PARLIAMENTARY NATIONAL PARTY OF WESTERN AUSTRALIA

Submission into the Productivity Commission's Inquiry into Horizontal Fiscal Equalisation

5 July 2017

INTRODUCTION

At both the State and Federal level, The Nationals WA have long campaigned for reform to the current GST distribution methodology. It is our view that the current model of Horizontal Fiscal Equalisation employed by the Commonwealth Grants Commission (hereafter the CGC) fundamentally distorts Western Australia's (WA) productivity, growth potential and capacity to manage annual budgets.

On 12 September 2011, The Nationals' Federal Member for O'Connor Tony Crook raised this issue in private members' business in the Federal Parliament, calling on the Federal Government to stipulate a minimum GST revenue-sharing relativity of 75 per cent. Despite the GST distribution being previously criticised by NSW[1] and Victoria[2], the Federal Member for Kennedy Bob Katter and Mr Crook were the only elected representatives to vote in favour of the motion.

On 12 November 2011, former Leader of The Nationals WA Brendon Grylls called on the Federal Government to implement a minimum GST revenue–sharing relativity of 75 per cent in WA's Legislative Assembly. On 15 August 2013, The Nationals Member for Mining and Pastoral Region Hon Jacqui Boydell MLC also called on the Federal Government to undertake an immediate review of the GST arrangements to ensure a more equitable distribution. These motions both received bi-partisan support from Members of the Western Australian Parliament.

The Nationals consider the current GST distribution as the most critical issue facing WA's long-term economic and social development. We regard the GST distribution system as fundamentally flawed. It is a model that is meant to deliver equity and fairness for all states and territories yet after a period of unprecedented investment and growth due to the construction phase of a significant iron ore sector expansion, WA faces considerable economic and fiscal pressure.

In this submission, we will address both the impact of the HFE system on WA and outline recommendations for alternative mechanisms.

WESTERN AUSTRALIA'S ECONOMIC CONTEXT

Over the past ten years, Western Australia (WA) has transitioned through an economic boom almost unparalleled in Australian history. It led to WA being hailed as the engine room of the national economy, driven by record iron ore prices and strong global demand for commodities. Individuals and businesses in WA paid billions of dollars in GST during a period of unprecedented investment in new capital infrastructure and a mining construction boom. WA also had strong wage growth, contributing further to the national economy, via income and company tax.

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[1] NSW government calls for population-based GST, 2011. http://www.news.com.au/breaking-news/nsw-government-calls-for-population-based-gst/news-story/ebe225f0bedd56345487e0b1c0cc14f1

[2] Victoria calls for greater share of GST, 2011. http://www.theage.com.au/victoria/victoria-calls-for-greater-share-of-gst-money-20111019-1m85z.html;

Treasurer Michael O'Brien calls for GST reform after Victoria loses at least $140m, 2014.

http://www.abc.net.au/news/2014-03-27/treasurer-calls-for-gst-reform-after-victoria-loses-24140m/5348744

The WA State Government facilitated this growth, catering for the massive increase in population by building essential infrastructure (schools, hospitals, water, power and transport), and investing in essential services through the provision of more teachers, nurses, health professionals, and police. The wages and conditions for these essential workers were all negotiated against a backdrop of increasingly high wages in the mining sector. The Government, like other non-mining sectors, was faced with mounting pressure to attract and retain their workforce.

There was also a commitment by Government to invest in the regions that generated the wealth of the State and nation to improve the standard of infrastructure and services, and diversify the economy. Between 2008 and 2017, under the program known as *Royalties for Regions*, the State Government spent $7.2 billion driving regional development, including the provision of services and infrastructure necessary to allow economic expansion, job creation and population growth; building social development by creating liveable, vibrant and sustainable regional communities and addressing market failures by providing doctors and improved health facilities, and quality education in regional areas.

Off the back of a massive period of capital investment, WA has experienced a sharp decline in operating revenue, driven by a declining iron ore price. Graph 1 shows the iron ore price tracking at its peak of $170 per tonne, declining to below $50 in 2015.

Graph 1: Historical Iron Ore price, in US dollars[3].

WA is highly dependent on the performance of a highly volatile and cyclical industry, where small movements in the iron ore price have a substantial impact on the operating budget. The CGC assumes that WA has the strongest fiscal capacity to raise revenue and meet ongoing expenses. This assumes that resource revenue remains consistently elevated over the longer term, and ignores the realities of a State economy heavily reliant on a volatile revenue source in mining royalties.

