



SUBMISSION TO THE PRODUCTIVITY COMMISSION

Horizontal fiscal equalisation

Chamber of Commerce and Industry of Western Australia

SUMMARY

The principle and scale of horizontal fiscal equalisation (HFE) of Australian states and territories has significantly reduced incentives for national economic growth and has diminished GST revenue stability for the leading state. Reforming the distribution formula of the GST is in the national interest and can stimulate national economic growth. A multi-faceted solution is proposed that grows the GST pie over the long term and leaves no state worse off in the next two years.

THE PROBLEM

HFE raises the service delivery capacity of each state up to that of the leading state, before distributing any remaining GST equally on a per capita basis. This equalisation diminishes incentives for states to make difficult political and policy decisions that promote economic development, because they know they will receive a significantly diminished amount of GST if their state-based revenue increases through the development of under-utilised industries. Recipient states know that they will always have their capacity to deliver services raised to the leading state's level through GST distribution, regardless of their own industry development efforts.

PROPOSALS

The Chamber of Commerce and Industry of Western Australia (CCIWA) proposes that the GST be reformed to create greater incentives for states to contribute to national economic growth. The models proposed include partial equalisation (reducing the overall distribution between states by either discounting a portion of revenue or equalising to a pre-determined level of acceptable services) and the 'Alberta model' of excluding a portion of mining royalties. These proposals ensure that every Australian citizen lives in a state that has the capacity to deliver an acceptable standard of services, while also restoring strong incentives for states to promote economic development.

RECOMMENDATIONS

CCIWA's recommendations will create GST revenue stability for the leading state and strengthen incentives for all states to fully develop their industries and boost national economic growth.

1. Immediately introduce a 0.70 ratcheting relativity floor for all states. The floor should be introduced at WA's current relativity and increased each year WA exceeds that floor, until the floor reaches 0.7. Based on WA Treasury relativity forecasts, no state's GST relativity would be impacted as a result of the floor in the next two years.
2. Implement partial equalisation over a transition period to strengthen incentives for states to develop their industries. This can be phased in over time and will stimulate national economic growth, growing the GST pie.

ABOUT THIS SUBMISSION

This submission is made on behalf of the business community in Western Australia. The Chamber of Commerce and Industry of Western Australia has more than 9,000 members who employ more than 300,000 people. A full list of industry groups who support this submission can be found on the signing page.

This submission will address how the current GST distribution principle of HFE has removed reliability in GST revenue and has substantially weakened economic growth incentives for state governments.

CCIWA does not believe the current WA budget deficit or debt is attributable to the existing GST distribution model. This submission acknowledges that WA governments have consistently increased spending beyond revenue growth against a backdrop of falling GST revenue forecasts produced by WA Treasury, and it is this overspending that has led to the current structural deficit. It is recommended that the Productivity Commission also separate the issue of WA state finances from this review of the GST by focusing on economic growth.

HORIZONTAL FISCAL EQUALISATION HAS MERIT

The principle of horizontal fiscal equalisation has merit. It ensures every person living in Australia has access to an acceptable standard of service delivery capacity as provided by the leading state, regardless of where they live. It takes into account natural challenges faced by each state, called disabilities, (i.e. differences in costs of delivering services) and natural advantages in revenue (i.e. presence of natural resources). The principle of having an acceptable standard of service delivery across the nation has served Australia well and is a fundamental principle of federation. HFE has also been adopted around the world with varying degrees of equalisation.

A key feature of HFE is that each state's determination of capacity be policy agnostic, meaning no state should be rewarded or penalised for the policy choices of their state government. This is important to avoid incentives for states to 'game' the system to attract more GST by lowering taxes – HFE achieves that goal to some extent, but the unintended bi-product of this approach is that if a state makes a policy decision to prevent development of a resources sector, the GST system ignores this decision and the potential revenue it could bring, and concludes the state must need more GST.

The original intent of HFE is unintentionally producing perverse incentives for state governments which hinders national economic growth. While HFE and full equalisation are intended to promote equality and prosperity across the nation, their application has extended far beyond the original intent, with vastly greater redistribution occurring than was originally envisaged. A more optimal outcome can be achieved by equalising less and incentivising growth more.

CCIWA believes the GST system can be adjusted to increase economic growth whilst maintaining the original intent of HFE, which is to ensure an acceptable level of service delivery standard for each state can be achieved. Reforming the GST system to re-introduce incentives for states to develop their industries will stimulate new business growth and job creation, spreading greater prosperity across the entire Australian community.

National economic growth brings with it prosperity that is shared by all Australians. Prosperous and growing Australian businesses create jobs, new technology and improve economic productivity which benefits all.

It is more important that Australia's businesses and overall economy are strong than it is for each state to have absolutely the same capacity as the leading state – it is economic growth and productivity that drives increases in prosperity, not equality in service delivery capacity. The GST distribution is only a zero-sum game in any given single year but not over the long run. By equalising the states to a lesser degree, national economic growth can be stimulated and the GST 'pie' can be grown incrementally larger.

UNDERSTANDING FULL EQUALISATION

The size of the equalisation task is growing

as states begin to diverge in capacity. The potential growth of some states is higher than others, which can be due to a combination of both natural and created competitive advantages such as geography, natural endowments or industry development. What is clear is that the scale of redistribution is growing over time as the potential growth rates of states diverge.

