



POST DRAFT SUBMISSION

Horizontal Fiscal Equalisation

Chamber of Commerce and Industry of Western Australia

SUMMARY

The Chamber of Commerce and Industry of Western Australia (CCIWA) strongly welcomes the Productivity Commission's draft report on Horizontal Fiscal Equalisation. The draft report has supported many of the conclusions outlined in CCIWA's submission.

CCIWA proposed in its initial submission that Horizontal Fiscal Equalisation (HFE) has merit and should be retained, but the extent of redistribution had become too large and the system should be reformed to create greater incentives for states to contribute to national economic growth. The Productivity Commission has agreed that Horizontal Fiscal Equalisation has merit and should be retained, however the equalisation task of raising each state's capacity to the leading state is now unsustainable.

CCI's proposal to equalise to the average of the states ensures that every Australian citizen lives in a state that has the capacity to deliver a reasonable standard of services, while also restoring strong incentives for states to promote economic development. This is in line with the draft conclusion and recommendation of the Productivity Commission which CCIWA supports.

DEFINING REASONABLE EQUALISATION

CCIWA strongly supports equalising to the average (ETA), as we proposed in our first submission, and rejects equalising to the second leading state or to the average of the donor states, as these proposals have fatal flaws which are described in this submission. Equalising to the average will achieve a high level of equity among states, ensuring every state has at least the average capacity to provide services, whilst improving efficiency in the system. These changes will ensure a robust and flexible system into the future.

It is therefore strongly proposed that the Productivity Commission recommend in its final report that reasonable equalisation be defined as equalising to the average – this will allow for maximum durability and efficiency whilst maintaining equity for all states.

PRINCIPLES FOR TRANSITION ARRANGEMENTS

CCI has used the following criteria to determine the most suitable transition arrangements:

- **Fair:** every Australian should continue to expect a high standard of services from their state government.
- **Pro-growth:** States should be rewarded, not punished, for growing their own economy.
- **Durable:** The new distribution method must last and each state should be able to rely on their forward estimates of GST revenue.

RECOMMENDATIONS

1. It is recommended that the Federal Government immediately implement equalisation to the average.
2. The Federal Government should allocate \$5.07 billion over 3 years to top-up payments. With these top-up payments, no state will be worse off over the forward estimates¹.

¹ Each State's actual GST revenues would be expected to fall within the historical forecasting error of +/-6% of GST revenue.



PRODUCTIVITY COMMISSION DRAFT REPORT

THE ISSUE WITH FULL EQUALISATION

Full equalisation raises the service delivery capacity of each state up to that of the leading state, before distributing any remaining GST equally on an equal per capita basis. This equalisation diminishes incentives for states to make difficult decisions that promote economic development, because they know they will always be raised to the same level of service delivery capacity as the leading state, regardless of whether they develop their underutilised industries or not. The trade-off of efficiency to achieve a very high degree of equity is damaging the national economy.

REASONABLE EQUALISATION SHOULD BE DEFINED AS THE AVERAGE OF ALL STATES

CCIWA strongly welcomes the Productivity Commission's finding that the current system struggles with extreme circumstances, and this is corroding confidence in the system [Figure 1]. CCI agrees with the conclusion of the Productivity Commission that equalising to the fiscally strongest state means the redistribution task is too great for any jurisdiction to bear, and is volatile at times of significant cyclical and structural change.

Given that durability of the system through volatile and significant cyclical and structural change has been highlighted as a high priority for the proposed level of "reasonable equalisation", it is recommended that both equalising to the second strongest state and equalising to the average of the donor states be dismissed in the final report. Under the current method of HFE, there is no incentive for any State to improve its capacity since the GST pool is distributed to top-up all states to the leading state's capacity. We discuss the merits of each proposed equalisation point in terms of the marginal incentives it creates for each state to improve its own capacity and the durability of the system under extreme circumstances.

Equalising to the average of all states ensures each state has 'skin in the game'.

ETA creates positive marginal incentives for each state to increase its own capacity, since improvement in any state's capacity raises the equalisation point. A continuous marginal benefit for developing a state's own capacity is introduced, compared to a relative fixed point of equalisation (such as the leading state) where improvements in capacity are traded off with GST revenue. Efficiency is increased as all states contribute to progression of the average, rather than the equalisation point being a fixed point or the responsibility of a subset of states which the remaining states cannot influence and therefore have nothing to gain by raising capacity. This is an important difference in incentives created by equalising to the average compared to full HFE, equalising to the second leading state or equalising to the donor states.