[3] Market Insider, 2017. http://markets.businessinsider.com/commodities/iron-ore-price

The previous State Government's substantial investment in other industries (agriculture, forestry, tourism)[4] and investment in job-creating infrastructure to modernise Perth and regional WA reinforces the Government's commitment toward strengthening our economic capacity beyond mining. Such a commitment, however, has required substantial investment.

WA's debt is anticipated to reach $42 billion by 2020. The 2017 Commsec State of the State report presents a poor economic outlook, which based on an assessment of key economic indicators such as economic growth, retail spending, business investment, unemployment, construction work done, population growth, housing finance and dwelling commencements, ranks WA worst in economic performance.

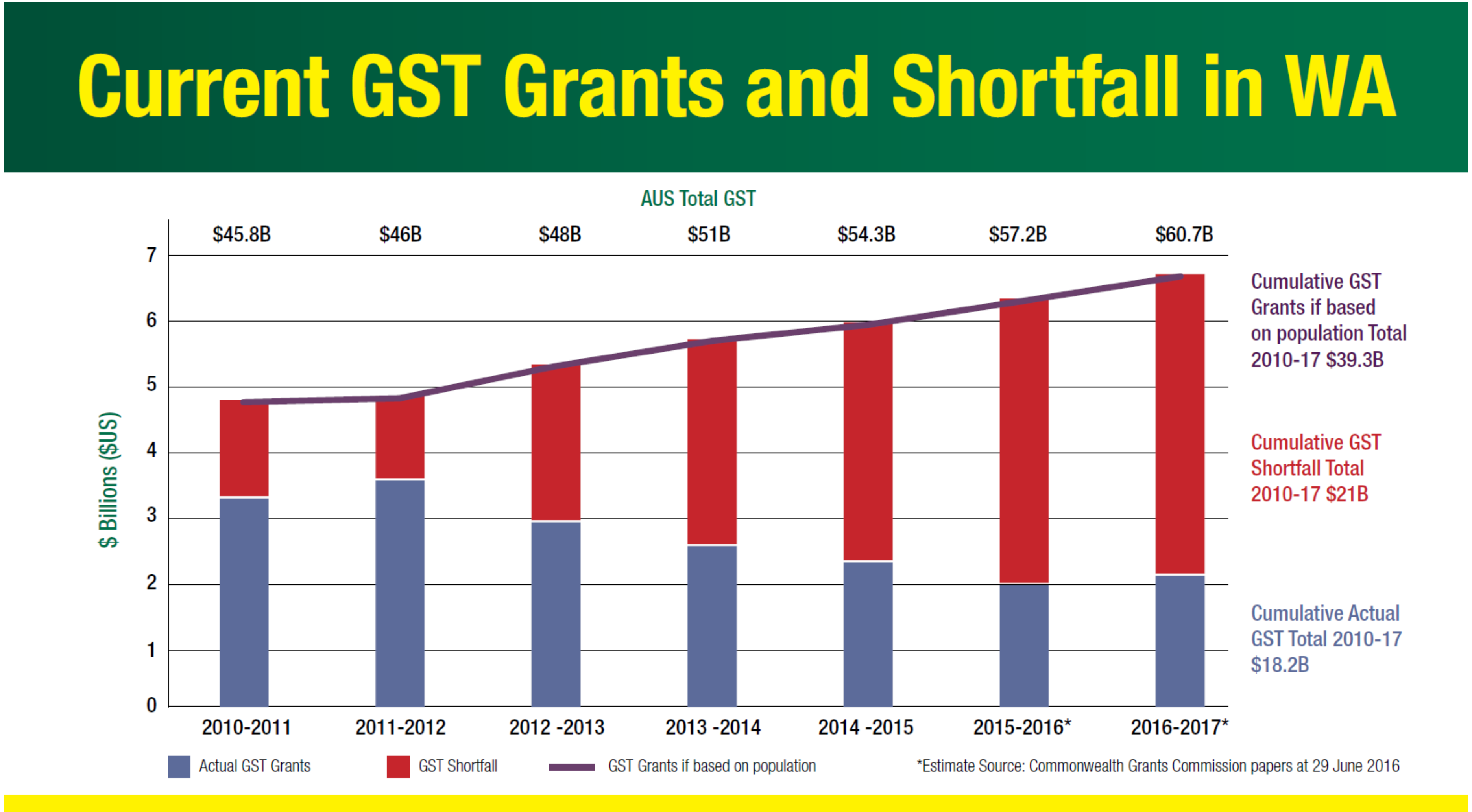
The end of the mining boom has severely impacted WA's capacity to meet its inflated ongoing expenses and has limited the State's capacity to drive further investment into priority job-creating infrastructural projects. This has resulted in the recent introduction of a bill to authorise an increase in WA's debt by $11 billion.

