GST SHARES IN THE PRESENCE OF LARGE AND VOLATILE STATE REVENUES

Introduction

1 In this paper, the Commission presents its response to the Treasurer's letter to the Chairperson of 23 December 2014 (at Attachment A) on the treatment of GST relativities where a particular revenue source is a large and volatile proportion of a State's revenue.

- Part A contains our interpretation of what we have been asked to provide.
- Part B provides information on volatile revenue sources and describes how the current HFE system accommodates that volatility.
- Part C contains alternative approaches considered by the Commission.
- Part D contains the Commission's views.

2 State views were sought in the preparation of this paper. They are presented in Attachment B.

3 The issue of dealing with volatile iron ore royalty revenues was raised by Western Australia in the course of the 2015 Methodology Review. Our response to that related issue, including further State views, is contained in our report of that review. We have drawn on material in that report in preparing this response.

A. The task as we understand it

4 The advice sought from the Commission specifically relates to:

- the context of the 2015 methodology review and the volatility of mining revenues
- where a particular revenue source is a large and volatile proportion of State revenues
- mitigating negative effects of revenue volatility on the GST distribution system
- ensuring States' shares of the GST in a given year are appropriate for their fiscal circumstances in that year.

5 In this Part we set out our understanding of these terms.

6 The Commission considers that to provide its advice in the context of the methodology review, and because any approaches involve a distribution of GST revenues, it should frame its response against the objective that the Commonwealth and the States have agreed for the distribution of the GST revenue, namely that it is to be done on the basis of the principle of horizontal fiscal equalisation (HFE).

7 We have understood the reference to a "large and volatile" revenue source (in the context of mining revenues) as relating to the iron ore revenues of Western Australia. Mining revenues are not the largest of the various State revenues and are not

uniquely volatile, but iron ore royalties are an unusually large proportion of Western Australia's own-source revenues.

8 Western Australia has asked that we also consider oil and gas revenues from the North-West shelf. However, as many other revenues of the States are as large, or larger, than this item, we have restricted our consideration to possible alternative approaches in the assessment of iron ore royalties, while retaining the remainder of the assessments proposed in the 2015 methodology review.

9 We have understood the reference to negative effects on the GST distribution system as referring to possible negative effects on fiscal equalisation under that system, consistent with the overall assessment objective. We have not interpreted them as financial effects on any one particular State budget, noting that any movement in the relativity of one State is matched by opposite movements for others.

10 Finally, we have interpreted the requirement that GST shares in a year be appropriate for fiscal circumstances in that year broadly as requiring that the GST shares achieve fiscal equalisation. In our report, we have cast our contemporaneity supporting principle in broadly similar terms, and we apply that supporting principle in concert with other supporting principles (in particular practicality and policy neutrality) to produce an appropriate distribution in the application year. A key feature of the longstanding methodology approach has been that equalisation is achieved over a run of years. In this paper, we consider whether any alternative approaches to the assessment of iron ore royalties would produce a similarly appropriate distribution consistent with fiscal equalisation.

11 Our understanding of the advice sought, in particular that any approaches must meet the goal of HFE, constrains the alternatives that we have considered and guides our analysis of them. In substance, in response to requests in similar terms from Western Australia, the Commission undertook a substantially similar analysis of options during the latter part of its 2015 Review. Its conclusions were that the existing methodologies best meet the requirements of HFE for all assessments, including for iron ore royalties.

12 Of course, the adoption by Government of other objectives for the distribution of GST revenues could lead to different results. Since the early 1980s, Governments have set out a limited number of specific requirements for the assessment of certain items in the terms of reference provided to the Commission. We have not interpreted the request for advice as asking us to consider alternative objectives and have not sought to do so. However, in Part C we provide calculations of the effect of advancing, for any reason, illustrative amounts of GST to Western Australia in 2015-16 with an equal per capita reduction in the distribution for the other States.

B. How the current HFE system deals with volatility

13 This section describes how the current approach to HFE deals with volatility and places the impact of prospective volatility in iron ore revenues into a historical context. It draws on material included in the Commission's Report on the 2015 Methodology Review.

14 The current system bases its assessments on the average of the last three years for which final budget outcomes (and other relevant data) are available. To obtain an appropriate reflection of State shares of GST revenue in the application year, the assessment year data are in effect indexed by the expected growth in the size of the GST pool. In the first instance, by taking an average of assessment years, the volatility of a revenue stream in any one of the three years is reduced. A spike or dip in a revenue stream in a year has a lagged one third effect on the relativities over three successive updates to relativities.

15 When volatility is limited the lagged three year average does well in forecasting the application year. However, by definition, the historical average will generally not recognise precisely cyclical movements occurring in the application year, or other spikes or dips.

16 A result of this is that in any one year the averaging approach may underestimate actual revenue outcomes in the application year (and thereby provide more GST than a fully contemporaneous assessment would). However as each year moves through the system, there will be compensating overestimates of actual revenue outcomes in the application year, thereby reclaiming previous overprovision of GST revenue. This process, of under and over estimating application year outcomes, is a desirable consequence of the averaging approach and mitigates the need for any formal error corrections. It is an integral, if informal, part of the process of delivering HFE, albeit through a lagged process.

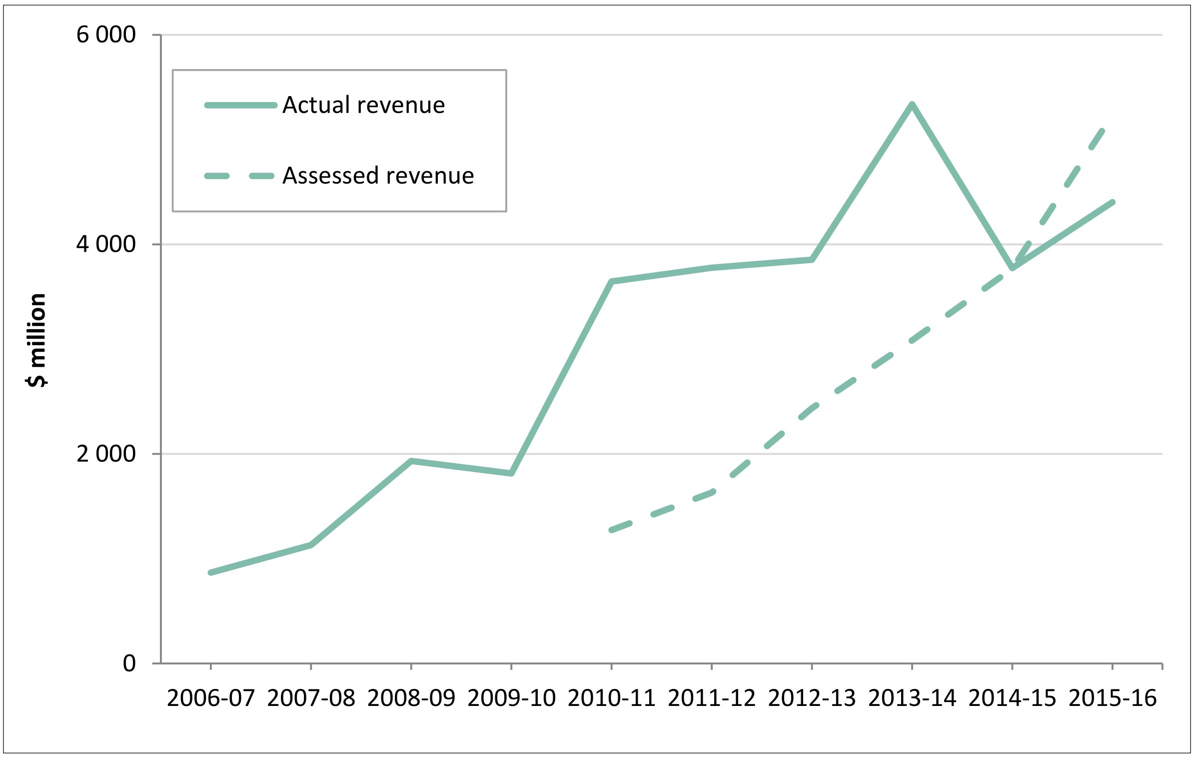
17 Figure 1 illustrates how the system has worked for iron ore royalty revenue, from the commencement of the lagged three year average approach in the 2010 Review. The assessed revenue applying in 2010-11 was based upon the revenues collected in 2006-07 through to 2008-09.

18 In any one year different revenues and expenses may be being over- and under-compensated, compared with a fully contemporaneous outcome. For example, Figure 1 shows that from 2010-11 to 2014-15 the lagged approach significantly under-estimated actual royalty revenues. However in 2015-16 the lagged approach would overestimate them (by an estimated $836 million on Western Australia's current projections), as the process of reclaiming the previous under-estimates begins.

19 To the extent that different revenues or expenses may move in offsetting directions, this aspect of the system also acts to smooth volatility in GST shares. This balance

would be at risk should different elements within the system be treated in different ways.

Figure 1 Iron ore royalties, assessed and actual (projections from 2014-15)



Notes: From 2010-11 to 2014-15 (the 2010 Review to the 2014 Update) iron ore was assessed in two groups, a high royalty rate group (lump iron ore) and a low royalty rate group (iron ore fines). Assessed royalties are the sum of these two assessments.
Actual royalties for 2014-15 and 2015-16 are projections.

Source: Western Australia budget papers and mid-year financial projection statements; Commission calculation.

20 The lagged average approach is less contemporaneous when dealing with larger scale variations in trends (relative to the trend growth rate of the GST pool). Where revenues are trending upwards at an unusually fast pace, as in a mining expansion, the lagged average approach routinely underestimates actual revenues in the application year. Conversely, the lagged average approach regularly overestimates actual revenues in the application year during a larger than average downward trend. However, to the extent that these developments are cyclical, rather than ongoing structural trends, the effects of the system in achieving HFE over time apply irrespective of the relative amplitude of the cycle.

21 The three year lagged average approach also assists States with budget management, in that any State's GST revenue is not immediately subject to the volatile outcomes in other States. For example, while the equalisation system will see Queensland compensated by the other States for expenses incurred in addressing natural disasters, States do not bear this cost unexpectedly in the year in which the disasters

occur. States can plan to absorb those costs through reductions in GST revenue as the relevant year moves through the equalisation system. States are well aware of this longstanding aspect of the HFE system and manage their budgets accordingly.

