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Re:think Tax discussion paper

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About CME

The Chamber of Minerals and Energy of Western Australia (CME) is the peak resources sector representative body in Western Australia funded by its member companies, which generate 95 per cent of the value of all mineral and energy production and employ 80 per cent of the resources sector workforce in the state.

The Western Australian resources sector is diverse and complex, covering exploration, processing, downstream value adding and refining of over 50 different types of mineral and energy resources.

In 2014, the value of Western Australia's mineral and petroleum production was $114.1 billion. Iron ore accounted for approximately $65.1 billion of production value to be the state's most valuable commodity. Petroleum products (including LNG, crude oil and condensate) followed at $25.1 billion, with gold third at $8.7 billion.[1]

Notwithstanding the recent decline in the price of several export commodities, the estimated value of royalty receipts the state received from the resources sector still composed almost 20 per cent of estimated total state revenue in 2014-15, or around $5.34 billion.[2]

As at March 2015, there was approximately $179 billion in resources sector projects committed or under construction in Western Australia and a further $118 billion in proposed or possible projects.[3]

Recommendations

Minerals Council of Australia endorsement

- CME supports the submission from the Minerals Council of Australia to the Australian Government's Re:think Tax discussion paper.

Western Australian resources sector

- Government must maintain its focus on a predictable, transparent and stable fiscal regime to assist in attracting more projects to the resources development pipeline.

Western Australian taxation specifics

Fringe Benefits Tax

- CME recommends more recent census data be used to classify areas as 'remote'.
- CME considers the current concessions for (Fly-in Fly-out) FIFO transport are necessary and appropriate and should be maintained.
- The FBT exemption for remote area housing benefits should remain unchanged.
- Remote area housing benefits are a deliberate policy position to provide further incentives to encourage residential living in remote areas and should remain.
- CME considers a review of the zone tax offset is required to ensure it delivers a genuine financial incentive to workers residing in remote areas.
- CME opposes any changes to the current treatment of FBT concession as they apply to FIFO practices.

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[1] Department of Mines and Petroleum (DMP), *Mineral and Petroleum Industry 2014 Review*, 2015, www.dmp.wa.gov.au/1525.aspx, p. 1

[2] DMP, Government of Western Australia, *2015-16 Budget, Budget Paper No. 2 Volume 2*, www.ourstatebudget.wa.gov.au/Budget-Papers, pp. 541 & 593

[3] DMP, Resource Data Files: Royalty Receipts, www.dmp.wa.gov.au/documents/royaltyreceipts1314.xlsx

- Any consideration of changes to the current FBT exemptions must consider the economic, financial and social ramifications impacting the broader resources industry.

Goods and Services Tax

- Transitioning GST distribution to an equal per capita basis must be a longer term goal of the Government to promote fairness, economic growth and policy neutrality.

State taxes

- Reform to payroll taxes should be considered in consultation and agreement with the states.
- CME recommends the Federation White paper look at the fiscal imbalance between the states and Australian government to determine a more efficient allocation of the tax base.
- Local government fees and charges should be considered as part of broader tax and revenue distribution recommendations in the Federation White paper to ensure simplicity, uniformity and efficiencies.

Royalties

- Given the detailed royalties review recently undertaken in Western Australia, CME does not recommend any changes to state royalty systems should be considered.

Context

The resources sector makes a significant contribution to both Western Australia and the Australian Government's economies and revenues. The growth in the value of minerals production and new minerals industry capital investment has been the main driver of the exceptional performance of the Western Australian economy over the past decade.

As reiterated in the Intergenerational Report, continuing strong growth and prosperity cannot be taken for granted. To continue to increase living standards, Australia must improve productivity and participation. Productivity growth in particular will be the key long-run driver of income growth.

Tax reform has a vital role to play to encourage future growth in productivity across the economy.

Minerals Council of Australia Submission

CME endorses the submission from the Minerals Council of Australia (MCA) to the Australian Government's Re:think Tax discussion paper.

This submission is a supplement to the MCA submission and as such should be read in conjunction with the MCA document. Of particular note, CME supports the focus on tax reform being guided by the two core objectives of:

1. Improving the competiveness of Australia's tax system and the nation's growth potential, and
2. Establishing a more sustainable and stable revenue base.

