

# Western Australian Comments on Contemporaneity Options

## *Key Points*

- Western Australia continues to believe that the Commonwealth Grants Commission (CGC) should use forecasts (with ex post adjustments) to achieve contemporaneity.
- We also continue to believe that substantial discounting is appropriate for the mining revenue assessments. This would help ameliorate contemporaneity concerns.
- Of the options proposed by CGC staff recently, we consider the absorption approach (Option A) to be the most acceptable.
  - This should be implemented using assessed (rather than actual) royalties.
  - We would prefer a purer variant under which the CGC would calculate relativities (excluding royalty needs) to be applied to a GST-only pool, with the results to be adjusted for royalty needs based on the application year royalties.
- A ‘fall-back’ option would be to disregard the 2013-14 data year in the three-year averages of iron ore royalty assessments, as it is not representative of the application years.
- We do not support five-year averaging (Option B), smoothing through a repayable adjustment to GST outcomes (Option C) or a higher weighting for recent data years.

This submission responds to the options floated by CGC staff in their 20 January 2015 e-mail for improving the contemporaneity of assessments.

As per our December 2014 submission we continue to believe the use of forecasts (particularly for volatile revenue sources), with subsequent corrections, is the most appropriate method for achieving contemporaneity.

Compared to the other proposed options, we consider the use of forecasts is most effective at addressing contemporaneity (and volatility), is mechanically simple and the most transparent.

Although the CGC considers the use of forecasted revenues is not sufficiently reliable, the current lagged three-year average effectively forecasts that needs in the grant year will be the same as in the past. This is clearly no more robust than an approach that uses forward looking forecasts. What matters is the speed of the adjustment – the current approach is a much more drawn out process of estimation and correction than the approach proposed by Western Australia.

We acknowledge that the use of forecasts and subsequent corrections will involve volatility in GST relativities. However, as we noted in previous submissions, this volatility is expected to be small compared to the large budget volatility if there are not contemporaneous assessments.

Revisions and ex post adjustments are a necessary part of providing contemporaneous relativities. We previously considered this to be impractical, but have since re-examined the practicalities of implementing horizontal fiscal equalisation in this way and now believe that it is achievable. The Commonwealth already makes ex post adjustments to GST grants to correct for differences to forecasts of the size of GST revenue collections and State population shares.

Some States (including Western Australia in previous years) have also argued that the use of forecasts may provide opportunities for 'gaming' the system. However, any opportunities would be very limited and of little worth if adjustments are made to GST grants relatively quickly (e.g. within a year) to reflect the actual outcome.

More generally, we continue to believe that substantial discounting is appropriate for the mining revenue assessment (to reflect uncertainty in the measurement of policy neutral revenue bases, to address grant design inefficiency and to account for unrecognised expenditures). This would also help address contemporaneity concerns, by reducing the impact of data-years which may not be representative of the application year.

While the options provided by the CGC staff appear to be aimed at reducing the volatility of, say, mining revenue assessments, we consider that only the absorption approach (Option A) would deliver relativities appropriate to the fiscal circumstances in that year (i.e. the other options may reduce volatility but do not deliver contemporaneous assessments). Therefore, we do not support the other options.

## Absorption Approach (Option A)

We consider the CGC staff's absorption approach option to be acceptable, as it gives results that would be very similar to using forecasts (assuming that the forecasts were updated during the application year). Under this option, the CGC would calculate relativities (excluding royalty needs) and apply these to a combined pool of GST and royalty revenue. A State's actual (or assessed) royalties would then be deducted from their grant share of the combined GST and royalty pool to give their GST grant.

An absorption approach should be implemented using assessed royalty revenues, rather than actual royalty revenues. This would focus on a State's capacity to raise royalty revenues rather than how much is actually raised and would be more consistent with the fiscal equalisation principle, which requires a GST distribution that reflects average revenue raising effort. The assessed royalty revenues should be calculated the same way as in lagged assessments (including any discounting that the CGC adopts for its mining revenue assessments), but using current data within the application year.

However, we have a variant on the staff proposal, which we consider would be a purer approach.

Under this variant, the CGC would calculate relativities (excluding royalty needs) to be applied to a GST-only pool, rather than for a combined pool of GST revenue and royalties. When these relativities are applied in the application year, the resulting GST grant would be adjusted for royalty needs (based on the application year royalties), rather than for total royalties. These needs would be calculated the same way as they would be for a data year.

We prefer this variant on Option A for the following reasons.

- It would avoid the perception of a loss of States' sovereignty that could arise from applying a relativity to a pool that includes royalties.
  - Royalties are the price paid to extract ores owned by the people of the State. The CGC staff's proposed option could make it appear as if the royalties instead belong to the people of Australia.

