

**PUT WESTERN AUSTRALIA FIRST PARTY**

**RESPONSE TO THE PRODUCTIVITY COMMISSION'S  
DRAFT REPORT ON HFE**

**November 2017**

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# Put Western Australia First Party (PWAFFP)

## 1.0 SUBMISSION SUMMARY

### OBJECTIVE OF HFE

#### DRAFT RECOMMENDATION 2.1

##### ***PWAFFP Response***

*Clearly articulating the objective of HFE is long overdue.*

*The objective and application cannot be arrived at by a popular vote. The contributing States should have a more powerful voice in the outcome than the recipient states who are prepared to take but give little in return and who have indicated their resistance to changes to a system that the key independent voices have agreed is broken.*

#### DRAFT FINDING 3.1

##### ***PWAFFP Response***

Is the achievement of “almost complete degree of equalisation – unique among OECD countries” necessarily a good point?

It begs the question, if it is so good, why aren’t the other OECD countries doing it?

We recommend that the draft report be altered to support the need for better definition of the rationale for the HFE process and its long term economic as well as social objectives.

#### DRAFT FINDING 8.1

##### ***PWAFFP Response***

*This finding points to the overly academic approach adopted by the CGC. In attempting to achieve an outcome no other country has achieved or wants to achieve, the CGC has overlooked that the outcome has grossly penalised Western Australia. This is exacerbated by the Commonwealth restricting HFE to only one component of the national tax system.*

## HFE and STATE POLICIES

### DRAFT FINDING 4.1

#### ***PWAFP Response***

*This finding is surely sufficient trigger to require a change to the current approach.*

### DRAFT FINDING 4.3

#### ***PWAFP Response***

*The PWAFP notes the draft PC report conclusion that there is no direct evidence of policy being distorted by the GST redistribution however this issue has only become evident as a result of the current WA situation. This issue is however now a topic of both government and public discussion and is already distorting State policy as predicted by the PC.*

*While the PWAFP accepts that it may be difficult to introduce incentives to encourage resource exploration, it is incumbent on the Federal Government to remove the penalties that the current HFE model applies to the States who are exploiting their resources. There seems to be no concern about States autonomy when it comes to the Federal government support for the HFE which now transfers most of the royalty income generated from a State's ownership of resources.*

## HFE and MIGRATION

### DRAFT FINDING 6.1

#### ***PWAFP Response***

*This is an interesting finding when considering that estimates of the shortfall in WA's share of the GST revenue when comparing the impact of receiving 34c in the dollar in 2016-17 compared to a per capita distribution equates to \$4.659 Billion which in the WA context could have built 323 primary schools, 2 new hospitals or 3 Perth Stadia. In Western Australia, these are significant pieces of infrastructure.*

*If the redistribution amount is small as the report indicates, then it should be possible for the Commonwealth to provide transition compensation to States that may be impacted by changes in the methodology.*

# METHODOLOGICAL CHANGES TO THE CURRENT SYSTEM OF HFE

## DRAFT FINDING 7.1

### ***PWAFP Response***

*Removing mining from the HFE process may be inequitable because it primarily benefits one state – WA, however the current model of penalising the same state for its investment over many years to build a strong resource industry is even more inequitable. The PWAFP reiterates the point made in its original submission that the resource industries continue to be strong sources of wealth creation for the nation as a whole.*

*How much wealth has been created for the nation by other revenue sources such as state taxes and gambling taxes?*

*It is with this viewpoint that PWAFP recommended a discount on the assessment of mining revenue in our original submission.*

## DRAFT FINDING 7.2

### ***PWAFP Response***

*The introduction of a relativity floor is supported as a purely interim solution providing that immediate steps to address the identified deficiencies are being pursued. While it may be a band-aid solution, it is however urgently required to address the ongoing transfer of the Western Australian Government's revenue. Western Australia has suffered a relativity of less than 80c in the dollar of GST raised now for 8 years while various Federal Governments have tip toed around the problem.*

*A BAND-AID IS URGENTLY NEEDED as an interim solution until more fundamental change is implemented.*

## DRAFT RECOMMENDATION 7.1

### **PWAFP Response**

*The final report should clearly state that the Commonwealth Grants Commission takes its direction from the Federal Treasurer and does not require COAG support. The report should also document what direction the Treasurer has given to the Grants Commission over the period when the GST became the basis for HFE.*

*Equally, the report needs to make explicit that the methodology for HFE has been evolved by the CGC and that it has not been specifically set nor agreed by State Governments.*

*PWAFP strongly supports simplification of the assessment process. In particular, the irrational approach for measuring remoteness needs redirection as does the treatment of gambling revenue.*

