



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

Western Australia's Submission to the

Commonwealth Grants Commission's 2020 Methodology Review

Improving the Policy Neutrality
of the Mining Revenue Assessment

January 2019



Key Points

- The mining revenue assessment has always suffered from sensitivity to State royalty rates.
 - The discussion paper proposals to aggregate onshore minerals to one or two groups do not solve this problem, and in some respects make it worse.
- There are three methods we support that remove or minimise sensitivity to State royalty rates: global revenue assessments; uniform fixed standard royalty rate; and use of land area as the revenue base.
 - The discussion paper rejects global revenue assessments and a uniform fixed standard royalty rate on the basis of the standard revenue rate differing from actual revenue rates on individual revenue bases. However, it identifies this exact same concern with its aggregation proposals.
- There is no “true” measure of mining revenue raising capacity, because it is not possible to quantify mineral production under average policy, and the concept of average revenue raising effort is unclear when one State dominates the standard.
 - Hence, the Commonwealth Grants Commission (CGC) should be prepared to consider a wider range of imperfect solutions.
 - We believe that Western Australia’s three proposed methods each reflect a reasonable measure of revenue raising capacity.
- Given the insurmountable conceptual issues with the mining revenue assessment, and the CGC’s reluctance to adopt a broader approach (such as our three proposals), there would be no improvement in horizontal fiscal equalisation (HFE) from moving away from the current assessment method.

This submission responds to the CGC discussion paper CGC 2018-07-S,¹ which floated possible changes to the mining revenue assessment.

On 30 November 2018, the CGC advised that the Federal Treasurer has written to the CGC stating that he will amend the terms of reference for the 2020 Methodology Review so that no changes will be made to the mining revenue assessment. However, to our knowledge, this amendment has not yet been made. As such, the CGC has advised that States may make submissions on its discussion paper if they wish.

The discussion paper responds to concerns by the Productivity Commission about the lack of policy neutrality of the mining revenue assessment. The paper discards the possibility of using a profitability approach as impractical, and also rejects Western Australia’s proposals for a global revenue assessment claiming they are unrepresentative of underlying revenue capacity.

¹ Commonwealth Grants Commission (2018), *Improving the Policy Neutrality of the Mining Revenue Assessment*, Staff Discussion Paper, CGC 2018-07-S.

The discussion paper concludes that two options are worth considering:

- assess onshore minerals as a single aggregated group; or
- assess onshore minerals in two groups (“major” minerals comprising iron ore, coal, bauxite, and onshore oil and gas; and other minerals). (This option is very similar to the low rate/high rate approach adopted in the 2010 Review.)

In considering these options, the paper appears to focus on two policy neutrality issues:

- the sensitivity of assessment results to changes in States' royalty rates; and
- the relevance of the standard rate to actual rates.²

The paper recognises that the current mineral-by-mineral assessment is highly sensitive to changes in royalty rates when there is a dominant State for that mineral. It suggests that this can be addressed by aggregating onshore minerals into one or two groups. The paper recognises that amalgamating minerals results in differences between the standard royalty rate and actual royalty rates for individual minerals, however it suggests that this problem can be reduced by choosing a two-group structure.

We argue that the sensitivity to royalty rate changes would still be unacceptably high under the two aggregation proposals in the paper. However, this issue would be addressed by our global revenue base³ and fixed uniform standard rate⁴ proposals, as well as our proposal to use a policy neutral indicator such as land area.

Although we accept that our proposals may give more deviation between actual and standard tax/royalty rates for individual revenue bases than the current assessments, the deviation is comparable to the discussion paper's single-group and two-group mineral aggregation proposals.

We also argue that it is inherently impossible to determine a “true” mining revenue assessment so the choice is between alternatives with different imperfections.

Policy sensitivity to changes in States' royalty rates

While aggregating onshore minerals into groups would reduce some of the policy sensitivity, the results presented in the discussion paper show that an increase in Western Australia's royalty rates would still result in an associated GST loss of about 40%.⁵ This sensitivity is far greater than the maximum 10% loss applying to taxes.

² A new project will be more (less) desirable to a State if the royalty rate that State levies on the project is higher (lower) than the standard rate used to assess mining revenue capacity.

³ Amalgamating the existing revenue bases for taxes and royalties into a single revenue base.

⁴ Aggregating all royalties and applying a fixed standard royalty rate (that does not change with State royalty policy changes) to assess mining revenue capacity, with the choice of the standard rate determined by whether it can be reasonably applied across all minerals.

⁵ Throughout this submission, we describe how the mining revenue assessment operates under pre-reform arrangements. The interaction with the GST reforms is dealt with in a specific section headed *HFE reforms*.

