



MINERALS COUNCIL OF AUSTRALIA

SUBMISSION TO THE PRODUCTIVITY COMMISSION INQUIRY ON HORIZONTAL FISCAL EQUALISATION IN AUSTRALIA

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A PROPOSAL FOR REFORM TO GST DISTRIBUTION ARRANGEMENTS

All states and the commonwealth have signed the Intergovernmental Agreement on Federal Financial Relations. This agreement established that all funds raised from the Goods and Services Tax (GST) will be distributed to the states as untied grants. The agreement further stipulates that the distribution will be in accordance with the principle of horizontal fiscal equalisation (HFE). However, it does not define what HFE is or provide objectives that are to be achieved.

As a foundation of reforming the GST distribution a definition of HFE must be developed along with objectives for what it is intended to achieve. The Minerals Council of Australia recommends that these establish an appropriate balance of equity considerations, incentives for states to develop their economies and stability in state public finances.

The methods to assess and distribute the GST should be re-designed based on the new objectives to remove the perverse incentives that punish states that seek to maximise their own-source revenue or improve operating efficiency in the provision of public services. A priority area for reform 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.

The Minerals Council of Australia proposes that the impact of the mining revenue assessment be discounted in the current GST distribution methods to encourage states to develop their mineral and petroleum resources. Transitional arrangements that lock in a baseline funding year and only apply the new formula to the growth in the GST funding pool could be implemented to ensure that no state is worse off from this policy shift.

The need for GST distribution reform

Economic conditions are rarely uniform within a nation, particularly for larger countries with diverse populations and geography such as Australia. As a result state governments generally have differences in their capacity to raise revenue and in demand for government services such as a healthcare, education and infrastructure. Horizontal fiscal equalisation (HFE) is an inter-regional income transfer system that enables each region to provide the same standard of services to its people. Many OECD countries undertake fiscal equalisation including Australia, Canada, Germany and Norway. However there is no standard approach and most countries implement it in a different way that meets their particular circumstances and desired outcomes.

In Australia the revenue collected from the Goods and Services Tax (GST) is distributed among the states as the principal fiscal equalisation mechanism. This distribution is in accordance with the Intergovernmental Agreement on Federal Financial Relations that was signed by all states and the commonwealth in 2009 (IGAFFR).¹ The IGAFFR states that the 'Commonwealth will distribute GST payments among the states and territories in accordance with the principle of horizontal fiscal equalisation'.² These payments 'will be freely available for use by the states and territories for any purpose'.³ However, the IGAFFR does not provide a definition of horizontal fiscal equalisation, its objectives or how fiscal equality is to be measured. As a result fiscal equalisation in Australian can currently be more accurately described as a process than an outcome. This is a significant void for a policy that is now distributing over \$60 billion per year of funding.

The 2012 GST Distribution Review undertaken by Brumby, Carter and Greiner also identified these definitional issues in Australia's HFE system:

¹ The *Intergovernmental Agreement on Federal-Financial Relations* replaced the previous *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* that was signed by all states in 1999 and agreed the terms of the GST distribution.

² Council of Australian Governments, [Intergovernmental Agreement on Federal Financial Relations](#), Part 4 – Provisions of GST Revenue to the States, Clause 26

³ Ibid, Clause 25

HFE is not strictly defined in any act or agreement, so the CGC has developed its own interpretation, in close consultation with States. While the CGC's definition has the implicit approval of the Commonwealth — which could reject the CGC's advice or specify its own definition of HFE in the CGC's Terms of Reference, but has chosen not to — it has not expressly adopted or enacted it.... it is difficult for the public to have confidence in a system where the goal has not been explicitly endorsed by government. It is therefore important for the Commonwealth to be clear about what HFE is supposed to achieve.⁴

Based on its consideration of Australia's HFE system governance structures the 2012 GST Distribution Review recommended that a definition of HFE be established. However like most of the 2012 GST Distribution Review's recommendations, this has not been implemented and both a definition and objective for fiscal equalisation in Australia remain undetermined.