*We also note that there has been no comment on the point raised by the NSW Government regarding the way that states receive positive assessments on the basis of disabilities in services such as health resulting in additional funding. Because there is no recognition that funding may have been given in the previous period because of this disability, States are able to leave a disability in an area that the CGC presumably sees as a significant policy area and continue to receive additional funding in subsequent years. Surely, any assessment of current disability in an area should be reduced by the funding previously allocated to address the area.*

## ALTERNATIVE APPROACHES TO HFE

### DRAFT FINDING 8.4

### **PWAFP Response**

*The dismissal of an equal per capita approach assumes that the current horizontal fiscal equalisation approach is the benchmark for equity. As recognised elsewhere by the Productivity Commission, the current CGC approach pursues purity rather than encouraging effective and efficient State government performance and we would argue that dismissing the EPC approach is pursuing equity purity at the expense of fairness.*

*We note that the Productivity Commission's modeling of fourteen alternative approaches to equalization shows that only two of the alternates produce distributions to WA that are lower than the current approach. This would suggest that the current approach is an outlier and shouldn't be seen as a fair and reasonable model.*

## **DRAFT FINDING 8.5**

### ***PWAFP Response***

*Equalising fiscal capacity to that of the strongest state has proven to be “an undeliverable ideal” that might be popular with the recipient states but to be sustainable relies on the contribution to the redistribution pool being spread evenly and being seen as fair by the main contributor States.*

*The extent to which all other states and the Federal Government have been happy to disadvantage Western Australia severely the last 8 years is no longer seen as fair or acceptable by Western Australians and so they expect that the HFE principles be substantially modified to reintroduce fairness and promote economic efficiency in all states.*

## **DRAFT RECOMMENDATION 9.1**

### ***PWAFP Response***

*PWAFP strongly supports increasing the visibility of the CGC and its members. For too long they have been able to sit in isolation making assessments and decisions that impact the direction of huge amounts of government revenue without accountability or being open to challenge.*

*We also strongly suggest the final PC report proposes an increase in CGC membership to five by include two additional members appointed by COAG State Government members. These additional members should have expertise in economic and or Federal/State management.*

## **DRAFT RECOMMENDATION 9.3**

### ***PWAFP Response***

*PWAFP strongly supports a reform of Federal – State fiscal relations particularly if the intention is to reduce duplication and excessive Federal management of services that are better delivered by the State Governments.*

## **2.0 OVERVIEW**

The Put Western Australia First Party (PWAFP) is pleased to see that the Productivity Commission (PC) has recognised that the current approach to Horizontal Fiscal Equalisation (HFE) is economically flawed, not in the long term national interest and demonstrably unfair to WA.

There has been acknowledgement by both major political parties that the HFE process has increasingly disadvantaged WA as the PC interim report demonstrates.

We note statements from the Prime Minister stating that he was "... the first Prime Minister to acknowledge that WA is not getting a fair deal out of the GST" ; that WA was getting "raw deal" and that his Government was "...seeking to get a fairer deal on GST".

We also note that the Treasurer has stated that the way HFE is currently applied is a drag on the Australian Economy and so change is required.

The Leader of the Opposition has also acknowledged that the improvement was needed on the "...rotten deal that WA is currently getting". He also said "everybody knows there's a problem with WA's share of the GST".

However bipartisan support for change to address the issue is limited. The arguments being put forward by the Productivity Commission's final report will therefore be critical to getting future support for the changes to the HFE formula to encourage WA and National economic development.

The Commonwealth Grants Commission itself now accepts that change is needed as shown in their recent 2020 Review on "The Principle of HFE and its Implementation". Within the Position Paper, the CGC acknowledge that the treatment of mining royalties has proved difficult to manage fairly in their models and they have therefore proposed changes to their methodology from 2020 on. This change proposes that a "dominant state retain at least half of the own-source revenue effects of its tax or royalty rate change". (While this is a worthwhile change, the principle would have been better applied to existing mineral royalties too rather than just to increases in royalties.)

So, political leaders and the two independent sources that understand the HFE model and its impact, all recognise that the current system is broken and needs to be changed. One would think the need for change was undeniable.

Unfortunately, following the release of the Productivity Commission's Draft report, all those States that have been happy accept handouts at Western Australia's expense have been quick to complain about the fact that their share of



the GST revenue might be reduced and so there will be loud argument to retain the status quo.

While the Put Western Australia First Party would prefer a solution that more directly deals with the impost on the wealth generated by the State's exploitation of the mineral resources that are owned by the State, we recognise that this is probably unachievable in this process.

