Submission to the Australian Government Productivity Commission

Inquiry into Horizontal Fiscal Equalisation (HFE)

From the Office of Western Australian One Nation Senator Peter Georgiou

30th June 2017

The current Goods and Services Tax (GST) distribution system has become one of the most important issues for Western Australia in recent years. The state generates over 35% of the country's foreign income yet only receives 34c for every dollar raised in GST. The existing system is inefficient, unfair and extremely unpopular and there is now growing public anger at this massive redistribution of wealth out of the State. Politicians and bureaucrats who continue to ignore this do so at their own peril.

Recommendation:

1. **That there is a complete impartial review of the current Income Equalisation System.**
2. **That the Commonwealth Grants Commission immediately introduce a floor of 70c for each dollar raised in GST for all States.**

This will create greater revenue certainty for all States and strengthen incentives for economic development throughout Australia.

It isn't that complicated and the system could be fixed tomorrow. There is no legal reason why the system can't be changed immediately. Both major parties have done little to address the concerns of the electorate even though they have had years to do so. If all WA politicians used their power and acted in the best interest of their constituents this unfair system could be changed and the State and the Nation as a whole would be much better off.

At the recent Senate Estimates hearings only two of the States twelve Senators even bothered to turn up and argue for a fairer deal for WA. One Nations Senator Peter Georgiou was one of the two and he will continue to lobby for a fair deal for all the people of WA.

When the GST was first introduced in 2000 it was sold by the then Howard Government as a fairer better tax however over the last ten years the State's share of the GST collected has fallen from 95c for every dollar raised in 2007 to just 34c in 2017. No other State receives below 88c, Tasmania receives 1.80 and the Northern Territory gets $4.66.

State Governments who actively reject minerals developments are effectively rewarded through the higher distribution of revenues to those States. The current system is promoting less productivity, less growth and fewer jobs.

It is in the Nation's interest that reforms are made. It is ironic that the Western Australian economy has been deemed by the Commonwealth Grants Commission as the State with "the strongest fiscal capacity" resulting in it being stripped of 66 c in every dollar it collects while CommSecs annual state of the States analysis confirms WA's economy is at the bottom nationally.

Commonwealth Grants Commission member professor Jeffrey Petchy noted in 2011 that the current equilibrium model distorts taxing and spending behaviour in the States making the system inefficient and he predicted the current political crisis over the GST.

In 2004 Petchy reported in a paper that he co-authored that the strategic behaviour induced by equalisation perversely leads to under provision of public services in contributing States and over provision in recipient States relative to efficient levels.

It is very much in the National interest that the current system is changed. The Chamber of Commerce and Industry of WA believes holistic GST reform could inject billions of dollars into the national economy by incentivising States to grow underdeveloped industries in their economies which is in the interest if the entire country, not just an individual State.

During the resources boom over the last decade Western Australia had an unprecedented influx of workers to build and service its developing resources. The State had to build roads, railways, schools and other infrastructure to accommodate this boom and yet at the time when funds were most needed to pay for this extra expense the federal government reduced significantly the amount of tax retained in the State to an all-time low of 30c in the dollar in 2015 & 2016.

Under the current system States do not need to strengthen their economies or drive efficiencies in service delivery, because they can simply sit back and be brought up to the leading states capacity every year. As an example NSW and Victoria have banned onshore gas development and therefore have a lower capacity to raise their own revenue. They then pick up more in GST than they would need if they developed their own gas industries. Billion dollar industries which could create hundreds of millions of dollars in revenue for these State governments are being stopped while at the same time Western Australia which is more progressive is being called on to prop up the less productive States. The current system does not work in the Nation’s best interest and needs urgent overhaul.

Some other states have argued that the current review was being driven by the failure of the WA Government to get its budget in order, these States conveniently overlook the fact that they get over twice, and up to six times more in the case of Tasmania, the allocation of funds from GST than what Western Australia receives. Cut billions from the revenue of these States and they would have budget problems too.

Businesses have proposed changes to the current system. Woodside director Peter Coleman has been reported as saying that in the interests of energy security and economic development that it is time for changes to the GST formula. “Only by rewarding States that encourage companies to develop untapped resources could the country ensure it has appropriate access to cheap gas reserves.” He has highlighted that the Western Australian Government had actively supported the development of the North West Shelf gas project by building the Dampier to Bunbury gas pipeline and signing the take-or-pay contract reportedly costing the WA taxpayers $8billion. This has helped Western Australia avoid the energy crisis currently plaguing the Eastern States that have placed bans on offshore gas development. States that make the most of their natural resources should be rewarded with a greater share of the tax rather than be penalised.

