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WESTERN AUSTRALIAN PARLIAMENTARY LIBERAL PARTY

SUBMISSION TO THE PRODUCTIVITY COMMISSION INQUIRY INTO HORIZONTAL FISCAL EQUALISATION

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WESTERN AUSTRALIAN PARLIAMENTARY LIBERAL PARTY

SUBMISSION TO THE PRODUCTIVITY COMMISSION INQUIRY INTO HORIZONTAL FISCAL EQUALISATION

THE CASE FOR REAL REFORM OF THE GST DISTRIBUTION

There is a long and tortuous history to financial arrangements between the Commonwealth and the States. It is a history of arguments between the different levels of government and a constant bickering amongst the States.

Not surprisingly, local politics has impinged on what should be a professional and objective task of allocating financial resources. And while blame may be directed at the States, it is equally true that the Commonwealth has been content to use disagreements amongst the States as an excuse for the lack of genuine reform.

The Productivity Commission Inquiry into Horizontal Fiscal Equalisation is welcome on the presumption it will raise the level of debate on what is a serious issue both for the States and also for the national economy.

So far, most of the public debate has been on the issue of fairness between the States. The Inquiry expands the debate to matters of efficiency and economic growth. While that is welcome, it should be recognised that the equity considerations will remain at the forefront of public and political debate, just as they have been since federation.

For Western Australia the situation is acute with the share of the Goods and Service Tax (GST) revenue falling to a low point of just 30 cents in the dollar and currently being 34 cents in the dollar, while all other States receive somewhere in the range of 89 cents to 181 cents in the dollar. (The Northern Territory is an extreme case, receiving 557 cents in the dollar). The previous lowest relativity for any State was Victoria at 84 cents in the dollar in 1994/95.

For Western Australia the simple reality is that with the current share of GST revenue there is no circumstance under which a budget surplus can be achieved without substantial reductions to Government services both in terms of quantity and quality. Therefore, there is no circumstance under which state debt will not continue to rise.

For 2016/17 the forecast budget deficit is $3 billion while at the same time Western Australia loses $4.7 billion in GST redistribution. If the State received a full share of GST revenue (i.e. 100 cents in the dollar) then there would be a healthy budget surplus of $1.7 billion.

For both the 2015/16 and 2016/17 years the Commonwealth did make some adjustment by providing an additional $0.5 billion to transport projects in Western Australia. While this was appreciated, it did come as tied grants rather than as general revenue. The extra payment was of some assistance, but limited. Also, it should be noted that for 2017/18 Western Australia will only receive 8.7 per cent of Commonwealth transport funding compared to a population share of 11 per cent.

It is easy to dismiss this as just a problem for Western Australia and to try to apportion blame. However, that ignores the likelihood that other States will experience something similar in the future, albeit to a lesser extent. It also ignores the potential impact on the national economy and in particular on the finances of the Commonwealth Government itself.

With the royalty income from mining being effectively taxed out of Western Australia by the system of GST distribution (to the extent of around 90 per cent), there is a reduced incentive to further expand a mining and petroleum industry which already has a value of $95 billion. It is not out of the question that public support for the industry will decline and that calls to 'leave it in the ground' will increase. Indeed, that is already happening. The negative implications for economic growth and Commonwealth tax collections are both obvious and against the national interest.

The other aspect of economic efficiency relates to the sheer complexity of the GST distribution. The system, as administered by the Commonwealth Grants Commission, is a product of decades of rules, new rules and changes to rules. It is both complex and inconsistent and is best described as a 'black box' which few can understand.

As such the process of GST distribution is in itself an inefficiency and waste of resources. To continue with a tinkering of a system which is broken, or at least past its useful life, would represent a failure by this Inquiry. If there is to be reform, then it needs to be fundamental reform which looks forward rather than backwards.

When Prime Minister John Howard introduced the GST in 2001 it was an important economic reform which reduced Australia's reliance on direct taxation by establishing a broadly based indirect tax. It was also a bold reform of the federation by directing that all GST revenue would go to the States in exchange for the States giving up their existing right to share in collections from company and personal income tax. The States also abolished some minor or nuisance taxes as part of the overall deal.

The logic was that the States needed a stable source of revenue to fund the services they provide, principally in the areas of education and health. Those two areas alone account for around half of State expenditures and are directly related to the size of the population in each State. The policy was sound, but unfortunately the implementation has been flawed due to the way in which the GST distribution has played out and hence this Inquiry.