There are two ways to view the current process of GST distribution, which describe the same method in separate ways.

1. Equalising to the 'average'

"GST revenue is first distributed on a population basis, raising the fiscal capacity of all states equally. Then there is a redistribution to achieve equalisation – from states with above average capacity to those with below average capacity."¹

2. Equalising to the leading state

"GST revenue is first distributed to bring the initial fiscal capacities of all states to that of the strongest. The remaining GST is then distributed equally among all states."²

To understand how the GST distribution has created perverse outcomes and substantially weakened incentives, it is best to consider the distribution method in the second way – equalising to the leading state. The task and scale of equalising states to the leading state's capacity via GST is depicted below:

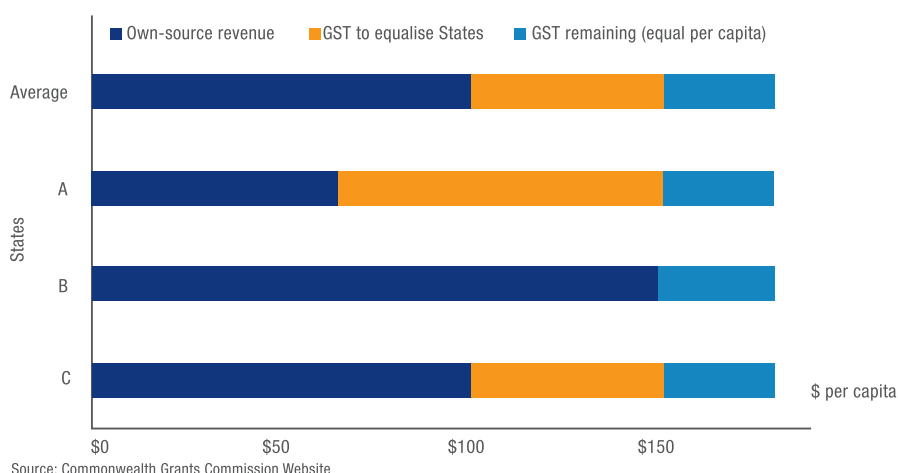


Figure: Simplified depiction of GST distribution

¹ 2017 Commonwealth Grants Commission Report

² 2017 Commonwealth Grants Commission Report

THE PROBLEM WITH FULL EQUALISATION

HFE attempts to be policy agnostic by ignoring the actual taxation of a state's revenue base and instead applying the national average rate to each state's revenue base. This approach achieves policy neutrality of taxation rates, but fails to consider the role of state government policy in promoting or even allowing the development of the state's revenue base. In other words, the role of government policy impacting industry development is ignored.

As a result, if one state strengthens its revenue base through development of industry it will lose GST. This signaling to state governments has weakened the incentives for states to develop all sectors of their economies. The incentives that once existed for states to promote economic activity so the overall state economy (and national economy) would flourish, have been diminished by the GST distribution – state governments no longer significantly benefit from major growth of their own industries.

For example, by WA Treasury estimates, around 85-90 per cent of any marginal increase in mining royalties are offset by an equal loss in GST revenue.

As one state grows its own revenue capacity through industry development (rather than increased taxes), it only retains a small proportion of that increased revenue. This means that smaller states have a reduced incentive to develop industries that would generate large revenue to their state – particularly if developing said industry would present a political risk.

Considering this, it is difficult to see why any state government that receives a large proportion of its revenue from GST would be inclined to pursue such industry development, knowing that their GST share would diminish if that industry was successful.

HFE SYSTEMATICALLY REDISTRIBUTES FROM HIGH TO LOW PRODUCTIVITY ECONOMIES

The GST distribution has facilitated a consistent redistribution away from high potential growth states – which are actively

growing their economies and strengthening their own source revenue– to lower potential growth states. The result is a loss in national productivity from forced redistribution into low growth sectors of the economy.

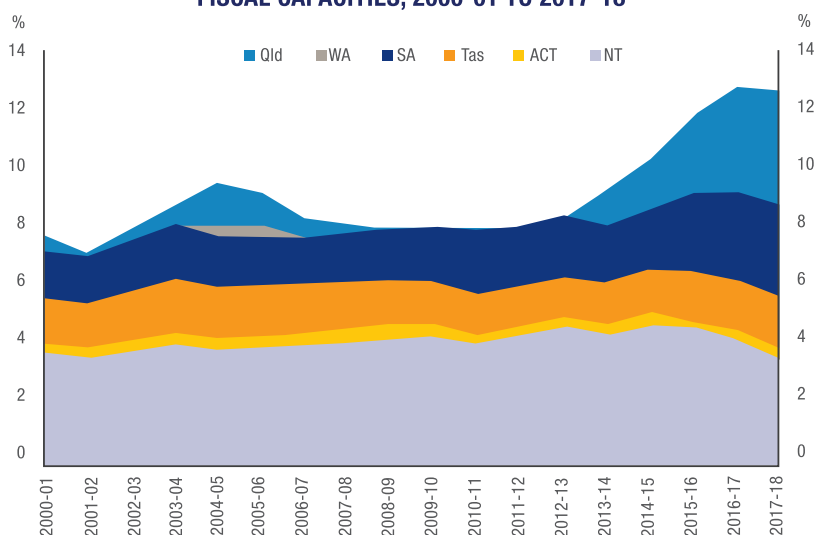
The consistency of redistribution through the GST can be viewed over time since the introduction of the GST in 2000. It can be seen through the sustained distribution away from one set of states towards others.