Volatile revenues

22 Attachment C provides data showing year to year variations in different State revenues. We have presented data on the main revenue sources which are subject to differential assessment; Payroll Tax, Stamp duty on Conveyancing and Mining Royalties. We have also provided data for those revenues showing how the assessed revenues for a year (with the influence of policy differences removed) differ from the revenue implicit in the GST distribution of that year. It is this gap which leads to over or under payments in a cash, though not necessarily in an accruals, sense.

23 The figures in Attachment C suggest volatility appears to be an issue mainly for:

- mining royalties
- Western Australia.

24 Across the States, between 1988-89 and 2013-14 the annual change exceeded $200 per capita on nine occasions in mining royalties (four of those exceeding $400 per capita), on six occasions in stamp duty on conveyances and on one occasion in payroll tax. Most changes were increases. Of the total events, nine occurred in Western Australia.

25 Over the same period, the difference between assessed revenues (calculated using the three year lagged average approach) and actual revenues exceeded $300 per capita on 20 occasions for mining royalties (15 relating to Western Australia), on six occasions for stamp duty on conveyances (five relating to Western Australia) and on no occasions for payroll tax.

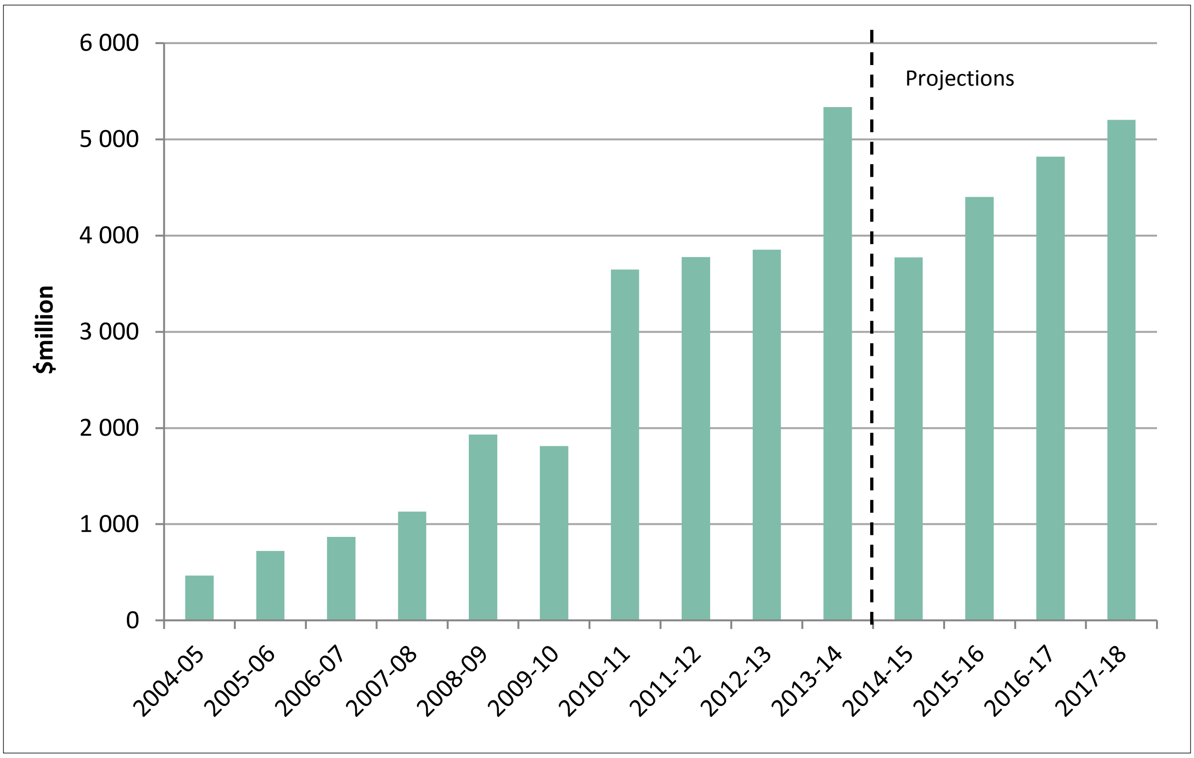
26 Given past assessment methods that grouped minerals, we do not have data that allow us to reliably chart historical volatility for individual minerals. However, noting the Treasurer's letter refers to large and volatile revenues in the context of the situation facing Western Australia, and our recommended move to a mineral-by mineral assessment, we focus on iron ore revenues in the following sections of this paper. However, in principle much of the discussion and issues with potential approaches could apply equally to other revenues if they were to be judged as meeting a test of 'large and volatile'.

Volatility in iron ore royalties

27 Western Australia's iron ore royalty revenue has grown close to ten-fold in the past decade, from $465 million in 2004-05 to a projected $3.8 billion in 2014-15, with a peak of $5.3 billion in 2013-14. Figure 2 shows Western Australia's royalties during this time, along with its most recent projections for future years. During this time,

iron ore royalties have increased from representing 3% of Western Australian Government revenues in 2004-05 to an estimated 14% in 2014-15.

Figure 2 Western Australia iron ore royalties, actual and projected from 2014-15



Source: *Overview of State Taxes and Royalties, 2014-15*, WA Treasury; Western Australia *Mid-Year Financial Projections Statement*, December 2014.

28 Figure 2 shows Western Australia expects receipts in 2014-15 to be at about the same levels as in 2011-12 and 2012-13 (though well below those of 2013-14), before resuming steady growth.

Assessed and projected revenues in 2015-16

29 Table 1 shows our lagged three year average approach would assess Western Australia's iron ore royalty capacity to be $5.2 billion in 2015-16 (the application year), $836 million (19%) above its latest projection.[1] Feeding the spike year of 2013-14 into the three year average is what causes the divergence between the assessed and projected revenue for 2015-16.

[1] Based on the Commission's mineral by mineral assessment of mining royalties as recommended in its 2015 methodology review report.

Table 1 Comparison of Western Australian and Commission iron ore royalty data

	Assessment period				Assessed application year (a)
	2011-12	2012-13	2013-14		
	$m	$m	$m		$m
2015 Review	3 708	3 767	5 328		5 238
Western Australia budget data	2011-12 Actual	2012-13 Actual	2013-14 Estimated actual	2014-15 Forward estimate	2015-16 Forward estimate
	$m	$m	$m	$m	$m
December MYFPS	3 776	3 853	5 337	3 773	4 403
Difference	68	86	9		-836

(a) This is Western Australia's assessed iron ore capacity for 2015-16 based on the lagged three year average 2015 Review assessment.

Source: Western Australian 2013-14 and 2014-15 Budget Papers, Budget Paper No 3, Table 17, Page 112. Western Australian 2014-15 *Mid-Year Financial Projections Statement*, Table 5, page 13. Commission assessments for the 2015 Review.

A comparison of the estimated 2015-16 result with historical variations

30 A directly contemporaneous assessment (assessed without regard to the fiscal outcomes and GST distributions of any other years), if based on Western Australia's latest forecast of $4.4 billion[2], would reduce Western Australia's assessed capacity and increase its GST distribution. However, this takes no account of previous under-estimates of Western Australian royalty revenues, which provided Western Australia with more GST than it would have received under a more contemporaneous approach.

31 Table 2 below shows Western Australia's actual iron ore royalties and the assessed iron ore royalties included in the GST distribution for that year, from the commencement of the three year averaging in the 2010 methodology review.[3] When the actual royalties exceed the assessed (a positive difference) Western Australia would have received more GST than it would have if fully contemporaneous

[2] Western Australia's latest iron ore royalty forecasts are from its latest December *Mid-Year Financial Projections Statement* (MYFPS). These forecasts are lower than its May 2014 budget by $1.8 billion for both 2014-15 (a 33% reduction) and 2015-16 (a 29% reduction).

[3] The assessed application result was calculated by indexing the three historical assessment years by growth in population and the GST revenue between the assessment years and the application year, then taking the average. For the years 2010-11 to 2014-15 (representing the 2010 Review through to the 2014 Update) lump iron ore was assessed in the high royalty rate group and iron ore fines assessed in the low royalty rate group. The assessed column in Table 2 represents the sum of these two iron ore assessments. The2015-16 year (representing the 2015 Review) reflects all iron ore being assessed collectively in a separate mineral group.

assessments had been in place, while a negative difference means it would receive less. In 2015-16 the difference is estimated to be -$836 million ($308 per capita).

Table 2 Actual, projected and assessed Western Australian iron ore royalties

	Actual	Assessed	Diff. (Actual - Assessed)
	$m	$m	$m
2010-11	3 647	1 272	2 375
2011-12	3 776	1 630	2 146
2012-13	3 853	2 438	1 414
2013-14	5 337	3 084	2 253
2014-15 (a)	3 773	3 768	5
2015-16 (a)	4 403	5 238	-836

(a) Actual royalties for 2014-15 and 2015-16 are projections.
Source: Western Australia budget papers and mid-year financial projection statements; Commission calculation.

32 The Commission estimates that during the mining boom, in the years to 2013-14, Western Australia received around $7 billion more in GST revenue than it would have if fully contemporaneous assessments had been in place. The net impact on Western Australia would be affected by under or over adjustments in other revenues and expenditures.

33 In 2014-15 and 2015-16, when actual royalties are expected by Western Australia to return to levels of 2011-12 and 2012-13 before growing again, the HFE system will act to reduce this over-payment by about $740 million (as Western Australia keeps its population share of assessed revenues). However, unless iron ore royalty revenues grow at low rates into the future, a significant part may remain as a permanent net benefit to Western Australia. This reflects the fact that there is both a structural trend and a shorter term cycle affecting Western Australian royalty revenues. The lags in the assessment system have provided a large and likely ongoing benefit to Western Australia (at the expense of other States) while cyclical developments (around the trend) provide broadly offsetting short term gains and losses.

34 Over the last two decades, there have been twenty six instances where the difference between a States' assessed fiscal capacity in the assessment period and application year exceeded $308 per capita. With two exceptions, they relate to Western Australia and the Northern Territory. Most relate to mining revenues, although there were six instances in conveyance revenues. Most occurred during up-cycles (where the State benefitted from the lagged three year average assessment), only eight occurred in down-cycles. In Western Australia's case the difference has exceeded $308 per capita in fifteen of its last twenty one mining assessments (to its benefit in all but two cases in the mid-nineties).