The PNP believes the current HFE modelling fails to accurately reflect current economic standing, having the effect of rewarding those States that are overly content with the status quo, such as Tasmania, while punishing those that are doing poorly due to factors outside its control.

As shown in Graph 2, if the HFE was applied on a per capita basis, WA would be $21 billion better off, which would allow the State to continue investing in our economic strengths that support the nation's prosperity.

[4] **WA Open for Business** - https://www.mediastatements.wa.gov.au/Pages/Barnett/2016/12/WA-open-for-agribusiness-investment.aspx; **Ord Stage 2** http://www.abc.net.au/site-archive/rural/content/2008/s2494644.htm; **Water for Food** http://www.abc.net.au/news/rural/2015-02-06/$24.5-million-for-wa-water-projects/6073640; **Gascoyne Food Bowl** http://www.nationalswa.com/gascoyne_growing_future_part_of_the_master_plan; **Regional Telecommunications Project** https://www.mediastatements.wa.gov.au/Pages/Barnett/2014/12/Communications-project-connects-regional-WA.aspx; **Softwood Industry Strategy** https://thewest.com.au/news/south-west/big-investment-in-the-regions-pine-industry-ng-ya-119110; **Grower Group Grants** https://www.mediastatements.wa.gov.au/Pages/Barnett/2015/10/Grants-to-increase-agricultural-exports.aspx

Graph 2: Current GST Grants and Shortfall in WA



ABOVE AVERAGE EXPENSES

The CGC employs HFE as an equaliser to balance each states and territory's revenue potential against its fiscal capacity to finance the average level of service. The CGC is correct in its assumptions that Western Australia (WA) has "high expenditure requirements" attributable to our Aboriginal population, our vast remoteness, high wage growth and below average non-State provision of health services[5].

The policy position employed by the CGC is that State Government support for the mining industry is minimal[6]. The PNP suggests that while the mining boom brought WA considerable prosperity, it also involved substantial direct and indirect costs. The Utah Point Port Facility in Port Hedland for example was a direct $300 million investment into the mining industry by the State Government to enable junior iron ore miners access to port facilities. Similarly, between 2009 and 2017, the State Government provided $130 million under the Exploration Incentive Fund to support exploration in the mining industry.

The State Government also contributed $310 million, alongside the Federal Government's $676 million commitment, to facilitate the Gateway and Perth Airport Project, which was necessary to reduce road congestion and improve access to Perth Airport as a result of the significant FIFO workforce. The PNP would also argue that the $1.7 billion *Pilbara Cities*[7] investment and the $110.8 million District Allowance[8] were necessary State Government commitments attributable to the mining industry.

In addition, the industry also receives considerable State Government assistance in the form of subsidies, concessions and cheap access to infrastructure. In fact, according to Australia Institute's "The Age of Entitlement" report, the WA State Government's financial support for the industry totalled $6.2 billion between 2008 and 2014[9].

Furthermore, in 2015 the Chamber of Minerals and Energy, the peak body representing the mining industry in WA, called for the State Government and private sector to work together to define a State-wide infrastructure plan to assist with the transition of the resource sector from construction to production. This plan called for improvements to water, energy, roads, rail, ports, aviation and telecommunications infrastructure for the direct benefit of the resources sector[10]. By failing to appropriately account for the State Government's mining-related investment, it is not possible to make an accurate assessment of our expense profile.

Moreover, during this boom period, WA also facilitated a population growth of 500,000, equivalent to the population of Tasmania. Following calls within the community that Perth and

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[5] Commonwealth Grants Commission, "Overview: Western Australia" https://www.cgc.gov.au/index.php?option=com_content&view=article&id=260&Itemid=537

[6] Commonwealth Grants Commission, "Investment for Mining" https://www.cgc.gov.au/index.php?option=com_content&view=article&id=258&Itemid=536

[7] Pilbara Cities was a past State Government investment, funded through *Royalties for Regions,* to address the challenges and opportunities associated with the mining industry's incredible growth in the Pilbara. The funding was used to address housing affordability, inadequate infrastructure, poor health and education facilities and support local business development.

[8] The District Allowance was also funded via *Royalties for Regions* to help public sector employees meet higher living costs and compensate them for working in a remote area.

