QUEENSLAND TREASURY AND TRADE

COMMENTS ON CONTEMPORANEITY AND ADJUSTMENT FOR REVENUE VOLATILITY

Response to CGC email of 5 January 2015

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.

Overview

On 23 December 2014, the Commission received an additional request from the Commonwealth Treasurer to:

…provide advice on a possible approach, as well as corresponding GST relativities, that would mitigate the 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 Commonwealth Treasurer noted that this request was in the context of the volatility of mining revenues, and that the Government understands the current challenges facing Western Australia with regard to the GST distribution.

While Queensland broadly acknowledges concerns about own-source revenue volatility, this request has been made far too late in the 2015 Review for meaningful and robust consideration by the Commission and states. Over time, Queensland has experienced considerable volatility in mining royalty revenue, as well as transfer duty receipts, as have other states.

It is unclear whether, in practice, an approach that attempted to more closely reflect fiscal circumstances in the application year for volatile revenues (i.e., a more contemporaneous approach) would produce a better HFE outcome than the current lagged average approach. The current approach also balances contemporaneity against other considerations such as accuracy, predictability and stability.

Queensland also considers that it is questionable whether recent volatility in mining revenues is sufficient to warrant special treatment, where this has not been provided for other volatile revenues or for other states in similar circumstances. The Commission must be cautious to not solely consider the volatile revenue of Western Australia, to the detriment of all other states. Such an approach may address Western Australia's concerns about its current fiscal circumstances, but would result in a piecemeal and partial approach to the revenue difficulties of the States, and may compromise the application of the principle of HFE.

There are significant risks associated with making last-minute changes to the Review methodology. Without the time to fully consider the implications of greater contemporaneity, or other adjustments that may be considered to address volatile revenues, the Commission should take a cautious approach, and recommend minimal changes in response to the Commonwealth's new request.

More generally, Queensland supports the Commission further investigating means by which relativities could be made more contemporaneous without compromising HFE or other supporting principles, but this should be a matter for the next review.

Mitigating revenue volatility thorough GST shares

Queensland is concerned that the additional Terms of Reference provided to the Commission may. serve the purpose of assisting states (particularly Western Australia) with managing their revenue volatility, rather than better achieving HFE through more contemporaneous assessments. The Commission's purpose in redistributing GST is to achieve HFE as closely as possible, and its reviews have consistently found that the best balance between achieving accurate and contemporaneous HFE outcomes is to implement assessments that are lagged to some degree. A specific instruction to the Commission to investigate more contemporaneous assessments in response to the challenges facing Western Australia may erode the focus on HFE and introduce an additional purpose – the management of states' revenue volatilities through the GST pool. At this late stage of the Review, this would be an undesirable development.

Queensland cautions the Commission against recommending changes in response to the new Terms of Reference that detract from the robustness of its equalisation methodology in favour of a new fiscal objective of managing the volatility of state revenues.

What are the potential negative effects of revenue volatility on the GST system?

The Commission has been asked to advise on a possible approach to "*mitigate the negative effects of revenue volatility on the GST distribution system*". In Queensland's view, the potential negative effects of revenue volatility on the GST system are as follows:

- High volatility means that lagged assessments may less closely reflect fiscal capacity in the application year. In terms of achieving HFE in the application year, this is an issue both when revenues are rapidly increasing (where application year revenues may be far higher than assessment years) and when revenues are decreasing (where states may be assessed as having higher capacity to raise revenue than is available to them in the application year).

- A consequent effect on states is that the lagged average approach does not adjust perfectly to sudden downturns and in some circumstances may have the potential to exacerbate revenue cycles. However, a fully contemporaneous assessment also has the potential to exacerbate sudden downturns for individual states (this is discussed later).

Would more contemporaneous assessments better achieve HFE?