It has been reported that Western Australia has received only about $1.6bn in royalties from the North West Shelf, while the other States have pocketed about $14bn.

Mining Company Rio Tinto has also come out saying that the broken GST distribution system rewards lazy states at WA's expense. Rio has blasted the "perverse" system that penalised pro-development States to the benefit of those that "restricted" growth. They have noted that WA is one of the world's leaders for resources development whereas other States "rank significantly lower". Rio has said that under the current GST formula about $41 billion of revenue has been transferred out of WA to other States since 2013 because of its mining success. As a result the system would discourage WA to develop projects, against the long term interests of Australia.

Australia's peak gas industry body, the Australian Petroleum Production and Exploration Association has said there needs to be changes to the methodology, which unfairly rewards states that have moratoriums on gas development.

The Minerals Council of Australia has said that the current system punishes rather than rewards States that try to maximise their revenue base through minerals development.

The Association of Mining and Exploration Companies (AMEC) has said the current GST formula creates an unpredictable and unstable environment for State and Territory governments.

Another unfair anomaly in the current system is that billions of dollars in pokies revenues generated mainly in NSW, Victoria and Queensland are not distributed among the States in the same way that WA's mining royalties are. It is estimated that if the Commonwealth Grants Commission assessed this revenue that WA would benefit by at least $400million a year. The current system favours gambling over resource development which is absurd and not in the Nation's best interest.

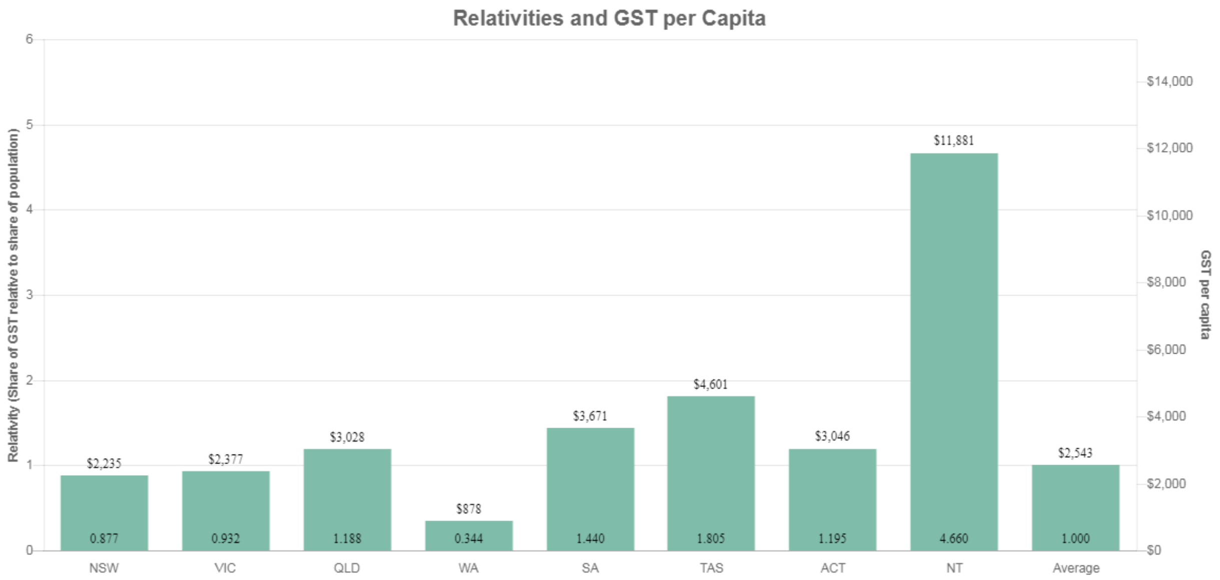
Under the current system the distribution of GST revenue is as follows:

	Population Share % *	GST Share % *	$bn *	$ received per $ GST Collected	$ Per person +
NSW	32.1	28.2	17.544	0.88	2,235
VIC	25.3	23.7	14.765	0.93	2,377
QLD	20	23.9	14.870	1.19	3,028
WA	**10.8**	**3.7**	**2.327**	**0.34**	**878**
SA	7	10.1	6.302	1.44	3,617
TAS	2.1	3.8	2.387	1.80	4,601
ACT	1.6	2	1.224	1.19	3,046
NT	0.9	4.7	2.908	4.66	11,811
		TOTAL	62.340	AVERAGE:	2,534

*source: 2017 budget papers

+source: Australian Government Commonwealth Grants Commission 2017 overview

https://www.cgc.gov.au/index.php?option=com_content&view=article&id=260&Itemid=537