The issue of the GST distribution has not suddenly come upon us. As early as 2009 the then Western Australian Government warned that under the existing distribution system the State's share of GST would fall dramatically. At the time it was at an acceptable level of 85 cents in the dollar. The then Government also acknowledged that Western Australia was a more prosperous state and it had a capacity to support the weaker states. The proposal put forward was that a floor be set at 75 cents in the dollar below which it could go no further. At that stage no state would have been worse off and the critical situation we now face could have been avoided.

Regrettably the Commonwealth Government did not act and successive Prime Ministers and Treasurers continued to say publicly that any such change would require the agreement of all States and that was not in place. Such statements were incorrect as the distribution of the GST is by law a matter for the Federal Treasurer on the advice of the Commonwealth Grants Commission. The role of the States, under the GST legislation, is to require all States to agree to any change in the tax rate of the GST or any change in its coverage (for example to include fresh food). The system of distributing Commonwealth funds to the States was not changed by the introduction of the GST. This misrepresentation of the respective roles of the Commonwealth and the States has been a continuing frustration to Western Australia and has impeded debate on sensible reform.

That frustration has extended to the many inconsistencies in the system. For example, Western Australia is penalised for having a successful mining export industry while other states are effectively rewarded for having a massive gambling industry with all the associated social costs. (Western Australia has a bipartisan position which outlaws poker machines in the state). Another example is that Hobart is treated as being remote even though it is a capital city.

So, what is the fundamental reform that is recommended?

There have been many proposals put forward with most revolving around some variation of a floor or at what level a floor should be. Suggestions have also been made to exempt some portion of mining royalties, or to penalise states that place bans on mining, or to raise the GST rate, or for the Commonwealth to take full responsibility for the Territories, and so on. While each may improve the situation they all face the criticism of just being a further tinkering of a broken system.

In 2012 the States got closer than ever before to a credible way forward. The four big States (New South Wales, Victoria, Queensland and Western Australia) reached a signed agreement that the solution was to allocate the vast majority of GST revenue on a population or per capita basis. Put simply, the bigger the population the more money you got. Together these four States represent around 90 per cent of Australia's population and 90 per cent of Australia's economy. It was also a fundamental recognition that population determined respective state expenditures and that a simple system would be well understood and do away with the complexity and mystique of what we have.

The recommendation of this submission is that fundamental reform of the GST requires, on both equity and efficiency grounds, that the large majority of GST revenues be distributed to the States and Territories on a population (or per capita) basis.

It is worth noting that even under a system of full distribution of GST revenues on an equal per capita basis (i.e. all States getting 100 cents in the dollar) there is still an implicit redistribution because in higher income States the actual collection of GST per person tends to be higher.

This submission does not advocate a full distribution of GST on a per capita basis. It does, however, recommend a large majority be distributed on that basis and that a smaller proportion be distributed along the lines of horizontal fiscal equalisation.

This submission also acknowledges that change takes time. There would need to be a transition period of several years as the existing system evolves into a simpler and fairer per capita distribution. This should be done in such a way that no state experiences a year to year decline in actual GST receipts. It is this context that the Commonwealth could play an effective role in supplementing distributions to the weaker States. The Commonwealth might also take responsibility for the Northern Territory. It is as simple as that.

Some preliminary modelling prepared for this submission indicates that a starting point of 55 cents in the dollar would be appropriate. If that applied as an automatic distribution to all States then it would be the case that no State would need be worse off in terms of the actual dollar amount of GST revenue they received. The remaining 45 cents in the dollar would be distributed in accordance with state relativities as determined by the Commonwealth Grants Commission. Over time the 55 cents in the dollar automatic distribution would be progressively raised. The pace at which this occurs will depend on the growth in the overall GST revenue pool and the preparedness of the Commonwealth to assist.

Allocating GST revenue on a population basis is the fundamental reform that is needed. It would provide financial certainty for State Governments into the future. The transition arrangements, if carefully designed and managed, can also preserve the broad principle of horizontal fiscal equalisation, without seriously compromising economic efficiency or growth.

Economic Impacts

That does lead to the wider issues of the economy. It is a strange situation that the current system of GST distribution would seem to penalise success and reward failure. It is also a perverse situation that the same system exaggerates economic cycles rather than moderates them.