Theoretically, assessments that are fully contemporaneous would best achieve HFE, ensuring that states' shares of GST in any given year reflect their fiscal circumstances in that year. However, practical limitations mean that a fully contemporaneous assessment is unlikely to produce the best HFE outcome:

- Such a system would need to rely on forward estimates of revenue and revenue bases, with adjustments in following years to account for errors between estimates and actual outcomes.
- Errors could easily be sufficiently large to override the HFE benefit of a more contemporaneous assessment. This is particularly a problem for volatile revenue sources, which are inherently difficult to accurately forecast, and for revenue shocks, which are unlikely to be predicted in advance.
- For example, a fully contemporaneous assessment of mining royalties in 2014-15 would have reflected forecast royalties of $6.379 billion for WA[1], while the WA 2014-15 mid-year update estimates 2014-15 royalties of $4.368 billion. Similarly, large revenue revisions made by all states in 2008-09 would not have been reflected in the relativity for that year. These kinds of revisions would defeat the purpose of implementing a more contemporaneous assessment for volatile revenues.
- The sourcing of data or estimates to implement a fully contemporaneous assessment would also present practical difficulties. Using state estimates would have severe policy neutrality and grant design issues, and could encourage states to 'game' the system though their revenue projections. On the other hand, developing a comparable set of forecasts would be a significant task which may require confidential or market sensitive state data (such as transactional level data). This cannot be developed in the time remaining for the 2015 Review, even for a limited number of assessments.

In practice, attempts to introduce greater contemporaneity may give rise to greater complexities in the process for the determination of GST relativities. It would seem, at the very least, that initial or preliminary relativities would need to be determined on revenue projections presented in Budget papers, and there would then need to be a 'true up' or end-of-year adjustment to GST relativities once actual revenue outcomes are published. There may even be a case for an intervening adjustment to GST relativities when revenue projections are revised at mid-year reviews by states, especially where these adjustments are significant. What this illustrates is that introducing greater contemporaneity may also mean introducing greater complexity into the determination of GST relativities and

[1] Western Australia 2013-14 mid-year review (royalty income, not including grants in lieu of royalties)

distributions. It is not clear that this will produce a demonstrably better equalisation outcome.

While in principle, Queensland acknowledges that there may be some merit in the greater contemporaneity, practical limitations mean that improved contemporaneity may not produce the best HFE outcome. Queensland would support the Commission investigating ways of overcoming practical limitations, but this would need to be part of the next methodology review.

Other considerations

Predictability and stability

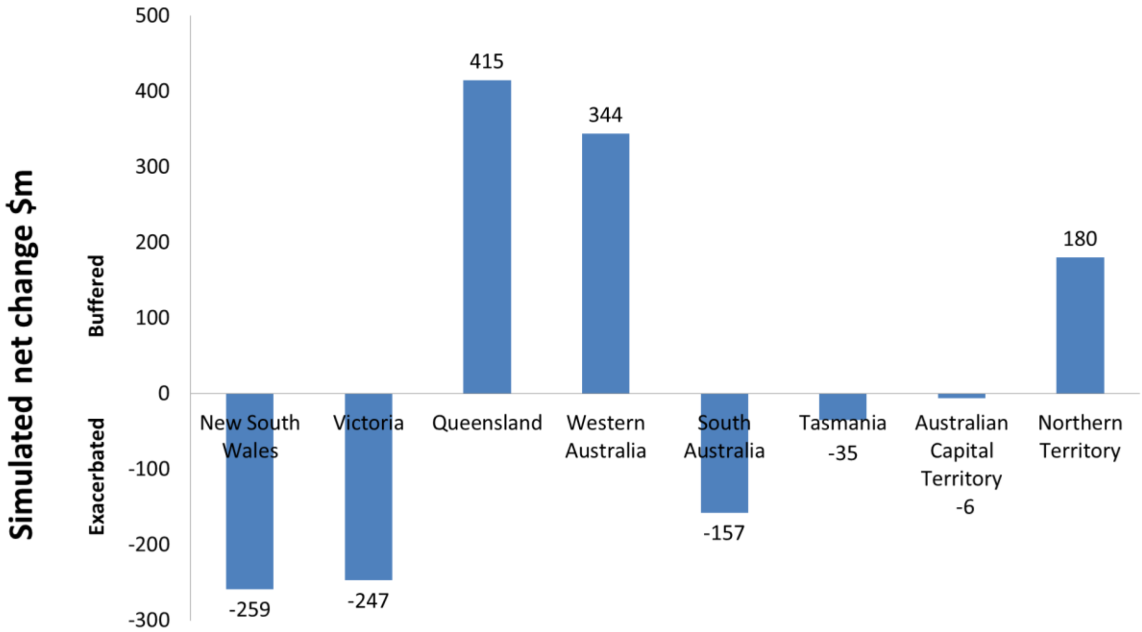
In the Commission's methodology, there are trade-offs between contemporaneity, predictability, stability and accuracy. While Queensland is concerned that a more contemporaneous assessment will not be a more accurate reflection of fiscal circumstances in the application year (as described above), it is also an issue that more contemporaneous GST shares will be less predictable and stable. This may outweigh the potential benefits of increased contemporaneity.