Similarly, we judge that while a move to equal per capita distribution would be more beneficial to WA, the transition issues and the step away from any equalisation mean that the change will be hard to achieve and if it were accepted, benefits to WA are likely to be delayed.

Accordingly, we are prepared to offer strong support to the core of the Productivity Commission's recommendations.

We believe that the adoption of equalisation to the average State's capacity is the best achievable approach in the current climate.

While offering this support we also make the point that, while there is concern about the transition to this approach being managed to protect the fiscally weaker states, there is an urgent need to lift the excessive burden of supporting those states from Western Australia.

If this is the next model to be adopted, we expect that this change should be introduced as soon as possible – in the next round of GST distribution. We recognise that this will require direct action by the Commonwealth to support the fiscally weaker States.

This is far more preferable to continuing with a broken system while providing compensation to WA as is proposed by the Government and Opposition currently.

### **3.0 RESPONSE TO KEY POINTS**

#### **Broad support for fiscal equity**

There is no longer broad support in Western Australia for fiscal equity. We have seen other States and the Federal Government resist changes to the HFE model that is supposed to deliver fiscal equality despite Western Australia's share of GST revenue dropping below 80c in the dollar over the last 8 years. Ignoring the unfairness of the situation has eroded goodwill in the principle and only a significant change will rebuild that support across WA and increase WA economic activity.

#### **Specific practice of HFE**

As above, the application of HFE and the way in which an unfair outcome results for WA have been ignored or defended. As the report recognises, Western Australia's share of GST has reached an extreme low and in fact has been below the 80c mark that NSW has flagged as untenable for them, for 8 years.

Despite Western Australia's "extreme low" we still find other states such as South Australia and Tasmania calling for "hands off our GST" in response to the Productivity Commission's draft report.

#### **HFE – undeliverable ideal**

Equalising fiscal capacity to that of the strongest state has proven to be an "undeliverable ideal" that might be popular with the states on equity welfare, however it is only reasonable if the contribution to the redistribution pool is spread evenly and is seen as fair by the main contributor States.

Because HFE has resulted in all other states and the Federal Government being net beneficiaries at Western Australia's expense over the last 8 years, it is no longer seen as fair by Western Australians and so they expect that the HFE principles significantly amended to reintroduce fairness and economic integrity to the process.

#### **HFE good points**

Is the achievement of "almost complete degree of equalisation – unique among OECD countries" necessarily a good point? It begs the question, if it is so good, why aren't the other OECD countries doing it?

Similarly, while the CGC may have "well established processes", this does not necessarily mean they are good processes. The approach to measuring remoteness and the treatment of gambling are two processes that may be well established, but they hardly seem to be "good" and are clearly inequitable to WA.

### **HFE impact on interstate migration**

While HFE per se may not introduce distortions to long term interstate migration, the slowing economy in WA following the end of the construction phase of the mining boom has been exacerbated by the reduced revenue caused by the redistribution of GST. This has indirectly precipitated interstate emigration and has resulted in a short term net fall in population in WA. Secondly, the short term increased in interstate migration to WA for the mining construction phase resulted in a significant increase in demand for WA Government services at a time when WA's GST revenue share was decreasing.

### **Current HFE model struggles with extreme circumstance and this is eroding confidence in the system.**

There is **no** confidence in the HFE system in WA, and there are increasing concerns in NSW about the model as their economy has picked up.

It is good to note that the Productivity Commission recognises that in the current CGC system, equalisation is too great for the fiscally strongest state to bear. Western Australia has been required to bear an impost, relatively far greater than that borne by any other individual state since Federation. The difference between the previous lowest relativity of 0.84 and the low mark of 0.30 experienced by WA demonstrates the extreme imbalance.

This key point recognises the scope for the current HFE system to discourage desirable mineral and energy resources policies. Certainly, in WA, now there are questions raised about the value to the State from resource developments when the bulk of the wealth created flows elsewhere in Australia while WA bears the supporting investment costs. For the first time broad public support in WA for resource developments is waning.

The current CGC system is extremely complex and appears to have grown into an academic model that no one is prepared to challenge even when it turns up results that see Western Australians receiving the equivalent of \$878 per person while those in the Northern Territory receive \$11,8812 and the average of all states other than WA is \$4,406. Neither the CGC nor the Treasurer has been able to explain how this is fair.

CGC accountability is very unclear to most people. There is a myth that the formula can only be changed if all states agree. However, PWAFP understands that the existing system of HFE has been created by the CGC with no detailed involvement or approval by the States. We further understand that the Federal Treasurer directs the CGC and therefore has the power to direct changes even though successive Treasurers from both political parties have lacked the political will to do so.