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

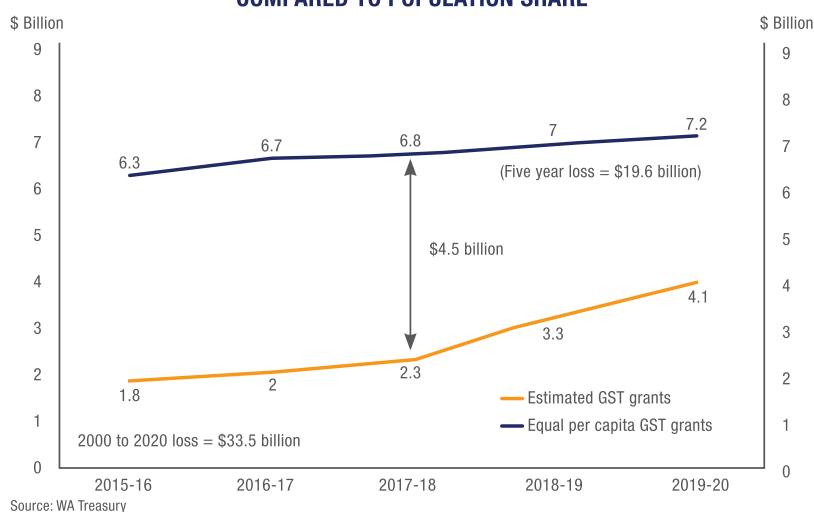


Figure 1: Full equalisation is unsustainable and has eroded confidence in the system.

Equalising to the second leading state and average of donor states is flawed

A fatal flaw in equalising to the leading state is that if the leading state pulls too far ahead of the other states then the equalisation task becomes too great, eroding confidence in the system.

Equalising to the second leading state means that the point of equalisation does not move if the leading state continues to pull ahead of the pack. There will be no benefit in terms of GST revenue for other states as the leading state moves relative to other state capacities. This diminishes equity in the system compared to ETA.

Likewise, it is foreseeable that if both the leading state and second leading state were to simultaneously strengthen ahead of the pack the same problem as the current system would occur – the equalisation task would continue to be too great. For example, a future mining boom could see revenues in the two resource rich states of Western Australia and Queensland pull ahead of the other states.

Equalising to the donor states is also flawed. It is possible that only one state will be above the equalisation point, leaving the task of equalisation at risk of being too great. Whilst the leading state will always be included in defining the point of equalisation the recipient states will not. Recipient states will not have an incentive to increase capacity so long as they remain recipient states. Any improvements in capacity will be traded off with GST revenue. Recipient state incentives are diminished given they have no 'skin in the game'. Increased capacity will take them closer to the point of equalisation rather than incrementally moving the point of equalisation up as they progress.

Equalising to the second leading state or to the average of the donor states is not sustainable under extreme circumstances and should be dismissed.

Equalising to the average of the states allows for the most flexibility in the system, maintains equity across all states, and maximises incentives for states' development.

Stability and predictability increases by equalising to the average

Predictability of GST revenues for all states will be much greater as forecasting the point of equalisation becomes easier [Figure 2]. The average of all states will not be moved

significantly by large swings in capacity from donor or leading states, making forecasting more reliable for all states.

Stability of GST revenues will also increase as extreme circumstances have a diminished impact on the average of the states. This was a major concern raised by some states.

Equalising to the average will increase growth incentives as well as improving the durability, predictability, and stability of the GST distribution system. It is strongly recommended that the Productivity Commission's final report adopt equalising to the average as the recommended point of equalisation given the benefits this approach highlights.

STRUCTURAL CHANGE IN RELATIVITIES

The recent change in WA's capacity is structural. The major factor for WA's falling relativity is a significant change in iron ore royalties. Given the

task of equalising to the leading state, this has caused major strain on the system that will not abate in the foreseeable future.

As per CCIWA's letter from Chief Economist Rick Newnham to Deputy Chair of the Productivity Commission Karen Chester on 24 October (attached), the increase in WA's iron ore production, and therefore royalties, will be sustained for several decades. The increase in capacity is structural. The key driver of WA's own revenue capacity volatility will come from iron ore price fluctuations [Figure 3]. This means WA's capacity will remain far beyond other states and the equalisation task will continue to be far beyond a sustainable level.

The structural change in WA's iron ore production and therefore the ongoing large equalisation task means the current strain on the system will also be sustained. The GST formula must be changed as a result – the system will not rebalance on its own.

