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ROYALTIES FOR REGIONS: ACCOUNTABILITY AND SUSTAINABILITY

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Royalties for Regions: accountability and sustainability

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To determine whether the Western Australian (WA) Government's 'royalties for regions' policy will enhance economic welfare it is necessary to: know the net fiscal transfer that the community wants the State Government to provide between Perth and regional WA; and determine whether the royalties for regions policy brings the Government closer to, or further away from, that goal. In recognition of this, it is recommended that the State's public accounts be complemented by a new budget paper that reports on public finances for 'Perth' and the 'Regions' separately, which will improve government accountability, and classifies mineral royalties as 'capital' revenues, which will enhance sustainability provided these capital revenues are hypothecated for expenditure on capital projects.

In the lead up to the Western Australian (WA) election held on Saturday, 6 September 2008, the State's National Party, under the leadership of Brendon Grylls, campaigned as an independent political party. The National Party's election platform centred on its 'royalties for regions' proposal under which 25 percent of the State's royalties would be paid into a special fund each year and hypothecated for expenditure on regional investment. One outcome of the election was that the National Party acquired the balance of power in the WA's Legislative Assembly. After negotiations with both major political parties, the National Party entered into a power sharing arrangement with the Liberal Party, which facilitated the appointment of the Liberal's Colin Barnett as the Premier of WA.

At this still early stage in the Barnett Government's first term, the 'royalties for regions' program remains a general agreement on underlying principles. The aggregates are broadly known, as one quarter of the State's royalties equates to about $675 million and total funding under this program will be capped at $1 billion per year (Grylls 2008). However, the details of the program are still being finalised. Local press reports have suggested that

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the main sticking point between the two parties concerned the question of whether the forward estimates of expenditure prepared by the previous (Labor) State Government, led by Premier Alan Carpenter, should or should not represent the benchmark from which the Government's future increases in regional expenditure under this program will be determined.[2]

From a practical perspective, the focus on changes to the forward estimates is indeed understandable. However, from a policy perspective, that is just a small part of a larger picture. A more fundamental issue concerns the development of a fiscal framework for this program that will facilitate public accountability and sustainable outcomes. When royalties for regions measures are announced in the May 2009 State Budget, it is important that all fiscal elements associated with this policy be fully reported for geographically defined areas. Otherwise, the social and economic welfare propositions underlying the State's resource allocation will only be revealed in a partial and distorted manner, making it difficult, if not impossible, for observers and the community at large to assess the overall economic and social consequences of fiscal transfers within areas of the State.

Accountability in WA

Accountability will, in my view, be best served through the introduction of a new budget paper that decomposes the current State government accounts into two component accounts: first, the 'Perth accounts', being the WA Government Accounts for the Perth Statistical Division; and second, the 'regional accounts', being the WA Government Accounts for all regions outside the Perth Statistical Division. The goal of the proposed new budget paper is to explicitly identify and report: the geographic origin of public revenues; the geographic destination of public expenditures; and the consequent, positive or negative, net fiscal transfer between Perth and regions. In short, the purpose of the proposal is to better inform public debate on the relative net contributions of Perth and the regions to the State as a whole.

At this stage, information is not publicly available to enable the decomposition of the State accounts into component geographically defined accounts, or even to identify the direction of net fiscal transfers within the State. While royalties may suggest a partial fiscal transfer from the regions to Perth, State taxes are mainly collected in Perth and the cost of service

[2] Examples include the *West Australian*, 'Grylls to stand firm over Royalties for Regions' (20 October 2008), and *The Australian*, 'Colin Barnett's backflip on mining royalties' (24 October 2008).

provision in regions is typically higher than in the metropolitan area. The geographic direction of net fiscal transfers within WA as a result of State Government activity simply remains uncertain. Consequently, the proposed new budget paper should include 'Perth' and 'regional' accounts for a number of years immediately prior the introduction of the 'royalties for regions' program. As the 'royalties for regions' program represents a major re-allocation of State resources within WA, special 'Perth' and 'regional' accounts should also be extended beyond the budget year (2009–10) and across the forward estimates period too. The resulting mini time-series would not only reveal the immediate net redistributive effect of the 'royalties for regions' program, it would also assist informed discussion of the State Government's general net fiscal transfer between Perth and the regions, or the regions and Perth, before and after the implemental of the 'royalties for regions' program.[3]

A number of significant complexities associated with implicit and explicit inter-regional spill-over effects[4] will need to be considered when decomposing the State's accounts in the manner suggested above. For example, some expenses incurred in Perth implicitly provide benefits to residents of regional WA (e.g. central policy and central administration and co-ordination) and some other expenses incurred in regional WA implicitly provide benefits to residents of Perth (e.g. State road spending). Moreover, some revenues are collected in one region when the activity being taxed spills across metropolitan and non-metropolitan regions of the State, an issue that is further complicated by the employment of progressive revenue raising scales with grouping and / or aggregation provisions, as in the case of payroll and land tax. Consideration will also need to be given to accounting for deliberate policy directed spill-over effects such as intended cross subsidies between Perth and the regions associated with services provided by government corporations, through community service obligations or through Government restrictions that prevent full cost pricing (e.g. uniform tariff policy).

