COMMONWEALTH GRANTS COMMISSION (CGC) 2015 REVIEW

CGC REQUEST FOR COMMENTS ON ISSUES IDENTIFIED IN THE COMMONWEALTH TREASURER'S LETTER OF 23 DECEMBER 2014 TO THE COMMISSION

NSW TREASURY COMMENTS

JANUARY 2015

Summary

This submission responds to the Commonwealth Grants Commission's request, contained in its email of 5 January 2015, for State comments on issues of revenue volatility and contemporaneity of outcomes raised in the Commonwealth Treasurer's letter of 23 December 2014 to the Commission.

There are major challenges in developing a system of horizontal fiscal equalisation (HFE) that is contemporaneous, as well as reducing volatility and increasing predictability. NSW Treasury provided comments on Western Australia's proposal to base assessments on prospective fiscal circumstances in the year of application of the relativities in our December 2014 submission on *Significant Changes to the Draft Report*. We consider the approach suggested by Western Australia would be impractical, unreliable, inconsistent, more volatile and more judgmental than the current approach.

New South Wales has suggested over a sustained period of time in submissions to CGC methodology reviews and the GST Distribution Review the need to fundamentally change the system to one that does not have the problems inherent in the current system: an equal per capita (EPC) distribution of GST revenue among the States supplemented by top-up payments from the Commonwealth Government to the smaller States if further fiscal equalisation is thought desirable.

As the Commonwealth Treasurer notes in his letter of 23 December 2014, the principle of HFE will be explored through the *White Paper on the Reform of the Federation*.

NSW Treasury considers that no adjustments to the current system can be adequately designed and evaluated in the time available before finalisation of the 2015 Review. Any such adjustments should only be considered in the context of the *White Paper on the Reform of the Federation*, along with other more fundamental solutions to the problems inherent in the current implementation of HFE in Australia.

Background

In his letter of 23 December 2014, the Commonwealth Treasurer noted:

- the volatility of mining revenues
- the potential for a State's fiscal circumstances to differ significantly between the assessment years and the application year for the GST relativities calculated on particular assessment years and
- the potential that applying the usual GST methodology can give rise to significant differences in fiscal capacity between States, with particular reference to the current challenges facing Western Australia.

The Commonwealth Treasurer requested the Commission provide 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 State's shares of the GST in a given year are appropriate for their fiscal circumstances in that year.

Contemporaneity in the context of the current HFE methods has been considered in previous methodology reviews and all States and the Commission have generally taken the view that basing the assessments on the average of a number of years (five up to 2009-10, and three since then) is preferable to avoid the volatility in year-to-year changes in state circumstances.

All States and the Commission also have generally agreed that measuring State relative fiscal capacities requires reliable data on State finances and demographic and economic circumstances. This necessarily entails a time lag between the data used to measure State fiscal capacities and the year the relativities resulting from that measurement are applied.

GST distribution in context

Since the introduction of the GST, New South Wales and Victoria have borne the major fiscal burden of equalisation, with Western Australia and Queensland (briefly) only relatively recently becoming 'donor' States (i.e., receiving a less than per capita share of Commonwealth GST revenue payments).

Table 1 shows that since the introduction of the GST in 2000-01, New South Wales GST revenue payments have been $18 billion less than its population share and Victoria's $17 billion less. Western Australia's GST payments over the period have been $14 billion less than its population share, mostly concentrated in the last five years reflecting its mining royalty revenue in those years and consequently lower assessed need for GST payments. Queensland has been a net recipient of GST cross subsidies, receiving $561 million more than its population share since 2000-01.

Table 1: GST revenue payments cross subsidies compared to an equal per capita distribution

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	$m	$m	$m	$m	$m	$m	$m	$m
2000-01	-959	-963	113	-23	383	394	78	978
2001-02	-894	-1,002	32	-89	413	417	106	1,018
2002-03	-1,198	-1,188	110	-79	511	516	119	1,210
2003-04	-1,485	-1,255	177	-112	604	598	122	1,351
2004-05	-1,921	-1,389	484	134	608	590	114	1,380
2005-06	-2,008	-1,354	414	115	630	611	129	1,462
2006-07	-2,066	-1,211	254	20	616	635	140	1,612
2007-08	-1,929	-1,237	98	-275	732	674	165	1,772
2008-09	-1,557	-896	-306	-601	718	643	173	1,826
2009-10	-972	-888	-751	-979	816	632	194	1,949
2010-11	-667	-655	-779	-1,477	950	634	109	1,885
2011-12	-602	-1,035	-560	-1,435	911	612	77	2,031
2012-13	-703	-949	-222	-2,262	1,016	652	173	2,295
2013-14	-501	-1,179	612	-3,088	973	694	191	2,298
2014-15	-367	-1,534	887	-3,732	1,129	754	214	2,650
Total	-17,828	-16,733	561	-13,882	11,008	9,055	2,103	25,716

Source: NSW Treasury calculations. Populations used to calculate the equal per capita distribution are those used to determine final advance payments in each year. Residual GST payments, paid in the following year once final GST pools and State populations have been determined, are included in the year paid.