These objectives can and should be achieved in a way that supports fiscal repair over time and maintains a high level of equity in the tax system. More broadly, tax reform proposals should be developed in light of the following high-level principles:

- Reform proposals should enhance Australia's productivity performance, workforce participation and international competitiveness
- Reform proposals should adopt an economy-wide and Federation-wide perspective
- Reform proposals should be consistent with a strong budgetary position into the future
- Reform proposals should not adversely affect existing investments or create perceptions of sovereign risk. A stable, competitive tax system encourages investment, especially in highly capital-intensive industries characterised by multi-decade investments
- Fairness should be assessed from the perspective of an overall tax reform package, not based on individual elements. Both the progressivity of the tax-transfer system and intergenerational equity are key dimensions of a fair tax system
- Reform proposals should as far as possible reduce tax complexity and minimise administrative and compliance burdens
- Strong consultation and appropriate transitional arrangements are essential to good tax policy design and sustainable reform.

With these principles in mind, the remainder of this submission focus on additional matters specific to the Western Australian resources sector.

Western Australian resources sector

Contribution

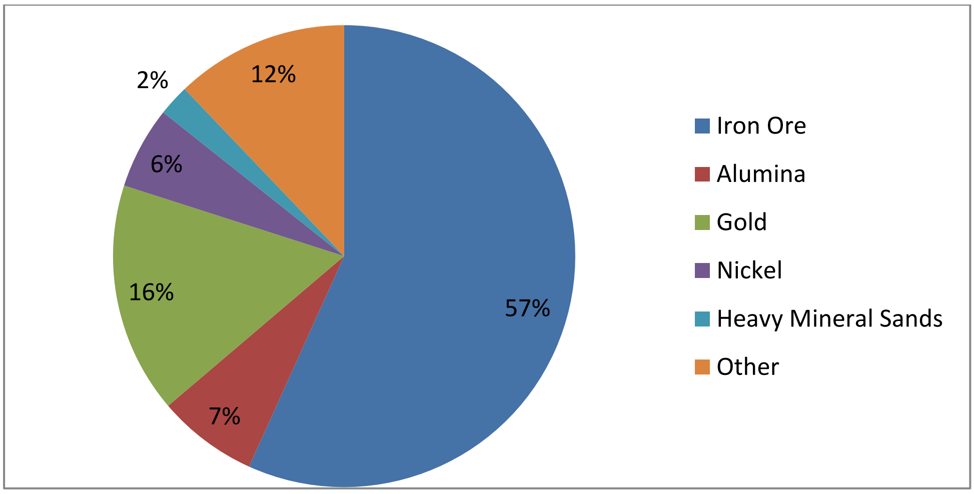
Western Australia's gross state product (GSP) was $265 billion in 2013-14, contributing 17 per cent of Australia's gross domestic product.[4] The mining industry alone accounted for 30 per cent of Western Australian GSP in 2013-14. GSP per capita in Western Australian was $103,770 in 2013-14, 53 per cent higher than the national average of $67,932.[5]

Business investment contributed 26 per cent of Western Australia's GSP in 2013-14. The State accounted for 26 per cent of Australia's business investment in 2014 and 51 per cent of the value of Australia's resource projects under construction or committed in October 2014.[6]

At 5.5 per cent in March 2015,[7] unemployment in Western Australia remains below the national average of 6.1 per cent. Despite cost cuttings across many Western Australian resources operations due to commodity price falls impacting employment, total employment in Western Australia grew 2.2 per cent (40,300 people) through the year to March 2015, higher than Australia's growth of 1.6 per cent (184,200)[8].

Western Australia's low unemployment rate is predominantly due to the strength of the resources sector which is a significant direct and indirect employer in the state. Using 2014 figures, the operational resources sector employs approximately 107,000 people across 26 sectors. Over 90 per cent of these people are employed in the iron ore, gold, alumina and nickel sectors.[9]

Figure 1: Western Australian mining employment[10]



Very importantly, as a result of the depth and breadth of the local value chain a job in the mining industry in Western Australia is worth more to the economy of Western Australia than a job in most other sectors.[11]

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[4] Department of State Development Western Australia Economic Profile – April 2015.

[5] Ibid.

[6] Ibid.

[7] Ibid.

[8] Ibid.

[9] Western Australian Department of Mines and Petroleum Resource Data Files, Employment 2014, http://www.dmp.wa.gov.au/1521.aspx

[10] Ibid.

[11] CME, KPMG *Economic Reach of the Western Australian resources sector,* July 2013.