The Australian Capital Territory, Northern Territory, South Australia and Tasmania are consistent recipients of GST. Queensland is the only state (since the introduction of the GST) that swings between recipient state and contributing state.

New South Wales, Victoria and now Western Australia are consistent net contributors to the GST pool.

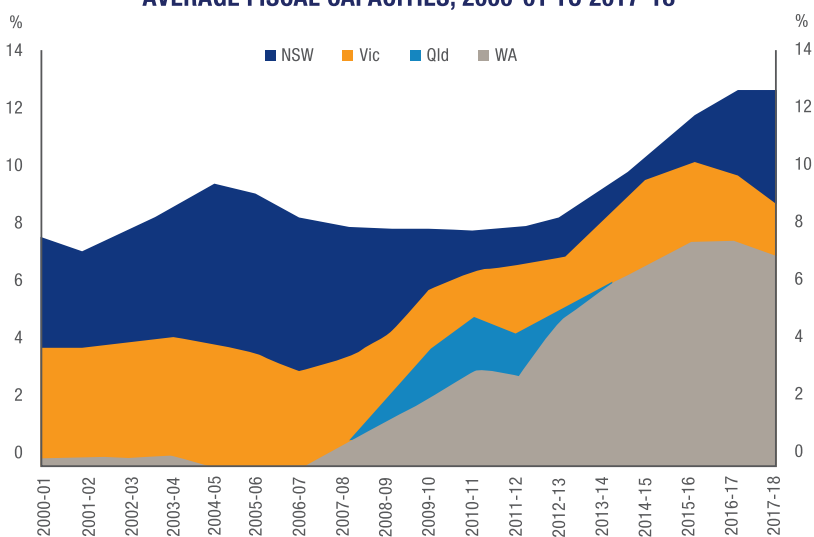
This consistent redistribution completely dispels the notion (and belief of many Australians) that the GST exists to support states as their economies fluctuate through cycles, and that states and territories oscillate between givers and receivers. As their economies move through economic cycles, they fluctuate from net givers to receivers. While the scale of redistribution alters slightly during the cycles, the status of net recipient or contributor does not alter for every state, except Queensland (and WA for a short period).

PROPORTION OF THE GST REDISTRIBUTED TO STATES WITH BELOW AVERAGE FISCAL CAPACITIES, 2000-01 TO 2017-18



Source: Commission calculation

PROPORTION OF THE GST REDISTRIBUTED FROM STATES WITH ABOVE AVERAGE FISCAL CAPACITIES, 2000-01 TO 2017-18



Source: Commission calculation



RELIABILITY AND STABILITY OF GST REVENUE

All states depend on the GST as a source of revenue – when the GST was introduced, it coincided with the removal of several state taxes. The states shifted their reliance from their own consumption taxes to that of the GST, with the acceptance that GST revenues would vary slightly from time to time but would be dependable. It was not foreseen that the scale of redistribution between states would be so vast as it is now.

Nor was it foreseen that as states diverged in capacity, the leading state may receive no GST at all. As the leading state increases its capacity to deliver services more than other states, it is possible that the scale of equalisation task becomes so vast that in the process of raising other states to the leading state's capacity, there is no GST left to distribute to the leading state.

WA came close to a single year relativity of 0.0 when its GST relativity was calculated to be 0.085 for the year of 2013-14. It is likely that as states continue to diverge that relativities of 0 will become a reality for leading states.

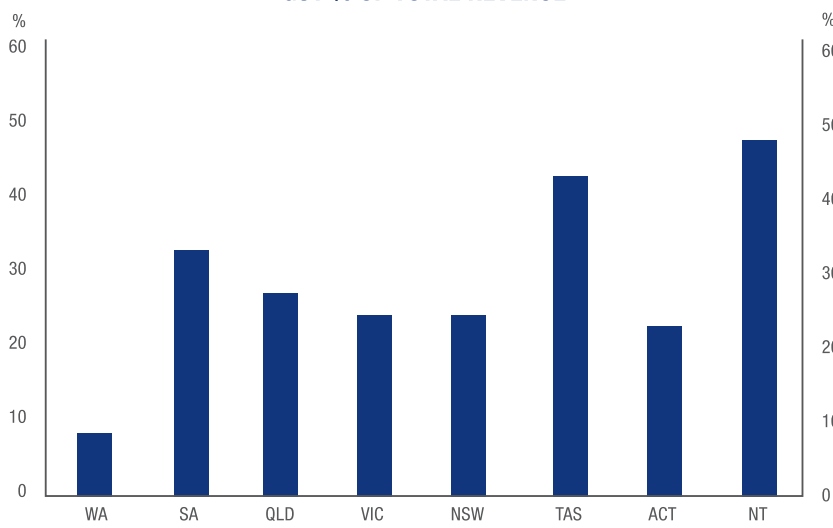
GST TAX REFORM

Tax reform of the GST will be hindered by the leading state if it remains at risk of extremely low relativities.