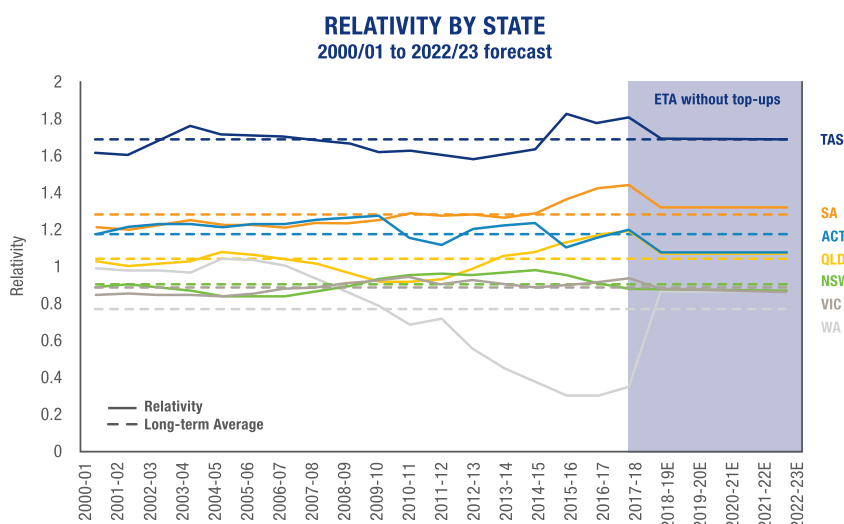
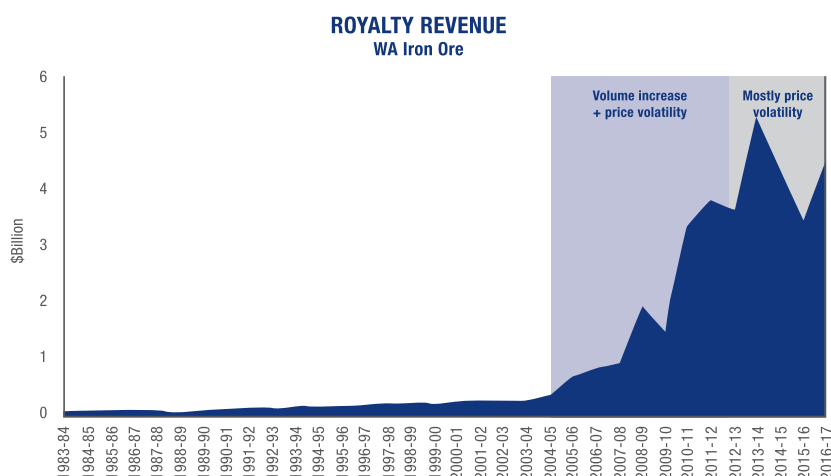


Figure 2: ETA will return states to their long-term average relativity



Source: Department of Mines, Industry Regulation and Safety

Figure 3: Sustained increase in WA's iron ore royalties puts permanent strain on the current system



TRANSITION ARRANGEMENTS

The objective for transition arrangements is to ensure that every state can continue to rely on the GST as a reliable revenue source whilst adopting the principle of equalising to the average as soon as practically possible.

There are four key factors in transition:

1. Implementation date;
2. Transition length;
3. Pace of adjustment; and
4. Compensation during transition.

Implementation date

Given the negative impact on the national economy through the inefficiency created by full equalisation it is recommended that reasonable equalisation, to the average, be implemented immediately.

It is expected that the Federal Treasurer will announce relativities for all states in March 2018.

When the Federal Government tables the Productivity Commission's report it should also announce the implementation of ETA. It should simultaneously direct the Commonwealth Grants Commission to implement ETA which would affect the relativities from the year 2019-20. This allows for the Federal Budget to reflect the transition top-up payments required

for a three-year period from 2019-20.

Transition length

The transition period for implementation should be across the forward estimates. This ensures a 3-year implementation from 2019-20 for all states so they can adequately prepare for the full effect of the changes beyond the forward estimates whilst ensuring a swift implementation.

Pace of adjustment

It is possible to have an accelerating implementation (e.g. 25%, 50%, 75%, 100% between leading state equalisation and ETA implementation). This was considered and modelled by CCI but is not recommended. Should the Federal Budget for top-ups be limited then pacing could be considered as the next best option.

Compensation

The Federal Budget should 'top-up' state government budgets during an implementation phase. This submission focusses on determining a reasonable amount of compensation.

NO TRANSITION ARRANGEMENTS

If ETA were to be introduced from 2018-19 some states would be negatively impacted compared to their current forward estimates of GST revenue [Figure 4].

Given the immediate impacts that ETA implementation would have on state budgets it is recommended top-up payments be paid by the Federal Government to the states during transition.

