PRODUCTIVITY COMMISSION INQUIRY

RESOURCES SECTOR REGULATION

SUBMISSION BY ALEX DOBES

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Summary

Resources sector regulation was a point of discussion in the recent Productivity Commission (PC) inquiry into Horizontal Fiscal Equalisation (HFE). The issue elicited a number of submissions from the resources sector, with the common theme being that HFE is a major barrier to resources development.

The resources sector favoured a Canadian-style approach, where resources revenue is discounted when calculating equalisation payments.

The PC did not support the Canadian approach, but recommended a changed HFE approach that would provide greater incentive for states to support resources development.

The Commonwealth Government has so far rejected the PC's recommendations. The Commonwealth's preferred solution provides no incentive for resources development and relies on an open-ended Commonwealth subsidy.

With a recent slowdown in economic growth, the Commonwealth Government may wish to re-visit its approach, and adopt a HFE policy more conducive to resources development. A variant of the Canadian model is a realistic option.

A discount applied only to future resources projects would provide an incentive for development without leaving any state worse off. Rather than a subsidy that includes no incentive, the Commonwealth could provide payments to states for project approvals and legislative changes that facilitate resources development.

About the author

Alex Dobes has worked on regulatory and microeconomic reform in a number of jurisdictions. This submission expresses only his personal views.

Introduction

Thank you for this opportunity to make a submission to the Productivity Commission (PC) inquiry into resources sector regulation.

Some key points of resources sector regulation were previously examined in the PC inquiry into Horizontal Fiscal Equalisation (HFE). It is worth re-visiting the discussions and the outcome of that inquiry.

The HFE inquiry recognised the importance of the resources sector, and the terms of reference included the specification that "the Commission should, in particular, consider: …

- Policies affecting energy and resources, noting the uneven distribution of natural resources across the nation; whether sufficient consideration is given to the different underlying and structural characteristics of different revenue bases;
- State laws and policies restricting the development of energy resources"[1]

HFE is a problem for resources development

The response from the resources sector was unambiguous in pointing to HFE as a barrier to resources development.

For example, the Minerals Council of Australia (MCA) stated that:

> A priority area for reform in the GST distribution must be the treatment of revenues from mining and petroleum developments which have been a key driver of states' finances and the Australian economy over the past 15 years. In effect, current approaches punish rather than reward state governments who seek to maximise their revenue base through the attraction of minerals development. Conversely – and perversely – state governments who actively reject minerals development (through the imposition of exploration and production bans) or implement regulatory settings that discourage business investment are effectively rewarded through the distribution of revenues earned in other states.[2]

The Australian Petroleum Production & Exploration Association (APPEA) stated that:

> … the HFE system offers perverse incentives to prohibit or limit gas activities for non-scientific reasons, as the loss of revenue from such decisions is in part shielded by increased shares of GST revenue. Not only is this hampering economic development, it is placing even further pressure on those states and

[1] Productivity Commission, *Horizontal Fiscal Equalisation Productivity Commission Final Report*, May 2018, pp. iv-v. https://www.pc.gov.au/inquiries/completed/horizontal-fiscal-equalisation/report/horizontal-fiscal-equalisation.pdf Further cited as "PC Final HFE Report".

[2] Minerals Council of Australia submission p. 2, at https://www.pc.gov.au/__data/assets/pdf_file/0008/218825/sub034-horizontal-fiscal-equalisation.pdf

> territories that have chosen not to impose restrictions. Such an outcome is inequitable.[3]

BHP Billiton stated that:

> We recognise there is a need for the HFE system to account for differences in the fiscal strength of the States. The system's treatment of resources revenue, however, is problematic for the economy in that it dulls the incentives for States to stimulate development of their resource endowment. Over time, this is likely to result in less investment in the resources sector than would otherwise be the case. This translates to lost opportunity for jobs (including flow on opportunities for other businesses that support the resources sector), less activity in regional communities and, in turn, a less productive, efficient and robust national economy.[4]

Rio Tinto stated that:

> A necessary foundation for an efficient, equitable and sustainable HFE mechanism is a clear definition of the objectives and intended outcomes of the regime, taking account of the need to balance equity considerations, incentives for states to develop their economies and stability in state public finances. Under the current framework, the Commonwealth Grant Commission (CGC) would appear to have given undue weight to redistributing jurisdictions' GST revenues, and less priority to ensuring jurisdictions are incentivised to make the most of their capabilities, including natural resource endowments. As a consequence, jurisdictions that have adopted growth-enhancing policies supportive of resource development are effectively penalised, while jurisdictions that have restricted such activities are rewarded.[5]

Some (non-resources) stakeholders considered that HFE is not a barrier to resources development. This counter-argument was a common theme among governments that derive a significant subsidy from the HFE status quo, such as Tasmania, South Australia and the Australian Capital Territory.[6]

However, the submission from the Western Australian Government reinforced the message from the resources sector, stating that:

> There is a large disincentive to develop industry, as most of the fiscal benefits are redistributed to other States, but there is no sharing of much of the costs of development, creating a penalty for success.[7]

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[3] APPEA submission p. 2, at https://www.pc.gov.au/__data/assets/pdf_file/0007/218572/sub018-horizontal-fiscal-equalisation.pdf

[4] BHP Billiton submission p. 1, at https://www.pc.gov.au/__data/assets/pdf_file/0004/218983/sub042-horizontal-fiscal-equalisation.pdf

[5] Rio Tinto submission p. 2, at https://www.pc.gov.au/__data/assets/pdf_file/0011/218828/sub037-horizontal-fiscal-equalisation.pdf

[6] PC Final HFE Report p. 125.

[7] Western Australian Government submission p. 50. At

This submission noted that "for Western Australia, royalty (and tax) policy proposals now routinely include an assessment of the related GST impacts."[8] In other words, the Western Australian Government confirmed the resource sector's contention that the GST distribution affects state government decisions.

The resource sector's preferred solution - the Canadian approach

A number of submissions pointed to the precedent of Canada, where mining revenues are discounted by 50 per cent in the equalisation formula. In its final report, the PC summarised this as follows:

> A common proposal among inquiry participants was to impose discounts of 25 per cent or 50 per cent to the mining revenue assessment. Canada applies a 50 per cent discount to mining revenues in its equalisation formula (although Canada's HFE approach is not full equalisation to begin with). Applying a mining discount would deliver significant benefits to Western Australia, and to a lesser extent, Queensland and the Northern Territory.[9]

On balance, the PC was not in favour of a Canada-style approach:

> Proponents of this option argue that applying a discount would reflect the lack of policy neutrality inherent in the current mining assessment. However, a discount does not sit well with the main fiscal equality objective of HFE. Mining revenue, in particular, is a prime example of a source-based advantage — one a State benefits from by virtue of where its borders happen to be drawn — and should prima facie be included in the equalisation process. Further, there is a possibility that introduction of such a discount would herald calls for other carve outs. The proposal of a discount points to a legitimate problem in the HFE process, but provides a less than robust solution.[10]

The Productivity Commission's preferred solution

In its final report, the PC considered that the existing HFE structure had problems of efficiency and fairness, and concluded that:

> Many of these problems are due to the pursuit, above all else, of comprehensive equalisation of fiscal capacities. In doing so, it is likely that opportunities are being missed to achieve broader equity outcomes (which incorporate fairness by rewarding States for their policy efforts) and to improve efficiency in the Australian economy.

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https://www.pc.gov.au/__data/assets/pdf_file/0008/218564/sub015-horizontal-fiscal-equalisation.pdf

[8] Western Australian Government submission p. 73.

[9] PC Final HFE Report p. 22.

[10] PC Final HFE Report p. 22.