Incentives for low GST-relativity states to support the broadening of the GST base and increase of the GST rate have been weakened because the benefits of reform would not be shared by those states. In the extreme, any state with a GST relativity of 0.0 would have no incentive at all to participate in tax reform, since none of the proceeds would flow to that state.

Over a 15-year period since the year 2000, more than \$13.9 billion was redistributed away from WA compared to its equal per capita share.

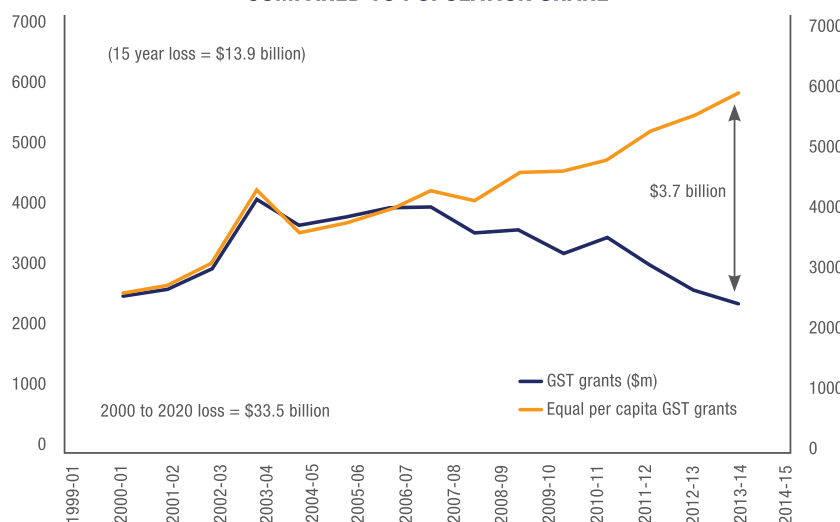
GST % OF TOTAL REVENUE



Source: 2015-16 State Budgets

THE SCALE OF REDISTRIBUTION: WA

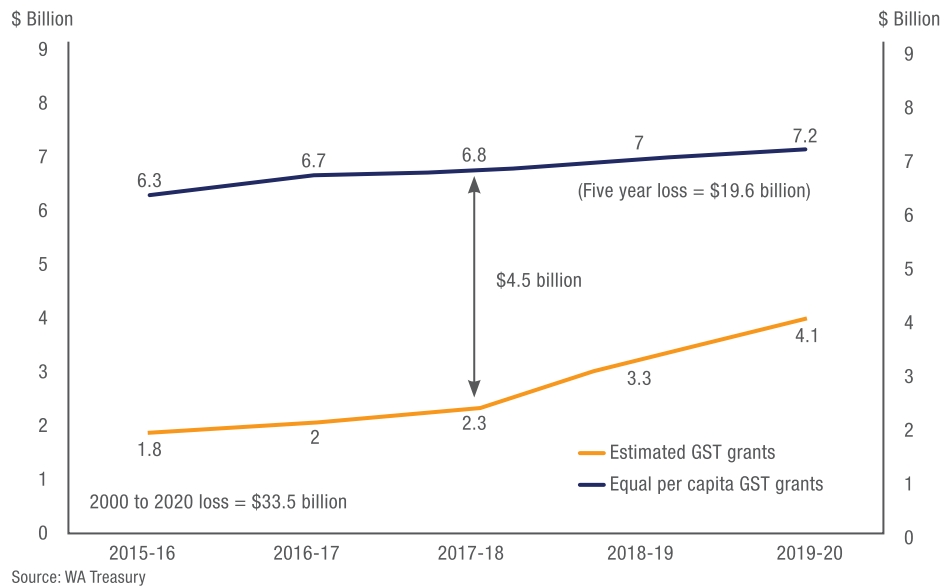
LOSS IN WESTERN AUSTRALIA'S GST GRANTS COMPARED TO POPULATION SHARE





Over the five year period from 2015-16, a further \$19.6 billion is expected to be redistributed away from WA. Between 2000 and 2020, a total of \$33.5 billion will be redistributed from the high-growth state of WA to the rest of the country.