It is also not necessarily the case that a more contemporaneous assessment will improve the stability or predictability of states' revenue overall. Some improvement in stability could occur where sudden revenue increases or decreases experienced by individual states could be somewhat offset by changes to GST shares in that year.

However, as described above, this is unlikely to occur in practice because revenue volatilities in the application year will not be known at the time the CGC produces its annual update. Also, if sudden revenue revisions are experienced by all states, volatility will not be offset by changes to states' GST revenue, which will only recognise changes to the relative difference in states capacities.

Chart 1 illustrates a simulated effect on GST redistribution for transfer duty if the 2008-09 assessed revenue was used in 2008-09 without lagged three year averaging. The results of this show that in the event of a revenue shock, contemporaneity has the potential to exacerbate the net effect (New South Wales, Victoria and South Australia in this simulation) and to a certain extent a buffering effect for others (Queensland, Northern Territory and Western Australia).

Chart 1 – State by state simulated buffering and exacerbating effect of contemporaneity on Transfer Duty in the 2008-09 year[2]



On the basis of this simple example, there is at least *prima facie* evidence that a fully contemporaneous assessment may not necessarily be effective in assisting states to manage revenue volatility.

The predictability and stability of the long-standing Commission practise of using lagged averages must be balanced against any improvements to HFE arising from improved contemporaneity. On balance, Queensland prefers the current lagged system for all 2015 Review assessments as the benefits of increased contemporaneity are unclear and predictability and stability of GST outcomes are important considerations for states.

Symmetry over the equalisation cycle

While high own-source revenue volatility can be a problem for a state experiencing a revenue decline, any decision on the treatment of these revenues should also take into account the benefits accruing to states that experience high revenue growth.

In recognition of these benefits, the need to have symmetry over the equalisation cycle is very important. While lagged equalisation does not adjust perfectly to sudden downturns, HFE will be compromised if the Commission reacts to one-off shocks by applying one methodology on the up-cycle, and a different treatment on the down-cycle. Over the history of HFE, all jurisdictions have needed to absorb and manage volatility in their GST shares brought on by varying economic shocks.

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[2] Impact on the stamp duty on conveyances assessment of revenue volatility in 2008-09. Calculated as the difference between the 2007-08 and 2008-09 assessed difference for the stamp duty on conveyances assessment.

Is an adjustment for volatility necessary for mining revenue in 2015-16?

As noted above, revenue volatility can have a negative impact on lagged HFE because relativities are less likely to reflect fiscal capacity in the application year, and revenue cycles or sudden downturns can be exacerbated by lagged assessments.

While Queensland does not consider there is sufficient time remaining in the 2015 Review to properly address this issue, there could potentially be circumstances under which some kind of adjustment is warranted to ensure the assessments are a reasonable reflection of differences in fiscal capacities in the application year. However, before the Commission considers increasing the contemporaneity of mining revenue (or making some other adjustment) in 2015-16, there must be strong evidence that an adjustment is necessary in this case, and that revenue volatility is a more serious issue for Western Australia's mining in 2015-16 than it has been for other states or other assessments in the recent past.

Data is not currently available to reliably compare the impact of a mineral-by-mineral assessment of the current lagged system compared to a more contemporaneous approach. However, a comparison of the estimated revenue from mining royalties in the application year compared to the average of assessment years indicates whether Western Australia's circumstances for mining royalties are expected to be markedly different.