The Productivity Commission Inquiry will no doubt do some modelling of the impact on the national economy, though the results are likely to be modest. The true impact is felt at a State or regional level. The recent experience of Western Australia is an obvious example.

The rapid expansion of a modern China led to an unprecedented surge in demand and price for key commodities. This so-called ‘resources boom’ reached a peak in 2012 with a surge in mining production and investment. For Western Australia this super-cycle will, by the end of the decade, have resulted in a doubling of iron ore production and a trebling of liquefied natural gas

(LNG) production to the extent that the State will be the world leader in both. That is a proud achievement, but it comes at a cost.

The attraction of well paid jobs saw the population of the Western Australia grow by 490,000 people within just a few years. That is equivalent to the entire population of Tasmania. For the State Government that meant more expenditure on education, health, housing, water, electricity and so on. Both the demand for government services and the cost of delivery rose. It also meant more spending on infrastructure in regional areas to support both mining investment and workers. All of that is a good thing and could be accommodated by the strength of mining royalties flowing through to the State Treasury.

When the inevitable collapse of commodity prices (especially iron ore) came in 2014 the flow of royalties dried up, but the demand for government services continued. That is not unusual and could be accommodated. After all, Western Australia has a long history of cyclical growth. What could not be accommodated was that at the exact same time there was a sharp drop in GST revenues. The perverse nature of the system, with its built in three-year lag, meant that the economic downturn was exaggerated and the State Government was forced into a large budget deficit. The GST distribution system had been pro-cyclical rather than anti-cyclical or at least neutral. That has proven to be a true economic cost and a real constraint on economic growth and the future provision of government services. For Western Australia, it was a perfect storm.

Over the longer term there are structural issues which should not be ignored. In particular, it is important for future economic prosperity that there be mobility of capital and labour to growth industries and growth regions. Only through resource mobility can Australia maintain and hopefully enhance areas of comparative advantage in a global economy.

To the extent that the current GST distribution props up weaker states and declining industries it also mitigates against the mobility of capital and labour. In the same context it limits the capacity to support growth sectors though economic and social infrastructure.

The development of the Pilbara region in Western Australia is an obvious example. It has been the State Government which has funded and settled native title claims for industry sites. In the small town of Onslow the gas industry and the State Government have jointly funded a range of support projects including an airport, hospital, water supply, power supply, sports facility, housing and so on. There are many other examples throughout the Pilbara.

In the Kimberley the expansion of the Ord River Irrigation project has only been possible through the State Government investment in major water channels and roads. In this case the Commonwealth did support on social infrastructure.

The point is that such projects are often in remote locations. They simply will not happen in the future unless there is a high standard of economic and social infrastructure and the ongoing funding of services. For Western Australia, the ability to continue to support big projects of national significance is severely limited by the current low share of GST revenues. It is worth noting that the Pilbara alone accounts for 27 per cent of Australia's exports. Western Australia as a whole accounts for 43 per cent of national exports and at one stage over 50 per cent.

For Western Australia it is ironic that the cost to government of these nation-building projects does not get proper recognition in the GST distribution. The irony is even more so given that the major beneficiary is the Commonwealth through company tax, income tax and the petroleum resources rent tax (PRRT). A slowdown or possible reduction in the mining industry has significant implications for future Commonwealth Government revenue.

A final comment could be seen as somewhat political, though it is not intended to be so. Western Australia is a mining and export state. The State accounts for 42 per cent of Australia's mineral production (excluding coal). For the future it is significant that over 90 per cent of Australia's conventional gas reserves are found off the north-west coast. The mining and petroleum industries have long held strong community support. They have also enjoyed bipartisan political support. This can no longer be taken for granted.

Already on the east coast there are bans on uranium mining, bans on fracking, for the extraction of coal seam gas, and a growing campaign against coal mining and coal fired power generation. The same pattern is now emerging in Western Australia. The newly elected Labor Government has announced a ban on uranium mining (though previously approved projects could go ahead) and an intention to ban fracking in the south west.

However, there is a difference in Western Australia. During the recent state election the National Party campaigned for an additional tax of $5 per tonne of iron ore mined. This proposal gained a degree of public support on the basis that many felt the mining companies should pay more in tax. The argument was that given the GST situation a new source of government revenue was needed. It also prompted a sentiment that perhaps the mining industry wasn't such a great benefit to the State after all. This was further supported by the loss of jobs as the mining sector slowed down.