The lack of policy clarity in the IGAFRR has led to a system of fiscal equalisation evolving over time with no clear objectives for what it is intended to deliver. As custodians of the GST distribution assessment the Commonwealth Grants Commission (CGC) has developed a comprehensive, but complicated, set of policies, rules and calculations that determine the amount of GST funding states should be allocated. This system is not supporting economic growth as the CGC's approach to HFE is producing perverse incentives that encourage free rider behaviour among states. Although unintended these perverse incentives punish states that seek to maximise their own-source revenue or improve operating efficiency in the provision of public services. These incentives have been well documented in a number of economic papers with Garnaut and Fitzgerald presenting a comprehensive discussion in their 2002 discussion of commonwealth-state funding arrangements.⁵

As a starting point for reform a definition of horizontal fiscal equalisation must be developed that establishes an appropriate balance of equity considerations, incentives for states to develop their economies and stability in state public finances. Based on this definition the methods used by the CGC to assess and distribute the GST should be re-designed to reward states that place a greater focus on economic development and efficiency in their delivery of public services.

Mining revenue assessment is a priority for reform

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. This perverse incentive is highlighted by the mining revenue assessment which in the 2017 distribution update report from the CGC reduced WA's GST funding by \$5.5 billion but provided \$2.8 billion to Victoria and \$191 million to Tasmania – both of which have policies that limit, and in some cases ban, the exploration and extraction of minerals and gas.⁶

While the CGC acknowledges that states pursue 'different policies' in relation to minerals development, it claims that it would be too hard to develop a new approach. In its 2015 Review the CGC stated:

We recognise there may be differences in State efforts and there is a conceptual case that any differences in efforts should be removed. However, it is not clear to us how we would quantify those differences. In the case of mining, any differences in efforts would be confounded by the differences in mineral endowments. It would be difficult to untangle these influences and make judgments about the impact of State efforts on production levels.⁷

⁴ The Australian Government, 2012, [GST Distribution Review](#), page 64

⁵ Ross Garnaut and Vince Fitzgerald, 2002, [Issues in Commonwealth-State Funding](#), paper for Australia Economic Review

⁶ Commonwealth Grants Commission, 2017, [Report on GST Revenue Sharing Relativities 2017 Update](#).

⁷ Commonwealth Grants Commission, 2015, [Report on GST Revenue Sharing Relativities 2015 Review, Volume 1 – Main Report](#)

Mining investment is influenced by a broad range of complex state government policies on workplace relations, environmental regulation, royalties, energy, infrastructure and regional development. While it is correct to imply that quantifying the impact of these is difficult it is not impossible to assess and recognise a conceptual difference between state policies in these areas. This is already done in the Fraser Institute's Annual Survey of Mining Companies which provides a policy perception index based on survey responses by company executives on different mineral provinces.⁸ The latest survey clearly shows the differences in policy support for mining in Australia with WA ranked the ninth most appealing jurisdiction in the world (out of 104 regions) while New South Wales ranks 66th (and has slipped from 27th in 2012). The full set of rankings is shown in table 1 below.

Table 1: Fraser Institute policy perception index ranking

	NSW	Vic	QLD	WA	SA	Tas	ACT	NT
2012	27/96	33/96	32/96	16/96	19/96	51/96	n/a	17/96
2016	66/104	42/104	36/104	9/104	21/104	32/104	n/a	22/104
Change	-39	-9	-4	+7	-2	+19	n/a	-5

Source: Fraser Institute

The assessment of states' GST funding must provide an incentive for states to develop their resources. The mining industry not only provides substantial direct economic benefits such as investment, regional employment and higher wages it also supports a significant supply chain of services providers. Research undertaken by Deloitte Access Economics in 2017 concluded the total economic contribution of the mining and mining equipment, technology and services (METS) sector in 2015-16 was \$236 billion which was equivalent to around 15 per cent of the Australian economy.⁹ While all states have the opportunity to participate in and benefit from this supply chain the burden of equalisation of state mining revenues falls on just three states – Western Australia, Queensland and the Northern Territory. Discounting the impact of the mining revenue assessment will provide an economic incentive for all states to participate in resources development with a distribution of benefits that extends beyond the sharing of royalties. Recognising policy differences and adjusting funding transfers is a fundamental step that must be taken in the GST distribution which has placed too much emphasis on attempting to equalise funding outcomes without enough consideration of the range of efforts made by states.

