

# Submission to the GST Distribution Review

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## Mining revenues

### **Proposal:**

*That, when it comes to mining revenues, the Grants Commission be instructed to redistribute the sustainable 20-year annuity from a notional sovereign wealth fund into which all State royalty and similar receipts for the previous two decades would be deemed to have been deposited.*

Relates especially to Terms of Reference 3 (sustainability); 5c (untied); 5d (predictability); 6b (equal capacity).

### **Advantages:**

1. The proposed treatment of royalties would bring a greater degree of predictability to one major component of State revenues.
2. By recognising the exhaustibility of mineral resources,
  - a. it would use a superior measure of fiscal capacity than is currently employed by the Grants Commission,
  - b. it would encourage States to spend more sustainably.
3. It would not prevent a State from deciding to spend more (or less) than the amount distributed.
4. The GST grants would remain untied.
5. It would remove a disincentive against up-front auctioning of mineral rights.
6. It could encourage the formation of actual wealth funds, which eventually could displace the notional fund.
7. Its calculation would use objective data on mining revenues and interest rates.

### **Disadvantages:**

1. It may not mollify Western Australia or Queensland because it maintains the principle of redistributing mining revenues on an equal per capita basis (albeit, one that differs in timing from the current arrangement).
2. It 'stands between the premiers and a bucket of money'.
3. It may encourage a mineral-rich State to spend all its royalty receipts (and not merely the annuity), in the expectation that this will cause the HFE arrangement to revert to the present system, to the State's advantage in

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later years, if mining revenues fall below the value of the annuity. This strategy would be discouraged if the States were required to pay royalties into an actual wealth fund under the control of the States collectively. (The possibility of 'time inconsistency' is further discussed, below.)

4. It relies on a notional, retrospective, sovereign fund, rather than an actual fund.
5. It may seem fiscally too conservative, with mineral prices and outputs high and rising. In particular, it could be argued that a reasonable basis for calculating the annuity is an estimate of the present value of the mineral revenues expected over the next twenty years. However, such an estimate would be subjective, not objective; and, to repeat, there is nothing in the proposal that prevents any State from acting on the basis of its expectations about future revenues.
6. It does not increase the relatively low fiscal incentive for the resource-rich States to approve mining activities, in opposition to groups concerned about the natural environment and human amenities: the State can bear all of the odium, and gain merely its population share of the revenues. (If Commonwealth approval is required and received, then that government bears some of the maybe larger odium.)
7. It does nothing to discourage States from requiring that miners make non-royalty expenditures of a type not captured in the HFE process; and doing so in preference to royalties, so long as the benefit/cost ratio exceeds the State's population share.
8. The proposal appears to require the Grants Commission to disregard the actual past spending practices of the States. However, the Grants Commission should devise and use its own definition of 'capacity', one consistent with economic reasoning.

***Discussion:***

The aggregate or collective revenue of the States (and Territories) has three main components:

- GST revenues distributed to the sub-national jurisdictions;
- Non-GST grants;
- Own-source revenues—taxes, fines and charges, including royalty payments, which comprise the main mining revenues received by the States.

The States and Territories own the sub-soil resources in their jurisdictions. However, through horizontal fiscal equalisation, every jurisdiction obtains a pro rata share of the aggregate resource revenue: the pooled resource revenues are distributed on an equal per capita basis (after a short time lag).

On the revenue side of fiscal equalisation, redistribution of mining revenues causes the largest movements away from equal-per-capita GST grants. The Grants Commission recommended that WA receive \$3.3b in GST in the current year, after \$2.5b in GST grants was redistributed away from WA on account of its disproportionate mining production. WA would receive less than half an equal-per-capita share of GST grants, if the only factor adjusting GST grants were

mining revenue assessments; Queensland and the Northern Territory would lose over one-fifth of grants made under EPC.