The point is that the effective redistribution of mining royalties to other states through the GST system has reduced public support for mining. A reduction in public support, which is in addition to the growing environmental opposition to the industry, has the potential to see the mining and petroleum industry not achieve its full potential with obvious implications for jobs, export income and tax revenue.

These are some of the reasons why the Parliamentary Liberal Party believes that the time for real reform of the GST distribution system is long overdue. A shift to a sharing of GST revenues on a population (or per capita) basis is not only critical for Western Australia, it is also an important reform for national prosperity. We urge the Inquiry to be bold and to focus on long-term and fundamental reform of the GST distribution system.

ATTACHMENTS

1. Trends in GST Distribution
2. Four State Agreement on GST (2012)

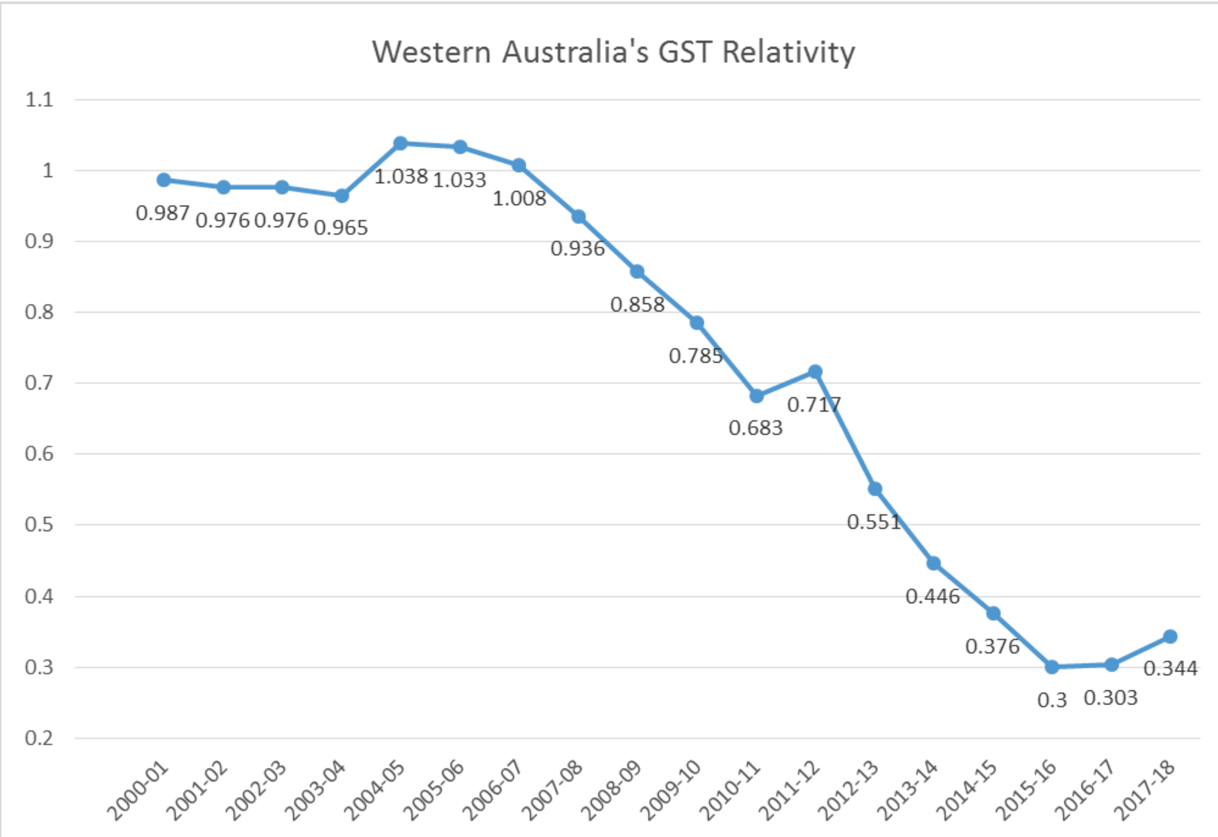
ATTACHMENT 1

TRENDS IN GST DISTRIBUTION

At the time the GST was introduced in 2001 the relativities of the various Sates were broadly in order.

For Western Australia the relativity was set at 98 cents in the dollar. As *Table 1* shows this relativity fell dramatically from 2009 to a level of just 30 cents in 2015 and 2016. It has since improved slightly to 34 cents in 2017.