35 In view of the above, the Commission considers that the prospective difference between the projected and assessed revenues of $836 million ($308 per capita) in 2015-16 is not of itself an unusual circumstance. Differences of this magnitude have been observed in recent years and have been accommodated within the system.

C. Alternative approaches considered by the Commission

36 The broad assessment approach of the Commission and its implications for volatile revenues are set out in Part B. This general approach has been followed by the Commission and Governments since the early 1980s for the distribution among the States of Commonwealth general purpose funds (previously financial assistance grants and now the net GST revenues).

37 The approach has been based on balancing a number of supporting (but often competing) principles:

- Practicality – in particular the use of reliable data available from the historic assessment years, together with other features such as materiality tests.
- Contemporaneity – data are updated each year on a rolling basis and uplifted by growth in the GST pool. Provided that the broad assessment approach is maintained each year, this generally achieves HFE over a run of years, albeit with some lag arising from the use of historic data.
- Policy neutrality – basing assessments on an average of years reduces the impact of policy changes in any one year.

38 States have generally supported this approach also because they embody some smoothing of the results through use of three year averages, and because the use of historic data provides greater certainty and predictability of GST shares for their budget formulation.

39 We have considered alternative approaches against the key criterion that they meet the objective of HFE. Although a very large number of possible approaches could be considered, we focused our attention in consultation with the States on four main alternative approaches.

40 However, we have not concluded that any of these would provide an appropriate result (or a more appropriate one) consistent with HFE.

41 In particular:

- Under the practicality and policy neutrality supporting principles, we do not support the use of revenue forecasts as the basis of assessments since they are not reliable and could allow State policies to more directly determine GST shares.
- We do not support the use of single year forecasts, or any other directly contemporaneous methods, in the context of the circumstances facing the iron ore industry, because to do so will not deliver HFE over the run of years consistent with our objective. Rather, as demonstrated in Part B, it would provide for

Western Australia to fully retain windfall fiscal gains already obtained under established methods without their partial amelioration under the continued application of those methods.

42 In addition, we are concerned that there may be unintended impacts on fiscal equalisation from treating one revenue or expense fundamentally different from others. We are concerned that asymmetric treatments create problems within the HFE system. The asymmetric approach could lead to a situation where, over time, one State would be given a greater fiscal capacity than other States, which would not be consistent with HFE. In their submissions, a number of States expressed concerns about applying an adjustment to address volatility for iron ore but not for other minerals or for other assessments. A further concern with a partial approach to volatility is that it is possible that a State's positive volatility for some assessments is offset by its negative volatility for others.

43 Finally, we also note:

- From an HFE perspective, we do not consider the GST distribution is intended to offset the impact of individual State policy choices relating to their revenue and expenditure settings. Rather it is intended to equalise fiscal capacities in the application year, not budgetary circumstances which include State policy choices.
- Nor is HFE about achieving a particular desired State budget outcome in the application year. HFE does not aim to bring State budgets into alignment in cash terms.

44 Against these criteria, we considered a number of possible alternative approaches. These are set out in the following section. We consulted States on these approaches and their views are contained in Attachment B.[4] In general, States other than Western Australia did not support consideration at this time of a more contemporaneous iron ore assessment, or a change from the lagged three year average approach more generally.

Approach 1: Using projections or State forecasts

45 Western Australia has stated that with a major fall forecast for iron ore royalties, using average royalties for 2011-12 to 2013-14 as the basis of the 2015-16 GST distribution would be inappropriate. It suggests that a distribution based on prospective 2015-16 conditions would be preferable.

46 Under this approach, assessments would be based on State or independent forecasts of revenues in the application year. While this approach may improve

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[4] State views on Western Australia's suggested approach of using projections or forecasts are included in the Report on the 2015 Methodology Review and are not reproduced here. States were separately asked for their views on the other three approaches and these views are included at Attachment B.

contemporaneity (to the extent that any forecasts are accurate), we do not consider State, or independent, forecasts of revenues, for example for royalties, are sufficiently reliable for us to use as the basis of the GST distribution. In recent years errors in these forecasts have been very large. Further, policy neutrality concerns around using State own-forecasts introduce the opportunity of gaming the system and would require corrective adjustments once the final outcomes were known.

47 Therefore becoming more contemporaneous by using forecasts inevitably introduces its own errors, which the HFE system would need to internalise. Doing that, which can only occur once history is revealed, itself acts to undermine the contemporaneity of future GST distributions. In future years the assessment would be a projection plus an adjustment for past errors.

48 The Commission addresses Western Australia's argument fully in its Report on the 2015 Methodology Review.

Approach 2: A fully contemporaneous assessment

49 Under this approach we would determine what shares of the nominal pool of GST revenue and iron ore royalties combined would achieve HFE. Our current approach, excluding an iron ore assessment, would be used to do this. In the application year a State would retain its iron ore royalties and receive GST revenue equal to the difference between this and its assessed share of the nominal pool. Any increase or decrease in iron ore royalties in a State would be shared among all States as it occurred.

50 Western Australia has proposed a variation on this approach under which the Commission would calculate relativities (excluding iron ore royalty needs) to be applied to a GST only pool, with the results to be adjusted for iron ore royalty needs based on the application year royalties.

51 Either approach would provide the most contemporaneous treatment of iron ore royalties in the equalisation system. However, the Commission considers they share two primary drawbacks:

- As previously noted, during the mining boom Western Australia received more GST revenue than if fully contemporaneous assessments had been in place. We consider adopting either of these approaches now would undermine HFE. Moving now to this approach, without recognising the HFE consequences of that additional revenue provides a permanent fiscal advantage to Western Australia to the detriment of other States. The balancing aspect of the system over time would be lost.
- While in any one year volatility of overall revenue would be reduced for Western Australia, it would be at the cost of increased volatility in overall revenue for all other States. Their GST revenue would respond immediately in relation to

movements in iron ore royalties, leading to uncertainty for all States in what their actual GST revenue would be in any particular year.

Approach 3: A longer lag to smooth volatility

52 Under this approach, the Commission would use a lagged five year moving average of assessed iron ore royalties and a lagged three year moving average for all other assessments to generate application year relativities.

53 While this approach would smooth the impact of large changes in royalty revenues, it would be at the cost of spike or dip years being included in the equalisation system for a longer period. We also do not have confidence that five year averaging would provide an unambiguously improved HFE outcome compared with three year averaging. For example, five year averaging is less contemporaneous than three year averaging during a sustained trend. In addition, this approach would also introduce an imbalance to the equalisation system, although not to the same extent as a fully contemporaneous approach.

Approach 4: A contemporaneous adjustment to be reversed in future years

54 Under this approach, the Commission would provide relativities as per its general methodology for the distribution of GST revenue in the application year.

55 An adjustment would then be made for States affected by large and volatile revenues, on the basis of objectives specified by Government, with the adjustment financed by reductions in GST grants to other States allocated on an EPC basis. The size of the adjustment would be determined on the basis of the fiscal circumstances of the affected State in the application year. This could be done either in advance of the application year (based on expected circumstances) or in the course of the application year (based on actual emerging circumstances). If HFE is to be subsequently achieved the adjustment would need to be appropriately reversed in future years.

56 The difficulty with this approach lies in determining under what circumstances it might be applied and the appropriate quantum of the adjustment, such that it has minimal disruption on the HFE system overall.

57 While such adjustments might more closely align the GST distribution of States with large and volatile revenues to their fiscal circumstances in respect of those revenues in the application year, there is no assurance that this would be the case for the other States or for any States in future years as the adjustment was unwound. Further because the adjustment is limited to large and volatile revenues and ignores the cumulative impact of volatility in other State revenues, expenditures and payments from the Commonwealth on the difference between the GST distribution and prospective conditions it is by nature partial. There could be no assurance that it

would more closely align the GST distribution of all States to their prospective fiscal circumstances.

Illustrative relativities

58 Because we have not been able to identify a suitable modification to the current system we cannot provide alternate relativities for a recommended alternative approach for 2015-16.

59 However, as noted above and in Part A, should the Government decide to apply different objectives for any reason for some part of the GST distribution, it is relatively straightforward to increase the GST share for any State (in this case Western Australia). The offsetting reduction in GST share for other States would be applied on an equal per capita basis.

60 While we make no recommendations in this regard, for illustrative purposes the table below shows, relative to our 2015 Report recommendations, the effects of additional GST allocations of various amounts to Western Australia.

Table 3 Illustrative relativities, 2015-16

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Recommended	0.947	0.893	1.128	0.300	1.359	1.819	1.100	5.571
WA +$100m GST	0.945	0.891	1.126	0.315	1.357	1.817	1.098	5.569
WA +$300m GST	0.941	0.887	1.122	0.347	1.353	1.813	1.094	5.565
WA +$500m GST	0.938	0.883	1.118	0.378	1.349	1.809	1.090	5.561

Source: Commission calculation.

Table 4 Illustrative shares of GST revenue, 2015-16

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	%	%	%	%	%	%	%	%
Recommended	30.3	22.3	22.8	3.4	9.7	3.9	1.8	5.9
WA +$100m GST	30.2	22.3	22.8	3.6	9.6	3.9	1.8	5.9
WA +$300m GST	30.1	22.2	22.7	3.9	9.6	3.9	1.8	5.9
WA +$500m GST	30.0	22.1	22.6	4.3	9.6	3.9	1.8	5.8

Source: Commission calculation.

D. The Commission's view

61 In considering the request made of us, the evidence to hand and our experience with the HFE assessment system over a number of years, we consider that:

- The current approach acts to mitigate the impact of volatility on the GST distribution system in a robust fashion. It quarantines own source revenue volatility within the State it occurs until the lagged and averaging process distributes that among States in a known and predictable way. State budgetary practices have evolved to incorporate how the system currently works. Becoming more contemporaneous makes the GST distribution system more volatile because it would act to spread external volatility more quickly to other States, increasing their budget uncertainty.