> The objective of HFE should be reframed to allow for trade-offs to be made between equity and efficiency. The system should enable State Governments to provide a 'reasonable' standard of services, rather than the 'same' as under the current system.[11]

In proposing a revised objective for HFE, the PC noted:

> This revised objective will inevitably (and desirably) still involve redistribution from fiscally stronger States to increase the fiscal capacity of the fiscally weaker States. Yet it does not require that States have an identical fiscal capacity. Some differences may be acceptable in order to provide reward for policy effort (fairness) and to achieve more policy-neutral (efficient) outcomes. In striking a balance between these outcomes, a reasonable standard of services also balances the benefits and costs to the Australian community from redistributions between States. A similar objective has been adopted in several other countries; for example, in Canada equalisation is intended to achieve reasonably comparable levels of public services at reasonably comparable levels of taxation across provinces.[12]

In other words, the PC did not propose an end to equalisation, rather a re-balance of the sometimes competing objectives of equalisation, fairness and efficiency.

The PC noted that "no alternative benchmark for equalisation is unambiguously superior to any other."[13] Nevertheless, it concluded that "equalising to the average (pre-GST) fiscal capacity of all States is judged to provide a better balance than the current benchmark and is thus a preferred alternative."[14]

Therefore the PC's key recommendation (8.1) was as follows:

> The Commonwealth Government should transition Australia's system of HFE towards equalisation to the average (pre-GST) fiscal capacity of all States, with the remaining GST revenue distributed on a per capita basis.[15]

[11] PC Final HFE Report p. 163.
[12] PC Final HFE Report p. 176.
[13] PC Final HFE Report p. 255.
[14] PC Final HFE Report p. 255.
[15] PC Final HFE Report p. 255.

The Commonwealth Government's proposed solution

In its interim response, the Commonwealth Government did not agree with the PC's key recommendation:

> The Government has carefully considered the PC's preferred option and formed the view that it is not the appropriate way forward to update the way the GST is distributed.[16]

Instead, the Commonwealth proposed a model with minimal change:

> … the Government's preferred model involves moving to a benchmark that would ensure the fiscal capacity of all States is at least the equal of NSW or Victoria (whichever is higher). …
>
> Benchmarking all States to the economies of the two largest States would remove the effects of extreme circumstances, like the mining boom, from Australia's GST distribution system. …
>
> In addition to moving to an updated, more stable equalisation standard, the Government proposes to put in place a 'floor' below which no State's relativity can fall. The GST relativity floor would be set within the GST distribution system, rather than by an external ex-gratia payment. …
>
> The Government is proposing to implement a ratcheting floor over the course of the transition to a new equalisation standard. …
>
> The floor would initially be set at a relativity of 0.70, before moving up to 0.75.[17]

Distributing GST revenue is a zero-sum game, so on its own a relativity floor would leave some states worse off. To ensure that this does not occur, the Commonwealth Government proposed to add funds to the GST pool from its own resources.[18] These would vary over time, starting with $883 million in FY 2019-20, of which $814 million would go to Western Australia and $69 million to the Northern Territory. By FY 2026-27, the Commonwealth's contribution would be more than $1 billion, with around two-thirds going to Western Australia.[19]

The Commonwealth's proposed solution assumes that the GST pool (without the Commonwealth top-up) will grow from ~$70 billion in FY 2019-20 to ~$100 billion in FY 2026-27. This represents a growth rate of more than 5 per cent each year.

This growth rate in GST collections evidently assumes continued strong growth in the overall economy, but this latter assumption is not made explicit. However, the

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[16] Australian Government, *Productivity Commission inquiry into horizontal fiscal equalisation: Government interim response*, July 2018, p. 14. https://treasury.gov.au/sites/default/files/2019-03/HFE-Government-Response.pdf Further cited as "Commonwealth Government interim HFE response".
[17] Commonwealth Government interim HFE response pp. 16-17.
[18] Commonwealth Government interim HFE response p. 18.
[19] Commonwealth Government interim HFE response p. 21, particularly Table 5.

Commonwealth does note the importance of economic growth to the GST framework:

> The biggest risk to GST distributions in the future is a weaker economy. A growing economy ensures that even if States experience a fall in their GST shares as a result of the CGC's distribution formula, their nominal distribution can increase because of the larger GST pool generated by a stronger economy.[20]

The likely impact of the Commonwealth's proposed solution

The Commonwealth's proposed HFE solution arguably has two basic flaws.