Table 1



As mentioned, the Commonwealth did try to make some adjustments through extra payments of $0.5 billion in each of 2015/16 and 2016/17. This was argued to increase the relativity to 37 cents in the dollar. This is still an unacceptably low figure. It also came in the form of funding toward specific infrastructure projects (Airport Rail and then Perth freight Link) and as such was a specific grant rather than the untied GST funds. Even with this extra funding Western Australia's share of infrastructure funding was well below other States on a comparative basis. With around 11 per cent of the national population Western Australia received just 7.8 per cent of Commonwealth transport funding.

Some will say that Western Australia should not complain because the state had previously been a beneficiary of the Grants Commission process. In the early years of Federation, Western Australia did get some extra funding but that was primarily on the basis of tariff compensation for the protection of east coast manufacturing and the higher costs that resulted.

What is undeniable is that any past differential in funding has never been on the scale of what is being experienced today. In modern times the previous low point was Victoria in 1994/95 which received just 84 cents in the dollar. That appears generous to the 34 cents in the dollar applying to Western Australia.

State Comparisons for the GST

Table 2A shows the relativities and *Table 2B* shows the actual funding from the GST for each State from 2001 to 2016.

For Western Australia the dollar amount in 2017-18 was almost identical to that for 2000-01. For every other State the dollar amount has increased by a factor of two to three times.

If these figures were adjusted for inflation there would be a real decline in GST funding to Western Australia of some 35 per cent. And given Western Australia's relatively higher rate of population growth over the period a comparison of real funding per capita would show an even greater disparity.

The inequality of the system is blatantly obvious. It is an inequality which is well understood by the Western Australian population.

Table 2A

GST Relativities								
	NSW	Vic	Qld	WA	SA	Tas	NT	ACT
2000-01	0.889	0.845	1.025	0.987	1.204	1.610	4.794	1.171
2001-02	0.902	0.852	1.006	0.976	1.200	1.605	4.615	1.211
2002-03	0.884	0.842	1.017	0.976	1.217	1.682	4.916	1.226
2003-04	0.865	0.842	1.025	0.965	1.240	1.753	5.135	1.234
2004-05	0.835	0.836	1.070	1.038	1.230	1.715	5.003	1.214
2005-06	0.836	0.849	1.057	1.033	1.227	1.704	5.005	1.228
2006-07	0.842	0.875	1.033	1.008	1.208	1.696	5.065	1.229
2007-08	0.864	0.882	1.011	0.936	1.231	1.687	5.096	1.247
2008-09	0.887	0.913	0.962	0.858	1.232	1.663	5.258	1.256
2009-10	0.932	0.919	0.916	0.785	1.247	1.620	5.251	1.271
2010-11	0.952	0.940	0.913	0.683	1.285	1.621	5.074	1.153
2011-12	0.958	0.905	0.929	0.717	1.271	1.599	5.357	1.116
2012-13	0.953	0.921	0.985	0.551	1.285	1.581	5.528	1.198
2013-14	0.966	0.904	1.056	0.446	1.262	1.615	5.314	1.221
2014-15	0.975	0.883	1.079	0.376	1.288	1.635	5.661	1.236
2015-16	0.947	0.892	1.127	0.300	1.358	1.819	5.570	1.100
2016-17	0.904	0.909	1.171	0.303	1.416	1.776	5.284	1.156
2017-18	0.876	0.932	1.187	0.344	1.439	1.804	4.660	1.194

