence in Western Australia's 2021 Update and 2022 Update new issues submissions.[6]

At the time, the CGC claimed that State health and business support spending did not align with its Health and Services to Industry assessments, but could not identify any drivers of COVID-19 State spending.[7] To this day, it is not clear what those drivers were. The CGC decided, if it were allowed in its terms of reference to change methods in an update (which it was not), to treat the funding *National Partnership on COVID-19 Response* as impacting the assessment, and the associated and equivalent State spending as actual per capita (APC). This is despite evidence we provided that showed that the National Partnership funding bore no relationship to the number of COVID-19 cases in each State and State baselines on preparedness and equipment were different.

The CGC concluded that revenue assessment methods adequately captured COVID-19 impacts.

Most of the issues with COVID-19 are through data concerns, rather than method issues. For example, public transport passenger numbers were unusually low during COVID-19 years (due to social distancing and lockdowns), so the data from affected years cannot be used for future grant years. These issues are resolved each update through New Issues consultation. They do not require any method changes.

6 Government of Western Australia, *2021 Update New Issues*, October 2020, and *2022 Update New Issues*, November 2021.

7 Commonwealth Grants Commission, *Discussion Paper, 2023 Update: New Issues, October 2022*, p. 12, paragraph 55.

Note that the COVID-19 shock occurred at the worst possible time; essentially at the same time as the 2020 Review report was released. That made the inability to change methods between reviews as instrumental as possible, and yet we are not convinced that any accurate and meaningful changes could have been made. Had the pandemic occurred a year or two later, the 2025 Review would be timely to assess any drivers (if possible). This would be true for any shock that affects States differentially a year or two into a review period. The subsequent review would be best placed to consider the effects.

Our concern follows the significant disagreement as to the degree to which policy drove the substantially different impact from COVID-19 in different States. We would not want to see decisions on such divisive issues rushed through in an update, or even over two updates. It takes time to ascertain the drivers and to obtain data. As noted above, it is unclear to us even now what the drivers were (if you strip away the considerable policy differences between States).

An APC assessment was certainly not appropriate, even if policies were uniform across States, because State baselines were different, both for State expenditure and Commonwealth grants. Spending did not equate to case numbers and the COVID-19 impacts across States. Had the CGC had the ability to change methods, we fear they would not have been correct. Furthermore, we struggle to grasp what changes would have been appropriate, other than changing the business development / regulation ratio in the Services to Industry assessment. For Health, what were the drivers of COVID-19 costs?

Furthermore, should another pandemic arise, the lessons learned from COVID-19 would enable States to act quicker and more in unison (aligned policies) than the first year or two of COVID-19, and likely not have a differential impact between States.

Concerns and challenges

Definitional problems

We consider that it would be problematic to determine what shocks are ‘significant’ and what policy reforms are ‘major’. A definition based on materiality would require judgement on the expected magnitude of the impact, which is especially challenging for policy reforms, and given the duration of the shock would initially be unknown.

Paragraph 17 of the CGC paper provides two necessary conditions where the CGC should have the flexibility to change methods between reviews: that there is a significant differential effect between States; and that the existing methods do not appropriately measure the change in States’ fiscal capacities.

Paragraph 18 provides a non-exhaustive list of three possible shocks that could require the CGC to implement changed methods between a inter-review period. However, we provide reasons above as to why all three would not require this.

Paragraph 21 of the CGC paper states that the CGC's view is that it may be too restrictive to seek to define a shock, implying that it would need to be determined on a case-by-case basis, based on judgement. We agree, but are not sure how discrete shocks could be relatively evaluated. If the CGC decides Shock A requires mitigation through changed methods, that would benefit State Y, how does it then decide on Shock B, which stands to harm State Z, if the shocks are of a very different nature? Further, the CGC would open itself to criticism for driving State policy through its decisions on whether policy reforms should be mitigated. It would attract State lobbying on issues that would tend to become increasingly minor; akin to pre-2010 materiality restrictions.

Paragraph 15 and 19 state there may be a case for the CGC to have greater flexibility, but there would be "very limited circumstances" in which this would be required, but we consider it is dangerous territory to enter for very limited use. To allow this flexibility could be a slippery slope. The risk appears to outweigh the potential benefit.

Notwithstanding that we argue that this flexibility would not be required, if it proceeds, there should be strict guidelines around when it would be appropriate.

Paragraph 14 discusses the Update Guidelines that were developed in 1994, which specify the circumstances in which the Commission could make method changes in an update. Perhaps this document could be updated in consultation with States and made public on the CGC website. Only a long-serving member of our team was aware of its existence, and none were able to find it.

Time constraints

Constraining method changes to distinct review periods, which typically last several years, allow for extended thought, consultation, and the collection and examination of data.

As noted above, to develop a method can take a long time, and in some cases *should* take time, to properly develop. This would not be possible if method changes were to be considered in an update year, which implies that such changes would be rushed, and possibly ill-conceived.

Stability of methods is important

Methods can substantially change in a review, and there have been frequent method changes across subsequent reviews for some assessments that have otherwise had relatively stable circumstances. For example, there have been six significantly different methods of assessing mining revenues over ten method reviews (from 1981 to 2020). Frequently changing methods imply a search for something appropriate but never getting there.

Making changes more frequently, in an update and at reviews, would exacerbate this issue.

Other options

We consider that there are better options other than giving the CGC flexibility to make method changes between reviews.

Firstly, the Commonwealth Treasurer can already achieve this through including provision for the CGC to change methods in an update year through its terms of reference.[8] However, this would not solve the time constraint issue, which is a major concern.

Paragraph 33 of the CGC paper says the Commonwealth Treasurer should not be put in a position of 'umpire' on whether changes should occur. But the decision could be made at CFFR, and the Commonwealth Treasurer simply carry out that decision through the update terms of reference.

The process could be as follows:

- CGC could identify an issue (perhaps through a State alerting it of such);
- CGC produces a document that describes the issue and possible consequences;
- which is discussed in a CFFR meeting;
- where the Commonwealth Treasurer makes the final decision whether to act; and
- if so, includes the provision in the update terms of reference (which would require it to be drafted earlier than it has been in some years).

Secondly, flexibility could be improved, without the problems noted above, through building flexibility into CGC methods. The CGC methods could provide constrained changes should certain occurrences arise. This would be similar to the provision in Mining Revenue assessment to assess minerals separately should they become material, and provisions in the Health and Wages assessment to consider the use of a new non-admitted patients' dataset in 2021, and to consider the use of the new compensation of employees dataset in 2016, respectively.

This approach, if the conditional provisions could be broad enough, yet constrained enough, would allow most of the thought and consultation to have occurred during Reviews, and would remove the need for rushed reactions and consequential judgement.

For example, an issue for COVID-19 that we believe was valid, was the inability to change the business development / regulation ratio in the Services to Industry assessment. Ratios and weights that the methods currently hold fixed between reviews can always be changed between reviews if the methods allow for this. The method could be that a ratio or cost weight, ordinarily set between reviews, is adjusted should a shock impact the assessment in such a way that the ratio or cost weight is no longer valid. Often the reason to set them between reviews is for practicality reasons to lessen State and CGC workloads. Such a method would only add to those workloads in extraordinary circumstances.

[8] Despite aggressive lobbying from New South Wales and Victoria, this was not done for the years in which COVID-19 had an impact, possibly because the Commonwealth had concerns around policy differences.

A final note is if the CGC is allowed the flexibility to change methods between reviews, it should not limit itself to resolving the issue in a single update. If it does make a decision in a single update, it should be prepared to adjust this in the next update if the situation evolves.