The Grants Commission assesses mineral taxing capacity as the gross value of minerals produced in each State (plus an adjustment for revenue received in lieu of royalties from offshore wells, under revenue sharing arrangements with the Commonwealth). In effect, the Grants Commission's recommendations redistribute ownership of sub-soil mining rights, but only in so far as ownership manifests as taxable mining output.<sup>1</sup> However, the capacity of the States, collectively, to fund the sustainable provision of infrastructure and services is not increased, dollar for dollar, by the receipt of royalty payment in any one year.

Royalties can usefully be regarded as a *deferred, contingent payment for the right to mine*: the State owns an asset—the mineral deposit—and transfers rights over that asset in return for a stream of payments. The receipt of a royalty payment has no net effect on the State government's balance sheet: cash assets have increased, while the value of mining assets has decreased by like amount (alternatively, the value of the asset presented by the royalty agreement has diminished). Similarly, an *ex ante* auction for the right to mine would not alter the State's balance sheet, even if the state agreed for the auction price to be paid over a period of years. The State is exchanging a portion of an asset for cash; the same is true for the States collectively.

That is to say, the capacity of a State to provide current services, on a sustainable basis, is boosted by this year's royalty payment, but by less than the full amount of the royalties.

In view of the exhaustibility of the resources involved, many economists argue that revenue from resources should be treated differently from other revenue. Rather than regard all cash receipts from mining as being immediately available for State spending, the States should plan to spend the sustainable or 'permanent' income from the assets. For example, Norway deposited its oil revenues into a 'sovereign fund', and spends the annuity generated by the fund.

To avoid an unsustainable cash-funded 'splurge' in expenditure, the States need to invest a much higher proportion of their collective mining revenue than, say, of their tourism revenues. The Grants Commission's methodology has recently moved a little way towards a balance sheet approach.<sup>2</sup> A treatment of mining that would be more in keeping with a balance sheet or sustainable approach would be for the Grants Commission to assess the size of the 'permanent income'

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<sup>1</sup> This is one case in which the CGC assessment methodology is far from being 'policy neutral': mining production is so unevenly distributed across the states that, say, a decision by WA to raise its royalty rates will have a significant effect on the Australian-average rate. It has been claimed that the 'average' royalty or mining tax rate used by the Commission is very sensitive to WA's tax rates, in a slightly mysterious ways: see David Uren, 'State's "own goal" over royalties', *The Australian* newspaper, May 21-22, 2011.

<sup>2</sup> More strictly, the CGC's approach is implemented by calculating the net lending a State would need for its end of year net financial worth per capita to be equal to the average, if it started the year with the same net financial worth per capita as other States (CGC 2010:60).

stream that is provided by a state's natural capital.<sup>3</sup> The current proposal concerns only one component of natural capital, namely, mineral resources.

What is proposal here is related to, but does not apply the 'Hartwick rule', which is that all mineral rents should be invested. Firstly, there is no adjustment to the GST funds if a State decides to spend more than the funds attributed to mining revenues: to repeat, the GST funds remain untied. Secondly, the notional fund is not perpetual (as under the Hartwick rule). This is in recognition that the Hartwick rule is based on the assumptions that all productivity improvements are endogenous (to Australia) and embodied in Australian physical or human capital; and that there are constant or non-increasing returns to scale. Third, not all mineral rents are captured by government—some remain with the mining companies, and their investment decisions are their own. Fourth, some rents are captured by Commonwealth taxation. Finally, some revenues received by governments from mining (or planned to be captured) are not pure rents.

### **Time inconsistency**

Just as with the Hartwick rule, there is a danger of 'time inconsistency' with the proposal made here, alluded to in the second and third disadvantages listed earlier, and now discussed further.

The GST grants remain untied, under the proposal made here. Any State can decide to spend more than its per capita share of the national aggregate of mining revenues (or less); but only those States earning mining incomes above the national average, per capita, would have the cash in the bank with which to finance 'excessive' recurrent spending; the others would have to borrow or sell other assets. Thus, the proposal imposes the same burden of abstention on all States, but not the same temptation.