International experience contradicts the view that full equalisation of mining revenues should occur irrespective of deliberate policy choices. Canada, another federation with substantial minerals endowment, has developed an approach which seeks to ensure that policy incentives favour resources development rather than indolence. Under Canadian arrangements only 50 per cent of a province's mining revenues are taken account of in arrangements to determine HFE. In other words, mining revenues are 'discounted' by 50 per cent.¹⁰ This rewards the provinces that develop their mining industries, stimulates productive industries that deliver jobs for provincial residents and reduces the need for handouts from the central government. While a similar discount would be ideal in Australia the impact on the GST distribution would be substantial and present significant difficulties from a policy implementation perspective.

A new proposal

The Minerals Council of Australia proposes that Australia initially apply a 25 per cent discount to the mining revenue assessment in the GST distribution calculations (which includes oil and gas revenues). The use of a discount is not new in CGC arrangements. The CGC already applies a 25 per cent discount to elements of its land tax, health costs and regional costs assessments to adjust for areas of uncertainty.

⁸ Fraser Institute, 2017, [Annual Survey of Mining Companies 2016](#)

⁹ Deloitte Access Economics, 2017, [Mining and METS: engines of economic growth and prosperity for Australians](#)

¹⁰ [Department of Finance](#) (Canada), accessed 28 June 2017

The impact of a 25 per cent discount on the mining revenue assessment on the GST distribution is shown in Table 2. This discount would result in the mining revenue assessment distributing \$4.3 billion of GST in 2017-18, down from the currently proposed \$5.7 billion.

Table 2: Impact of 25 per cent discount on mining revenue assessment on GST distribution (\$m)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
Actual 2017-18	17,680	14,829	14,963	2,354	6,360	2,403	1,230	2,921	62,740
25% mining discount	17,139	14,138	15,008	3,736	6,248	2,356	1,181	2,933	62,740
Impact	-541	-692	45	1,382	-113	-47	-50	12	0

The resulting change in states' relativities is shown in table 3.

Table 3: Relativities with a 25 per cent discount on mining revenue assessment

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Actual 2017-18	0.877	0.932	1.188	0.344	1.439	1.805	1.195	4.660
25% mining discount	0.852	0.891	1.194	0.548	1.418	1.774	1.151	4.693
Impact	-0.025	-0.041	0.006	0.204	-0.021	-0.031	-0.044	0.033

Tables 2 and 3 clearly show there are different short term outcomes for states arising from this proposal. However, in the longer term as states' policies affecting resources development converge their economies, and consequently the Australian economy as a whole, would grow. Previous research commissioned by the Minerals Council of Australia shows that between \$160 billion and \$280 billion of additional GDP could be gained over ten years if policy settings were more supportive of starting new resources projects.¹¹

There are economic gains to the economy from encouraging more mining investment but there are short-term fiscal impacts for states that need to be considered. To manage short term impacts a transitional arrangement could be implemented that minimises the losses to states while they adjust their resource development policies.

A 25 per cent discount with a 'safety net'

One option for implementing the 25 per cent discount is to impose a floor on the GST distribution to every state and use the growth in the total GST funding pool to gradually increase the GST revenue being distributed to the states that benefit from the mining revenue discount. Under this option some states would forgo some of the growth in their funding (under the existing distribution method) but they would not face an immediate cut in their funding as part of the transition to a system that has removed the perverse incentive that punishes a state that develops its natural resources and rewards those that do not.