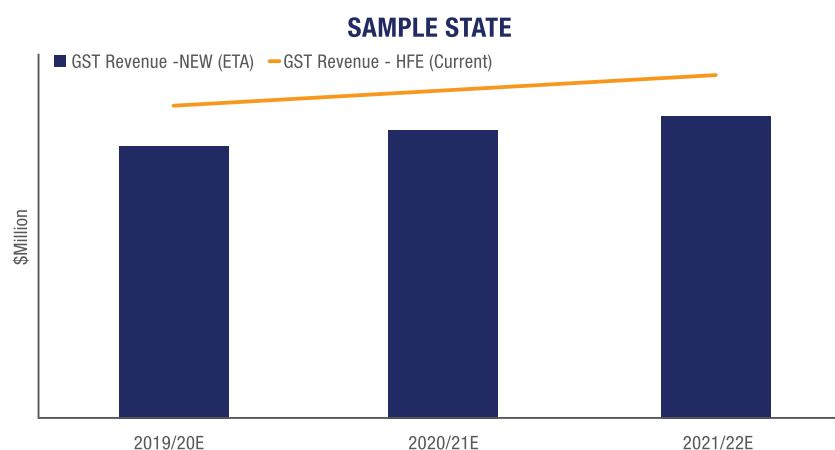


Figure 4: Shortfall of revenue in an example state from immediate implementation with no transition arrangements.

THE FEDERAL GOVERNMENT SHOULD USE ITS OWN BUDGET TO TOP-UP A PORTION OF THE EXPECTED SHORTFALL IN STATE GOVERNMENT REVENUE.

TOP-UPS

The Federal Government should use its own budget to top-up a portion of the expected shortfall in state government revenue over the forward estimates. This ensures no state has a major short-fall in revenue over the forward estimates period.

100% GST Revenue top-up

If the Federal Government were to top-up 100% of any losses the states may incur under ETA, compared to their current forward estimates, it would cost the Government \$11.2 billion [Figures 5 & 6].

This would ensure every state government has absolute certainty in their expected future revenue during transition [Figure 7].

This is the ideal method of transition as it allows for the immediate implementation of a new GST formula that more strongly encourages national economic growth whilst giving absolute certainty to each state budget over the forward estimates. This method however will be quite costly for the Federal Government.