- It is true States experiencing revenue volatility have to manage within their own budgets, but they can plan in the certainty that with an unchanged HFE process future year's GST distribution will recognise this with a compensating GST adjustment over time. The system has experienced and coped with volatility of the size in prospect in Western Australia in 2015-16 in the past.
- Over recent years the rapid trend growth in iron ore royalties has meant that Western Australia has received more GST than a fully contemporaneous assessment would have provided, most likely in excess of $7 billion (although the net impact on Western Australia could be less because of offsetting impacts in other assessments). If HFE is to be achieved the fiscal consequences of that additional GST revenue has to be, at least in part, recognised over future years. A move now to a different assessment method for iron ore which ignores history undermines HFE.
- Particular issues arise if one type of revenue (or expenditure) is treated differently than others. Since relative fiscal capacity relates to the overall budget position of each and every State, to treat one item differently than others can mean that States in otherwise the same overall fiscal position could receive substantially different GST shares merely because they have different revenue or expenditure compositions. For this reason, the Commission (within the practical limits that it faces) has always tried to apply the same assessment guidelines and supporting principles to each of its assessments

62 We have considered how the current system could be modified to both achieve HFE and have a GST distribution in the application year which more closely reflects the fiscal capacities of States in that year. We could not identify a modification which would operate with reliability over a span of years. While we can appreciate the budgetary pressures facing Western Australia, we do not consider that the HFE system is designed, or can reliably be redesigned, to provide partial responses to year to year budgetary problems and also achieve the objective of HFE.

ATTACHMENT A

TREASURER

Mr Greg Smith
Chairperson
Commonwealth Grants Commission
First Floor, Phoenix House
86-88 Northbourne Ave
BRADDON ACT 2612

2 3 DEC 2014

Dear Mr Smith Greg

I am writing to you with regard to the Commonwealth Grants Commission's *2015 GST Methodology Review.*

In the context of the Methodology Review and given the volatility in mining revenues, I am writing to request that the Commission consider the treatment of GST relativities where a particular revenue source is a large and volatile proportion of a state or territory's (state) revenue.

As you would be aware, where a state is reliant on a volatile revenue base and its fiscal circumstances differ significantly between the assessment years and the application year for the GST relativities, applying the usual GST methodology can give rise to significant differences in fiscal capacity between states. In this regard, the Government understands the current challenges facing Western Australia with regard to GST distribution.

To assist in considering this issue, I request the Commission provide me with advice on a possible approach, as well as corresponding GST relativities, that would mitigate negative effects of revenue volatility on the GST distribution system and ensure that states' shares of the GST in a given year are appropriate for their fiscal circumstances in that year.

The principle of horizontal fiscal equalisation will be explored through the *White Paper on the Reform of the Federation*. However, I would appreciate the Commission's recommendation on the above matter to inform consideration of the 2015-16 GST revenue sharing relativities.

I would appreciate your advice on this matter by 28 February 2015, in line with the due date of the Methodology Review and including the supplementary Terms of Reference. I understand the challenging nature of this task and thank you in advance for your timely and independent advice.

Yours sincerely

HON J. B. HOCKEY MP

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ATTACHMENT B

Contemporaneity approaches — Summary of State views

General comments

63 New South Wales said that contemporaneity has been comprehensively addressed in previous methodology reviews and that there is not enough time to address this issue adequately at this late stage of the 2015 review. Victoria, South Australia, Tasmania and the Northern Territory agreed. South Australia and the Northern Territory said it would not be possible in the remaining time to identify all potential impacts that could produce significant changes to equalisation outcomes.

64 Victoria said the proposed changes are inequitable, complex, and are likely to compound volatility in GST shares. South Australia said, while it is open to measures to improve contemporaneity, changes to averaging periods should only be made at a time of relative stability in states' fiscal capacities so that no one state is advantaged or disadvantaged compared to the others.

65 Tasmania does not consider it the role of the GST distribution system to do anything other than deliver distribution outcomes based on the principle of HFE.

66 The Northern Territory said that other States have previously experienced significant variation in revenue sources due to the inherent data lags under the current methodology. The Territory said these States were not afforded special treatment to smooth or lessen the impact on its fiscal capacity, and it does not consider that it is appropriate to do so for Western Australia.

67 Western Australia said the Commission should use forecasts (with ex post adjustments) to achieve contemporaneity. It said its view is that substantial discounting is appropriate for the mining revenue assessments. This would help ameliorate contemporaneity concerns.

68 Queensland and the ACT did not provide specific comments on the alternative options. In earlier submissions both States said that it was too late in the 2015 Review to properly address this issue. Queensland said that there are substantial practical limitations and complexities in implementing greater contemporaneity that mean a contemporaneous approach is unlikely to better achieve HFE than the current lagged average approach. It said the current lagged three-year average approach is the best balance between contemporaneity and other considerations (accuracy, predictability, stability and the need to have symmetry over the equalisation cycle) that can be achieved at this late stage of the 2015 Review.

Fully contemporaneous (Absorption) approach

69 Most States did not support this option. New South Wales said the need for adjustments throughout the year as actual iron ore royalties became known would add to the uncertainty generated by this approach. South Australia, Tasmania and the Northern Territory all said that an absorption approach would be complex. Victoria and Tasmania said this approach spreads revenue uncertainty and volatility across all States. The Northern Territory said it would not result in an appropriate HFE outcome, due to the associated dilution of the impact of iron ore royalties on states' assessed relative fiscal capacities.

70 Some States said while it the approach would be more contemporaneous, it would not address the benefit of the lag accruing to Western Australia during the strong growth in iron ore royalties.

71 Western Australia said it considered the absorption approach to be the most acceptable, but that it should be implemented using assessed (rather than actual) royalties. Western Australia said it 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. It said its preferred approach would avoid the perception of a loss of States' sovereignty that could arise from applying a relativity to a pool that includes royalties. Western Australia said royalties are the price paid to extract ores owned by the people of the State and that the absorption approach as proposed could make it appear as if the royalties instead belong to the people of Australia.

72 Western Australia said 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.

A lagged five year moving average

73 No State supported this option. All States said that this approach would increase the lag in the system and decrease contemporaneity. Some States also said that different years would also have unequal weights in equalisation outcomes.

74 The Northern Territory said this approach presents the difficulty of appropriately determining what revenues are considered 'large and significantly volatile' and raises transition issues regarding the treatment of the 'large and significantly volatile' revenue once it ceases to be 'significantly volatile'. It said any reversion to the three-year average once revenues were no longer considered volatile could result in windfall gains for some States at the expense of others.

Smoothing through an adjustment to GST outcomes, that would be reversed over subsequent years

75 No State supported this approach. New South Wales and Tasmania said the approach would add to volatility and unpredictability. New South Wales and the Northern Territory considered the approach to have many of the difficulties inherent in using forecasts to determine GST, an approach that has already been rejected by most States and the Commission as it is not reliable.

76 Western Australia said that if an adjustment is required to achieve contemporaneity, then making a State repay that adjustment effectively negates the achievement of contemporaneity, requiring the CGC to make numerous, arbitrary judgements about the application and subsequent repayments of subsidies.

77 Tasmania questions how such an adjustment can be implemented in a way that is equitable for all States and so that revenue volatility for one State is not transferred to other States through reduced GST. It said the principle of States being forced to lend their GST revenue to other States is highly questionable, particularly at a time when most Government's face budgetary challenges. It risks the GST distribution system being seen as a temporary loan facility for Government's facing fiscal difficulty.

Contemporaneity approaches - Full extract from State submissions

New South Wales

NSW Treasury considers that contemporaneity has been comprehensively addressed in previous methodology reviews, with the Commission deciding on the current lagged three year averaging approach in the 2010 Review.

NSW Treasury notes that there have been a number of booms over time, whether in mining, property or some other revenue base, that have resulted in relatively temporary boosts to revenue to one or a small number of states. Changing the mining revenue assessment now, for example, would mean that over-payment in GST revenue during revenue upswings is never offset on the down side of the cycle.

NSW treasury does not believe there is time to address this issue adequately at this late stage of the 2015 Review and believes it should be addressed in the Federation White paper.

Nonetheless, Staff have requested State views on the following three options in response to the Australian Treasurer's letter to the Commission on the appropriate treatment of large and volatile revenue shocks:

- Option A: Absorption approach
- Option B: A lagged five year moving average
- Option C: Smoothing through an adjustment to GST outcomes.

New South Wales considers that the pros and cons of any change in treatment to the current three year average must be balanced against the issues of data availability, contemporaneity, judgement, predictability and volatility.

In general, the Staff options would require significant judgement in determining which revenue assessments are subject to any change in the treatment of contemporaneity. If the Commission was to recommend changes to the treatment of contemporaneity, states would need to be provided with adequate details of the basis on which the changes were to be applied and the justification, with an adequate time period to allow informed discussion of any proposals.

More detailed comments are provided following each proposal.

Absorption

Presumably, this would be equivalent to the approach previously adopted for health care grants prior to the 2010 review. However, HCGs were distributed across all states and were relatively stable, whereas iron ore royalties are effectively sourced from one state only and can be volatile. These differences could lead to variations due to policy changes and added volatility to revenues, with adverse effects on predictability.

The need for adjustments throughout the year as actual iron ore royalties became known would add to the uncertainty generated by this approach.

This distribution would take some account of the actual circumstances in the application year, but I think that it would have significant problems in implementation.

NSW Treasury does not support this option.

A lagged five year moving average

This option

- needs CGC judgement to determine which revenues would be subject to different averaging
- Doesn't adjust GST for immediate movements in royalties.
- Actually lengthens the lag between the application year and the data.

NSW Treasury does not support this option.

An adjustment to GST outcomes

It is unclear to me how any adjustment would be calculated – rolling forecasts of the application year, over what time periods?

This approach would need judgement to determine the basis for the adjustment and the timing of any adjustments. This approach seems to have many of the difficulties inherent in using forecasts to determine GST in the first place and would add to volatility and unpredictability. I believe this approach would be very difficult to implement.

NSW Treasury does not support this option.

Victoria

Victoria thanks the Commission for the opportunity to comment on its illustrative options for advice to the Commonwealth Treasurer on revenue volatility and timeliness of GST relativities.