Firstly, it only marginally addresses the fundamental problem of disincentives for state governments to develop resources. A 0.70-0.75 floor is of benefit only to Western Australia, and does not require Western Australia to develop resources in order to obtain additional revenue. It does not materially change the incentive (or disincentive) for other states to re-consider some of the restrictions they have imposed on mineral and energy extraction. The PC identified the following as typical examples:

- NSW, Victoria, Queensland and Western Australia ban uranium mining.
- Victoria has a moratorium on onshore conventional gas mining.
- All States except Queensland, South Australia and the ACT have placed heavy restrictions on coal-seam gas extraction …[21]

Secondly, the solution envisages constantly increasing Commonwealth subsidies so that no state is ever worse off. This is quite different to previous one-off Commonwealth payments to state governments to provide an incentive for reform, as for example occurred with National Competition Policy (NCP).

A predictably increasing subsidy has a strong demonstration effect, signalling to state governments that they need not undertake reform to gain increased revenues. The Western Australian Government gained little or nothing from the lengthy, difficult and costly process of expanding its resources sector. By contrast, lobbying the Commonwealth to improve Western Australia's GST allocation has brought rich (and almost immediate) rewards. In future, why would a state government choose the development option over the lobbying option?

A change in Commonwealth priorities?

In a narrow sense, there are good reasons for the Commonwealth's preferred HFE approach. The national division of GST revenue relies on a high degree of consensus among states. A new approach that makes some states worse off will

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[20] Commonwealth Government interim HFE response p. 4.

[21] PC Final HFE Report p. 128.

most likely prove impossible to implement. At the same time, the (understandable) dissatisfaction of Western Australia with existing arrangements meant that something had to change. The Commonwealth chose a quick solution that would satisfy all governments.

However, since the Commonwealth published its interim response in July 2018, there has been a significant economic slow-down. For the June quarter of 2019, the Australian Bureau of Statistics (ABS) reported annualised economic growth of only 1.4 per cent[22], compared to the long-run average of 3 to 4 per cent[23]. Consumer spending was a weak spot.

The ABS noted that the resources sector was a rare bright spot in the growth picture.

> Net exports contributed 0.6 percentage points to growth this quarter, reflecting strong exports of mining commodities. "Strength in mining related activity was seen across a number of measures in the economy" [ABS Chief Economist] Mr Hockman added.
>
> Mining gross value added increased 3.4 per cent with strong production of coal and liquefied natural gas. Mining profits rose by 10.6 per cent driven by strong export growth and a continued rise in the terms of trade. Mining investment rose 2.4 per cent, with increases in investment in machinery and equipment.

If Australia's economic slowdown is a temporary anomaly, there may be no need to re-assess priorities. However, this slowdown appears to be part of a general worsening of economic conditions around the world. The European Central Bank (ECB), for example, recently announced that it would move to counteract a Eurozone economic slowdown by further cutting interest rates and buying bonds. The ECB encouraged Eurozone governments to cut taxes and increase spending "to stave off a fresh crisis".[24]

If sustained, the slowdown in growth has two important implications.

Firstly, slower economic growth leads to slow growth in GST collections, particularly if consumer spending is a weak spot. The Commonwealth's proposed HFE solution relies on high growth in GST collections.

Secondly, the Commonwealth Government now has a more pressing need to promote economic growth. This suggests a need for greater emphasis on efficiency and fairness (rewarding state governments for development) rather than the previous

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[22] Australian Bureau of Statistics, "5206.0 - Australian National Accounts: National Income, Expenditure and Product, Jun 2019", 4 September 2019. https://www.abs.gov.au/AUSSTATS/abs@.nsf/mediareleasesbyReleaseDate/C9973AC780DDFD3FCA257F690011045C?OpenDocument accessed 5 September 2019.

[23] *Sydney Morning Herald*, "Spending growth in NSW hits zero as Australia's economy slumps to GFC levels", 5 September 2019. https://www.smh.com.au/politics/federal/spending-growth-in-nsw-hits-zero-as-australia-s-economy-slumps-to-gfc-levels-20190904-p52o3e.html accessed 6 September 2019.