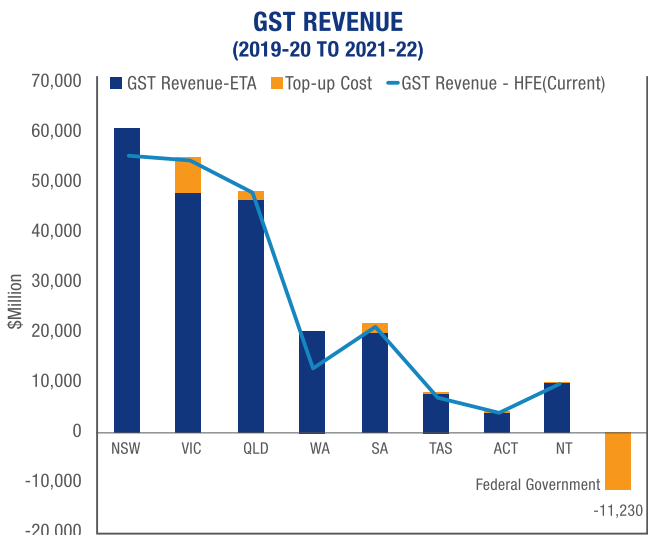


Figure 5: GST revenue by state with 100% top-up of all states

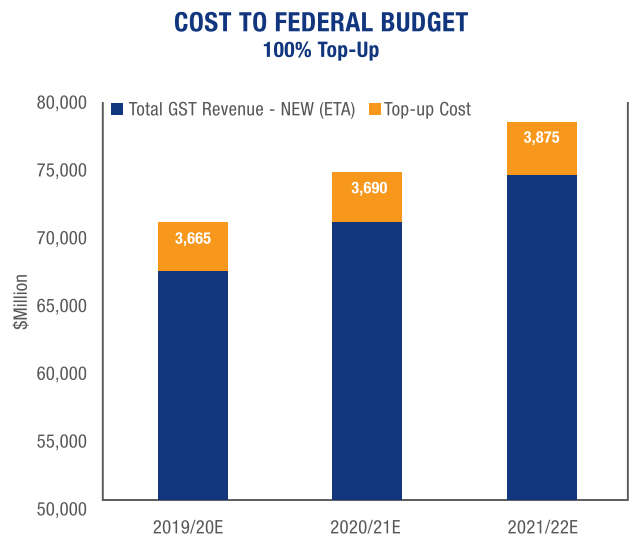


Figure 6: Cost to Federal Budget of 100% top-up

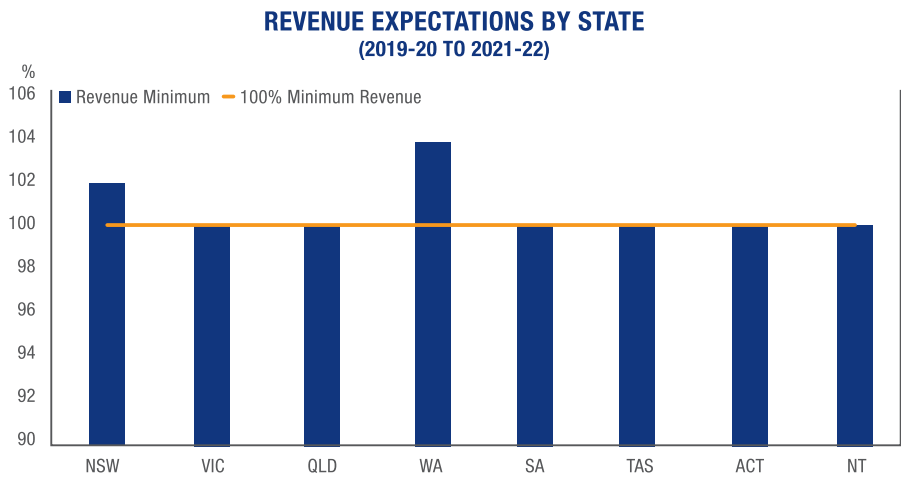


Figure 7: 100% minimum revenue top-up for all states



TOPPING-UP GST WITHIN THE FORECAST ERROR

It is recommended that the Federal Government top-up all state budgets across the forward estimates to within the historical average GST forecast error. This should be based on each state's 2017-18 budget forecast of GST for the years 2019/20 to 2021/22.

The average forecast error of state government forward estimates to actual GST revenue between 2009/10 and 2015/16 was +/-6% [Table 2].

State governments have become accustomed to managing a 6% variance in revenue expectations and therefore it is reasonable for the Federal Government to top-up revenues to within the 6% band of forecast error.

The recommended top-up level is 95% of forecast expected revenue which is within the 6% forecast error band.

The Federal Government can top-up every state government's forward estimates of GST revenue to a minimum of 95% for \$5.07 billion [Figures 8 & 9]. This equates to each state receiving at least 98.35%

of their total revenue over the forward estimates. Every state, except one, will receive >99% of their expected revenue.

With a 95% top-up, no state will be worse off by implementing equalising to the average over the forward estimates, given the normal variance in GST forecast to actual revenues seen historically.

RECOMMENDATION 2:

The Federal Government should allocate \$5.07 billion over 3 years to top-up payments. With these top-up payments, no state will be worse off over the forward estimates compared to the usual forecast error for states.

**GST REVENUE
(2019-20 TO 2021-22)**

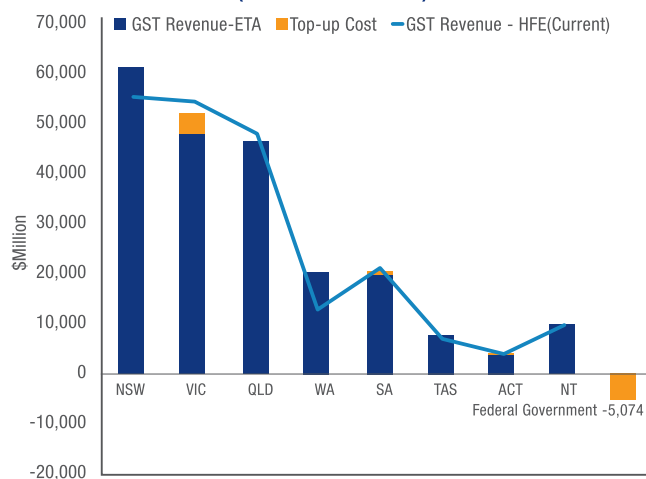


Figure 8: 95% GST Revenue Top-up by State

**COST TO FEDERAL BUDGET
95% Top-Up**

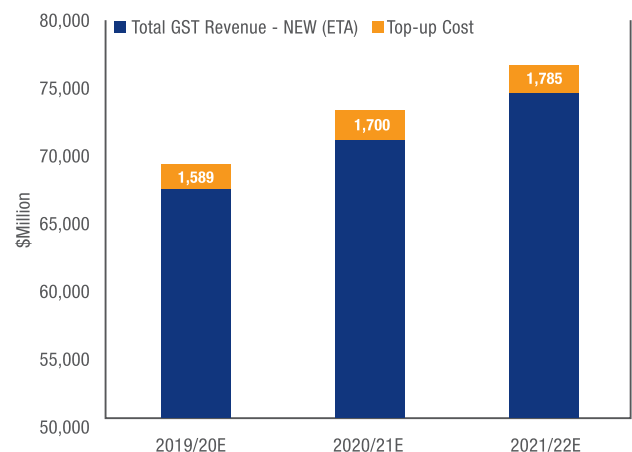


Figure 9: 95% top-up cost to Federal Budget.



Table 1 displays how much revenue each state should expect to receive, compared to their current forward estimates, with a 95% GST revenue top-up.

