Response to Productivity Commission Draft Report on Horizontal Fiscal Equalisation

The Minerals Council of Australia (MCA) welcomes the Government's decision to refer the current system that underpins the distribution of the GST to the Productivity Commission. The GST is a pillar of the Australian taxation system and the distribution of the revenue it collects is a major source of states' revenue. It is therefore imperative that this revenue is allocated in the most efficient way to benefit the whole Australian economy and to ensure equity among citizens in the level of public services they receive.

In its submission to the inquiry the MCA highlighted many of the current issues in the GST distribution's policy settings, methods of assessing states' fiscal capacity and the perverse incentives that the system creates that are affecting economic growth. Despite the substantial volume of analysis in the Productivity Commission's draft report many of these issues remain unresolved. The headline recommendation in the draft report, to shift from a target of full equalisation to equalising states' fiscal capacity to an average level, addresses symptoms of the current equalisation system rather than its underlying problems. It is not clear how this proposed reform relates to the terms of reference for the inquiry or how it will improve fiscal equalisation in Australia, the methods used to assess fiscal capacity or economic growth across the country. Therefore, while the MCA agrees with some of the report's findings we recommend further analysis of both the current assessment framework and the economic impacts of the proposed reforms is required.

The MCA agrees with draft finding 2.1 of the draft report that there are 'several deficiencies with the objective of Australia's horizontal fiscal equalisation system'. This issue was highlighted in the MCA's submission to the inquiry along with the problem that fiscal equalisation is not defined in any of the policy documents such as the Intergovernmental Agreement on Federal Financial Relations. The MCA welcomes the establishment of clear policy objectives for the GST distribution along with measurable outcomes.

The MCA also supports the retention of equity as a main objective of fiscal equalisation but recommends that the GST distribution should also provide states with incentives for encouraging economic growth. In particular, states that choose to develop their natural resources should be rewarded by retaining a greater share of the benefits. In draft finding 7.1 the Productivity Commission has acknowledged the problem arising from different state mining policies but has not recommended an approach to dealing with this issue as directed by the terms of reference for the inquiry.

The Productivity Commission's draft finding that discounts to mining revenue in the assessment of GST requirements (as recommended by the MCA) are unjustified should be reconsidered. This finding is underpinned by the explanation that 'the introduction of a discount does not sit well with the broad objective of horizontal fiscal equalisation' (i.e. equity). However, the main recommendation of the draft report is that a new objective for horizontal fiscal equalisation is required which is to equalise to a reasonable level of fiscal capacity. A discount to mining revenue is one way to achieve equalisation to a reasonable level of fiscal capacity that also provides a solution to the issue of mining policy differences among states. The MCA therefore recommends that the Productivity Commission reconsider its draft finding on mining revenue discounts.

This finding is also based on an incorrect assumption that Australia is already achieving full equalisation. As noted in the MCA's submission, full equalisation is not actually achieved under the

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current methods used to determine the distribution of the GST. Existing methods for assessing state revenue capacity have large portions of state own sourced revenue grouped into a miscellaneous category known as Other Revenue. This includes gambling revenue, user charges and financial returns on government assets for which the Commonwealth Grants Commission's methods cannot identify a reliable tax base.

Other Revenue is not equalised and has no direct impact on the GST distribution. However, as the percentage of state own source revenue that is classified as other revenue varies between states some states have more of their revenue equalised than others. This results in a less than full equalisation outcome that disadvantages states that have lower proportions of their revenue classified as Other Revenue. As highlighted in the MCA's submission, there is a clear correlation between the proportion of a state's revenue classified as other revenue and its assessed GST relativity. The MCA recommends the Productivity Commission give further consideration to this assessment method issue as it is a key driver of the unequal outcomes for states in the current GST distribution and is not addressed by the proposed reforms in the draft report. Discounting some revenue sources, particularly mining, is one reform that should be implemented to address the differences between states in the types of revenue they raise.

The Productivity Commission's recommended equalisation to a reasonable level results in significant changes in the amount of GST funding each state receives – far greater than the MCA's proposed 25 per cent discount to mining revenue. This impact is shown in table 1 below.

Table 1: Effect of equalisation to the average level of fiscal capacity (2017-18)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Current relativity	0.88	0.93	1.19	0.34	1.44	1.80	1.19	4.66
Relativity with reforms	0.87	0.87	1.06	0.87	1.32	1.68	1.07	4.55
Change in GST payment $m	**-110**	**-972**	**-1,588**	**3,602**	**-557**	**-168**	**-130**	**-79**

Source: PC, *Horizontal Fiscal Equalisation – Draft Report*, Table C.2

While this reform delivers substantially more funding to Western Australia the zero sum nature of the GST distribution means other states are losing just as much funding as an offset. Queensland alone stands to lose $1.6 billion from this reform if it is implemented. Such large fiscal impacts are likely to result in states raising taxes to address the deterioration in their fiscal position. The MCA submits that further analysis of the effects on the proposed reform on state economies, and any subsequent tax increases, is required.