Submission to the Productivity Commission

Inquiry into Australia's system of Horizontal Fiscal Equalisation

June 2017

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1. Introduction

The Western Australian Local Government Association (WALGA or 'the Association') is the united voice of Local Government in Western Australia. The Association is an independent, membership-based group representing and supporting the work and interests of 138 mainland Local Governments in Western Australia, plus the Indian Ocean territories of Christmas Island and Cocos (Keeling) Islands.

The Association provides an essential voice for over 1,200 elected members and approximately 14,500 Local Government employees as well as over 2.6 million residents of Western Australia. The Association also provides professional advice and offers services that provide financial benefits to Local Governments and the communities they serve.

The Association is grateful to the Productivity Commission for the opportunity to provide a submission in response to the *Inquiry into Horizontal Fiscal Equalisation.*

While Local Government is not a direct recipient of GST grants, the high degree of vertical fiscal imbalance and the legislative constraints on Local Governments' revenue raising capacity means that the sector is reliant on grant funding from the State Government in order to provide the services and infrastructure needed by the community. In this regard, any policies that impact on the State's financial position indirectly affect the Local Government sector.

In recent years, the HFE formula has seen Western Australia's share of GST revenue fall sharply. This has had a significant impact on the State's financial position, and has meant that the State Government has been forced to implement budget repair measures, many which have had broader implications for other sectors - including Local Government.

This submission provides WA Local Governments' perspectives on the implications of the current system of horizontal fiscal equalisation for the sector, and reform options to address these challenges into the future.

2. Key Points

- While Local Government is not a direct recipient of GST grants, the high degree of vertical fiscal imbalance in the Federation and the legislative constraints on the sector's revenue raising capacity means that it is reliant on grant funding from both the State and Commonwealth Governments in order to meet the costs associated with providing the services and infrastructure needed by the community. As a result, any policies that impact on the State's financial position indirectly affect the Local Government sector.

- The GST distribution process has not kept pace with the changing conditions in the WA's economy. As a result, WA's GST relativity is at a historic low, at a time when the economy has recorded its slowest rate of economic growth in 13 years. This has contributed to the state's significant financial challenges. It will take a number of years before WA's GST relativity returns to its previous levels.

- WALGA acknowledges that any change to the GST distribution formula will be difficult to negotiate with the States, as the limited pool of GST revenue available for distribution means that there will be clear winners and losers from any changes,

- Rather than fundamental changes to the methodology, in the short term, the Association considers that the introduction of a floor or continued "top up" payments to WA seems to be an appropriate way to manage the current challenges without adding further complexity to the system.

- However, this is not a permanent solution to the fundamental issues with financial relations within the Federation. WALGA considers that instead of changing the HFE methodology, the priority for reform should be to address the high level of VFI that exists, given that the tension around the HFE methodology largely reflects each state's reliance on GST grants as a source of revenue.

- Addressing the high level of VFI should occur as part of a broad tax reform agenda, which aims to improve the efficiency of the tax system, and provide the States and Local Government with access to additional quantum and sources of revenue. The Federal Government must take a leadership role to bring tax reform back onto the national agenda. All taxes should be considered as part of this discussion, including options such as raising the rate or broadening the base of the GST, reallocating appropriate existing taxation powers and the introduction of new taxation options.

- These reforms are important to improve the competitiveness of the economy, but would not directly provide Local Government access to the revenue needed to deliver on the community's service and infrastructure needs.

WALGA considers that any reform to the current system of Federal financial relations should look at options to provide the sector with greater funding certainty, and access to a "growth" revenue source.

3. Background

Horizontal fiscal equalization (HFE) has been in operation since the Commonwealth of Australia was established. The process has been used to address the fiscal differences between states as a result of the arbitrary nature of their borders.