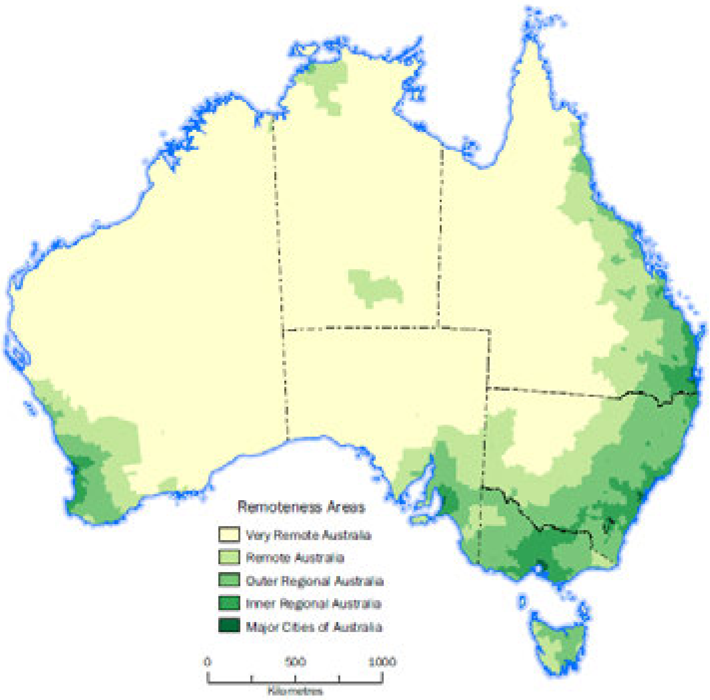
[9] Australia Institute, 2014. Mining the age of entitlement - State government assistance to the minerals *and fossil fuel sector.* http://www.tai.org.au/sites/defualt/files/Mining%20the%20age%20of%20entitlement.pdf

[10] Western Australia needs a state-wide infrastructure plan to support mining and resources growth, says peak industry body, 2015. http://www.abc.net.au/news/rural/2015-07-08/resources-sector-needs-support/6603868

regional WA needed investment and faced the challenges of excessive growth, an unprecedented investment ensued in health, education, transport and water infrastructure.

This investment was not only focused on metropolitan Perth, but across the large geographic spread of the State. The PNP also suggests the current methodology employed to determine remoteness is not reflective of the sheer geographic size of WA's predominately "Very Remote" status and the cost of service provision, particularly in those regions associated with mining, as noted in the Map below by the ABS. The PNP therefore suggest that WA's expense profile has been above average, and is currently incorrectly assessed by the CGC.

Map 1: Remoteness Area Boundaries[11]



Discourages Change and Reform

The PNP holds the view that the current HFE model discourages innovation, risk-taking, adaption, investment in industries and major infrastructure. Both the Northern Territory and Tasmania continue to benefit greatly from a lack of industry innovation and expansion at Western Australia's (WA) expense. At the same time, the current HFE method penalises states for their economic success.

If a state's drive to develop industries and new revenue sources leads to a reduction in GST revenue, there is little wonder why some states and territories would be less inclined to pursue growth strategies, especially if there is political risk or community contention surrounding such proposals.

[11] ABS, 2011. Australian Statistical Geography Standard (ASGS): Volume 5 -Remoteness Structure. http://www.ausstats.abs.gov.au/Ausstats/subscriber.nsf/0/EB3374C05104D74ACA257D1E00128192/$File/1270055005_2011_remoteness_structure_maps.pdf

However, given WA's fiscal situation and declining GST share, at the 2017 State Election The Nationals WA had the courage and foresight to embark on a bold policy position to strengthen WA's economic standing. This would have facilitated the State Government's continued investment in job-creating infrastructure during the post-mining construction boom-phase.

The Nationals proposed increasing a Special Lease Rental charge already paid by the State's two major iron ore miners, set in the 1960's and never increased. The rationale was that the purpose and reason for the charge was no longer reflective of the modern mining operations, for example the advent of fly-in fly-out, automation of machinery, a reduced permanent workforce, off-shore headquarters and a range of other aspects had never been anticipated in the State Agreements at the time they were struck.

It was The Nationals' intention to invest part of the revenue generated in job-creating and State-building infrastructure, providing a much-needed stimulus for the State's economy, while addressing the forecast debt emerging in the forward estimates of the Budget. In particular, it would be used to reduce the current payroll tax obligation for small businesses. The Nationals acknowledge the need to reduce this inefficient State tax, which was one of the main motivations for the introduction of the GST.

While this policy position would have enabled the State Government to access an additional $7.2 billion in revenue over four years, the main argument against this policy proposal, led by the Chamber of Minerals and Energy (CME), was the revenue source would benefit Eastern States through GST distribution.