### **Articulate a revised objective for HFE**

While acknowledging that the support for HFE in WA has been eroded significantly by the application of it over the last 8 years, we acknowledge that departing from HFE completely is unlikely to happen.

We strongly support moving away from equalisation to the level of the strongest state.

Any equalisation process relying entirely on GST revenue requires contributions from stronger states. Like any other tax redistribution, contributors will accept the process as long as the equalisation is reasonable and generates overall economic benefits to all participants in the long term. An equalisation process using tax redistribution where the target is to bring everyone to the highest paid group as the HFE currently attempts to do has the undesirable effect of magnifying the impact on high or low performing states in an economy which is subject to significant cycles as have affected the Australian economy. The impacts on WA and NT/Tasmania clearly illustrate this anomalous situation.

If the equalisation concept is to be continued, we can see no argument that would support equalisation to any level other than the average of all states. Indeed in the CGC Position Paper on “The Principle of HFE and its Implementation”, the point is made in several places that the CGC uses the weighted average of all states in various stages in their assessments.

Elsewhere in the report, there is discussion of relativity floors as being a “band-aid solution”. While we accept this assessment, a band-aid solution is urgently required to address the negative impacts on the Western Australian revenue and economic performance. The proposal for an introduction of a relativity floor only makes sense if steps to address the identified deficiencies cannot be implemented immediately.

Western Australia has suffered a relativity of less than 80c in the dollar of GST raised now for 8 years at a cost of approximately \$16 Billion. While various Federal Governments have tip toed around the problem, some recipient states are running budget surpluses while the Western Australian is running budget deficits largely in response service delivery demands generated by the mining construction boom.

**THIS BAND-AID IS URGENTLY NEEDED** if more fundamental change is not implemented immediately.

The draft report is also dismissive of “discounts for particular revenue streams”. While there may be good reasons not to single out one revenue stream, the draft report overlooks the fact that, unlike revenue sources relying on taxation, the revenue from mining royalties represents wealth creation and national export income. There is therefore a clear rationale for this revenue to be treated differently in the national interest.

See Attachment A – Royalties are different for more detail on this point.

### **Timing and transition**

Much is made here and elsewhere in the report about the need to “ensure that the fiscally weaker States are not significantly disadvantaged.”

Unfortunately there is not a similar concern to ensure that the burden for supporting the fiscally weaker States is lifted from Western Australia as soon as possible so that the significant disadvantage suffered by WA over the last 8 years is not continued.

If the Productivity Commission’s recommendation to adjust the equalisation to the average not the strongest state is accepted, this should be done in the next round of GST distribution. If the fiscally weaker states require top up to ensure they are not worse off, then this should be done by the Commonwealth as occurred prior to the introduction of the GST. It is not Western Australia’s responsibility to prop them up.

This is far preferable to continuing a broken system and providing top ups to Western Australia as both major political parties have suggested.

This immediate change using Commonwealth tax revenue to smooth the transition, would be a more politically acceptable position and could achieve bi-partisan support. That is, Western Australians would see that the Federal Government is serious about addressing the unfairness of the current system and the fiscally weaker States will see that the Commonwealth is supporting them.

As indicated in Finding 6.1, “..the redistribution that arises from Australia’s system of HFE is small in magnitude relative to total government revenue...” and so it should be possible. The fact that both the Government and Opposition can propose a top up WA should mean that the gap to compensating “losing” States should not be insurmountable and the cost to the Federal budget will in fact be offset to an extent by increased tax collections.

See Attachment B Impact of changes to equalize to the average for more detail on this point.

### **Revised objective and simplification**

As outlined above, if the Productivity Commission’s recommendation for equalisation to the average state is to be adopted, the CGC should adjust the relativities for the next round of GST distribution. PWAFFP strongly supports simplification of the assessment process.

### **CGC Communication**

PWAFFP strongly supports the CGC being more visible and taking more public accountability for its methods and outcomes.

**The benefits of reforming HFE**

PWAFP agrees that there is benefit to be gained by changing the HFE system so that it no longer penalises States that are successful in raising wealth creating revenue including national export income or implementing efficiency reforms. This should lead more rational States to take more responsibility for improving their own position rather than arguing for greater handouts.

## **ATTACHMENT A - ROYALTIES ARE DIFFERENT**

While the draft report dismissed the case for special treatment of royalties, we make the point that royalties are different from most other State revenue streams because they represent a net increase in Australia's wealth.

The recently published figures show that the September Trade Surplus doubled to \$1.74 Billion driven largely by iron ore exports with an 8% increase in the value of shipments.