The federal fiscal dimension to state public finances adds further complexity to this matter. The State's share of national goods and services tax (GST) collections and general health funding is determined by a distribution formula designed to achieve 'fiscal equalization'. As

[3] A comprehensive analysis of net fiscal redistribution within WA would, of course, need to be extended beyond the State government to include the influence of activities by the Federal government and the range of activities by fiscally equalised local governments within the State. Indeed, information derived from such a comprehensive approach would assist us greatly in studying the welfare economic dimension of regionally diverse public sector activities. However, this essay is motivated by a desire to encourage the State Government to report in a more accountable manner, so the impact of regional fiscal transfers associated with the activities of Federal and local governments have not been considered here.

[4] The literature review in Vo (2008) discusses the place of spill-over effects within the economics of fiscal federalism.

such, these grants are distributed in shares that provide a subsidy to states to compensate them for above average costs of service provision (such as high costs related to dispersion or to diseconomies of scale etc) and below average capacity to raise State revenue. This subsidy is funded by the remaining states with below average costs of service provision and above average capacity to raise State revenues. The resulting fiscal equalization formula is designed so that:

> State governments should receive funding from the pool of goods and services tax revenue and health care grants such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard. (CGC 2005: 4)

Three issues need to be highlighted here. The first concerns the extent to which Commonwealth grants to WA come from revenues collected in WA. Fortunately this issue may be readily solved. In 2006-07, the Commonwealth collected $6.2 billion more from the WA economy than it returned to the State in grants to the State Government or direct expenditure by the Commonwealth within the State (Government of WA, 2008: 81). Consequently, it can be safely assumed that all Commonwealth grants to WA are funded from revenue collected from within the State. The second issue concerns the influence of regional areas within the State on grants that the Commonwealth pays to WA. This will require the separate identification of the value of Commonwealth grants to the State from revenue originally collected from 'Perth' and from the 'regions' of WA. The third issue concerns the impact of the Commonwealth Grants Commission's (CGC) treatment of fiscal activity within the State. This will require that the distinct 'Perth' and 'regional' accounts for the State to be reported in two stages: first on a 'gross' basis, unadjusted for CGC effects; and then on a 'net' basis, reporting major fiscal magnitudes after adjustment for CGC effects.

In the WA context, the CGC's impact on the State's budget balance differs depending on whether its assessments concern expenses or revenues. The CGC recognizes that costs faced by the WA government are typically above average and these tend to increase the State's GST share, whereas the State's revenue raising capacities are typically above average and serve to reduce the State's GST share. As such, the gross expense incurred on, say education, recorded in the State's regional accounts would reflect the actual expense incurred in providing education services to residents of regional WA, whereas the net

expense for such services would be something less than the actual expense incurred because the CGC implicitly compensates the State for the relatively high education costs that it incurs as a result of dispersion and isolation. In the case of revenues, say, mineral royalties, the gross revenue that should be recorded in the State's regional accounts would be represented by the actual royalties collected by the State, while net royalties received by the State would be very much less because the net effect of the CGC process is to redistribute most of the States royalties among the other states (by decreasing WA's GST share and increasing the share of GST allocated to other states).

These accounting difficulties are not insignificant and they ensure that the decomposition of the State's public accounts into reliable 'Perth' and 'regional' accounts will be a non-trivial exercise for the public sector. Nevertheless, the WA Treasury has previously published analysis of the net effect of Commonwealth fiscal activities on the States (Government of WA 2008) in which similar spill-over type problems have been dealt with, such as the treatment of expenses and benefits associated with the provision of nation public goods. In addition, the State's Treasury has the capacity to estimate the net impact of CGC assessments on specific revenue and expense items reported in the State budget. On balance, it can be safely assumed that the WA Treasury can decompose the State's public accounts to produce reliable 'Perth' and 'regional' accounts in a systematic and impartial manner.

Sustainability in WA

Sustainability is very often discussed in a broad economic, social and environmental context, with emphasis given to the sustainable character of: private economic returns, net social benefits; and the ecology and the natural environment. Indeed, the broad approach to sustainability is associated with the notion of the 'triple bottom line', where firms extend their motivation beyond profit generation to include social and environmental goals that complement broad sustainability. In this essay, however, the broad view of sustainability is not utilised. Rather, a context specific and narrower economic perspective on sustainability is adopted under which sustainability depends only on the maintenance of the aggregate real economic value of assets owned by the State, be they natural resources or manmade physical capital goods. This narrow approach has been adopted here to direct discussion of sustainability towards the economic interest that each citizen of the State has in maintaining (or enhancing) the real value of commonly owned public property over time.