HFE is used at a Local Government level, to allocate Commonwealth Financial Assistance Grant (FAG) funding to individual councils. In WA, this occurs through the WA Local Government Grants Commission. FAGs funding is provided to Local Governments in WA on the basis of horizontal equalisation to ensure that each Local Government in the State is able to function at a standard not lower than the average standard of other Local Governments. All Local Governments are entitled to receive at least the minimum grant, which cannot be less than 30 per cent of its per capita allocation.[i]

However, the primary means of achieving HFE within Australia – and the focus of the Productivity Commission's Inquiry – is through the distribution of the Goods and Services Tax (GST) to the States and Territories. The Commonwealth Grants Commission (CGC) provides recommendations to the Commonwealth Government as to how GST revenues should be distributed to the States in order to achieve HFE. These recommendations aim to ensure that each State or Territory has the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.[ii]

The introduction of the GST was a major economic reform, which saw fundamental changes to Commonwealth-State Financial Relations. The creation of the GST through the *A New Tax System (Goods and Services Tax) Act 1999* aimed to improve the efficiency of the tax system by removing a number of narrowly based taxes and replacing them with a more efficient alternative. As part of this reform package, a number of smaller and less efficient taxes were abolished, including:

- Wholesale Sales Tax;
- Financial Institutions Duty;
- Bank Account Debits Tax; and
- Stamp Duties on Marketable Securities.

There were a number of other taxes that were initially earmarked for abolition (for example, payroll tax), however the narrowing of the base to secure political agreement to the reform meant that this was unable to occur.

While the reform was an important step to improve the efficiency of Australia's tax system, it also served to heighten the level of vertical fiscal imbalance (VFI) that exists within the federation. While the level of VFI is not specifically included in the Review's terms of reference, WALGA considers that this is the cause of many of the concerns about the current HFE methodology as the States have become increasingly dependent on the GST as a source of revenue.

Recent HFE Outcomes

The current system of HFE has come under increasing scrutiny in recent years as a result of the declining share of the total pool that has been received by Western Australia.

WA's strong economic performance over the past decade has resulted in a sharp decline in the state's GST. GST is expected to represent approximately 7.9% of total revenue in WA in 2016-17, compared to 22% a decade earlier.

The decline in WA's GST relativity primarily reflects its greater than average capacity to raise revenue, as a result of the significant increase in royalty income over the past decade during the mining boom. While it is difficult to precisely define the mining boom, it is considered that it commenced in the early 2000s (around 2002), when the prices of key commodities started to rise on the back of strong global demand, particularly from China.

However, the GST distribution process has not kept pace with the changes in the economy. WA's economic performance has weakened in recent years, and the significant lags associated with the GST distribution formula mean that WA's assessed relativities do not align with the current economic environment.

Conditions in the WA economy have deteriorated significantly since the mining investment boom peaked in 2012. The WA economy recently recorded its slowest rate of economic growth in 13 years, with Gross State Product increasing by just 1.9% in 2015-16, which is considerably lower than the annual average growth rate of 5.5% recorded in the 10 years to 2012.

At the same time, WA's GST relativity dropped to a historic low of 0.3 in 2015-16, and is expected to remain at a similar level in 2016-17 (0.34). WA's relativity is by far the lowest of all other jurisdictions, with NSW the next lowest at 0.88. This compares to a decade earlier, when WA's relativity stood at 1. The overall result of the declining relativities is that WA received a GST allocation of just $1.9 billion in 2015-16, and is expected to receive just $2.4 billion in 2016-17. A decade earlier, WA received almost $4 billion in GST grants.

Looking ahead, WA's GST share is projected to eventually improve, though it will take a number of years before it returns to pre-mining boom levels. Estimates contained in WA Treasury's 2016-17 Pre-Election Financial Projections Statement show that the state's GST relativity is expected to remain at similarly low levels in coming years, before returning to 0.6 by 2019-20.

However, the recovery in GST revenue has been delayed even more in recent months with WA's expected GST grants across the forward estimates (2017-18 to 2019-20) revised down by $1.2 billion in the *2016-17 Pre-Election Financial Projections Statement*. The state's share of GST has been revised down due to the recent improvements in the iron ore price, as well as downward revisions to the Commonwealth's estimates of population growth in Western Australia relative to other States, and a reduction in the size of the national GST pool.

4. Impact of the recent HFE outcomes on Local Government

The misalignment between actual economic conditions and GST revenue received has placed significant pressure on WA's finances. The 2016-17 Mid-Year Financial Projections Statement shows that WA is expected to record a net operating deficit of more than $3 billion, while net debt is expected to rise to more than $41 billion across the forward estimate period.