The CGC recognises that precise equalisation may not be achieved in a year. 'Since State conditions are constantly changing, …average historical fiscal capacities may not be the same as those currently applying or those in the year the GST is distributed.'[1]

In periods of rapidly increasing revenue historical fiscal capacities based on lower revenue of earlier years will understate a State's fiscal capacity in the application year. However, this is offset in the revenue downswing – when historical fiscal capacities based on higher revenue of earlier years could overstate fiscal capacity in the application year. It is not clear that any one State would systematically gain or lose in this aspect of equalisation, so that equalisation at least in this aspect is more or less achieved over time.

[1] CGC, 2014 Update Report on GST Revenue Sharing Relativities, p. 32.

Issues around contemporaneity proposal

Western Australia's September 2014 submission on the Draft Report suggested that a GST distribution based on prospective 2015-16 conditions would be preferable to using average royalties for 2011-12 to 2013-14 as the basis of the 2015-16 GST distribution given the major fall in iron ore royalties.

NSW Treasury believes that a major challenge for any system of HFE is to generate relativities that are as contemporaneous as possible, while increasing the predictability of the distribution and reducing the year to year volatility in the distribution.

The move from a five year to a three year averaging period for the data used in the calculation of the relativities in the 2010 GST Distribution Review was intended to try to balance these competing requirements.

NSW Treasury provided comments on the proposal to consider the use of the forecast data in the calculation of the relativities in our December 2014 submission on *Significant Changes to the Draft Report*. We consider that an approach based on using prospective estimates, particularly if only applied to mineral royalties, would be inconsistent, impractical, reduce predictability and increase the volatility of the GST distribution and increase the need for judgment in calculating relativities.

- Using prospective estimates for the mining revenue assessment only would produce inconsistency within the assessments overall if other assessments are based on historical data. There are a number of revenues in addition to mining revenue which are large, can be highly volatile and can have a significant impact of the GST distribution. Transfer duty averaged 7.2 per cent of total NSW general government revenue in the decade to 2012-13. The timing of turning points is hard to estimate and outcomes can vary by more than plus or minus 30 per cent per annum. Most Commonwealth infrastructure payments are equalised and their variation from year to year can have noticeable effects on the GST distribution.
- Switching to an approach based on prospective estimates would introduce an additional source of inconsistency over time. States that benefitted from rapid increases in revenue over recent years, some of which could be equalised over time under current arrangements, would retain much of that benefit while being immediately compensated for a prospective reduction in revenue.
- Basing assessments on prospective estimates is not practical. While fiscal estimates are available from State budget papers, CGC assessments are not based on state budget data alone. The assessments use extensive data sets from other sources, such as administrative data from other state agencies, and data from the Australian Bureau of Statistics, the Independent Hospital Pricing Authority, the Australian Curriculum and Reporting

Authority and so on. Prospective information is not available from these sources and creating proxies or otherwise would involve a much greater use of judgment than is even currently the case in the CGC's assessments. In addition, forecasts can differ significantly from the final Budget outcomes, sometimes as a result of convention, for example not recognizing the impact of asset transactions until contracts are signed or proceeds received. This would require sometimes large consequent adjustments to GST revenue payments in later years, potentially introducing further volatility, reducing predictability and reducing the contemporaneity of GST revenue in subsequent years.

- It is not clear that it would be practical from a timing point of view. Importantly, State net lending projections – needed for the CGC's assessment of net lending – depend on State projections of revenues and spending and of GST payments from the Commonwealth. There is an apparent 'circularity' in this process that appears to involve basing GST relativity assessments on projections of revenue, spending and net lending that might then change when GST relativities are known, requiring further change to GST relativity assessments and so on. This apparent 'circularity' could also affect state governments' ability to finalise budget projections.
- Basing assessments on one year of data – the prospective year – rather than on an average of three years of data would increase rather than reduce the volatility of the assessments. This would be the case even if prospective year data could be projected with total accuracy.