In the DFAT figures published in 2016, 42% of exports were either mineral or energy resources.

4 of the top 5 exports were Iron Ore, Coal, Gold and Natural Gas.

In the list of benefits of trade, DFAT lists:

1. Trade promotes economic growth and raises household incomes
  - Australia's trade liberalisation has boosted Australia's GDP by between 2.5 to 3.5 per cent compared to where it otherwise would have been and lifted the income of Australian households by over \$4,600 per annum.
2. Trade creates and supports Australian jobs
  - Independent economic modeling estimates that Australia's free trade agreements with China, Japan and South Korea alone may create some 7,900 jobs in 2016 and over 14,500 jobs by 2020.
  - 1 in 5 jobs in the Australian economy involve trade-related activities.

So, trade boosts the national wealth and supports job creation.

Resources are major exports for Australia and so their export has a significant impact on the nation's wealth.

What other State revenue sources can claim this impact?

Royalties are different.

## ATTACHMENT B - IMPACT OF CHANGES TO EQUALISE TO THE AVERAGE

Table C.2 **Effects of equalisation to the average**  
2017-18 GST payments and relativities

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
<b>Relativities</b>								
Current approach	0.88	0.93	1.19	0.34	1.44	1.8	1.19	4.66
Equalisation to the average	0.87	0.87	1.06	0.87	1.32	1.68	1.07	4.55
<b>Change in GST payments</b>								
\$m	-110	-972	-1 588	3 602	-557	-168	-130	-79
\$pc	-14	-156	-321	1 343	-321	-321	-321	-321
New \$pc	2,221	2,221	2,707	2,221	3,350	4,280	3,046	11,560
<b>Total redistribution from EPC</b>								
Current approach								\$7 928 million
Equalisation to the average								\$5 407 million

Source: Productivity Commission estimates based on data provided by the CGC.

The fairness of the equalise to the average model can be seen in the change to GST returned per capita.

STATE	GST RETURNED PER CAPITA	
	CURRENT	EQUALISED TO AVERAGE
Northern Territory	11,881	11,560
Tasmania	4,601	4,280
South Australia	3,671	3,350
ACT	3,046	2,725
Queensland	3,028	2,707
Victoria	2,377	2,221
New South Wales	2,235	2,221
Western Australia	878	2,221

If equalising to the average is the accepted as the “fairer deal on the GST” that Malcolm Turnbull says his government is seeking, this equates to a relativity for WA of 0.87 cents in the GST \$.

If this relativity was applied in each year since 2008/09 when WA’s relativity first fell below this level, then the gap between actual GST received and fair assessment is approximately \$16 Billion.



In 2017-18, for WA the gap between actual and fair is \$3.602 Billion. This is also the total that the other states would see they would lose in applying the fairer system.

So if the Commonwealth were to top up the shortfall for all “losing” states, the cost would be - \$3.602Billion.

## Making it fair requires balancing a \$3.6B gap

Is fairer that WA has this loss....

...or other states share the loss



In the past three years the Turnbull government has found \$1.2 Billion to top up what they saw was an unacceptable distribution to WA.

Recently, Bill Shorten has promised \$1.6 Billion to top up WA through a “Fair share for WA fund”.

If we accept \$1.6 Billion as the starting point for funds that can be made available and then apply this across the States in proportion to their “loss” the amounts payable are:

\$M	NSW	Vic	Qld	SA	Tas	ACT	NT
Loss from Current payment	110	972	1,588	557	168	130	79
Transition payment	49	432	705	247	75	58	35
Difference	61	540	883	310	93	72	44

Given that in the current arrangement, it seems accepted that WA should tolerate \$2Billion shortfall or “loss” after being compensated with a “Fair share for WA fund”, then it should be equally fair that the other states should accepted this difference in the name of fixing the GST system that has been shown to be broken and unfair.

Alternatively, the Commonwealth my choose to ensure that there is no gap and inject a further \$2 Billion.

The Government and Opposition leaders both agree that the current system is unfair and funds are required to redress the unfairness.

To date the approach has been to leave the HFE model as is and offer partial top ups to WA.

As a transition strategy, moving to the equalise to the average model immediately and providing partial or full top ups to the “losing” states has much to offer:

- It provides a simple switch over without any staggered change
- The WA Government and WA voters will see that the Government has listened and acted decisively to address a situation that has developed over 8 years
- The NSW government will see that a decisive step has been taken to avert the looming impact on them
- The “losing” states will see that the Commonwealth government has acted to protect them (particularly if the full top up model is chosen)