While it is recognised that the state's own financial management has led to its weaker budget position, the declining level of GST revenue has added to these challenges given that it has fallen by more than $2 billion over the past decade.

The weaker financial position has meant that the State Government has been forced to implement budget repair measures, which have had implications for the broader economy.

There have been a number of examples which were introduced by the previous State Government, where the Local Government sector has felt the impact of these decisions.

- The 2011-12 to 2015-16 *State Road Funds to Local Government Agreement* provided for an allocation of 27% of vehicle licence fees (VLF) to Local Governments to assist in the task of funding the State's 128,000km local road network. In recent years funding has dropped to approximately 22% of VLF as the previous State Government has cut funding in response to the deteriorating budget position. This has resulted in declining funding that has not kept pace with State economic and population growth, and further added to the local infrastructure backlog.

- As part of a review of agency expenditure to repair the budget, the WA Department of Local Government and Communities (DLGC) made the decision to withdraw from the provision of property management services for local childcare and community centres. The decision to cease providing this service has provided a funding gap and means that Local Governments will be required to absorb rent that would have previously been provided by the DLGC, or to charge commercial rates to the community services providers using the facility. This decision will result in poorer outcomes by forcing service providers to move into areas where they can secure affordable lease arrangements, rather than in communities where the services are needed most. Alternatively, it will require Local Government to fund these lease costs at the expense of other key services or infrastructure, or through additional costs to ratepayers.

- The previous Government announced in the 2016-17 Budget that vehicle licence and stamp duty concessions currently provided to WA Local Governments will be discontinued from 2016-17. This decision was set to cost the sector up to $10 million per annum. While the Legislative Council recently passed a disallowance motion which means that Local Governments will retain an exemption from vehicle licence fees and stamp duty, this will be funded from a reduction in road funding to Local Government.

While it is recognised that it is prudent for the State Government to cut back spending as a result of its fiscal challenges, these decisions have occurred without consultation, and merely shifted costs rather than delivering genuine savings.

The Local Government sector has only limited capacity to absorb these cost shifts due to restrictions on its ability to raise own sourced revenue.

The State Government imposes often arbitrary restrictions on Local Government fees and charges which are prescribed and restricted by legislation, and are specifically limited to recouping the cost of service provision. Some examples of these include dog registrations and building permits. These constraints restrict the sector's ability to raise revenue as a result of:

- lack of indexation;
- lack of regular review (fees may remain at the same nominal levels for decades); and
- lack of transparent methodology in setting the fees (fees do not appear to be set with regard to appropriate costs recovery levels).

There are also some State Government mandated exemptions for rates that do not have a sound rationale, and serve as a constraint on the sector's ability to raise revenue. Some examples include State Trading Enterprises, and Independent Living Units.

As a result, these decisions are ultimately borne by the community as the sector is forced to reduce services or raise additional revenue in order to meet the funding shortfall.

5. Issues with the current HFE arrangements

While the Local Government sector is committed to fairness and equality across the Federation, WALGA considers that there are a number of features of the current methodology for HFE that are contributing to poorer outcomes for the economy and the community.

There are a range of issues with the HFE methodology, which were raised during the 2012 GST Distribution Review, and the associated submissions. However, the Review Panel found that many of the concerns raised were 'theoretical', or that efforts to adjust the formula to address these concerns may indeed deliver worse outcomes overall. [iii]

Although the Review Panel found that it is difficult to provide direct evidence to support these concerns, WALGA considers that the following are issues that are worthy of consideration by the Productivity Commission as part of this Inquiry.

Barrier to economic reform

In the current challenging fiscal climate, the outcomes of the HFE process have made it increasingly difficult for WA to undertake reforms that will enhance economic and productivity growth.

While it is recognised that the purpose of HFE is to redistribute wealth rather than to incentivise reform, the outcomes of the GST distribution formula in recent years have further added to the state's fiscal challenges, and made it difficult to undertake important economic reforms.