TOTAL REVENUE EXPECTATIONS WITH 95% GST TOP-UP	
NSW	102%
VIC	>99%
QLD	>99%
WA	104%
SA	>98%
TAS	>99%
ACT	>99%
NT	100%

Table 1: 95% GST revenue top-up for each state.

OTHER TOP-UP AMOUNTS

The Federal Government can choose to top-up each state government's budget to a minimum percentage of each state's forward estimates of GST revenue. For example, ensuring no state's GST revenue falls below 90% of their current forward estimates would cost the Federal Government \$1.4 billion [Figure 10].

STATE COMPARISON - ROOT MEAN SQUARE ERROR (RMSE)							
Forecast Horizon	NSW	VIC	QLD	WA	SA	TAS	Average
1 YR BEHIND	2.5%	0.7%	0.5%	0.5%			1.1%
SAME YEAR	4.2%	3.8%	3.9%	4.8%	3.5%		4.1%
1 YR AHEAD	6.2%	2.7%		15.3%	5.7%	7.2%	7.4%
2 YR AHEAD	6.9%	3.0%		28.3%	5.9%	8.5%	10.6%
3 YR AHEAD	5.7%			19.1%	6.5%	7.8%	9.8%
Average RMSE (across all forecast horizons)	5%	3%	2%	14%	5%	8%	6.1%

Table 2: Variation in actual and forecast GST revenue.

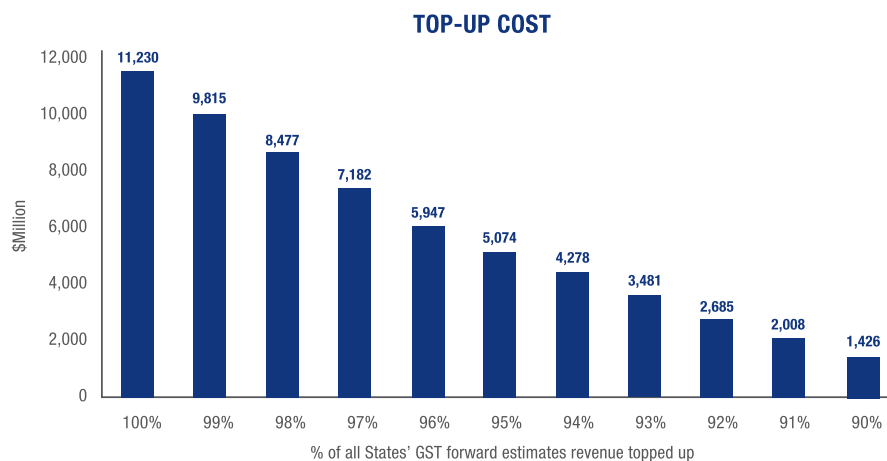


Figure 10: Cost to Federal Budget of Top-up minimum when transitioning to ETA

24 October 2017

Karen Chester
Deputy Chair
Productivity Commission
Level 12, 530 Collins Street
MELBOURNE VIC 3000

By email: Karen.Chester@pc.gov.au



Chamber of Commerce
and Industry WA

ABN 96 929 977 985

T: (08) 9365 7555

E: info@cciwa.com

W: www.cciwa.com

HFE INQUIRY: STRUCTURAL INCREASE IN WESTERN AUSTRALIA'S IRON ORE PRODUCTION

Dear Commissioner

Western Australia is setting a new normal for its royalties income given a structural increase in iron ore production.

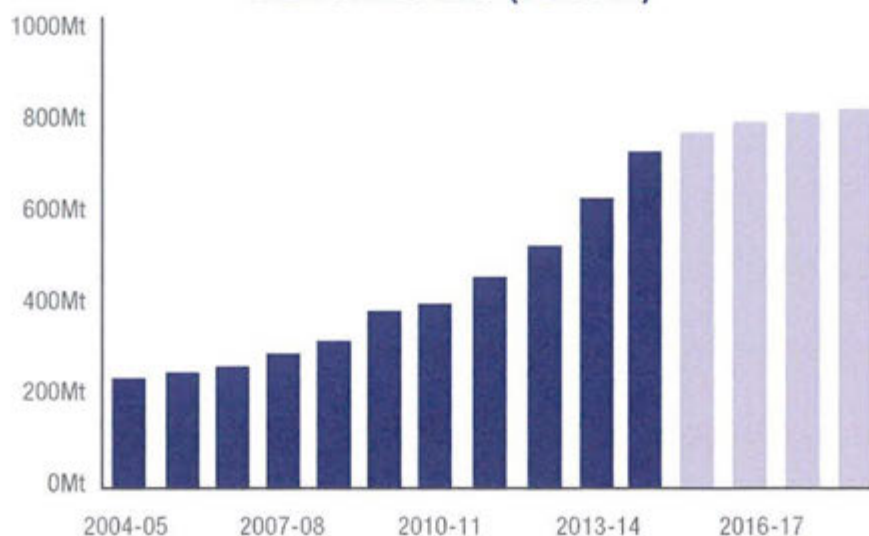
As the world's largest iron ore producer and exporter, WA accounted for 38 per cent of global production and over half of world exports in 2016. Rising at an annual average rate of 12 per cent since 2005-06, WA's iron ore sales have grown by 514 million tonnes in the ten years to 2016.