Victoria restates it is strongly opposed to implementing any of the proposed changes, especially at such a late stage of the assessment process. The proposed changes are inequitable, complex, and are likely to compound volatility in GST shares. In principle, Victoria strongly rejects any ad-hoc methodological changes to GST relativities that are largely designed for the benefit of a single jurisdiction.

The proposed changes would be unfair

As the price of iron ore began to appreciate sharply from 2008-09, Western Australia substantially benefited from the Commission's current three-year averaging methodology, which ensured that state concurrently received significant levels of both GST and mining revenue for a number of years. To change this approach now would represent an unjustifiable windfall gain to Western Australia through them benefitting from the upside of the existing system but changing it to protect them from the downside. It could effectively mean that no iron ore revenue collected at the peak of the iron ore price cycle was subject to equalisation. This outcome would be a highly inequitable departure from the fundamental principles of equalisation, undermining national confidence in the distribution system.

The changes would make the system more complex and less transparent

Taken on their own, each of the proposed options would likely represent one of the single largest methodological changes in the 2015 Review, a process that has extended over two years and included extensive analysis and consultation. Considering these new proposals in the final two months of this process does not allow adequate time to understand and assess their significant implications and runs the risk of significant unintended consequences.

Through no fault of the Commission, the options presented are too underdeveloped to make an informed assessment of how they would operate, or their merits and impact. Victoria considers implementing any of these options to largely be either technically impracticable or require an unacceptable level of judgement. Victoria is concerned that the proposed changes would leave the system of equalisation and the majority of states - including Victoria - worse off in an attempt to support the revenue management issues of one jurisdiction.

To the extent these options require direction from the Commonwealth Treasurer, implementing them has the potential to unduly politicise the GST distribution process and undermine the independence and transparency of equalisation. Victoria is not confident the Commission can satisfactorily resolve these implementation issues prior to finalisation of the Review.

The changes would exacerbate volatility in GST shares

In an effort to manage volatility in one revenue line for a single state, at least two of the Commission's proposals would greatly exacerbate volatility of GST revenue for all jurisdictions, greatly complicating the process of preparing state budgets and the development of reliable revenue forecasts.

To the extent these options rely on forecasts, Victoria considers the Commission's proposals also carry significant risk of gaming of GST shares by some states in preparing their budgets, by enabling states to directly influence their GST shares by varying their revenue forecasting assumptions. In the *2010 Methodology Review*, following extensive analysis and consultation, the Commission concluded that a three year averaging process applied across the entire assessment struck the right balance between minimising volatility, and ensuring that GST shares reasonably reflect states' current fiscal capacities. This view was reaffirmed in the Draft Report of the *2015 Methodology Review*. Victoria agrees with this assessment.

Assessment of options

Victoria strongly opposes implementing any of the proposed adjustments, which are likely to increase uncertainty, GST revenue volatility, and unfairly penalise non-mining jurisdictions such as Victoria. We however appreciate that the Commission is obliged to provide the Commonwealth Treasurer with advice on this issue. Victoria considers that this advice should discuss the complexities and compromises involved, as well as discussing the views of states and territories.

While the Commission has been asked to examine ways to improve contemporaneity associated with volatile revenue streams, this would come at the direct expense of broader volatility in GST shares. In seeking to address these issues, Victoria cannot recommend to the the Commission any option that would result in the exclusion of mining revenue from full equalisation. It is also likely that these approaches would create incentives for gaming.

Regardless of the Commission's final advice to the Commonwealth Treasurer, Victoria requests that relativities advice be provided to states as early as possible, given their significance in preparing the Budget.

Queensland

Queensland has a nil response and nothing further to add at this stage beyond the views expressed in our earlier submissions.

[Extract from Queensland's earlier comments on Contemporaneity and adjustment for revenue volatility]

Queensland's position

- Queensland acknowledges that revenue volatility can affect GST distribution, but it is far too late in the 2015 Review to properly address this issue. Queensland would support further examination of improved contemporaneity in the next review, on a comprehensive and considered basis, rather than a partial and piecemeal approach.
- There are substantial practical limitations and complexities in implementing greater contemporaneity that mean a contemporaneous approach is unlikely to better achieve HFE than the current lagged average approach.

- The current lagged three-year average approach is the best balance between contemporaneity and other considerations (accuracy, predictability, stability and the need to have symmetry over the equalisation cycle) that can be achieved at this late stage of the 2015 Review.
- Queensland does not consider that recent volatility in Western Australia's mining royalties is sufficient to warrant special treatment, where this has not been provided for other volatile revenues or for other states in similar circumstances.
- There is a high degree of risk in making methodological changes late in the Review, where the implications may not be fully considered. The Commission should recommend minimal changes in response to the additional Commonwealth request.
- If the Commission considers recent volatility in mining revenue to be so extreme as to warrant adjustment, the Commission could consider smoothing the GST impacts of particularly high revenue years over a longer time. While this may be a second best alternative, it would be preferable to introducing untested, hastily-conceived adjustments to methodology to recognise greater contemporaneity in any assessments at this stage of the Review.

Western Australia

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).[5]
    - This escalation issue is particularly material for jurisdictions with high non-royalty needs such as the Northern Territory (based on our current

[5] 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.

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.[6]

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.

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6 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.

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).

South Australia

On 20 January 2015 the Commonwealth Grants Commission (CGC) wrote to all states and territories seeking views on three potential options to improve the contemporaneity of relativities.

While South Australia is open to measures to improve contemporaneity, changes to averaging periods should only be made at a time of relative stability in states' fiscal capacities so that no one state is advantaged or disadvantaged compared to the others.

Over the last four years we have seen a rapid increase in global iron ore prices followed by a sudden decline over the past twelve months. Making significant changes to averaging periods in such a period of volatility makes the object of equitable equalisation difficult or impossible to achieve.

Accordingly, we believe that contemporaneity changes should not be pursued at this point in time. Should commodity prices stabilise over the next few years then consideration of changes could be pursued as part of the next CGC methodology review.

It is also too late in the 2015 Review process to fully consider major contemporaneity changes and identify all potential impacts that could produce significant changes to equalisation outcomes.

Consistent with this view, South Australia does not support adoption of any of the contemporaneity options outlined in the CGC email dated 20 January 2015 at this point in time.

Should the Commission be inclined to recommend a contemporaneity measure to deliver a financial gain to Western Australia, the only option South Australia would countenance would be a one-off capped advance, provided in the 2015-16 application year, with subsequent repayment over a three year period. Any advance should take into account the adverse budgetary impacts on other jurisdictions.

South Australia notes that an absorption approach would be complex, reliant on the use of forecasts (with subsequent corrections) and lacks transparency.

The introduction of five year averaging for revenue assessments has no conceptual validity as it would decrease the level of contemporaneity in GST relativities.

For the 2015 Review, South Australia considers that the current three year averaging arrangements should be retained for all assessment categories.

Tasmania

Introduction

Tasmania appreciates the further consultation that the Commission is undertaking on dealing with volatile revenues and contemporaneity.

Tasmania has comprehensively stated our views on the principles of this issue in our recent submissions. In the context of those principles, we offer the following comments specifically in relation to the illustrative options presented by Commission staff.

Option A: An absorption approach

Tasmania notes that this option proposes that iron ore royalties be removed from the standard assessment methodology, and for the resulting three assessment-year average relativity to be applied to a combined pool of GST revenue and total national iron ore royalties in the application year.

Tasmania sees little merit in this approach. Significantly, it proposes a major shift in the methodological approach of the Commission’s assessment without comprehensive consultation or adequate time to fully consider the implications of such a change. It also increases the complexity of the assessment and spreads revenue uncertainty and volatility across all states. We consider that a conceptual case supporting the need for such a change has not been sufficiently demonstrated.

As stated in previous submissions, Tasmania believes that Western Australia has been a clear beneficiary of the current lagged methodology; during the initial stages of the mining boom, they were able to retain the benefits of rapidly increasing iron ore royalty revenues through the lagged impact on the GST distribution. To fundamentally change the methodology for the purpose of ameliorating assessment outcomes at a time where the lagged assessment approach is unfavourable to Western Australia seems reactive and inequitable for other states. This option effectively “socialises” the volatility of a specific revenue source across other states for the clear benefit of one state.

Option B: A lagged five year moving average

Tasmania notes that this option proposes that specific revenue assessments use a lagged five year moving average, whilst other assessments would continue to use a three year moving average.

Tasmania sees some merit in this approach in that the assessments would still be based on actual assessment year data, and would remain relatively consistent with other areas of the Commission’s methodology.

However, the use of a five-year moving average would reintroduce the 2009-10 and 2010-11 data years to the assessment. Tasmania contends that previous GST distribution outcomes have already reflected the data of these years when they were part of the assessment years contributing to the three-year average. To return to a five year average will duplicate those benefits by redirecting GST revenue to certain states based solely on the reintroduction of past data.

Similarly, if a revenue assessment settles into a different pattern at a point in future (or a state argues strongly for a more contemporaneous assessment based on new "current circumstances"), it is plausible that the Commission could determine that the assessment should be transitioned back to a three-year average. Depending on the transitioning arrangements and data years involved, it is possible that further duplicate benefits may be delivered to a state at that point also.

Tasmania notes that the iron ore revenues Western Australia receipted in 2009-10 and 2010-11 are lower than those receipted in the three current assessment years. If these data years happened to include higher than average revenues for Western Australia, the option of moving to a five year average would be counterproductive, and would not be under consideration. Therefore, this option is only being considered because it delivers a particular outcome for one state in response to a specific set of circumstances. It is not broad enough to address the general issue of dealing with revenue volatility for any state or territory.

As discussed in our previous submissions, Tasmania notes that the Commission considered the length of the lagged assessment period in detail during the 2010 Review. The decision was made to move from a five year average to a three year average on the basis that it balanced the competing priorities of contemporaneity, and stability, simplicity and practicality. Tasmania reiterates its view that the balance achieved by a three-year average is still appropriate. Further, it is arguable that the move to a five year average for any revenue assessment results in less contemporaneity and increased complexity within the methodology.

Option C: Smoothing through an adjustment to GST outcomes, that would be reversed over subsequent years.

Tasmania notes that this option proposes that the outcomes of the standard HFE-based GST distribution be adjusted to ameliorate the impact of volatile revenues, with the adjustment reversed in later year/s.