For example, the significant fall in WA's share of GST revenues in recent years has meant that there is no capacity in the state's budget to reduce the overall tax burden or to reform the state's most inefficient taxes as a way to improve productivity and economic growth without undertaking substantial cuts to services – which can be difficult to achieve in practise, and can take some time.

WALGA considers that this represents a barrier to the structural adjustment in the economy, which is a key issue at present given efforts to encourage new sources of growth as the mining investment boom draws to an end.

Inadequate consideration of infrastructure needs

Infrastructure is a key enabler of economic and productivity growth, and is provided by all levels of government. Investing in appropriate infrastructure is important to the future growth of the economy by unlocking new industries and creating jobs over the longer term.

Despite the importance of infrastructure investment, WALGA considers that the current HFE arrangements are a barrier to investment in major productivity-enhancing projects. This is because the current arrangements do not adequately take into account the significant infrastructure costs that are involved in the development of industry in the "spending needs" assessment, particularly in the larger and more rapidly growing states.

The inadequate funding for infrastructure from the HFE process can have broader implications, such as increasing States' reliance on debt as a way to fund their infrastructure requirements, which comes at a cost to the community.

In recent years, it has also contributed to the challenges faced by Local Government in WA in funding key infrastructure, as grants to the sector were cut in line with the State's fiscal challenges (see page 7).

Local Government plays an important role in infrastructure development, particularly through its responsibility for the provision of local roads – which up make 88% of the state's total road network. However, the sector does not have the financial capacity to appropriately maintain the existing infrastructure and invest in new infrastructure, due to the significant constraints on its ability to raise revenue such as legislative restrictions on fees and charges and exemptions to the rates base, as discussed earlier.

The limited financial capacity of Local Governments to fund infrastructure is reflected in the *2014-15 Report on Local Government Road Asset and Expenditure,* which shows that Local Governments would have to spend 28% of their estimated revenue capacity to make up the difference between their road preservation needs and road grants. [iv] This proportion was significantly larger for regional areas, rising as high as 89% in the Wheatbelt. Many of the rural roads are important freight routes for mining as well as the other key industries that represent an opportunity for future economic growth, including agriculture and tourism.[v]

The impact of declining state funding for local roads is also reflected in the *2014-15 Report on Local Government Road Asset and Expenditure.* Despite the injection of $5.9 million from the Royalties for Regions program, there was an overall reduction of $13.9 million in funding from the State Government for roads under the control of Local Government. [vi] The funding contribution from the State Government has fallen 15% over the past two years. In line with this reduction, expenditure on local roads in WA fell for the first time more than a decade. In 2014-15, total expenditure on local roads in WA fell by 6.7% or $54 million.[vii]

Equity and Efficiency

While WALGA recognises that equity is an important objective of the HFE process, efficiency should also be an important consideration. The Association considers that any HFE process should look to find a balance between these two often competing objectives.

At present, the current arrangements excessively favour equity over efficiency, as GST revenues are not necessarily allocated in a way that will maximise the overall benefit to the nation. The redistribution of revenue away from the larger states and those that are recording stronger growth limits their ability to continue to grow and generate wealth.

A further example of the inequitable outcomes from the current system relates to mineral extraction. Royalty payments exist to compensate current and future citizens for the use of non-renewable resources that are owned by the State. However, the HFE process means that a significant proportion of royalties are redistributed to other states rather than being retained by the citizens that own the resources.

6. Addressing issues with the HFE Formula

With it likely to be a number of years before WA's share of GST revenue returns to historical averages, the debate over the HFE methodology is likely to continue in the near future.

Reform to the GST distribution process was considered in the 2012 GST Distribution Review. Despite a detailed consultation process and examination of the system, the final report recommended only minor changes to the HFE methodology in the short term given the challenges in producing similar outcomes to the current system in a simpler way and lack of direct evidence of the claims about the system's flaws. The key changes to the methodology that the Review Panel recommended related to increasing materiality thresholds, and rounding relativities to two decimal places. Other changes were also recommended in relation to governance arrangements, and communication of the CGC's decisions.[viii]

WALGA acknowledges that any change to the GST formula is difficult to achieve in practise due to the increasing complexities this would create, and the differing views between the States and Territories. The limited pool of GST revenue available for distribution means that there will be clear winners and losers from any changes, which will make it difficult to reach an agreement about a new approach going forward.

