

# WESTERN AUSTRALIAN SEPTEMBER 2009 SUBMISSION

## CONTEMPORANEITY

### Key Points

- Western Australia supports in principle a change from five to three year averaging.
  - This would improve budget management, by making the link between changes in current revenue capacity and future GST shares more immediate (i.e. strengthening the transparency of “equalisation over time”).
- However, the transition to a shorter data period has a substantial adverse impact on fiscal equalisation, which must be addressed by the Commission.
  - This is not like other transitional issues, where the objective is to ameliorate the Budget impacts of improving equalisation – such issues are appropriately addressed through the political process.
- To address the dislocation in fiscal equalisation in moving to three year averaging, we believe that the Commission’s recommended relativities should reflect at least a three year phase-in period.
  - During the phase-in period, relativities would be a weighted average of relativities based on five data years and three data years.
- We do not agree with the Commission’s view that the “equalisation over time” concept is no longer relevant.
  - There is no other valid interpretation of the Australian equalisation model (which clearly does not achieve equalisation in the year of application, as noted many times in the past when new Update relativities have been released).
  - History shows that three year relativities are not necessarily any better than five year relativities in representing the situation in the application year.

## MOVING FROM FIVE TO THREE DATA YEARS

Western Australia concurs with the general view of States that there would be benefits in moving to a three year data period for calculating relativities.

- In our view, this would improve budget management by making the link between changes in current revenue capacity and future GST shares more immediate, so that the actual working of “equalisation over time” becomes more obvious to budget decision makers.
- While our GST forecasting model does reflect the time lags in equalisation of States’ own-source revenue capacity, the length of the time lags has meant that much of the impact of changes in relative revenue capacity has fallen outside the budget forward estimates period. Reducing the data period to three years will help bring more of the forecast future GST changes into the forward estimates period, thereby improving budget management.

Whether using three or five year data periods, equalisation occurs with a time lag. However, the fiscal impact of the time lag is essentially offset by the escalation in the GST pool.

We do not believe that three year averaging will, as a general pattern, make a major difference to the contemporaneity of the relativities in any given Budget year. This is shown in Table 1.

**Table 1: Difference between lagged average relativities and fully contemporaneous assessments**

	NSW \$pc	Vic \$pc	Qld \$pc	WA \$pc	SA \$pc	Tas \$pc	NT \$pc	ACT \$pc
<b>2005-06</b>								
5-year averaging	-213	-141	+300	+602	-45	+119	-710	-309
3-year averaging	-222	-110	+281	+572	-20	+111	-673	-316
<b>2006-07</b>								
5-year averaging	-215	-147	+271	+681	-86	+49	-572	-209
3-year averaging	-188	-109	+207	+646	-82	+3	-664	-220
<b>2007-08</b>								
5-year averaging	-281	-110	+344	+534	-9	+183	-511	-85
3-year averaging	-217	-88	+256	+430	+15	+136	-452	-78

However, in specific cases (i.e. for particular States and particular years) there are significant differences between relativities based on three and five year data periods.

Changing the data period also causes significant distortions in fiscal equalisation, as not all data years will have 100% weight over time.

The key issue, therefore, is how to effect the change from a five year data period to a three year data period, while minimising the adverse impact on fiscal equalisation.

Our projections indicate that changing the data period to three years will reduce Western Australia's GST grants by around \$600-\$700 million over the period 2010-11 to 2014-15.

- Unlike all other changes being considered by the Grants Commission, this change is not driven by an improvement in equalisation – it reflects a distortion in equalisation.

Consequently, unlike other “transitional” issues (where the debate is about delaying the introduction of fiscal equalisation improvements), this issue falls within the purview of the 2010 Review.

Our proposal is that the Commission manage the conflicting objectives of reducing the data period and maintaining equalisation over time by phasing in relativities based on the new data period, over at least three years. Using a minimum three year phase-in period, the weights would be as follows:

	5 year relativities	3 year relativities
2010-11	67%	33%
2011-12	33%	67%
2012-13	0%	100%

This would still leave Western Australia around \$400 million worse off over the period 2010-11 to 2013-14, so we would prefer a longer phase-in period.

We note that the difference between five year and three year averaging has recently been greater than usual. An alternative to phasing-in the change would be to delay it for a few years, while the impact of the boom washes out of the numbers.

A risk with moving to three year averaging is that States will find that their forecasting errors increase.

- A typical approach to forecasting GST shares is to assume no revisions to the data year relativities used in the latest Update, and to project the data year relativities beyond the latest Update (e.g. on the assumption of no change to the latest data year relativities).
  - In Updates, revisions to existing data year relativities tend to be small compared to changes in future data year relativities.

- Therefore, on average, moving from five to three year relativities will increase errors in forecasting GST shares by 67%.<sup>1</sup>

There is a risk that this will prompt States to request a return to five year averaging, just as they did in the second annual Update in 1990.

As these issues are likely to be of considerable interest to Treasurers, we believe that the Final Report should include five data year relativities under the new methods, even if the Commission recommends three year averaging.

- This will quantify the impact of three year averaging under the new methods on 2010-11 GST grant shares.
- It will also allow the Treasurers' Conference to choose five year averaging if they consider that issues such as forecasting errors are of sufficient concern.

#### **THE "EQUALISATION OVER TIME" CONCEPT**

At the August 2009 meeting with Heads of Treasuries, the Commission questioned the relevance of the "equalisation over time" concept.

We do not understand the reasons for this.

In our view, Australian equalisation can only be understood in terms of "equalisation over time".

- It is reflected in the structure of the equalisation model, which makes no attempt to look at current economic conditions and fiscal circumstances (which would not be practicable).
- It is reflected in the empirical evidence of large differences between the relativities applied in a year and States' relative economic circumstances in that year.
  - This is shown in Table 1, and has often been the subject of media debate in past Updates.
  - The shift to a three year data period will not in general make a major difference to the large divergences between applied and "concurrent" relativities – this is also shown in Table 1.
- It is reflected in the way we (and we understand other States) forecast relativities for budget purposes.

We consider that it is in everyone's interests to represent equalisation the way it is (i.e. as an "over time" concept), and not the way we would theoretically like it to be.

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<sup>1</sup> This average increase in forecasting errors will apply for three Updates beyond the latest.