Tasmania sees some merit in such an approach in that it does not directly interfere with the Commission's methodology and its delivery of a HFE-based distribution outcome.

Undertaking such an adjustment within the GST distribution system would result in other States in effect "loaning" GST revenue to specific state (or states) for a set period of time. The principle of states being forced to lend their GST revenue to other states is highly questionable, particularly at a time when most Government's face budgetary challenges. It risks the GST distribution system being seen as a temporary loan facility for Government's facing fiscal difficulty. Further, it could lead to a situation where lender states need to borrow funds at market rates to compensate. This, combined with the increased uncertainty, could also negatively affect a state's credit ratings.

On a practical level, Tasmania questions how such an adjustment can be implemented in a way that is equitable for all States and that revenue volatility for one state is not transferred to other states through reduced GST. For instance, how will an appropriate level of adjustment be determined? How will repayments be structured to ensure that the net present value of the loaned revenue is maintained? Will some form of interest repayments be required from recipient states? Determining how this option will be implemented will require considerable judgement on the part of the Commission, on issues that are arguably outside of its remit.

Concluding remarks

Tasmania acknowledges the Commission, at the Federal Treasurer's request, has been tasked with providing advice on options to ameliorate the effect of revenue volatility on the GST distribution. We recognise that the Commission is obligated to provide a response.

However, Tasmania is concerned that endorsing or recommending any specific option for dealing with volatile revenues, particularly given such short timeframes and the inability for states and the Commission to adequately consider all of the issues involved, sets a concerning precedent.

Implementation of any of these options will have a material impact on the distribution of GST between states. Tasmania does not consider it the role of the GST distribution system to do anything other than deliver distribution outcomes based on the principle of HFE.

Tasmania considers options A and B are inappropriate in that they change the methodology to achieve a particular outcome for one state, in a way that reduces the achievement of HFE. While Option C does not change the methodology, Tasmania also considers this option inappropriate in that it proposes that the GST distribution system is used as a "bank" to address particular states' revenue volatility issues.

ACT

After some consideration the ACT decided not to provide a submission on possible options for improving contemporaneity. We consider that our submission on the Impact of Volatile Revenue Bases on HFE (January 2015) adequately sets out our position on the contemporaneity issues.

[Extract from ACT's Comments on the impact of volatile revenue bases on Horizontal Fiscal Equalisation]

…the system of horizontal fiscal equalisation is explicitly addressed in the Terms of Reference for the White Paper on Reform of the Federation. This is the focus of a yet to be released Issues Paper titled *COAG and Federal Financial Relations,* which is subject to final comments by States and Territories. In light of this reference, the ACT's view is that no radical changes to the current equalisation system should be considered prior to completion of the White Paper process. The proposed move to a fully contemporaneous system is, in our view, a radical change, and thus should not be implemented in advance of the White Paper. Following this, it can be addressed through the rolling review program we have proposed, in a known context for equalisation going forward.

How can Greater Contemporaneity be Achieved?

<u>Options for Implementation</u>

The most obvious method for achieving full contemporaneity is the use of estimates and adjustments (or "advances and completions"), the features of which have been well canvassed already by the Commission and some States. We do not propose to restate the arguments so far put forward. Suffice it to say that any estimates used must be independent of State governments, to avoid the possibility of gaming of the system, and that to the extent that estimates differ from actual outcomes contemporaneity will be diminished. Therefore, even this approach has significant weaknesses.

An alternative approach is to further reduce the number of assessment years, to one or two rather than three, while retaining the use of actual data rather than estimates. However, this would simply reduce the degree of lagging while not achieving full contemporaneity. The ACT does not support this option.

<u>Transitional Arrangements</u>

WA have claimed, in their submission on issues arising from their October 2014 meeting with the Commissioners, that the Commission has "in effect...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". On this basis they claim that the Commission has already been following an approach of contemporaneous equalisation, and that consequently transitional arrangements are not appropriate.

The ACT does not accept this proposition. Our view is that, other than for significant changes in Commonwealth-State financial relations, the Commission makes no assumptions about circumstances in the application year, rather intending to achieve equalisation over time through the lagged approach.

In any case, we consider that whether or not transitional arrangements should be employed is not a question of principle but a practical issue, which should take into account impacts on individual States and Territories of any large changes in GST entitlement occurring in a single year. The Commission has in the past (2004 Review, *Final Report*, Chapter 7) acknowledged that "States face practical budget management difficulties if confronted with large changes against the assumptions they have made about revenue" and expressed the view that a way to deal with this would be to phase in the recommended relativities over a period. The ACT agrees with that view.

Northern Territory

General comments

The Territory shares other states' concerns that it is far too late in the 2015 Review for the Commission to be considering far-reaching changes to its methodology. Changes to fundamental aspects such as the guiding principles should be considered in a measured way, with ample time provided for consultation and examination of proposals. The Territory's view is that there is insufficient time left in the 2015 Review for the states to conduct in-depth analysis of the changes that have been proposed in this regard. On this basis, the Territory considers that it would be more appropriate for this issue to be considered as part of the next methodology review.

The Territory notes that states have previously experienced significant variation in revenue sources, such as the significant decline in New South Wales' stamp duty on conveyances revenue in 2008-09, with the effects taking time to flow through the Commission's assessments, due to the inherent data lags under the current methodology. New South Wales was not afforded special treatment to smooth or lessen the impact on its fiscal capacity, and the Territory does not consider that it is appropriate to do so for Western Australia.

Western Australia enjoyed the impact of the lag effect in the early days of the mining boom, before the equalisation process reflected its significantly increased revenue capacity, and there was no movement to improve the contemporaneity of the assessment system at that time. Further, it is unlikely that should a similar situation arise in the future, that efforts will be made to reduce a state's GST share when its capacity to raise own-source revenue is understated in the application year, rather than overstated, due to the inherent lag in the Commission's methodology. As such, the proposed approaches are highly inequitable, and favour states with revenue sources subject to large fluctuations.

As stated in the Territory's previous submissions, the Territory does not support any measures that seek to alter the impact of HFE on a particular state by changing the way in which the contemporaneity principle is applied. As the Commission and all states are aware, the only objective for GST distribution, as agreed by all states and the Commonwealth in the Intergovernmental Agreement on Federal Financial Relations, is the achievement of HFE.

Further to the above concerns, the Territory's views on the Commission staff's three options for improving contemporaneity are provided below, assuming that iron ore royalties would be the object of the proposed changes. The Territory's view is that none of the options presented by Commission staff would achieve HFE, and all would instead add unnecessary complexity to the Commission's assessments. However, the Territory's view is that extending the averaging period is the least inappropriate option, predominantly because it ensures that data for all years is still assessed, and represents the least change to the current methodology.

Option 1: Absorption approach

The Territory does not support the proposed absorption approach, which would remove the differential assessment of iron ore royalties from the assessment methodology, with the ensuing relativities applied to a combined pool of GST revenue and iron ore royalties. In the application year, 'actual' royalties, or an estimate of actual royalties, would be netted off states' assessed GST and iron ore royalty needs to give states' shares of GST revenue.

While it would lead to a more contemporaneous assessment of the impact of volatile revenue sources on states' fiscal capacities, the absorption approach would add a significant level of complexity to the assessment methodology, and would not result in an appropriate HFE outcome, due to the associated dilution of the impact of iron ore royalties on states' assessed relative fiscal capacities. Further, it fails to recognise that Western Australia has enjoyed the benefits of significant revenue growth due to its iron ore endowments.

The Territory is concerned that the absorption approach has been proposed in response to Western Australia's present fiscal position, and is therefore unlikely to be appropriately applied over the longer term. No guidance has been provided on the likely timeframe that it would apply, and the Territory notes that there will be winners and losers in the transition away from the proposed changes back to the current methodology, if this occurs, which will create further equity issues in the future.

If the absorption approach would be applied in response to volatility of revenue sources other than mining royalties, the Commission will also need to determine the level of volatility necessary for a revenue source to be considered for special treatment and the length of time that the special treatment should be applied, which would be extending the role of the Commission beyond its current ambit; that is, the Commission would be required to determine when 'full' HFE should apply, and when partial HFE is appropriate.

While the Territory acknowledges that the absorption approach was used to assess states' shares of Health Care Grants prior to the 2010 Review methodology, it notes that this was more appropriate given the nature of the Health Care Grants, which were provided to all states by the Commonwealth on a needs-basis. This is not the case for iron ore royalties, and it is not clear how an appropriate end-point to the absorption approach would be determined.

Option 2: Lagged five-year moving average

The Territory considers that the option of assessing ‘large and significantly volatile’ revenues based on a lagged five-year moving average is the simplest and least inappropriate of the three alternatives. However, this option is also counterintuitive, as it seeks to address contemporaneity concerns by incorporating into the Commission's assessments data that is older than that used in the current method.

Further, in addition to the obvious issue of inconsistent treatment of different state revenues in the Commission's assessments (as all other revenues would be assessed based on a three-year moving average), consistent with the issues associated with the absorption approach, this option presents the difficulty of appropriately determining what revenues are considered ‘large and significantly volatile’ and raises transition issues regarding the treatment of the ‘large and significantly volatile’ revenue once it ceases to be ‘significantly volatile’.

The Commission would no longer have a basis for using the five-year moving average approach and, as such, the appropriate action would be to revert to the three-year average to bring the revenue in line with other assessments. The Territory considers that this transition would result in windfall gains for some states at the expense of others. The Territory does not believe that these questions have been adequately addressed so far in the 2015 Review.

Option 3: An adjustment to GST outcomes

The Territory is strongly opposed to the option of adjusting the outcomes of the Commission's assessments to increase the GST revenue of states affected by large and volatile revenues, as this option is neither reliable nor practical.

Commission staff have suggested that the size of the adjustment would be determined either in advance of the application year (based on expected circumstances) or in the course of the application year (based on actual emerging circumstances). The Territory does not believe that these options are feasible.

Determining the size of the adjustment in advance of the application year would require the use of estimates of states’ fiscal circumstances in the application year, an approach that has already been rejected by most states and the Commission as it is not reliable. In addition, determining the size of the adjustment based on emerging circumstances implies updating states’ GST relativities during the application year. The Territory is strongly opposed to this approach, as it would add significant uncertainty to states’ budget processes.