Say that the Council of Australian Governments or the Commonwealth commit to the scheme proposed here, but that the mining-rich States spend rather than invest all of their mining revenues. Assume that, in some future year, mining revenues fall far below the level of the annuity. Then any previously profligate States would suffer a fall in the stream of income for spending, a fall equal to the gap between their population share of the annuity, and their diminished mining receipts.

To the extent that this causes a financial crisis or serious hardship in those States, there would be pressure for the GST distribution to be modified, or for some other 'rescue' package to be devised.<sup>4</sup> The most obvious 'emergency response' would be for the Commonwealth to instruct that the GST distribution

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<sup>3</sup> The United Nations Development Program has a methodology for estimating 'natural capital'.

<sup>4</sup> Under the current arrangement, when mining revenues fall, then so does the collective income of the States, which fall is shared on a per capita basis. Under the proposed arrangement, the fall in income would be larger on the sub-set of States that had spent more than their past shares of the annuities, and spent in ways that did not sufficiently increase their revenues. Horizontal fiscal equalisation of non-mining revenues itself make it harder for a State to satisfy that sufficiency.

arrangement should revert to the current method of redistributing mining revenues whenever mining revenues fall below the annuity.

***Practical operation:***

The States would agree on the rules for the notional wealth fund, including the calculation of the rolling, 20-year annuity; if not, the Commonwealth Treasury would devise the rules. The Grants Commission would distribute that annuity on an EPC basis.

*Effects of 'discounting' CGC's 2009-10 mining adjustment by one-third*

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Grants Commission (\$b)	14.5	11.0	8.7	3.3	4.4	1.7	0.9	2.5
Alternative <sup>1</sup> (\$b)	14.0	10.4	9.1	4.2	4.3	1.7	0.8	2.5
Percentage difference <sup>2</sup>	-3.1	-5.6	4.6	25.4	-2.9	-2.5	-4.8	0.9

Note 1: Grants Commission's recommendations less one-third of its mining redistributions. This has the effect of reducing the mining redistribution from the Commission's \$3.8b to the annuity of \$2.5b.

Note 2: Percentage differences were calculated before the grant numbers were rounded.

As an indication of the effect this proposal, I have estimated of the value of the notional fund at \$37b, as of 2009-10 (using 5 per cent interest, and the consonant 20-year annuity factor).<sup>5</sup> The 2009-10 annuity would then have been \$2.5b, about 40 per cent the actual 2009-10 mining revenues of the States of \$6.5b, and about two-thirds of what the Grants Commission redistributed on account on mining. As a rough indication, the table shows the actual GST grants, and the alternative that applies a one-third reduction to the 2009-10 mining revenues adjustment made by the Grants Commission.

Thus WA would have received \$0.9b more in GST grants (that is, one-third of the \$2.5b that the Grants Commission estimated as WA's advantage in generating mining revenues), than under the Grants Commission's latest recommendations.

However, under the alternative system of redistributing mining revenues, an amount in total of around \$4b would be credited to the notional wealth fund for future redistribution on the equal-per-capita basis among all the States. This \$4b is the difference between the \$6.5b that the States received as mining revenues in 2009-10, and the \$2.5b that would be distributed under the current proposal. Of that \$4b, WA would 'contribute' \$1.9b.

Therefore, if WA wisely decided not to spend the \$1.9b of cash, its total revenues available for spending in the current year would actually fall, by about \$1b (or 4

<sup>5</sup> Glenn Pure at the Grants Commission kindly provided the data for mining revenues.

per cent); and the amounts available to all the States for sustainable spending would fall by the full \$4b credited to the notional wealth fund.

If a State's annual budget proposes to spend more than the per capita annuity, then there would be political pressure on the government to explain its apparent profligacy. Therefore, there would be considerable pressure on the resource-rich States to set up actual wealth funds to receive royalty payments and the like; or for the States to set up a common fund. It may offer a precedent for the Commonwealth government.