Table 2B

Actual GST paid in the year									
	NSW	Vic	Qld	WA	SA	Tas	NT	ACT	8-States
2000-01	7,258	5,099	4,658	2,375	2,279	988	1,226	473	24,355
2001-02	8,132	5,593	5,019	2,518	2,477	1,060	1,290	544	26,632
2002-03	9,080	6,365	5,888	2,910	2,859	1,247	1,515	616	30,479
2003-04	9,667	6,961	6,553	3,158	3,146	1,394	1,681	658	33,219
2004-05	9,884	7,346	7,329	3,624	3,293	1,435	1,730	680	35,323
2005-06	10,362	7,833	7,689	3,804	3,442	1,496	1,834	723	37,182
2006-07	10,938	8,588	8,092	3,968	3,605	1,568	2,015	778	39,552
2007-08	11,916	9,249	8,549	3,984	3,914	1,665	2,207	846	42,330
2008-09	11,844	9,315	7,972	3,594	3,786	1,595	2,248	835	41,189
2009-10	13,478	10,159	8,242	3,590	4,100	1,648	2,406	906	44,529
2010-11	13,881	10,520	8,321	3,158	4,252	1,653	2,345	833	44,963
2011-12	14,239	10,380	8,681	3,454	4,280	1,660	2,507	837	46,037
2012-13	14,744	10,989	9,470	2,935	4,510	1,729	2,793	971	48,140
2013-14	15,844	11,507	10,896	2,507	4,647	1,819	2,828	1,033	51,081
2014-15	16,896	11,907	11,771	2,262	4,988	1,929	3,223	1,104	54,080
2015-16	17,496	12,872	13,044	1,882	5,573	2,265	3,274	1,041	57,450
2016-17	17,215	13,631	13,995	1,950	5,933	2,259	3,165	1,129	59,240
2017-18	17,554	14,765	14,870	2,327	6,302	2,387	2,908	1,224	62,340

Winners and Losers

Table 3 shows which States receive more of their pro-rata share of GST collections and which States receive less. The winners are the Northern Territory, Queensland, South Australia and Tasmania. The losers are New South Wales, Victoria and Western Australia.

Table 3

$million	New South Wales	Victoria	Queensland	South Australia	Western Australia	Tasmania	Northern Territory	Australian Capital Territory
Per Capita share	20,111	15,862	12,565	4,405	6,818	1,328	625	1,026
2017-18 CGC	17,680	14,829	14,963	6,360	2,354	2,403	2,921	1,230
Difference	-2,431	-1,033	2,398	1,955	-4,464	1,075	2,296	204

The total gains of the winner States amounts to $7.8 billion. In other words, just $7.8 billion out of the total GST revenues of $62 billion. In that sense it is a comparatively small proportion and therefore the ultimate resolution is not as difficult as is commonly assumed.

For the loser States, Western Australia carried the greatest burden with $4.5 billion (or 60 per cent) of the total $7.8 billion redistributed coming from the State. It is also worth noting the huge cost to the overall system of the redistribution to the Northern Territory of $2.3 billion. Again, this makes the case for the Commonwealth to accept a greater responsibility for its own Territory.

The State Treasury has calculated that the $4.5 billion of GST redistributed out of WA accrues to the beneficiary states as follows in *Table 4*.

Table 4

GST Redistribution from Western Australia to the States				
Tas	SA	NT	Qld	Total
$604m	$1,084m	$1,594m	$1,277m	$4,559m

As previously stated, Western Australia can accept support for the weaker states of Tasmania and South Australia. We also recognise the situation facing the Northern Territory, but contend that the Commonwealth should play a greater role for what is a territory of the Commonwealth. It is however, unacceptable that Western Australia should be cross-subsidising Queensland which has both a large population and a strong economy. The Western Australian public fully understand the inequity of this situation.

ATTACHMENT 2

NSW GOVERNMENT

State Government Victoria

QUEENSLAND GOVERNMENT

GOVERNMENT OF WESTERN AUSTRALIA

The Hon Nick Greiner AC, the Hon John Brumby and Mr Bruce Carter
Review Panel
GST Distribution Review
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Messrs Greiner, Brumby and Carter

We have pleasure in providing to the Review of the GST Distribution a joint submission on behalf of the States of New South Wales, Victoria, Queensland and Western Australia.

The submission is provided in response to the First and Second Interim Reports of the GST Distribution Review of March and June 2012 respectively.

We urge you to take this opportunity for bold reform of the GST distribution system so it stands the test of time.

A population based distribution system, with the Commonwealth Government taking responsibility for funding the additional financial assistance required for States with lower fiscal capacity, is the preferred long term policy position of our four States.

This objective may not be achievable in the short term. An interim step is to move away from the Commonwealth Grants Commission's interpretative approach of full, comprehensive equalisation to a system that gives States the capacity to provide a comparable level of service delivery.

Confidence in any system of fiscal equalisation must be built on the imperative that the GST – the largest component of State revenue – remains untied and is distributed in full to the States each year, consistent with the 1999 and 2008 Intergovernmental Agreements.

Yours sincerely

Barry O'Farrell MP Premier of New South Wales	Ted Baillieu MLA Premier of Victoria	Campbell Newman MP Premier of Queensland	Colin Barnett MLA Premier of Western Australia

25 SEP 2012