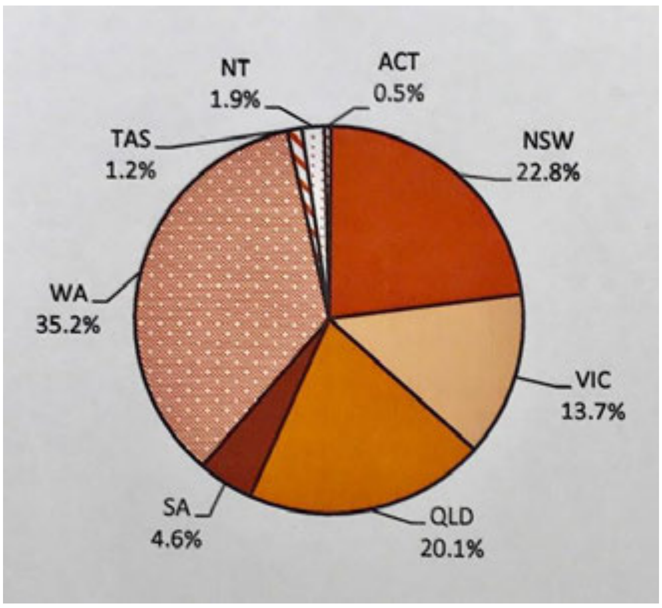
source: Australian Government Commonwealth Grants Commission 2017 overview

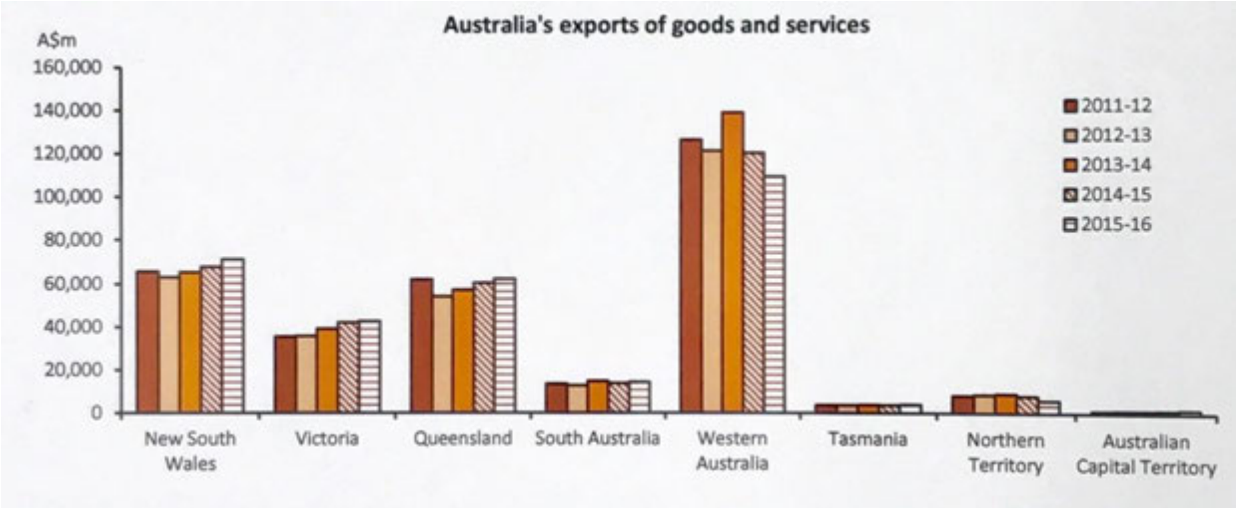
The average distribution per capita is $2,553 yet Western Australia gets only $878 per capita. Because of WAs relatively small population of 2.7m it would only take a small reduction just 7% in the other states GST allocation to allow for WA to receive the average being almost 300% more than what it gets now.

Western Australia's net fiscal contribution and net HFE over the period 1986-87 to 2014-15 was $206.6 billion. In 2014-15 alone WA contributed $22.7 billion or around $8,848 for every person in the State. South Australia by contrast was NEGATIVE $8.4 billion with SUBSIDISIES of $4,969 for every person (source Western Australian Treasury estimates and WA State Government).