Further, although the sensitivity is reduced for minerals that are predominantly produced in one State (such as iron ore), the 40% impact would now be extended to all minerals, including previously insensitive ones. For example, as shown in the following table, Western Australia's assessments are currently not highly sensitive to changes in the State's royalty rates for coal, copper, and onshore oil and gas, and only moderately sensitive for minerals in the other minerals component (such as mineral sands and diamonds). Under the discussion paper proposals, an increase in Western Australia's royalty rate for any of these minerals would result in a GST loss of about 40% of the additional royalty revenue collected.

Table 1: Sensitivity to Western Australian royalty rate changes under mineral-by-mineral assessment, 2016-17

Iron ore	Coal	Copper	Onshore oil and gas	Minerals in other minerals component
-88%	+10%	-9%	+9%	-15%

Source: Western Australian Department of Treasury calculation using the CGC 2018 Update.

A further concern is that a two-group assessment would raise scope for GST losses in excess of 100% of the revenue from changes to royalty rates in the event that a mineral changed groups. This problem existed in the low rate/high rate grouping implemented in the 2010 Review, which resulted in the Federal Treasurer instructing the CGC to not reclassify iron ore fines from the low rate group to the high rate group. The discussion paper suggests that freezing the groups between method reviews would address this concern, but it would merely delay any impacts.

- It should be noted that changes in royalty rates as soon as mid-2021 (less than a year and a half after the conclusion of the 2020 Review) can be expected to be partly assessed under 2025 Review methods.

We are aware of only four ways to reduce the policy sensitivity of mining revenue to that comparable to taxes: a global assessment that aggregates all tax and mining revenue bases; a uniform fixed standard royalty rate; a policy neutral revenue base measure such as land area⁶; or a rotating standard applied to a single onshore mining component.

The rotating standard was rejected by the Commissioners due to its complexity⁷ and is not considered further in this submission. We address the CGC's concerns with the remaining three options later.

⁶ Our submission on the draft assessment papers suggested that a discount on the mining revenue bases could be towards land area rather than population.

⁷ Commonwealth Grants Commission (2017), *2020 Review: The Principle of HFE and its Implementation*, Commission Position Paper CGC 2017-21, page 19.

We also note that the CGC has not analysed our preferred global revenue base approach of aggregating existing revenue base measures.⁸ The CGC said it was unsure how to compare this approach under previous review methods. However, we believe that it should be easier to accurately analyse this option than it would be for other options which the CGC did analyse. For those options, the CGC was comparing how the global revenue base option would operate now to how the methods applied previously. By aggregating all revenue bases under methods applied at the time, and comparing that to the sum of individual assessments under the methods that applied at the time, the CGC would be comparing like with like, minimising the distortions of method changes on the analysis.

Standard versus actual royalty rates

The discussion paper suggests that aggregating minerals will give States an incentive to prefer developing minerals on which they levy high royalty rates to minerals on which they levy low royalty rates. The paper attempts to ameliorate this concern through a two-group assessment. However, even a two-group assessment applies standard royalty rates to minerals that will vary from actual royalty rates.

For example, the suggested two-group assessment would apply a rate to iron ore that would be influenced by coal royalty rates, which are in part determined by the price of coal. While the rate difference may not appear large, it has a material impact, due to the production volumes of these minerals.

The discussion paper rejects the use of global revenue base measures because the standard revenue raising rate will not match actual revenue raising rates on individual revenue bases. However, this is exactly the concern that the paper raises in the context of aggregating onshore minerals into one or two groups. Furthermore, the CGC's average effort calculations for taxes often vary from States' actual policies, such as in the highly variable payroll tax thresholds applied by the States.

Although the discussion paper says that States would prefer high royalty rate minerals over low royalty rate minerals, we expect it is likely that State policies would be most influenced in the case of minerals that attract very low royalty rates, as it is easier to stop or discourage projects than it is to get projects established. Compared to the paper's proposed option of aggregating all onshore minerals, Western Australia's proposals for a fixed uniform standard royalty rate or a global revenue assessment would both apply a lower standard royalty rate to these low royalty rate minerals so they are less likely to distort State policies.

⁸ Initially discussed in Commonwealth Grants Commission (2018), *2020 Review: A Broader Assessment Approach*, Staff Research Paper CGC 2018-02-S, pages 8-9.

Measuring a “true” mining revenue assessment

The CGC uses its existing legal incidence approach (also known as the representative tax system approach) as a benchmark when examining alternative methods. However, we argue that the existing approach, or any other approach, cannot ultimately be described as giving a “true” measure of mining revenue raising capacity.