Table 1 –Western Australia estimated royalties, comparison of application year and assessment years ($m)

	Application year royalties[1]	Average assessment year royalties[2]
2013-14	6,025	3,627
2014-15	4,368	4,327
2015-16	5,184	4,931
2016-17	5,604	4,939
2017-18	5,978	5,192

1. Western Australia 2014-15 mid-year update, not including grants in lieu of royalties.
2. The three year average of actual royalties in the assessment years.

If Western Australia was projecting a large and more permanent downturn in its mining royalties compared to the recent past, there may have been substantial differences between its assessment year and application year royalties. The need to make an adjustment in the Commission's methodology to address this difference would then need to be balanced against the importance of symmetry over the equalisation cycle.

Instead, Western Australia's mining royalties have experienced an unusual peak in 2013-14, after which revenues are expected to return to previous levels, with reasonable growth projected across the forward estimates period. This means that all a fully contemporaneous assessment of this revenue would achieve is that the 2013-14 peak revenue would never be equalised. Queensland does not consider this to be a reasonable outcome and does not support applying a special treatment to Western Australia's mining royalties in 2014-15. Based on the data currently available, an assessment using the current lagged approach seems to be appropriate for Western Australia's fiscal circumstances in the application year, as there is a reasonable correlation between application year royalties and average assessment year royalties – not a significant disconnect.

The royalty peak in 2013-14 is not dissimilar to that experienced by Queensland in 2008-09, which was fully equalised. As Queensland's royalties remained volatile after falling in 2009-10, and other states' royalties increased more rapidly, Queensland's lagged average redistribution from the mining assessment was far higher than its relative capacity to raise royalty revenue in the application year.

Table 2 – Redistribution from the mining assessment – Queensland ($m)

	Application year	Assessment year (contemporaneous approach)
2010-11	-973	-828
2011-12	-1,213	-767
2012-13	-1,316	-275

Queensland shares Western Australia's concerns that it is difficult in practice for governments to 'bank' the temporary benefits of lagged equalisation as a reserve for future equalisation losses, but does not believe a special treatment should apply to the equalisation of volatile royalties in the 2015 Review.

Way forward

The Commission's response to the Commonwealth Government's additional request needs to take into account that:

- Overcoming the practical limitations of implementing greater contemporaneity, even for a limited number of assessments, is a complex issue that cannot be satisfactorily resolved in the time remaining for the 2015 Review;
- Current practical limitations mean fully contemporaneous assessments will not ensure HFE outcomes that more closely reflect circumstances in the application year;
- Symmetry over the equalisation cycle is important, as this ensures that HFE is achieved as closely as possible over time;
- Other considerations, such as predictability and stability of GST shares are at least as important as contemporaneity. A fully contemporaneous assessment is unlikely to be effective in assisting states to manage revenue volatility.

Without further work on potential approaches to overcome practical limitations to greater contemporaneity, Queensland considers the current lagged three-year average approach strikes the best balance between managing contemporaneity, accuracy, predictability and stability considerations, even for volatile revenues. Queensland would support the Commission investigating means of achieving greater contemporaneity in the next review.

If the Commission decides to implement changes to its methodology to manage the potential negative effects of revenue volatility, this should not take the form of increased contemporaneity for the more volatile assessments. It should also not take the form of any kind of arbitrary adjustment to bring the fiscal circumstances of states (or a state) closer to anticipated circumstances in the application year. There is a high degree of risk associated with making these kinds methodological changes late in the review. Difficult practical issues cannot be rigorously investigated or tested, so there are likely to be implications of a more contemporaneous approach that have not been anticipated.

Rather, a preferable approach would be to smooth the GST impact of states' particularly high revenue years over a longer time period. This may assist in managing revenue volatility, as it would ensure that the impact of particularly high revenue years for individual states is spread over a longer period of GST shares. It would also ensure that HFE is achieved over time. Queensland does not consider any kind of longer averaging period to be the most desirable outcome but, at this late stage of the review, it is preferable to attempting to implement greater contemporaneity for volatile revenues. In any case, as discussed above, Queensland does not believe states' current revenue circumstances warrant a methodological adjustment on the basis of high volatility.

If increased contemporaneity is attempted for any assessment in the 2015 Review, it is unlikely that HFE would be achieved over time, and the Commission should also consider implementing transitional arrangements to ameliorate this problem.