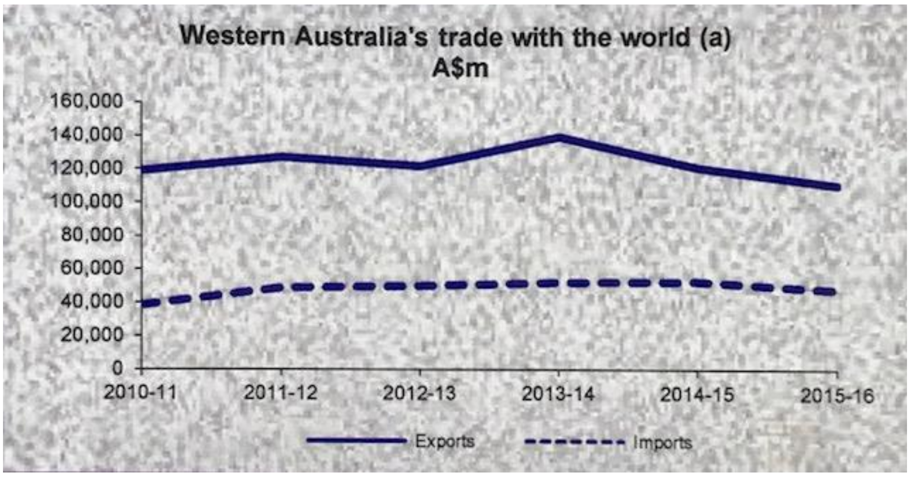
Western Australia's exports provide the income needed to fund eastern states imports:

Exports by States 2016-16

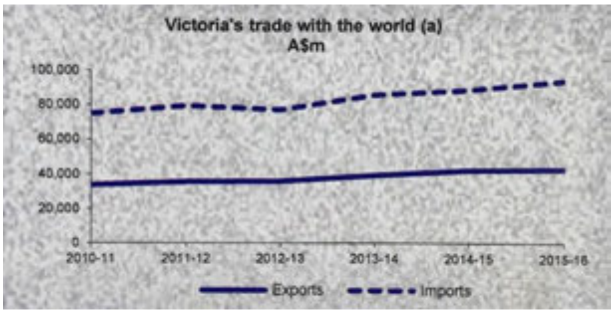




Western Australia as a State has a substantial trade surplus:



New South Wales and Victoria have substantial trade deficits with imports exceeding exports:



WA is supporting these states and the thanks we get is being ripped off in the GST distribution.

Independent International academic studies from some of the world's top universities also indicate that revenue transfer systems like the current GST distribution model are not in the Nation's best interest. The results of the study summarised below indicate that income equalisation systems have a negative impact on productivity and growth.

Extracts from:
The Fiscal Interest Approach: The Design of Tax and Transfer Systems
Caroline Pöschl, **London School of Economics and Political Science**
Barry R. Weingast, **Stanford University**
September 2013

https://web.stanford.edu/group/mcnollgast/cgi-bin/wordpress/wp-content/uploads/2013/10/Weingast-Poschl-BRW.13.1007..pdf

http://www.oxfordscholarship.com/view/10.1093/acprof:oso/9780198737506.001.0001/acprof-9780198737506

From page 1:
When the taxation and transfer system has subnational governments rely on own revenue generation from broad based taxes, subnational governments tend to be responsive to their residents' needs, the overall health of their economies, and more willing to provide market-enhancing public goods.

An excessive reliance on central government transfers, on the other hand, has a detrimental effect on subnational incentives to assist the production of wealth.

Australian State Governments need to be motivated to promote the prosperity of residents in their jurisdictions and the Tax transfer system needs to encourage this.

From page 3:
Governments that depend on own revenues have incentives to be more accountable to citizens, to provide market-enhancing public goods, and to be less corrupt. (Singh and Srinivasan, 2006; Rodden, 2003; Careaga and Weingast, 2003; Ambrosio and Borgignon 2006).

The current Australian system subsidises the less productive states at the expense of States that have greater economic production. While this may be seen as fair it discourages economic efficiencies.

From page 4:

"if a government is dependent on citizens and businesses for taxation, it has an incentive to increase productivity in its territory in order to secure or raise future earnings (Oates 1972, Olson 2000)."

The Current Australian system removes the need of less productive states to raise tax as they are effectively topped up by the more productive states. This system reduces the incentive for the subsidised states to raise tax within their own states.

From Page 10:

Transfer systems

The scholarship generally views own revenues as superior to central government transfers as a source of revenues for subnational governments in terms of the incentives they create for growth and development. Yet the specific transfer design and how intergovernmental transfers relate to taxes is also important (Faguet and Wietzke 2006, Weingast 2009).

Depending on their design, intergovernmental transfers to subnational governments can mitigate or magnify some of the incentive problems connected to transfers outlined above. They can encourage or destroy incentives for promoting growth directly and also indirectly by affecting incentives for tax collection.