[24] *Financial Times*, "ECB cuts rates and tells governments to act", 13 September 2019. https://www.ft.com/content/9b2c29c0-d53d-11e9-a0bd-ab8ec6435630 accessed 14 September 2019.

overriding priority of equalisation. The current status of the resources sector as a rare source of growth points to the useful role it can play when other sectors faulter.

The Commonwealth is still largely constrained by the need to leave no state worse off than previously in order to ensure consensus agreement to any solution. This is where a variant of the Canadian approach may be useful.

The Canadian approach revisited?

As mentioned above, the Canadian approach to equalisation discounts resources revenues by 50 per cent. The Australian resources sector has suggested a similar mechanism with a discount between 25 and 50 per cent.

However, applying a discount of any size to existing projects would result in a smaller GST allocation to states with a smaller resources sector. A better option is to apply a discount only to future projects.

A discount limited to future projects can be set as high as 100 per cent without making any state worse off compared to the status quo. However, states with a small resource endowment may argue against a 100 per cent discount. The exact level of discount is a matter for debate, and the Canadian solution of 50 per cent is a good starting point.

The PC has pointed out the flaws of the Canadian approach, such as the fact that it is not “policy neutral”, and it favours states with a larger resource endowment. However, in an environment where the PC’s (arguably better) preferred option cannot be implemented, it is worth considering a less elegant solution that is nonetheless an improvement on the status quo.

A discount for future resource projects does not solve the immediate grievance of the Western Australian Government. This is where a Commonwealth subsidy can be a useful interim measure. However, rather than an open-ended increasing subsidy, a time-limited decreasing subsidy provides a better incentive for resources development.

Additionally, the Commonwealth could provide specific payments as an incentive for state government legislative changes and project approvals, and these payments could apply to all states. A familiar precedent is NCP, where Commonwealth payments were a useful incentive for reform at state level.[25]

When considering how to apply a Canadian policy, it is worth noting the differences in context.

[25] See for example the OECD analysis of Australia’s NCP payments. Comisión Federal de Competencia Económica México/Organisation for Economic Co-operation and Development, *Australia’s National Competition Policy: Possible Implications for Mexico*, 2009, pp. 31-35. https://www.oecd.org/daf/competition/45048033.pdf accessed 14 September 2019.

Canadian provincial governments set their own rates of GST[26] and income tax, which they use for their own purposes. There is significant variation between provinces, with the provincial rate of GST ranging from 0 per cent in Alberta (a resource-rich province analogous to Western Australia) to 10 per cent in the four Atlantic provinces. The federal rate of GST is 5 per cent.[27]

In other words, Canada's provincial governments are less reliant on centrally determined payments than Australian state governments. Where the Commonwealth Government's GST payments to the states are in the order of $70 billion, Canada's federal equalisation payments are in the order of $20 billion.[28]

To use a technical term, Canada's vertical fiscal imbalance is less pronounced than Australia's. This may influence the details of policy application.

Conclusions

The Commonwealth Government and the Productivity Commission should re-consider the option of applying a discount to resources revenues in calculating equalisation payments.

Any discount for resources revenues should apply only to future projects, to ensure that states with a smaller resource endowment are left no worse off than the status quo.

To overcome Western Australia's current disadvantage, the Commonwealth Government should consider a time-limited decreasing subsidy.

The Commonwealth Government should consider the option of providing incentive payments to the states for project approvals and legislative changes that facilitate resources development.

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[26]For the sake of simplicity, this submission uses the general term "GST" to describe the equivalent Canadian value-added taxes, variously known as Provincial Sales Tax (PST), Goods and Services Tax (GST) and Harmonised Sales Tax (HST).

[27] Canada Revenue Agency, "GST/HST calculator (and rates)", 28 September 2016. www.cra-arc.gc.ca/tx/bsnss/tpcs/gst-tps/rts-eng.html#rt accessed 5 September 2019.

[28] Department of Finance Canada, "Federal Support to Provinces and Territories". https://www.fin.gc.ca/fedprov/mtp-eng.asp accessed 6 September 2019.