In fact, the impact of the new revenue source would affect our GST distribution after four years due to the lag period in the current methodology. The State would have had access to a much-needed revenue stream, and given the mood for change and statements by the Prime Minister, it was reasonable to believe the distribution issue could be addressed at some point in the near future[12].

The absurdity of the argument against a new revenue source is that the same position could be used to discourage any further State Government support or investment into facilitating new iron ore mines as the revenue and royalties will be distributed to other States. This is a reasonable argument as *The West Australian* reported, since 2006, $39 billion of the $46 billion in total mining and energy royalties WA raised was lost to other states and territories through the GST distribution[13].

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[12] *Turnbull pledges to fix WA's GST woes* http://www.businessfirstmagazine.com.au/turnbull-pledges-to-fix-was-gst-woes/17241/

[13] Wright, 2017. *How WA's iron ore royalties went everywhere else*. https://thewest.com.au/news/wa/royalties-lost-in-gst-carve-up-ng-b88428291z

RECOMMENDATIONS AND OPPORTUNITIES

The PNP regard the following as priority recommendations:

1. **Include assessment of direct and indirect state government investment associated with industry development**

The current policy position held by the CGC that State Government investment in the mining sector is limited reduces the usefulness and accuracy of the methodology. The CGC therefore should include assessment of direct industry investment.

2. **Change model for assessment of remoteness**

Given WA's expansive geographic remoteness as compared with other states and territories, the current methodology appears to be limited in its assessment of remoteness and the cost of providing services and infrastructure, especially in regions associated with mining.

3. **Partial Equalisation and Per Capita Sharing**

The PNP recommends that the preferred model of GST distribution would involve the application of partial equalisation and a per capita sharing model. This would better reflect actual circumstances and deliver a balanced GST share.

The PNP also suggest the following as opportunities to substantially improve the methodology:

1. **Quarantining 25 per cent of royalty income**

At present, any increase in royalty income is offset by a reduction in GST revenue. This situation therefore recommends quarantining a portion of mining royalty in recognition of the direct mining related expenses that are attributable to the industry.

2. **Removing the 3 year "lag"**

As states transition through economic peaks and troughs, a real-time annual assessment should be considered. The current 3 year historical average or "lag" has created perverse and unintended consequences.

3. **Introducing Key Performance Indicators**

In the early conversations around taxation reform, which ultimately led to the introduction of the GST, former Prime Minister John Howard suggested the new taxation regime had to pass three tests:

- it must generate more employment
- it must help boost exports, and
- it must generate higher living standards, encourage risk-taking and provide greater economic incentives[14]

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[14] Harrison, 1998. *The GST Debate - A Chronology.* http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/Publications_Archive/Background_Papers/bp9798/98bp01

It is evident the GST was introduced to drive Australia's competitiveness and productivity, not for the purpose of subsiding poor performing states and territories. However, recent history has shown this has become the case. The PNP recommends that these principles be used as a yardstick for GST allocation, thereby incentivising risk-taking, building competitiveness, employment and other key matters for the benefit of individual states, territories and the nation.

By establishing mechanisms for accountability using these key indicators, the GST revenue pool would then be used to drive competitiveness and productivity.

4. **Modify Policy Neutrality**

At present, the policy position of states and territories when determining GST distributions are not taken into consideration. In line with the previous recommendation, the PNP suggests modifying the stance of "policy neutrality" to acknowledge states with policies that drive economic development and exploit industry expansion. By taking economic development policies into consideration, states and territories are therefore encouraged and rewarded for their commitment to driving economic development and productivity.

5. **Remove Key Contradictions**

The PNP argues that while states and territories can actively choose not to undertake exploration activities and develop their resources, this revenue potential is not factored into the equation. However, in the case of gambling revenue, which WA has long held a socially responsible stance against, a per capita revenue distribution is applied to all states and territories. This means that WA is being assessed, and therefore penalised, for revenue it does not receive.

The PNP suggests that these contradictions show the failure in the system, and recommends a per capita base could also be applied to royalty revenue in the same way it applies to gambling revenue.

CONCLUSION

In closing, the PNP would like to emphasise that a number of inquiries and reviews have been progressed with the intention to overhaul Australia's taxation system, including the 2015 White Paper, yet change in this space has been largely unremarkable.

The PNP is concerned that the Productivity Commission's latest review of GST called for by the Federal Treasurer is another superficial attempt to appear to be addressing the issue. Political will and courage is now needed to deliver change.