Natural resources are the property of the State or, more concretely, the property of the people of WA now and over the full life of the State i.e. current and future generations of Western Australians. Resource royalties may be considered a payment to the State in exchange for giving up title to a resource. As the title to a resource sold by the State was effectively owned by current and future generations, there is an obligation on the State to largely transform that royalty stream into publicly owned assets that will provide benefits for current and future generations. Great care will be needed to ensure that the operational details of the 'royalties for regions' program is sustainable in the sense that it does not deprive future generations from sharing in the benefits of WA's current royalties.

As WA is part of a federation, it is socially fitting for the benefits from naturally endowed resources to be shared nationally and economically appropriate for this to be done without distorting resource allocation between regions across Australia. This is usually expressed in a context where resource royalties are presented as economic 'rents' (or a surplus over the cost of production) that will distort the migration decisions of labour if royalty receipts are expended in only one region of the nation. As such, redistribution of resource rents on a per capita basis across the states may act to reduce distortions to individuals' location decisions that would lead to resource rich areas becoming over populated.[5] Even though the emphasis in the preceding paragraph reflects the view that resources are publicly owned 'endowments' and that royalties are the price paid for an economic good, and not a pure economic rent, the logic underling the efficiency of redistributing resource rents can be extended to the 'endowment' conception of royalties when the exploitation of natural endowments is efficient[6] and citizen's rates of time preference are broadly consistent.

The CGC attempts, to the best of its ability, to distribute the GST among States in a manner that removes inefficient distortions related to resource royalties. Fault may surely be found with the CGC's royalty assessment mechanism, but not so with the objective of its assessment, at least not once it is accepted that it is appropriate for Australia to be an economically and socially integrated federation. Once the net impact of the CGC's assessment is accepted, and the majority of the State's royalties redistributed in the form of

[5] The relationship between rents, equalization and efficiency is discussed in Boadway and Flatters (1982) and extended by Petchey (1995) who looks at the effect of interaction between rents and differences in unit costs between states.

[6] Among other things, an efficient resource market would require different prices (i.e. different royalty rates) to reflect varying economic qualities of minerals and mineral deposits. While WA does not formally vary royalty rates with resource quality / extraction costs, it could be suggested that this is approximately achieved through the use of project specific Agreement Acts between the State and resource companies. For example, in the specific case of iron ore, the royalty rates specified in many Agreement Acts differ depending on the type of ore extracted.

increased GST grants to mineral royalty poor states and reduced GST grants to WA and mineral royalty rich states, the State should adopt a deliberate policy of quarantining the remaining 'net' royalties, i.e. royalties effectively retained *ex-post* of the fiscal equalization process, from the recurrent budget. In the interests of intergenerational efficiency and equity, those funds would be best treated as capital revenues and should be employed in the acquisition of public assets. Of course, this approach should not be limited to WA. States that receive a share of WA's royalties via increased GST revenues should similarly hypothecate those funds into a capital income account.[7] Furthermore, in the interest of inter-regional efficiency and equity, this information should be clearly evident in WA's State public accounts, including in the component accounts for 'Perth' and the 'regions'.

It might be objected that the proposed treatment of resource royalties in the State budget papers is unnecessary because the value of the State's capital works program already exceeds the value of royalties. However, I think that point of view suffers from three weaknesses. First, much of the State's capital works program is due to the activities of government corporations, whereas the correct comparative focus should be made with respect to general government capital works. Second, any surplus or deficit between royalty revenues collected and the value of capital expenditure will, in all likelihood, vary substantially between Perth and regional WA, and the reporting of such differences is important. Third, future generations, located in Perth or the regions, would be justified in expecting an explicit public record of the specific State assets provided for them by their parents' generation in exchange for the State's natural resources. As physical manmade assets tend to depreciate while the real value of resource deposits tend to appreciate, sustainability will, at the very least, require that income from such income generating assets be hypothecated to cover the depreciation in the value of these assets. When royalties are transformed into non-income generating assets, depreciation costs will need to be funded from general revenue to ensure that current generations do not benefit at the expense of future generations, as this would compromise sustainability.

A Hope: greater clarity in public finances to facilitate better political debate

In the lead up to the last State election, the need for a clear understanding of the relative contribution of Perth and the regions to the State's public accounts was repeatedly emphasised. I recall assertions in the media that Perth is riding on the back of the regions

[7] This may force the CGC to revise its assessments to reflect a new standard (or average) policy across the states of Australia, but changes of that character are too hypothetical to be considered in this general essay.

being met by assertions to the opposite effect. The fundamental problem was that the information required for the matter to be effectively debated was simply not available to the public. It is my great hope that the WA State government will introduce the new budget paper proposed in this essay so that, when the matter is debated during future elections, the debate can be informed and meaningful. It is also hoped that reporting royalties in the 'regional' budget as capital income, which is earmarked for 'Perth' and 'regional' expenditures on physical capital with a real economic value that is equivalent to that of the mineral resource given up (with the real capital value maintained over time through the imposition of depreciation charges), will improve the framework through which issues of fiscal sustainability and intergenerational equity are managed in WA.

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