The Territory notes that the adjustment would be funded by a reduction in other states’ GST revenue for the application year. In effect, this means that in attempting to reflect the likely circumstances of one state in the application year, the Commission would produce relativities that do not reflect the circumstances of up to seven other states, an outcome that is not equitable.

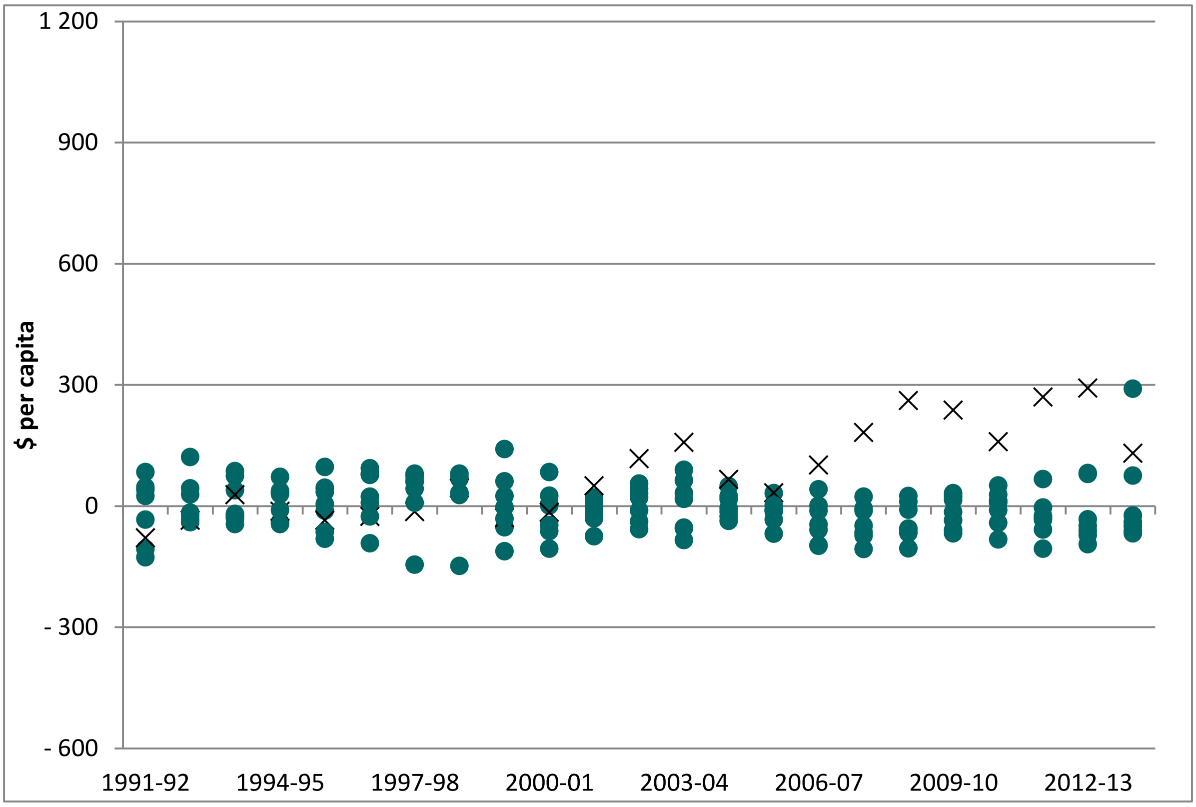
Finally, this option involves the subsequent reversal of the adjustment over a period of up to three years. This unprecedented arrangement represents a significant risk to the states whose GST revenue is reduced to finance the adjustment, particularly if the Commission adopts a method change before the reversal is fully implemented, potentially resulting in windfall gains to the state that benefits from the adjustment.

We trust that the Commission will give due consideration to the Territory's views and look forward to the Final Report of the 2015 Review next month.

What are the volatile revenues?

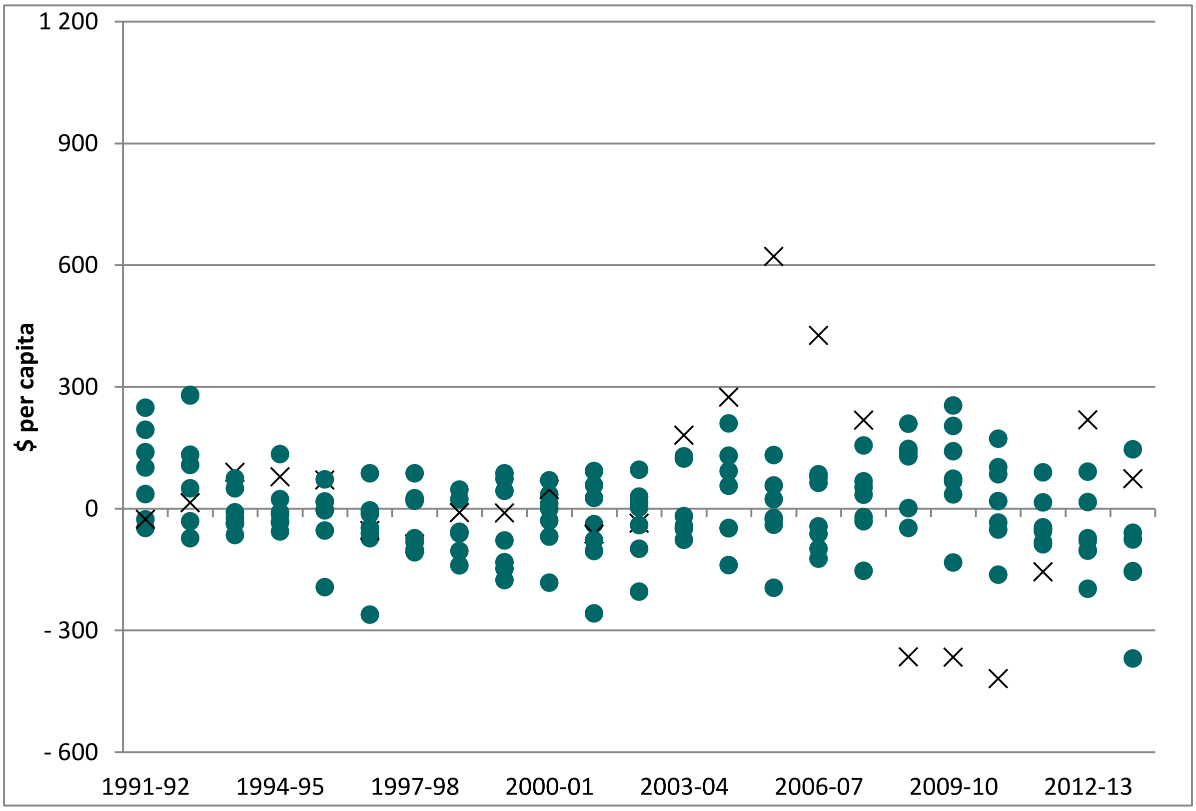
Figure 3, Figure 4 and Figure 5 show the difference between assessed revenues (calculated using the three year lagged average approach) and actual revenues in payroll tax, conveyance duty and mining royalties, for the period 1991-92 to 2013-14. The three figures use the same scale. Western Australian observations are indicated by an X, other States by a solid marker.

Figure 3 Volatility of payroll tax revenue, 1991-92 to 2013-14



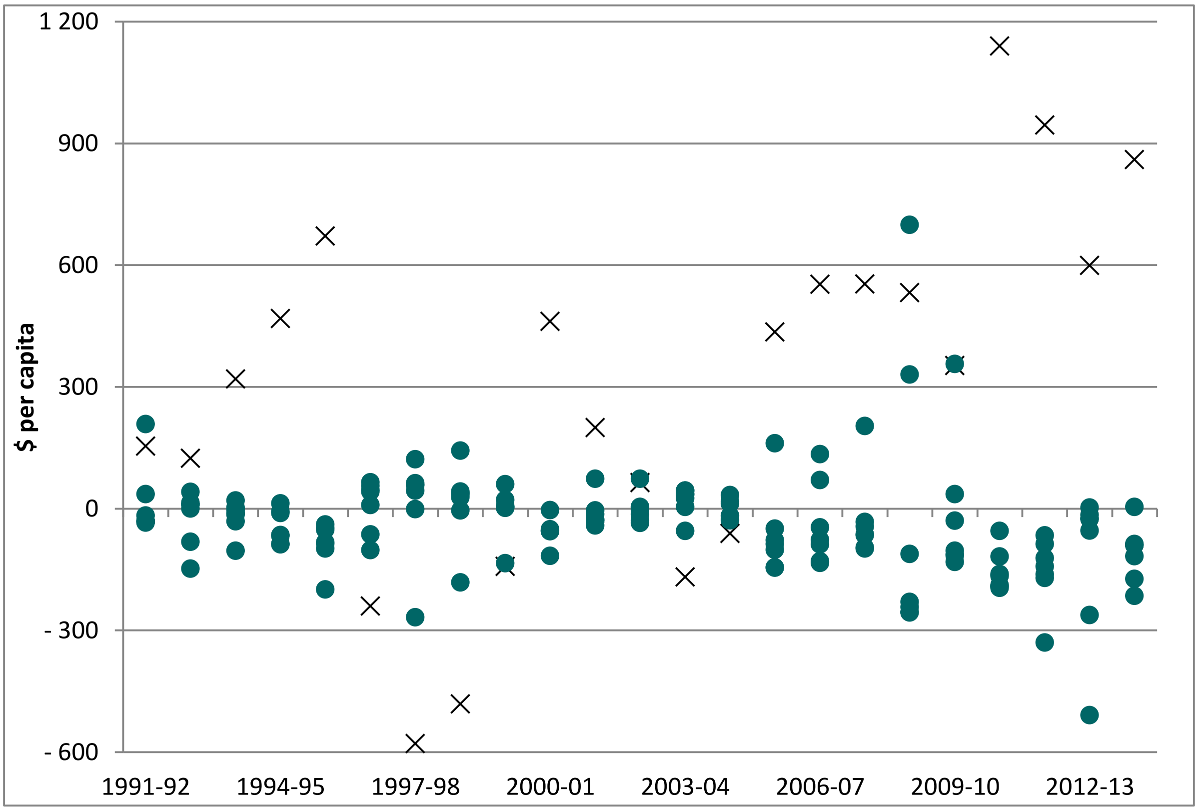
Source: GFS revenue data, 1991-92 to 2013-14; Commission calculations.