- It is more theoretically correct, as it escalates non-royalty needs in line with a GST-only pool, rather than escalating in line with the more volatile combined GST and royalty pool.
  - The process of converting data year needs to a data year relativity, which is then applied to an application year pool, is equivalent to escalating each State's needs in line with growth in that State's population share of the grant pool (from the data year to the application year).<sup>1</sup>
  - This escalation issue is particularly material for jurisdictions with high non-royalty needs such as the Northern Territory (based on our current forecasts, we estimate the Northern Territory would receive \$131 per capita more in the 2015-16 application year under our proposed variant, than under the CGC staff Option A). This would be consistent with doing an unlagged assessment.
  - The financial impact on Western Australia would be minor, as our negative non-royalty revenue needs largely offset our positive expenditure needs.

## Alternative 'Fall Back' Option

A possible 'fall back' option would be to disregard the 2013-14 data year for iron ore royalties in the three-year averages, as it is not representative of the 2015-16 and later application years.

Under this option, for iron ore royalty assessments, the 2015-16 application year would use the average of the 2011-12 and 2012-13 data years; the 2016-17 application year would use the average of the 2012-13 and 2014-15 data years; and the 2017-18 application year would use the average of the 2014-15 and 2015-16 data years.<sup>2</sup>

---

<sup>1</sup> In practice, there is a slight variation because the application year grants have to be scaled to add to the total application year grant pool. If this scaling factor was one, then the above description would be exact. Western Australian Treasury officers can provide an algebraic proof of this if required.

<sup>2</sup> Under a mineral by mineral assessment, it is a simple exercise to isolate the part of the data relativity that is due to the iron ore royalty assessments, as the contributions of the minerals that are individually assessed are additive. Western Australian Treasury officers can elaborate on this if required.

This will in practice give results much closer to an unlagged iron ore assessment and would be simple to implement. The main disadvantages would be that:

- it only addresses iron ore royalties (although this is the most significant contemporaneity issue at present); and
- it gives no framework for addressing contemporaneity issues in the future (although it may be some time before time lags have as significant impact as the current falling iron ore price).

## Options we do not Support

### Five Year Averaging (Option B)

Increasing the averaging period from three to five years for revenue assessments identified as being large and a significantly volatile part of State own-source revenues is a clear move away from achieving contemporaneity. For example, the longer smoothing period may further delay adjustments to structural changes.

This approach would make no material difference to the contemporaneity of the assessment relative to the current three-year averaging. It would just substitute one backward looking forecast of needs in the grant year for another, with no judgement about whether this historic data reflects a State's current fiscal circumstances.

While it is true that averaging over a long period will reduce volatility in GST revenues, it will generally *increase* volatility in States' revenues net of GST. For example, the anomalous 2013-14 data year for iron ore royalties would continue to affect Western Australia's GST share until 2019-20 (rather than 2017-18) under a five-year average approach.

Also, five-year averaging would generally not match well to unlagged assessments. For example, consider iron ore royalties and North West Shelf grants. In 2015-16, five-year averaging would give Western Australia half of the impact of an unlagged assessment. However, by 2017-18, five-year averaging would be costing us about \$100 million (whereas an unlagged assessment would give us a gain of about \$700 million in that year).

Western Australia lost around \$2 billion over five years in GST grants when the CGC moved from five-year averaging to three-year averaging in the 2010 Review. A move to five-year averaging would amount to 'double counting' the 2009-10 to 2012-13 data years and would cost Western Australia an additional \$0.7 billion over the next five years (for iron ore and North West Shelf royalties).

### **Adjustment to GST outcomes that would be Reversed over Subsequent Years (Option C)**

This principle is inconsistent with the CGC's contemporaneity principle. If an adjustment is required to achieve contemporaneity, then making a State repay that adjustment effectively negates achievement of contemporaneity.

This can be illustrated by Western Australia's circumstances, where we expect an unlagged (contemporaneous) iron ore royalty assessment would, compared to the existing three-year averaging, give Western Australia an additional \$832 million in the 2015-16 application year and an additional \$528 million in the 2016-17 application year. How could contemporaneity be said to be achieved in the 2016-17 application year if the additional \$528 million were to be offset by repayment of part or all of the \$832 million?

In addition to not achieving contemporaneity, this option introduces further complexity to the process while also requiring the CGC to make numerous, arbitrary judgements about the application and subsequent repayments of subsidies. The timing and quantum of both subsidies and repayments is unclear, introducing additional uncertainty, as well as adding to administrative and reporting complexity in recording GST debits and credits for each State.

### **Higher Weighting for Recent Data Years**

As noted by the CGC, some States have suggested giving greater weight to more recent data years in the three-year average.

This option would only have merit in circumstances when there is a clear trend in States' fiscal circumstances. However, when there is a marked change in the direction circumstances are moving (as currently faced by Western Australia), this option would give a result less reflective of application year circumstances than the existing unweighted average.

If a cyclical or structural change in commodity markets were to occur quickly, any better outcome from giving a greater weight to more recent data years would just be a fluke.

This principle also has similar drawbacks to the repayment option. It requires subjectivity by the CGC on the choice of weights and adds complexity to the process.

If the CGC were to acknowledge that recent years are of more relevance to a State's current fiscal conditions than later years, then it stands to reason that the most accurate assessment approach would be that of a zero year lag (i.e. using forecasts to calculate relativities).