Table 4 demonstrates how this funding floor could work. It guarantees all states the actual GST distribution for a baseline year (2016-17 in this example) and the distribution that would occur if the 25 per cent discount on the mining revenue assessment were implemented. The floor works by giving each state except WA the amount that is the highest out of its previous year's funding or the funding it would receive under the distribution with a 25 per cent discount on the mining revenue assessment. The balance between the sum of the state distributions and the amount available in the total funding pool is then the GST distribution that WA receives.

¹¹ BAEconomics, 2014, [The economic gains from streamlining the process of resource projects approval](#).

Table 4: Implementing a floor on GST funding distribution (\$m)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
Actual 2016-17	17,419	13,742	14,075	2,008	6,000	2,278	1,175	3,190	59,887
25% mining discount on 2017-18	17,139	14,138	15,008	3,736	6,248	2,356	1,181	2,933	62,740
Safety net	17,419	14,138	15,008		6,248	2,356	1,181	3,190	59,539
Balance to WA				3,201					
Final distribution	17,419	14,138	15,008	3,201	6,248	2,356	1,181	3,190	62,740
Relativities	0.866	0.891	1.194	0.470	1.418	1.774	1.151	5.104	

This transition plan is effectively a means of distributing the growth in the GST funding pool each year in way that provides a safety net for each state so that it can be no worse off relative to the previous year. As states respond to the incentive to develop their resources industries they would then retain more of the royalties and become less reliant on the GST distribution. Alternatively, states could implement policies to support their involvement in the broader mining supply chains and still receive some economic benefits.

Under this distribution method no state is worse off than they were in the base year, which in this example is 2016-17. However, some states have not received the increases in funding they would have had if the mining revenue assessment discount were not applied. Table 5 shows these states tend to have a less supportive set of policies for developing resources projects. At the same time the new distribution method would motivate these states to encourage development of their natural resources and to attract investment in related industries.

Table 5: Impact of mining revenue discount and funding floor (\$m)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
Original 2017-18	17,680	14,829	14,963	2,354	6,360	2,403	1,230	2,921	62,740
Discount & floor	17,419	14,138	15,008	3,201	6,248	2,356	1,181	3,190	62,740
Impact	-261	-692	45	847	-113	-47	-50	269	0

The bottom line

The GST distribution is an area of fiscal policy that must be addressed to deliver a fairer stream of funding for states who take greater responsibility for developing their economies and delivering services more efficiently. There are many areas of the fiscal equalisation system that require reform but particular consideration must be given to the impacts of state mining revenues – especially given Australia’s distinctive position as an advanced economy with a pronounced comparative advantage in resources exports.

The mining industry has been one of the principal drivers of economic growth in Australia in the 21st century. However, not all states have sought to benefit from the opportunities the mining industry offers with equal vigour. Excessive regulation has stifled project development in several states and in some cases states have even placed outright bans on exploration and extraction. Despite these differences in policy approaches, the revenue proceeds from the states that have supportive mining policies have been distributed to states that limit mining activity.

As a starting point, a definition of horizontal fiscal equalisation must be developed that specifies what its objectives and intended outcomes are. This definition should underpin an improved GST distribution that still provides states with the capacity to provide services but must also acknowledge the need for them to take a greater role in their own prosperity by incentivising economic growth. The treatment of mining revenues in such a system must change to address the perverse incentives which effectively penalise states that develop their minerals endowment and reward those who don’t. The Minerals Council of Australia proposes to apply a 25 per cent discount on the impact of the mining revenue assessment to recognise the differences in the broad suite of state policies that affect the

development of their resources. Under this proposal, states would no longer be rewarded for doing so at the expense of states who adopt policies to promote their mining sectors and, hence, their own regional economies. This would reduce the extent to which horizontal fiscal equalisation, as currently implemented by the CGC, is inadvertently hindering regional and national economic growth.