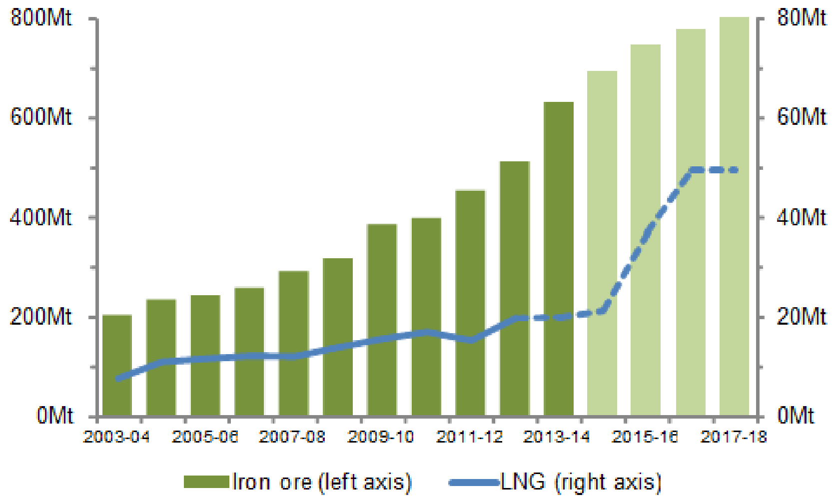
Projections

Western Australia's iron ore sales are forecast to rise by an annual average of 6.2 per cent to 802 million tonnes between 2013-14 and 2017-18.[12]

LNG sales are expected to grow from 20 million tonnes in 2013-14 to almost 50 million tonnes in 2017-18, assuming the Gorgon, Wheatstone and Prelude projects are operating at full capacity at this time and the North West Shelf maintains current production levels.[13]

Western Australia accounted for 40 per cent of proposed iron ore expansions by the top 10 iron ore exporting countries in 2012 and 27 per cent of global LNG capacity under construction in 2014.

Figure 2: Iron ore and LNG sales outlook (volume)[14]



Investment

The Western Australian resources sector competes in global capital markets for the significant capital investment required to expand existing and develop new projects. While project quality is a key factor in capital market competitiveness, a jurisdiction's cost structure, policy environment and tax system are also critically important factors in mining investment decisions.

Although large parts of the state remains under explored, generally Western Australia is viewed as a maturing minerals region. As such many projects in Western Australia present increasingly complex and marginal geological, mineralogical and geotechnical characteristics – this is particularly relevant for the gold sector. This in turn increases the costs of the industry and reduces mineable reserves.

Western Australia will continue to face increasing competition for investment capital from emerging minerals regions such as Africa, which compared to Western Australia is relatively underexplored and underdeveloped. As governments of African nations become increasingly democratic and adopt modern mining legislation and regulations, the relatively under-explored and underdeveloped prospective areas of Africa will become increasingly attractive to mining companies.

Changes in minerals taxation and royalty systems can have a dramatic and immediate impact on costs, as well as investor confidence for investing in the discovery and development of the next wave of investment in Western Australia.

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[12] Department of State Development Western Australia Economic Profile – April 2015.

[13] Ibid.

[14] Ibid.

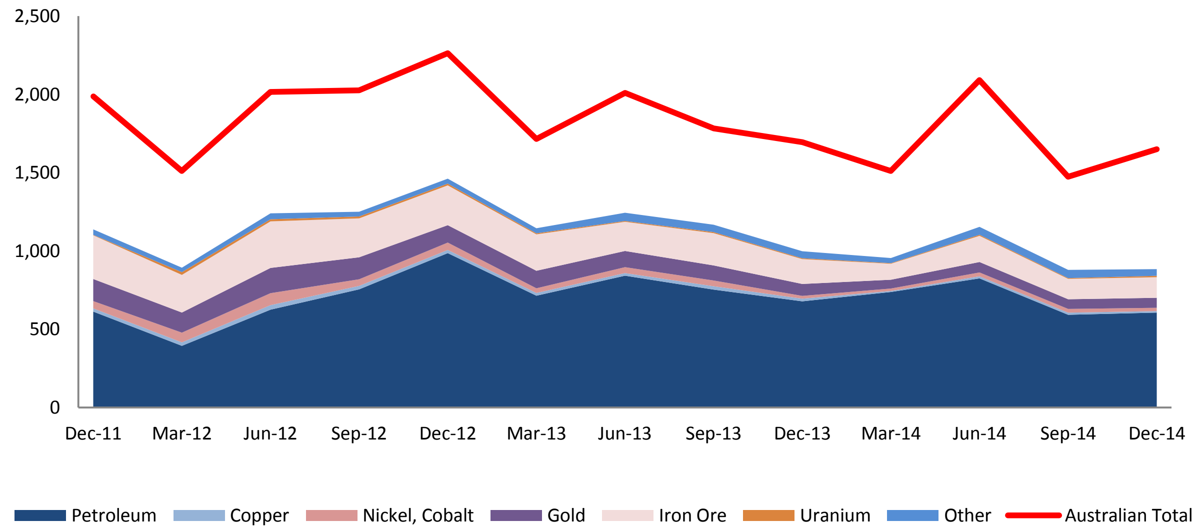
Any changes or proposed recommendations on fiscal policy needs to consider the international perceptions which impact investment decisions prior to undertaking any reviews.