LOSS IN WESTERN AUSTRALIA'S GST GRANTS COMPARED TO POPULATION SHARE



WESTERN AUSTRALIA'S RETENTION OF ROYALTIES AFTER ASSOCIATED GST LOSSES

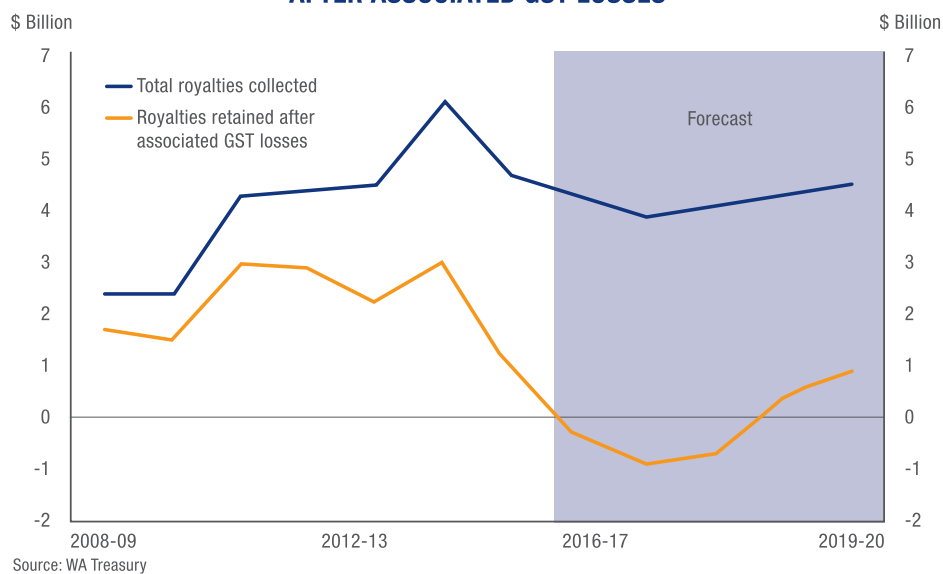


Figure: WA's revenue windfall eliminated by GST redistribution



MINING ROYALTIES – AN ERROR IN POLICY NEUTRALITY

Mining royalties account for the clear majority of GST revenue redistribution between states. This is simply because WA has significantly higher production of natural resources than any other state. The current formula considers New South Wales and Victoria to have very low potential for resource royalties.

A key flaw in the HFE calculation is in considering resource royalty potential – the approach to HFE adopted by Australia's Commonwealth Grants Commission (CGC) only considers actual production of resources, ignoring the revenue potential of resources blocked by policy. This is not consistent with the policy-agnostic approach to HFE demonstrated in relation to other areas of state revenue – it fails the policy neutrality intention because

state government policy can block production of industries, with no consequences to that state government's GST revenue.

A state government policy decision to exclude an entire industry blocks any production of that resource and therefore no revenue potential from that sector is considered. The formulae only looks at actual production when considering the revenue base, not potential production. The policy neutrality is achieved in averaging the tax rates across the country, but not the potential production of each state.

While it may seem obvious to consider natural resource reserves as the new base of potential production, doing so would introduce even more problems, given the complexity of determining these reserves and the impact that policy decisions have on exploration activity and therefore resource reserve identification. A state that has a policy to block production of a resource will have a significantly lower

level of exploration activity, which directly impacts the reserves identified in that state.

The current 'policy agnostic' process concludes that a statewide moratorium on developing a resource means there is no potential revenue possible from that banned resource, which is an incorrect assessment.

The current assessment of mining royalties does not achieve the policy agnostic test applied to other sources of state revenue.

The states of New South Wales and Victoria would receive less GST if government policy changed and development of on-shore gas was encouraged and fully developed. In this instance, government policy is directly responsible for an increased share of GST and the incentive to develop this revenue base is therefore weakened.

This approach rewards states that leave their natural resources undeveloped with additional GST because, unlike other taxes, the potential production is not identified by the CGC.

REVENUE FACTORS CAUSING DISTRIBUTION 2017-18



Source: Commonwealth Grants Commission



GST AND GOVERNMENT DECISION MAKING

No decision of government is made in isolation – a responsible government will consider the full range of consequences from any significant policy decision including its impact of government revenue streams. For this reason, it is unreasonable to expect any state government has taken a decision on the sole basis on GST revenue impact.

What is conceivable however is that a government would have less incentives to tackle a politically-sensitive policy decision that promotes economic growth, if that decision would reduce their state's GST revenue. If a political battle was required to bring a new industry on stream, but that industry's increased contribution to government revenue would mean a

reduction in GST, the political will has been reduced by the GST distribution method.

Coal seam gas is a contemporary example, given it has been banned or hindered by policy in both NSW, VIC and NT. Its emergence as an issue is also after the 2012 Greiner & Brumby Review was published, giving the GST review a new major policy impact to consider.

NSW, VIC and NT have both blocked on-shore gas industry development – either through moratoriums or lack of government support – which has caused these industries to flounder. Not only has this caused a significant shortfall in gas supply to the east coast, but it has not resulted in a reduction in GST revenues to those states.

While it is clear that the decision for those states to ban (or actively not support) the on-shore gas industry has been greatly influenced by environmental

activism, the incentive for industry development has been removed. When considering removing a ban of on-shore gas and the political battle that would be required, the government would also consider the net impact of revenue to the state – including the impact removing the ban would have on their GST share.

The Treasuries of these states will likely have each forecasted the incremental impact of a thriving onshore gas industry on their state government's revenues over the forward estimates.

These estimates would show a significantly increased rate of mining royalties, at the expense of subsequently falling GST revenues. This dampens the political will of states to promote industry development because the two together negate much of the benefit – industry development in this instance would generate prosperity through jobs, lower gas prices and more productive industries.

PROPOSALS FOR REFORM

Reform proposals can address the two key issues with the GST distribution under full equalisation of HFE. The first is the lack of stability in GST revenue for the leading state. The second is the weakening of incentives for states to fully develop industries in their economy.

It is important to separate out these two issues as they both need to be addressed by separate reforms.