There are at least two reasons for this.

- Firstly, the CGC cannot know the level of mineral production States would adopt under average policy. As a result, it relies purely on observed production under varying State policies. However, the HFE principle requires revenue capacity to be measured at the same effort.
- Secondly, the concept of average effort is unclear when a single State dominates the revenue base.

This can be illustrated by iron ore where, for the 2018 Update, the average rate (7.2%) is almost entirely determined by the Western Australian royalty rate (7.4%). By contrast, the other States’ iron ore royalty rates averaged 1.9%, and the maximum rate that any other State had in any of the data years for that Update was 3.4%.

There is no way to determine what other States’ policies would be if they had Western Australia’s iron ore resources, so it is not meaningful to describe the standard rate used by the CGC as average policy. If other States’ iron ore royalty rates were to be equally weighted with Western Australia’s rate (ignoring States with no iron ore production), then the standard iron ore rate for the 2018 Update would have been 3.2% instead of 7.2%.

An average rate can potentially be calculated using an unweighted average, a population weighted average or (as the CGC does) a revenue base weighted average. The HFE principle doesn’t give any rule for deciding between these options. When these give broadly similar results (as they do for taxes), then one can feel comfortable with the results. However, this is not the case for royalties.

The CGC sometimes deals with an inability to accurately quantify HFE by discounting. However, it only applies discounting in selected instances.

The discussion paper notes that the Productivity Commission does not consider discounting to be appropriate (as it would exclude some revenue from differential assessment). We agree that, if fiscal capacity were accurately identified, it would be inappropriate to discount. However, our proposal to discount is designed to address a different situation, where fiscal capacity cannot be accurately identified. The Productivity Commission described the CGC's current practice of discounting in these circumstances,⁹ and did not criticise this practice.¹⁰

Some disabilities cannot be reliably measured or have an immaterial impact and are either discounted or assessed on an equal per capita (EPC) basis.

Given that any measure of mining revenue capacity will be uncertain, we believe it is acceptable to consider solutions such as global revenue bases, a fixed uniform standard royalty rate or land area as the revenue base. While the discussion paper claims that a fixed uniform rate is a discount, this is not the intent of this measure and the claim could only be valid if there were a "true" measure of revenue capacity to which the fixed rate could be compared.

Although the discussion paper noted that the Productivity Commission commented on policy neutrality and discounting, it overlooked the Productivity Commission proposal that the CGC use simpler and more policy neutral indicators.¹¹ This could be achieved by using land area as the revenue base.

Method comparison

The discussion paper has considered both sensitivity to royalty rate changes and relevance of standard revenue raising effort. In the following diagram, we attempt to illustrate how we consider the existing assessment and alternative CGC and Western Australian proposals perform with respect to these two issues. From the CGC's perspective, preferred methods would appear towards the top and to the right.

The diagram shows:

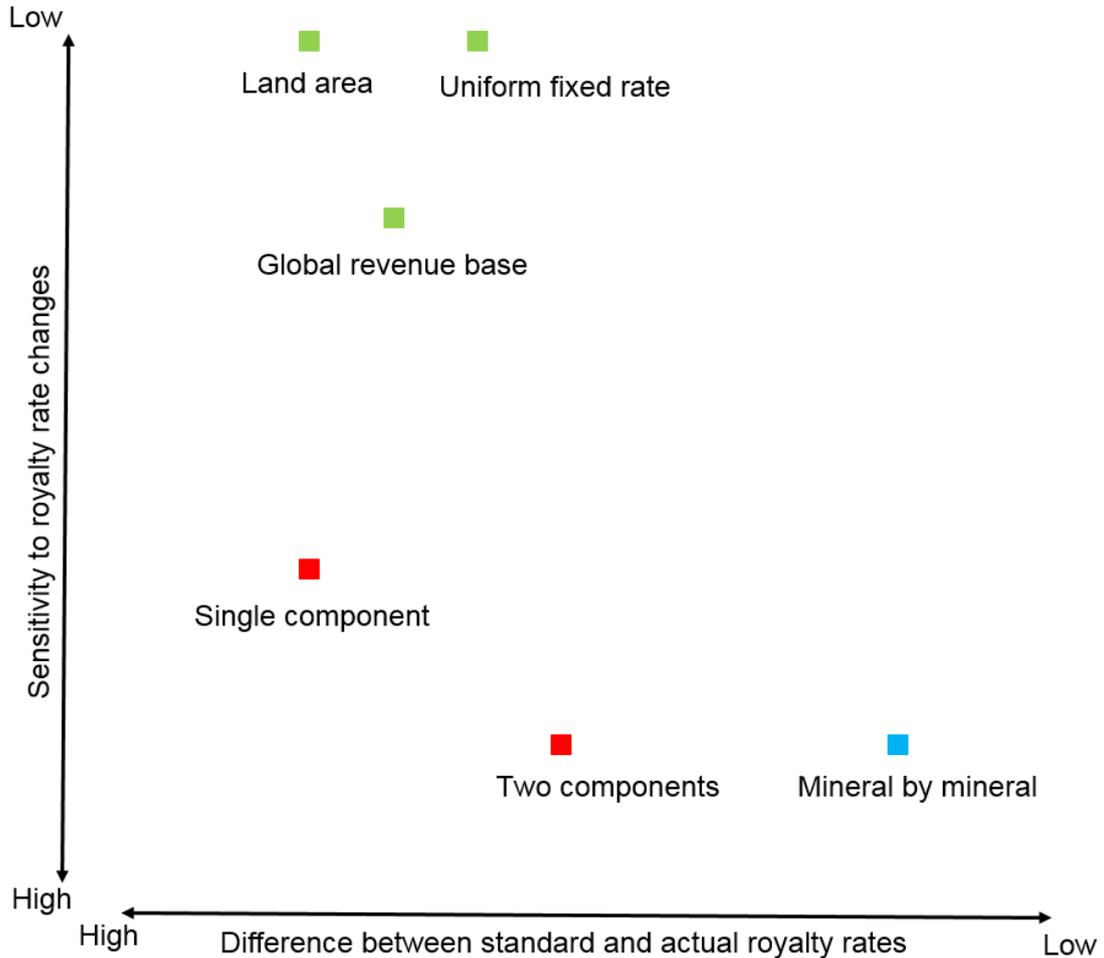
- the current mineral-by-mineral assessment (shown in blue) provides relevant standard rates to the minerals' actual rates, but has high sensitivity to royalty rate changes;
- the discussion paper proposals for a two-group or single-group option (shown in red) only achieve modest reductions in rate sensitivity compared to the current approach, while making the standard revenue raising effort less relevant; and

⁹ Productivity Commission (2018), *Horizontal Fiscal Equalisation*, Inquiry Report No. 88, page 7.

¹⁰ Although the Productivity Commission disagreed with discounting revenue categories, it always phrased this as not discounting for policy neutrality, rather than for inaccuracy of the measurement of HFE.

¹¹ Productivity Commission (2018), *Horizontal Fiscal Equalisation*, Inquiry Report No. 88, pages 23-25.

- the Western Australian proposals (shown in green) achieve minimal rate sensitivity, with broadly similar relevance in standard revenue raising effort to the discussion paper proposals.



Note: Compiled by the Western Australian Department of Treasury. Rationalisation is available on request.

HFE reforms

Some parties may consider that problems with the mining revenue assessment are no longer relevant in the context of the HFE reforms that have been implemented by the Commonwealth Government.

It is true that these reforms will ameliorate the impacts of the mining revenue assessments on Western Australia (and would do so for Queensland if its mining revenue raising capacity were to increase sufficiently to make it fiscally stronger than New South Wales and Victoria). However, we expect Western Australia's relativity to rise above the floor in a few years, at which stage equalisation to the fiscally strongest of New South Wales and Victoria will still have many years to phase in, so the problems with the mining revenue assessment and the choice of assessment method will have a material policy and financial impact for Western Australia. In the longer run, it is plausible under some scenarios that Western Australia could no longer be the fiscally strongest State, making the mining assessment again have a material policy and financial impact for Western Australia.

Conclusion

The mining revenue assessment has intractable problems when approached through the legal incidence/representative taxation system paradigm. These are not resolved by the CGC's proposals. While the problems exist, HFE is not able to be reliably quantified (noting that the mining revenue assessment is by far the largest driver of redistribution).

Western Australia considers that a global revenue base, a uniform fixed royalty rate, or using land area as the revenue base, provide the preferred solutions. These approaches provide low sensitivity to royalty rate changes (high policy neutrality), while offering acceptable relevance of standard revenue raising effort (what States do). Importantly, the relevance is broadly the same as the proposed options in the discussion paper, with much lower sensitivity.

However, given the CGC's reluctance to adopt a broader approach, and the impossibility of determining "true" HFE under current legal-incidence views, there would be no improvement in HFE from moving away from the current assessment. Retaining the mineral-by-mineral assessment has the advantages of being simple to explain, coming the closest to applying mineral specific royalty rates, and avoiding extending policy sensitivity to all minerals.