This growth is expected to continue in the future as mine construction and expansions are completed and our economy shifts from the investment to the production phase of the resources boom, but the rate of increase is forecast to be slower than the past ten years.

While the resources sector's contribution to the greater Australian economy has retreated from its peak in 2011, WA's iron ore sales are set to continue making their mark and are forecast to increase to 830 million tonnes by 2019-20.

The unprecedented boom in commodity prices and WA iron ore exports from the mid-2000s to late-2011 resulted in WA's iron ore production value reaching a new high and a new plateau, one that is significantly higher than its pre-boom average.

IRON ORE SALES (VOLUME)



Note – Forecasts start in 2015-16

Source: WA Department of Mines and Petroleum, Resource Data Files; and WA 2015-16 Mid-year Financial Projections Statement.

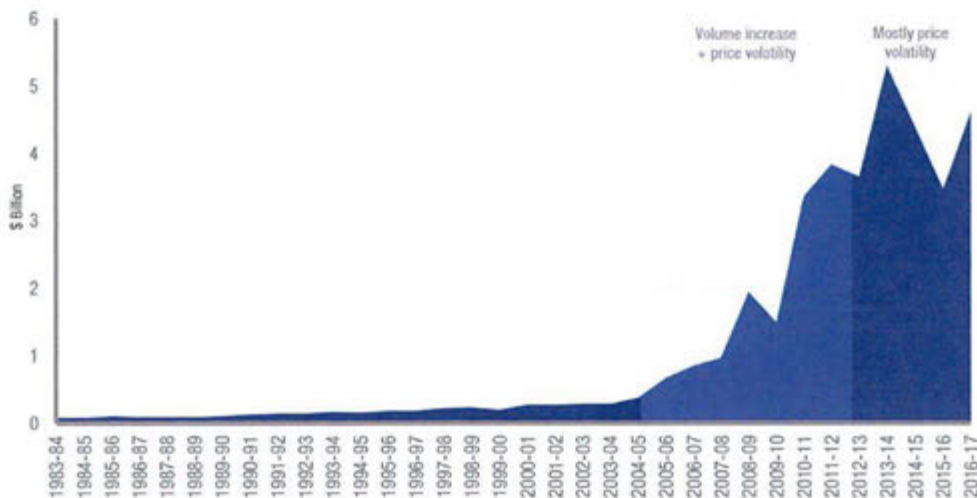
Even as iron ore prices decline, the value of iron ore exports should hold above the levels prior to the mining boom thanks to rising production which is expected to peak in late 2019.

The value of Western Australia's iron ore sales rose 11 per cent to \$55.1 billion in 2016, compared with annual average growth of 14 per cent over the past ten years.

WA received over \$4.6 billion in iron ore royalties revenue over 2016/17, accounting for over 80% of WA's royalty revenue.

ROYALTY REVENUE

WA Iron Ore



Source: Department of Mines, Industry Regulation and Safety

WA's iron ore production has reached a steady plateau. With an estimated 63 billion tonnes of iron ore reserves, WA could sustain its current production for another 76 years.

WA's iron ore giants – Rio Tinto, BHP Billiton, and Fortescue Metal Groups – are showing no signs of slowing down either. The trio produced over 760 million tonnes of iron ore in the last year.

Led by Rio Tinto, the nation's top three exporters plan to add about 170 million tonnes of new capacity, and are studying investments in infrastructure and equipment to boost export capacity to their long-term targeted rates. Fortescue expects to spend almost US\$1.5 billion on a replacement for its outgoing Firetail operation.

In recent years, Rio Tinto has invested over US\$14 billion in Pilbara mines and infrastructure growth, increasing production by more than 50 per cent and expanding port operations to 360 million tonne capacity.

Rio Tinto's US\$338 million Silvergrass iron ore mine officially opened last month and is on track to deliver its first production of 21 million tonnes per annum (Mt/a). Last year Rio fully commissioned the Nammuldi Incremental Tonnes project which provides 10 million tonnes of high-grade, low phosphorus ore annually.

Mines like West Angelas Deposit F and Yandi Oxbow, which are presently in development, will provide high quality, low cost options to sustain existing production levels by contributing over 90 million tonnes per annum. Feasibility studies undertaken for Koodaideri, Rio's potential \$2.2 billion major greenfield replacement mine, predict 40 million tonnes per annum of iron ore available from 2021.