Figure 4 Volatility of conveyance duty, 1991-92 to 2013-14



Source: GFS revenue data, 1991-92 to 2013-14; Commission calculations.

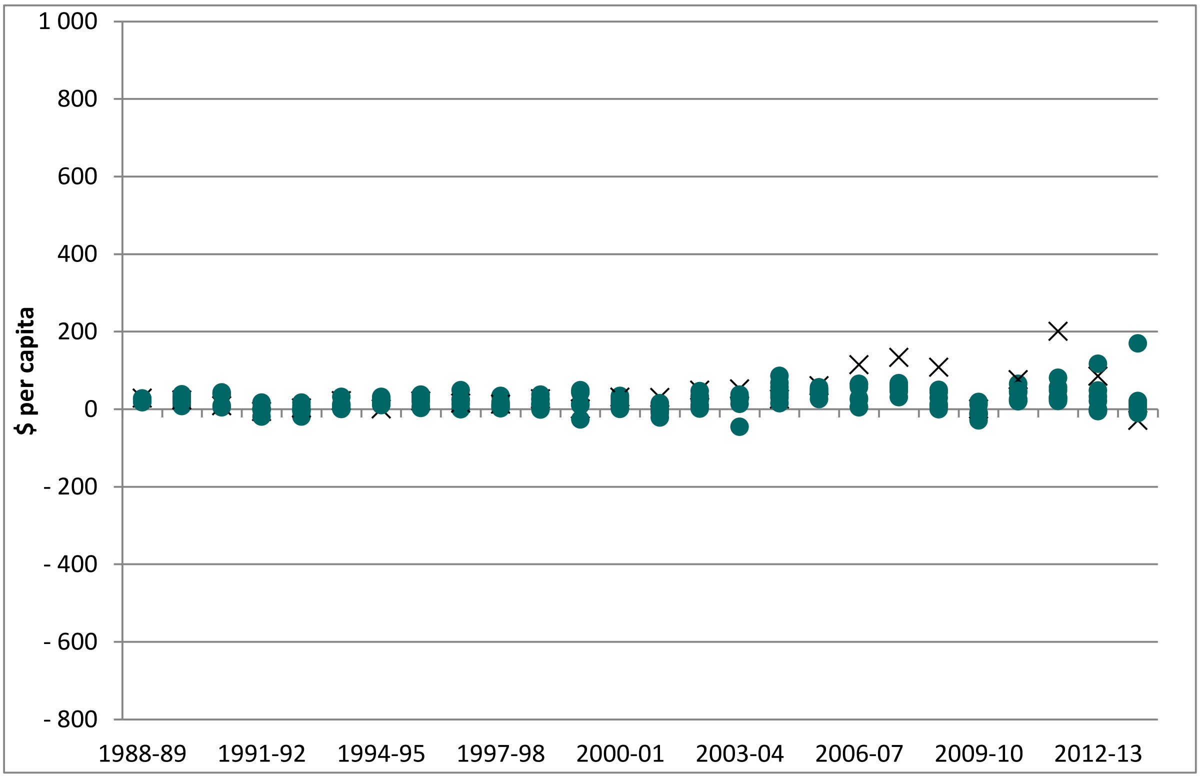
Figure 5 **Volatility of mining royalties, 1991-92 to 2013-14**



Source: GFS revenue data, 1991-92 to 2013-14; Commission calculations.

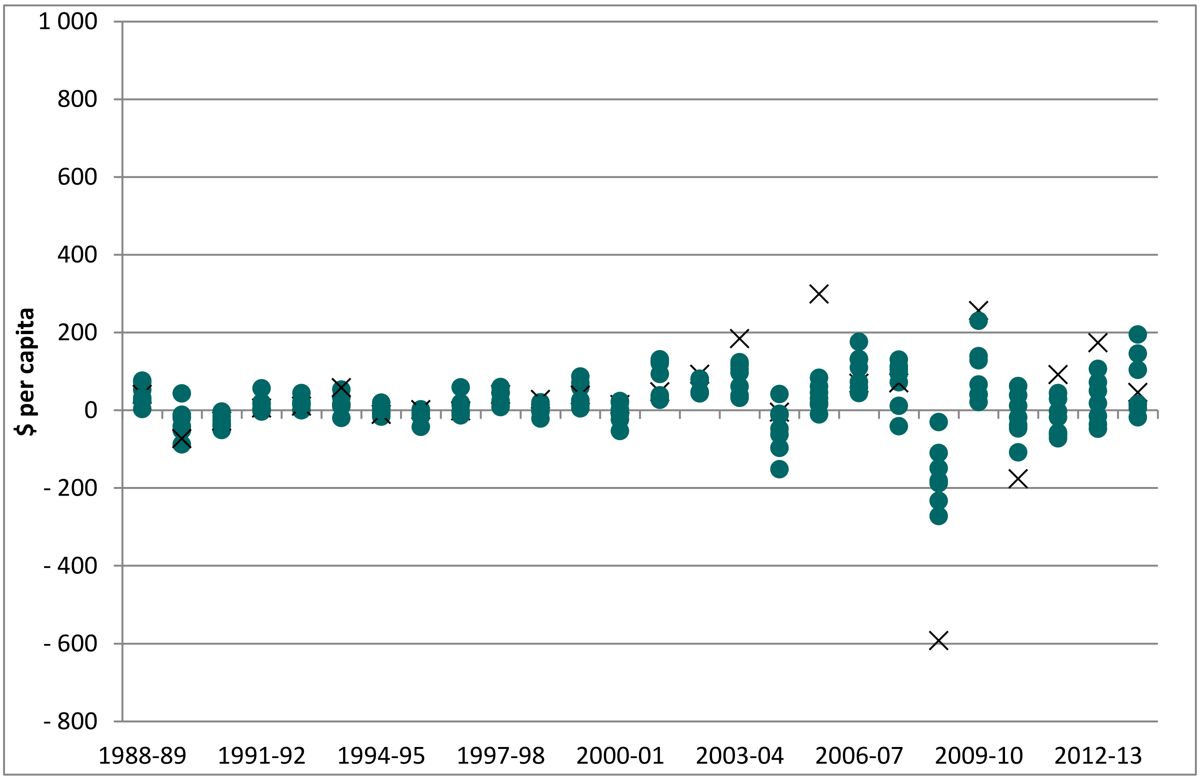
Figure 6, Figure 7 and Figure 8 show the annual change in revenue for payroll, conveyance duty and mining royalties, for the period 1988-89 to 2013-14. The three figures use the same scale. Western Australian observations are indicated by an X, other States by a solid marker.

Figure 6 Annual per capita change in payroll tax revenue, 1988-89 to 2013-14



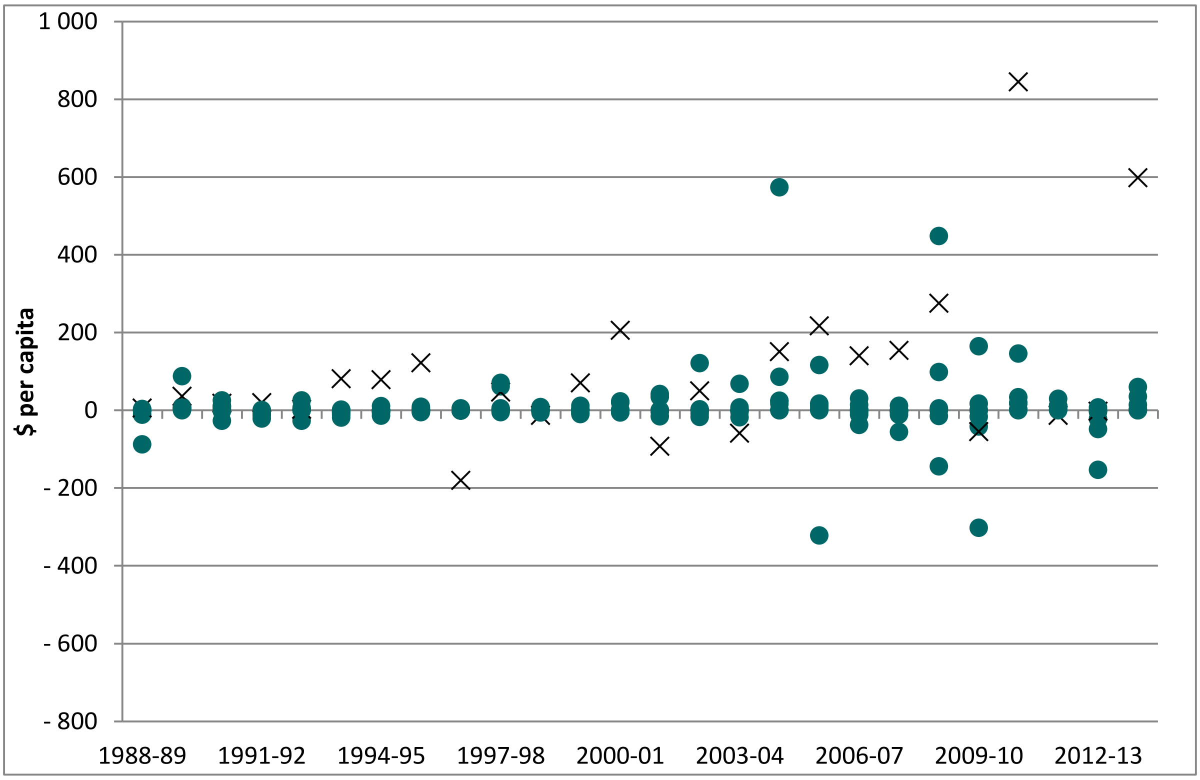
Source: GFS revenue data, 1988-89 to 2013-14.

Figure 7 Annual per capita change in conveyance duty, 1988-89 to 2013-14



Source: GFS revenue data, 1988-89 to 2013-14.

Figure 8 **Annual per capita change in mining royalties, 1988-89 to 2013-14**



Source: GFS revenue data, 1988-89 to 2013-14.