Rather than fundamental changes to the methodology, the Association considers that the introduction of a floor or continued top up payments to WA seems to be an appropriate way to manage the current challenges without adding further complexity to the system.

Long-term Reform

While these measures will help address the sharp falls in WA's share of GST revenue in the short term, they are not a permanent solution to the fundamental issues with financial relations within the Federation. WALGA considers that instead of changing the HFE methodology, the priority for reform should be to address the high level of VFI that exists, given that the concerns around the HFE methodology largely reflects each state's reliance on GST grants as a source of revenue.

The need for broader reforms over the longer term was also highlighted in the final report of the GST Distribution Review, which reinforced that there will be a need for a more detailed consideration of the overall size of Government, and the roles and responsibilities for services and revenue-raising between the levels of government. In particular, the report emphasised the need for an efficient and effective combination of taxes in order to maximise the citizens' value for money from tax revenue. The report states that tax reform is needed at both a State and Commonwealth level to put greater focus on more efficient taxes and reduce reliance on less efficient taxes. A tax system that favours broadly based taxes with fewer exemptions over narrow and distortionary transaction based taxes was identified as an important pursuit in this regard.[ix]

In recent years, there have been numerous studies that have considered these important issues, including the Henry Tax Review, Taxation White Paper process, Federation White Paper process, Competition Policy Review and the Commission of Audit.

It is disappointing however, that these processes have stalled, with limited genuine reform achieved to date.

WALGA considers that the Federal Government must take a leadership role and bring tax reform back onto the national agenda. Improving the current system will require fundamental changes to the tax mix by abolishing the most distortionary taxes altogether or replacing them with more efficient taxes. All taxes should be considered as part of this discussion.

One option to reduce the level of VFI and improve the efficiency of the tax system is to broaden the base and/or increase the rate of the GST. This is because consumption is a stable and efficient tax base, and the revenue is provided directly to the States.

At present, the GST base is narrow, with a range of exemptions including food, medical and health services, and education. Removing these exemptions will reduce the complexity of the system, and provide additional revenue to the states.

A further option to increase GST revenue as a way to address VFI is to raise the rate. The current rate of 10% is low compared to consumption taxes in other jurisdictions. Some 10 OECD nations now have a standard rate as high as 22%.[x] Imposing a higher GST rate would generate significant additional revenue for the states and help to address current issues with VFI. WALGA considers that modelling should be undertaken by the Productivity Commission to determine the most appropriate rate for the GST.

It is recognised that these reforms would impact on vulnerable members of the community. WALGA believes that it is important that these members of our community are protected, but this should occur through direct payments rather than through the tax system. In this regard, any moves to broaden the base of the GST should be accompanied by an appropriate support program to ensure that vulnerable community members are not worse off.

It is also important that any changes to the GST should not be used to fund additional spending, but to improve the overall efficiency of the tax system. Any additional revenue generated should be used as a way of abolishing inefficient taxes, which will deliver improvements in productivity and growth over the longer term.

These reforms are important to improve the competitiveness of the economy, but would not directly provide Local Government additional funding to deliver on the community's service and infrastructure needs.

The reform process must also consider ways to provide greater revenue adequacy and certainty for Local Government.

As the third sphere of Government with tax raising capacity, significant spending responsibilities, and assets in the order of $442 billion, Local Government is a key player in the future economic development of the nation. Local Government raises 4% of total tax revenue, and is responsible for 6% of total spending. The legislated constraints on the sector's ability to raise revenue means that it is reliant upon grants from the Commonwealth and State Government in order to deliver on the services and infrastructure demanded by the community. This is particularly important in WA, due to the difficulties and costs associated with providing public services over our State's vast and isolated geography.

The sector has come under growing pressure in recent times, as it has taken on a greater role in the delivery of services that were previously undertaken by other levels of Government. It has been estimated that cost shifting is costing the sector in the order of $500 million to $1 billion per annum.[xi] Funding these additional activities is a challenge given that the sector has only one source of its own tax revenue (rates) and it is not feasible for most Councils to provide a sufficient level of services from rates revenue alone.