Effect on promoting growth and development

Transfers to subnational governments are typically set by a formula that comprises a series of weights for different criteria, including economic and demographic characteristics, such as income and population. ***However, the attempt to correct horizontal imbalances by allocating more transfers to poorer regions often means that these transfer systems exhibit poor responsiveness to localities that foster local economic growth, and sometimes can even produce completely perverse incentives.***

The conclusions drawn above indicate that Australia's current system of HFE may well be adding to the imbalances between the States Economic outcomes and acting as an impediment to economic growth. This is not in the National interest, as a Nation we would be better off rewarding the more productive states and allowing the free market to determine where capital and resources are allocated.

From Page 12:

Fiscal systems that allow growing regions to capture a major portion of new revenue generated by economic growth provide far stronger incentives for local governments to foster local economic growth.

Western Australia is being penalised for its economic success. It would be better for the Nation if a greater proportion of the wealth generated here was retained here. The extra funds could be used to fund extra infrastructure such as roads, ports, hospitals, schools and extra development that a growing economically productive State needs. The current HFE system has produced the ridiculous situation where the state that generates the largest proportion of the Nation's wealth gets the smallest by far share of the GST.

From page 13:

Courchere (1981) and McKinnon (1997) raise a related incentive problem with transfer schemes that are designed to provide substantial subsidies to the poorest regions in rich countries. McKinnon, for example, contrasts the huge subsidies by Canada to the Eastern Maritime Provinces and by Italy to the Mezzogiorno in Southern Italy with the lack of subsidies by the United States to the American South. McKinnon suggests that the revenue transfers in Canada and Italy create dependency and a soft budget constraint. Transfers allow these regions to finance ailing and inefficient enterprises, seeming to saddle Southern Italy with highly capitalized, loss-making enterprises. The regional economy is far less likely to adapt so that it becomes more like the vibrant national economy.

In contrast, southern states in America faced a hard budget constraint and no national subsidies. The poorest region in the United States after the Civil War through mid-20th century, southern states were able to grow rich by redesigning their economies with low regulatory burdens relative to the industrialized North and to take advantage of lower labor costs. This adaptation fostered the booming sun belt economy of the late twentieth century. McKinnon argues that the economic rise of the American South is unlikely to have occurred had it been subsidized in the manner of the Canadian Maritimes and the Italian Mezzogiorno. For this reason, Courchere argues that these types of regional transfers are self-perpetuating.

The International fact based evidence above proves that the Income redistribution systems like Australia's HFE create a self-perpetuating cycle of economic underdevelopment in subsidised states (Like Tasmania and South Australia).

From page 18:

Reliance on such external unearned resources robs subnational governments of the motivation to engage with its residents in order to find out how to help them to produce wealth. Reliance on transfers also dampens the impulse to be innovative in pursuing strategies that create growth from below and to use resources more efficiently and effectively. Evidence shows that this reliance also creates complaisant attitudes and disinterest amongst officials and residents, and lead to wasteful management of public finances and corruption. This can have a detrimental effect on growth and development.

From Australia's Constitution:

Part V—Powers of the Parliament.

51 Legislative powers of the Parliament.

The Parliament shall, subject to this Constitution, have power to make laws for the peace, order, and good government of the Commonwealth with respect to:

(i) trade and commerce with other countries, and among the States;

(ii) taxation; but so as not to discriminate between States or parts of States;

As well as the fact that the current system is unfair and not in the Nation's best interest, it may also be unconstitutional

SUMMARY:

The current system takes away the incentive for states to develop their economies and to maximise economic growth. Under the current model states like Western Australia that have been active in developing their resources are penalised whereas States that have locked up their resources from development are subsidised.

The current system does not encourage economic growth.

Dr Ken Henry said in 2009 before handing down the report of his review into Australia's tax system that "*Successful tax reform is not just about increasing GDP or revenue, or making the system easier to understand, or more sustainable, or fairer, or better able to assist governments to address various social problems. It is concerned with all of these things. Successful tax reform means improving the wellbeing of the Australian people.*

We propose that the current GST distribution system is changed so that States that are more entrepreneurial are treated fairly giving them the funding required to continue to develop their economies. This will result in better use of both capital and the countries natural resources and be much better for the Nation as a whole.

Sources:

Australian Government Commonwealth Grants Commission

https://www.cgc.gov.au/index.php?option=com_content&view=article&id=260&Itemid=537

Australian Government Department of Foreign Affairs and Trade:

Australian trade by state and territory 2015-2016

http://dfat.gov.au/about-us/publications/Documents/australias-trade-by-state-and-territory-2015-16.pdf

Australian Government Productivity Commission:

Horizontal Fiscal Equalisation Public Inquiry

http://www.pc.gov.au/inquiries/current/horizontal-fiscal-equalisation