1. CREATING STABILITY AND PREDICTABILITY

A ratcheting relativity floor

A relativity floor ensures a minimum GST relativity for each state. It provides stability and predictability in the distribution for the leading state, which allows for better long-term planning in states that have strong but volatile own-source revenue (such as WA). It also creates greater incentives for the leading state to agree to GST tax reform, who will have no incentive to agree to spreading the GST base and increasing the GST tax rate if they know the vast majority of the increased funds will be redistributed away from their state. A floor would also ensure that capital remains in the highly productive leading state for re-investment, rather than being redistributed to other states.

The floor could be introduced incrementally, following the current relativity of WA. As the relativity of WA recovers, the floor should be set at WA's current level or at the highest level since the floor was introduced, up until the year that WA exceeds 0.7, at which time the floor should be set at 0.7.

With a floor in place, any state that has a relativity calculated below the floor would be distributed GST first to raise that state's relativity up to the floor. Distribution of the remaining GST would then continue as per usual, raising the weaker states to the leading state's capacity, followed by equal per capita distribution. The Federal Government would not be responsible for funding the gap between a state's relativity and the floor. In recent times, the Federal Government has handed out GST revenue 'top-ups' to Western Australia, given its low GST

relativity – this would not need to occur with a ratcheting GST relativity floor.

The proposed floor is in fact funded by the leading state's own redistributed GST. A floor is not funded by the other states. It simply limits the scale of redistribution that occurs under the existing system.

Based on the current WA Treasury estimates of GST relativity, no state would be worse off (compared to the existing arrangements, over the next two years) from the introduction of a ratcheting floor.

A floor also re-instates strong economic growth incentives for states that are at risk of relativities below the floor itself. It also ensures that no state will have their GST revenue collapse, as other revenue sources grow significantly.

2. STIMULATING ECONOMIC GROWTH

Three options are proposed that each restore strong incentives for economic growth.

Partial equalisation to a pre-determined acceptable level of services

Rather than equalising all states to the leading state's capacity each year, all states should be raised to a pre-determined level that represents a minimum standard of acceptable service delivery. This should be a moving level of acceptable services so no state is left behind. The standard could be determined by the pre-GST distribution average of service delivery capacity of all states.

This model ensures everyone living in Australia has access to a minimum level of services while encouraging states to develop their own industries to make up for the missing GST revenue and get 'ahead of the pack'. This is a trade-off in equalisation for prosperity through economic growth.

Partial equalisation by excluding 20 per cent of revenue

All states can be fully equalised on their differences in service delivery costs. This accounts for differences in geography,

demographics and other cost factors outside the control of the government.

Reducing the revenue equalisation by 20 per cent acknowledges that some revenue sources are outside the control of the state government, such as natural resource endowments. It also reinforces that state government's play a significant role in industry development, which is undervalued in the current system and can be encouraged.

Excluding 20 per cent of revenue from the GST calculation would allow states to keep more of the revenue they generate from industry development, which strengthens the incentive to develop industries and foster economic growth.

The Alberta Model: excluding 25 per cent of mining royalties

Canada has implemented a model that excludes a portion of mining royalties from their equivalent fiscal equalisation calculation. Adopting this model in Australia would address two issues:

- The first is the substantial weakening of incentives to develop natural resources within a state. It addresses this by allowing states to keep more of the resource royalty revenue they generate whilst not rewarding states who do not develop their natural resources with additional GST.
- The second is the failure to achieve policy neutrality in calculating a state government's policy impact on an industry, and the subsequent determination of revenue capacity. It addresses this by discounting the current revenue assessment and acknowledging the impact government policy has on the base.

Canada has excluded 50 per cent of mining royalties from their equivalent calculation which has created strong incentives for growth that could be adopted by Australia.

This submission suggests that 25 per cent of mining royalties would strengthen incentives significantly for states to prioritise resource industry development.



REFORM PROPOSALS NOT SUPPORTED BY CCIWA

Reinstating gambling to the calculation

There is a mistaken view that re-instating gambling revenue in the calculation would increase WA's share of the GST. Gambling revenues are currently assessed on a 'per capita' basis, meaning they have no substantive impact on the distribution of the GST.

Prior to excluding gambling revenue from the GST calculation (introduced in 2010), a state's revenue raising capacity from gambling was calculated by considering the average gambling rate and a state's average disposable household income.

Re-introducing this measure would mean states with a high average disposable household income would receive even less GST, due to their perceived higher capacity to raise gambling revenue. Gambling can cause significant issues for communities and can have an overall negative social impact on society.

Gambling revenues should not change in the assessment.

IMPLEMENTATION PROPOSAL

It is proposed that the GST be reformed in two stages to address stability in the system and restore strong incentives to

encourage national economic growth. No state would be worse off under this proposal in the next two years.

1. Ratcheting relativity floor of 0.7 (stability) – implemented immediately

A ratcheting floor should be introduced immediately. The floor would be introduced at WA's current relativity in 2017-18 and be raised in every year that WA's relativity exceeds the floor, up to a relativity of 0.7. On current forward projections of WA's GST relativity, no state would be worse off in the next two years. All states would continue to share the prosperity of WA's resources into the future while the predictability of revenue and confidence in the GST system would also be rebuilt for Western Australia.

2. Partial equalisation (economic growth) – implemented after the Productivity Commission reports

The CGC should be directed by the Federal Treasurer in the next Terms of Reference to transition from full horizontal fiscal equalisation to partial equalisation. This should take the form of one of the three options proposed in this submission: equalising to a pre-distribution average; excluding 20 per cent of revenue from the calculation or excluding 25 per cent of mining royalties. Each of these methods would incentivise national economic growth over the long-term.