Under the Western Australian *Local Government Act 1995*, the only source of tax available to the sector is rates. In this regard, there is no scope for the sector to establish an additional taxation revenue stream without legislative change. Further, any options to establish local level taxes are likely to come with significant administrative costs.

Local Government must therefore retain its access to taxation revenue from other levels of Government. WALGA considers that any reform to the current system of Federal financial relations should look at options to provide the sector with greater funding certainty. This could include exploration of options such as sector level Agreements with State and Territory Governments or other funding arrangements with State Governments, linked to increases in GST distributions. It is recognised that there would be considerable work needed to examine the feasibility of these options.

In the meantime, the current arrangements for Commonwealth Financial Assistance Grants (FAGs) should be addressed. Over time, FAGS as a proportion of overall Commonwealth taxation revenue have declined, which has placed additional financial pressure on the sector.

Looking at the overall pool of Commonwealth payments to Local Governments, the Association believes there is a case for increasing the proportion of untied funding. Local Governments and their Associations across Australia have long argued for an increase in general funding, and are seeking to increase the quantum of FAGs to at least 1% of Commonwealth taxation. Increasing the current base funding of approximately $2.3 billion to $4.4 billion would better reflect the actual cost of Local Government services and infrastructure provision, and assist with addressing the existing infrastructure backlog.

The decline in the overall share of revenue that is provided to the Local Government sector is due to the current escalation process for the general purpose component of FAGs funding. The current methodology is based on population growth and inflation, which is not an appropriate measure given that costs of councils are not driven by the same factors as the CPI.

The inadequate escalation methodology, has contributed to a growing gap in the funds required by Local Government to meet increased demand for local community infrastructure and services over the last decade. In this regard, introducing a more appropriate approach to escalation is an important aspect of any reforms to address the current levels of VFI.

This may require the development of a specific Local Government cost index which measures real cost growth for the sector – across all expenditure items, ranging from construction to staff costs. This is already produced by many of the state Local Government Associations, but would need to be formalised into a national measure. Funding for the sector could then be escalated against this cost index, ensuring that that Local Government funding is maintained in real terms.

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[i] Department of Local Government and Communities, 2017, *Local Government Financial Assistance Grants*. Accessed 14 May 2017 from https://www.dlgc.wa.gov.au/GrantsFunding/Pages/LG-General-Purpose-Grants.aspx

[ii] Commonwealth Grants Commission, 2017, *How Horizontal Fiscal Equalisation Works*. Accessed 14 May 2017 from https://www.cgc.gov.au/index.php?option=com_content&view=article&id=258&Itemid=536

[iii] GST Distribution Review, 2012, *Final Report*. Accessed 15 May 2017 from http://www.gstdistributionreview.gov.au/content/Content.aspx?doc=reports.htm

[iv] WA Local Government Association, 2014-15, *Road Asset and Expenditure Report*

[v] WA Local Government Association, 2014-15, *Road Asset and Expenditure Report*

[vi] WA Local Government Association, 2014-15, *Road Asset and Expenditure Report*

[vii] WA Local Government Association, 2014-15, *Road Asset and Expenditure Report*

[viii] GST Distribution Review, 2012, Final Report. Accessed 14 May 2017 from http://www.gstdistributionreview.gov.au/content/Content.aspx?doc=reports.htm

[ix] GST Distribution Review, 2012, Final Report. Accessed 14 May 2017 from http://www.gstdistributionreview.gov.au/content/Content.aspx?doc=reports.htm

[ix] GST Distribution Review, 2012, Final Report. Accessed 14 May 2017 from http://www.gstdistributionreview.gov.au/content/Content.aspx?doc=reports.htm

[x] OECD, 2016,
Consumption Tax Trends. Accessed 19 May 2017 from http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/consumption-tax-trends-2016_ctt-2016-en#.WR5u18Loucw#page13

[xi] House of Representatives Standing Committee on Economics, Finance and Public Administration, *Rates and Taxes: A Fair Share for Responsible Local Government*, October 2003