This proposal could lead to an increased use of judgment by the CGC to determine the revenues to which it is to apply and any phase in period for post hoc adjustments. Any reduction in predictability would be offset by additional uncertainty. Alternatively, the CGC could implement a system of objective and transparent rules to cover such situations where States ask for 'contemporaneity adjustments', given States are often dissatisfied with the CGC's calculation of GST relativities. Application of these rules would also rely on the use of judgment by the CGC.

Moreover, it is not clear that basing mining revenue assessments on three-year averages will greatly disadvantage Western Australia in the near future or has done so in the recent past.

Table 2 compares Western Australia's actual mining royalty revenue in any year to the average of its mining revenues in the three assessment years used for calculating GST relativities to be applied in that year. A ratio below one means the historical average produces a figure below Western Australia's actual revenue in that year, while a ratio above one means the historical average produces a figure above Western Australia's actual revenue in that year.

The three-year historical average exceeds actual Western Australian mining revenue (only very slightly) in only one year – 2014-15 – while is below actual Western Australian mining revenue, often by substantial amounts, in all years from 2010-11 to 2013-14. Based on

Western Australian mining revenue forecasts the three-year historical average will be below actual Western Australian mining revenue in the foreseeable future.

Table 2: WA actual royalty revenue compared to historical average used for mining revenue assessment

	Actual mining revenue [(a)]	Average mining revenue of three assessment years used in mining revenue assessment [(b)]	Ratio of assessment years' average to application year actual revenue
	$ m	$m	
2006-07	2,137		
2007-08	2,524		
2008-09	3,219		
2009-10	3,177		
2010-11	5,204	2,627	0.505
2011-12	5,335	2,973	0.557
2012-13	5,525	3,866	0.700
2013-14	7,193	4,572	0.636
2014-15	5,329	5,355	1.005
2015-16	6,042	6,018	0.996
2016-17	6,531	6,016	0.921
2017-18	6,893	6,188	0.898

Sources: Actual mining revenue from 2006-07 to 2012-13 is sourced from CGC, *2010 Review*, *2012 Update* and *2014 Update*; 2013-14 actual and forecasts from 2014-15 come from WA *2014-15 Government Mid-Year Financial Projections Statement*.
(a) In the mining revenue assessment the CGC includes mining royalty revenue, and Commonwealth North-West Shelf and compensation for changed crude oil excise arrangements payments to WA.
(b) The three year average assessment period lags the application year by 2 to 4 years, e.g, the assessment years for the relativities to be applied in 2015-16 are 2011-12, 2012-13 and 2013-14.

A More Contemporaneous GST Distribution

NSW Treasury recognises the problems with the current implementation of equalisation in Australia.

The solution New South Wales has suggested over a sustained period of time in submissions to CGC methodology reviews and the GST Distribution Review is to fundamentally change the system to one that does not have the problems inherent in the current system.

An equal per capita (EPC) distribution of GST revenue among the States is administratively simple, transparent and more predictable. It achieves the contemporaneity that the current system lacks and would be relatively stable over time. An EPC distribution would not have the complex data requirements and assessment methods of the current system. It would not require the large elements of judgment that are inherent in the current system. An EPC system would be totally policy neutral, providing no disincentives for tax or service delivery reform.

Importantly, a sustainable method of GST distribution should not require adjustment for changes in state fiscal circumstances; economic, commodity and housing cycles; and impacts on the Australian economy of global economic trends. NSW Treasury believes that an equal per capita distribution is best placed to achieve this.

An EPC distribution would redistribute GST revenue from financially stronger States, which contribute an above average per capita share of GST revenue but would receive only an equal per capita share of GST payments from the Commonwealth, to financially weaker States, which contribute a below average per capita share of GST revenue but also receive an equal per capita share of GST payments from the Commonwealth.

Under such a system any fiscal equalisation thought necessary for the smaller States above that provided by an EPC distribution of GST revenue could be provided by the Commonwealth Government with its greater access than the States to more broadly based and stable revenue sources.

The GST Distribution Review considered this system provided the appropriate long term vision for federal fiscal relations in Australia.

NSW Treasury recognises that the CGC has ruled out a move towards such a system in the 2015 Methodology Review. As the Commonwealth Treasurer notes in his letter of 23 December 2014, the principle of HFE will be explored through the *White Paper on the Reform of the Federation*.

Equally, NSW Treasury considers that no fundamental ‘adjustments’ to the current system can be adequately evaluated and implemented in the time available before finalization of the 2015 Review. Moreover, do so risks the achievement of the ‘fiscal equalisation over time’ inherent in the current system. Any such adjustments should only be considered in the context of the *White Paper on the Reform of the Federation*.