Partial equalisation could be progressively introduced over a transition period of 5-10 years, allowing state governments to adjust budgets and revenue expectations over the cycle.

HOW A CHANGE WOULD TAKE EFFECT

Floor - immediately

A ratcheting floor could be announced by the Federal Government immediately and can be implemented by the Federal Treasurer directing the CGC through the CGC's next annual Terms of Reference. This measure is outside the terms of reference of the Productivity Commission's review, given it addresses political stability of the system rather than national economic growth or productivity. As such it should be announced immediately.

Agreement from COAG is not required.

Partial equalisation - 2018

The transition to partial equalisation should be announced by the Federal Government after the Productivity Commission has released its final report. The Federal Treasurer can direct the Commonwealth Grants Commission to apply a partial equalisation model in the CGC's next Terms of Reference.

Agreement from COAG is not required.

This submission is signed by: CCIWA Chief Executive Officer

Deide Hillenst



This submission is further supported by the following Western Australian industry associations who represent WA business:



CONTACT

Further details regarding this submission can be obtained by contacting the Chamber of Commerce and Industry of WA.

MEDIA CONTACT

Kate Hodges – 0448 928 227

SUPPORTING DOCUMENTATION

IMPACT ON 2017-18 GST DISTRIBUTION FROM PROPOSALS DISCUSSED IN THIS SUBMISSION

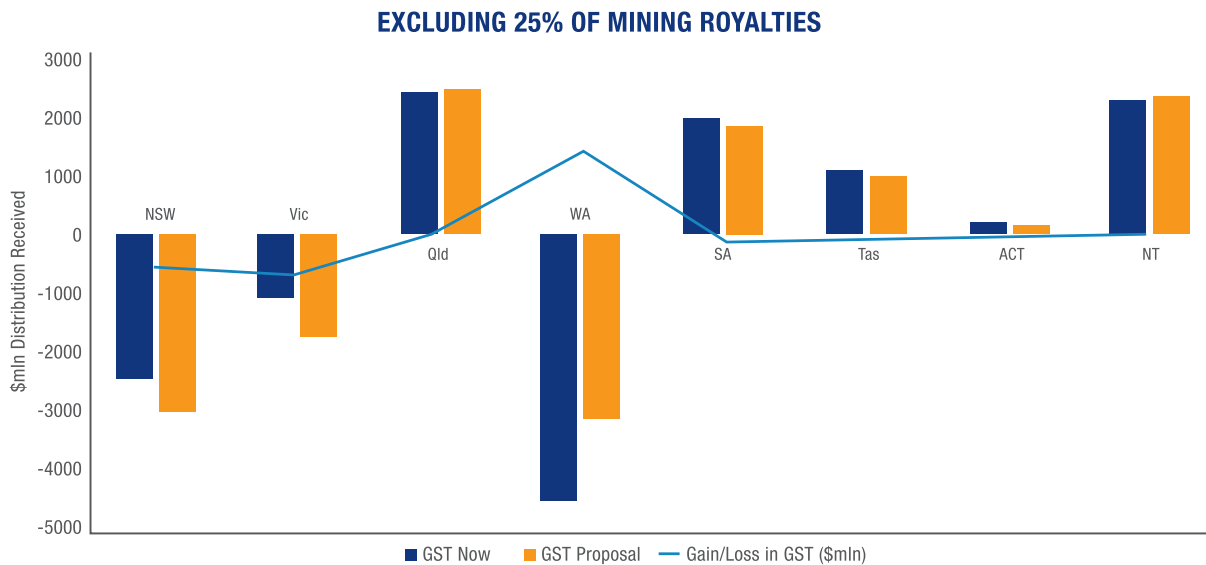


Figure: The Alberta Model

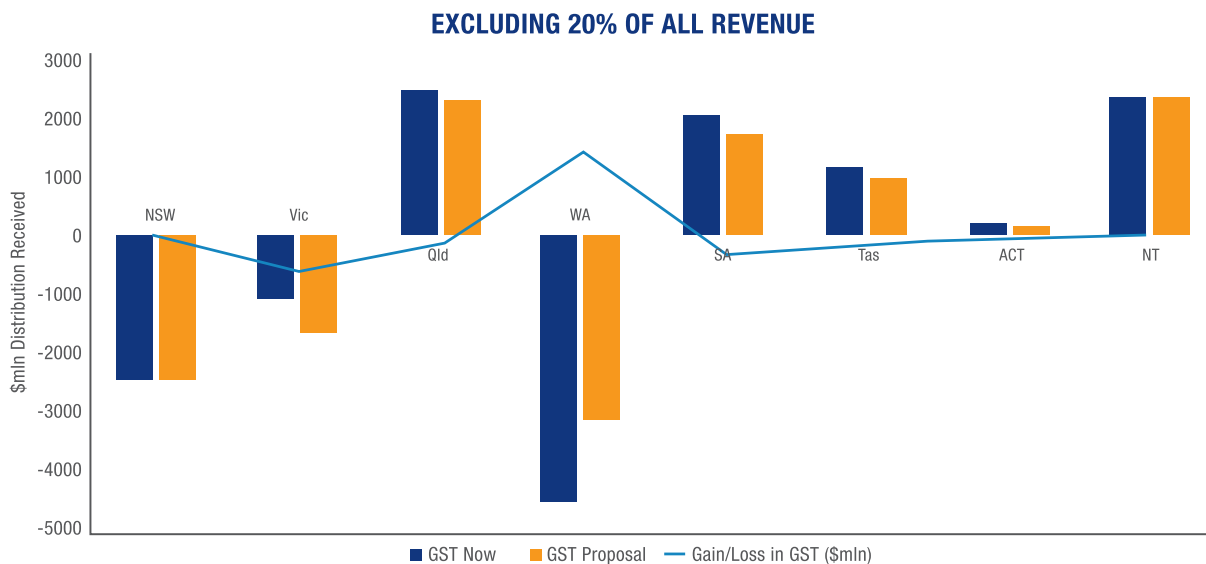


Figure: Partial Equalisation

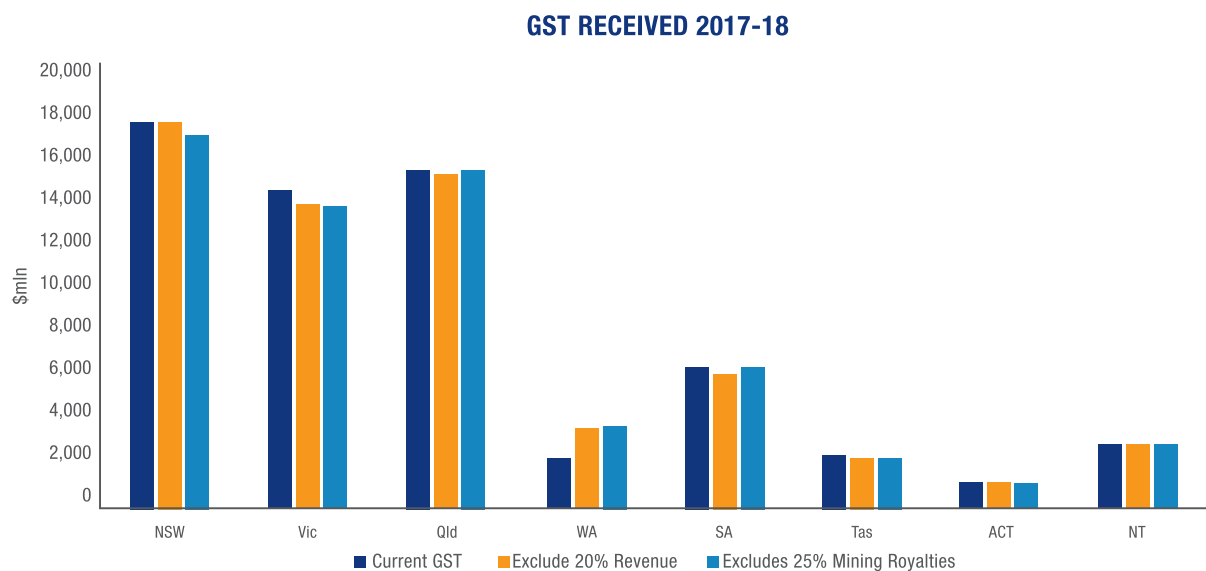


Figure: Impact of proposals on absolute GST distribution

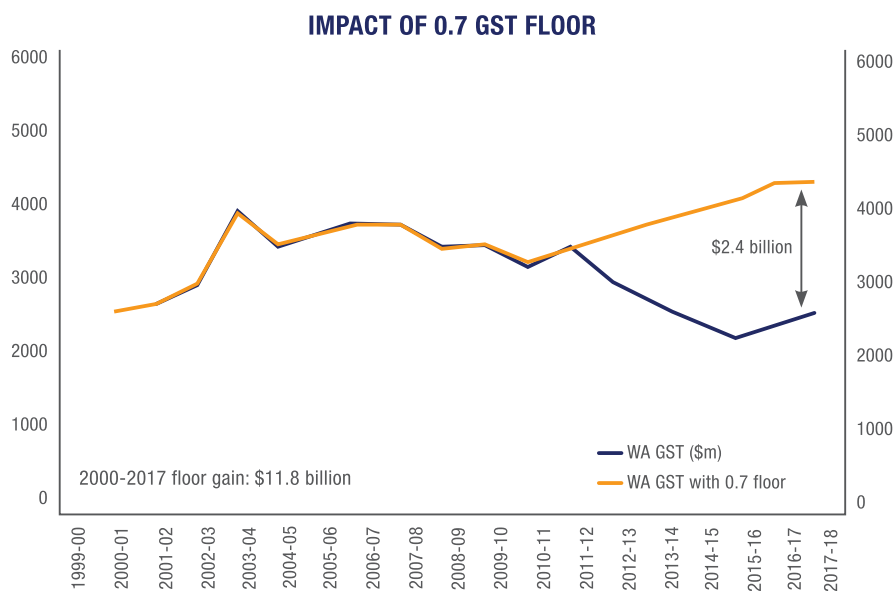


Figure: Impact of 0.7 relative floor on WA's GST receipts