Rio Tinto has also completed expansions at Cape Lambert and Dampier, increasing the capacity of these ports to 360 million tonnes. By 2018 capacity at Port Hedland – the world's largest bulk export port – could reach 495 million tonnes.

180 Hay Street, East Perth
Western Australia 6004
PO Box 6209, East Perth
Western Australia 6892

Chamber of Commerce and Industry
of Western Australia (Inc)
ARBN 099 891 611
Incorporated in Western Australia

CCI correspondence is managed in
accordance with CCI's Privacy Policy.

BHP's Jimblebar mine saw record iron ore volumes of 136 million tonnes in the first half of 2017 with their total production topping at 231 million tonnes last year.

Looking to the future, BHP forecasts its iron ore production at 239-243 million tonnes for the 2018 financial year. Continued productivity increases and improved reliability across the supply chain means that BHP will be able to support 290 million tonnes per annum capacity by the end of 2019 financial year.

Fortescue have achieved a 20 per cent improvement in productivity since 2012 by deploying new technology at their mine sites. Earlier this year, they announced the expansion of this technology across all their mines in the Solomon Hub to further improve productivity.



Deutsche Bank predicts consistent capital investment from Australian iron ore exporters over the next five years to keep up with production. Considerable improvements in macroeconomic conditions across advanced economies should see iron ore demand grow, driven by demand for manufactured goods and increasing replacement requirements.

Over the past decade, WA iron ore producers have invested tens of billions of dollars in new mines and associated infrastructure in response to growth in Chinese steel production. Forecasts of a slowdown in China's steel industry are proving to be misplaced with iron ore producers predicting continued consistent demand from China, as well as further supply from low-cost producers and new entrants in the market.

Western Australia's iron ore industry remains globally competitive with high quality reserves, low cost production and established, long-term markets in China, Japan, Korea and Taiwan.

Given the information provided it should be clear that WA's iron ore royalties will be sustained at their current level. In future, the volatility in WA royalty income will be largely from price changes rather than from production volume changes.

I trust you find this useful.

If you have any further questions please contact me

Kind regards,

Rick Newnham
Chief Economist

180 Hay Street, East Perth
Western Australia 6004
PO Box 6209, East Perth
Western Australia 6892

Chamber of Commerce and Industry
of Western Australia (Inc)
ABN 099 891 611
Incorporated in Western Australia

CCI correspondence is managed in
accordance with CCI's Privacy Policy.

Sources

- BHP Billiton (2017, March 29) *Global Iron Ore & Steel Forecast – Our Culture to Drive Value in the Pilbara*. Retrieved from <http://www.bhp.com/media-and-insights/reports-and-presentations/2017/03/our-culture-to-drive-value-in-the-pilbara>.
- BHP Billiton (2017, October 18) *Operational Review for the quarter ended 30 September 2017*. Retrieved from http://www.bhp.com/-/media/documents/media/reports-and-presentations/2017/171018_bhpoperationreviewforthequarterended30september2017.pdf?la=en.
- Department of State Development (2017, July) *Western Australia – Iron Ore Industry Profile*. Retrieved from <http://www.tsd.wa.gov.au/docs/default-source/default-document-library/wa-iron-ore-profile-0717.pdf?sfvrsn=8>.
- Rio Tinto (2017, March 1) *2016 Strategic Report*. Retrieved from http://www.riotinto.com/documents/RT_2016_Strategic_report.pdf.
- Rio Tinto (2017, March 29). *Global Iron Ore & Steel Forecasting Conference 2017*. Retrieved from http://www.riotinto.com/documents/170329_Presentation_Global_Iron_Ore_and_Steel_Forecast_Conference_slides.pdf.
- Rio Tinto (2017, August 9). *Iron Ore – Delivering Optimal Value*. Retrieved from http://www.riotinto.com/documents/170809_Presentation_Iron_Ore_roadshow.pdf.
- The Sydney Morning Herald (2017, August 21) *Fortescue records \$2.7 billion net profit, raises dividend*. Retrieved from <http://www.smh.com.au/business/mining-and-resources/fortescue-records-27-billion-net-profit-raises-dividend-20170820-gy0i0a.html>.
- The Sydney Morning Herald (2017, August 30) *Rio, BHP, Fortescue plan to spend billions to expand iron ore mines*. Retrieved from <http://www.smh.com.au/business/mining-and-resources/rio-bhp-fortescue-plan-to-spend-billions-to-expand-iron-ore-mines-20170829-gy6ve7.html>.

180 Hay Street, East Perth
Western Australia 6004
PO Box 6209, East Perth
Western Australia 6892

Chamber of Commerce and Industry
of Western Australia (Inc)
ABN 099 891 611
Incorporated in Western Australia

CCI correspondence is managed in
accordance with CCI's Privacy Policy.