Exploration

Exploration measures the health of the resources industry. Without new exploration, the Western Australia's inventory of mineral resources will decline and so will investment in mineral production, jeopardising the diverse range of benefits that flow from the development of mining projects in Western Australia.

In the March quarter 2015 total Australian exploration expenditure (greenfields and brownfields) hit its lowest level since 2007. The latest statistics show $223 million was spent on WA exploration projects in the March quarter, the lowest since $218 million in the March 2007 quarter.[15]

Figure 3: Exploration expenditure by commodity, Western Australia and Australia[16]



There remains an alarming trend of decreased expenditure across most commodities with current exploration expenditure at disturbingly low levels.

A key factor in exploration is business confidence. Continual changes to, and reviews concerning, resources regulation and taxation policy undermines this confidence and is likely to translate to decreased investment in exploration in Western Australia.

Challenges

While the removal of the mining and carbon taxes has assisted in policy perceptions of Australia as a place to do business, the Western Australian resources sector remains a high-cost place to do business; and this perception has a significant impact on investment and growth of the sector.

Low cost operations have been the foundation of both Australia and Western Australia's competitive position. Lower costs deliver higher returns under any conditions and attract investment. However, when future prices and margins are uncertain, as they are today, cost competitiveness is crucial to the attraction of future investment. Many Western Australian operations are increasingly becoming high cost when compared to similar projects in other regions.

Rising capital costs means new projects are also becoming less attractive. Globally, and despite more recent cost-containment from industry which should start to see this trend reverse, industry

[15] CME and Deloitte Access Economics Quarterly Economic Brief, June edition, data from ABS, www.cmewa.com.

[16] Ibid.

costs have been steadily rising for key inputs like labour, equipment, contracting services and raw materials. Nevertheless, capital costs for projects in Australia are generally higher than for other regions and over the past decade, have increased at rates higher than our competitors.[17]

While minerals may not be mobile, new investment in them (both sustaining and expansion capital) is most certainly mobile. Mining projects are characterised by high levels of capital investment usually with long lead times before the generation of sales income and production-dependent cash flows.

The scale of funding required and the limitations on funding capacity of domestic institutions means major Australian resource projects are heavily reliant on global capital for investment. Along with globally competitive tax arrangements, predictability of fiscal regimes is a critical factor influencing investment decisions.

As at March 2015, there was approximately $179 billion in resources sector projects committed or under construction in Western Australia and a further $118 billion in proposed or possible projects.[18] While these remain significant numbers, the future pipeline of projects has continued to decrease, and with many construction projects being completed in the coming years, there is not a correlating pipeline of projects waiting to take their place.

This serves as an important reminder projects can and do get shelved prior to commencement when the economic conditions and viability of a project are not appropriate for investors and project sponsors. There is no shortage of opportunity for capital in an industry that is increasingly globally integrated and where new capital for projects remains scarce.

Government must maintain its focus on a predictable, transparent and stable fiscal regime to assist in attracting more projects to the resources development pipeline.

Western Australian taxation specifics

Fringe Benefits Tax

Western Australia's resources sector is located predominantly in remote and regional areas of the State which presents challenges to attracting and retaining appropriately skilled labour. CME supports labour initiatives that deliver the dual objectives of meeting resource project labour demands and providing workers with alternative, flexible, and attractive employment options.

Given its operations in a global context, Australia needs tax policies that do not provide a disincentive to investment in an industry and so restrict the ability of Australian operations from competing internationally.

CME is concerned with the misperceptions surrounding the use of fringe benefits tax (FBT) concessions and the perceived misuse of these regarding fly-in fly-out (FIFO) employees.

The history of the concessions indicates limitations in the infrastructure and facilities in remote regions, particularly the shortage of suitable accommodation and schools, have led to support for temporary work arrangements, particularly FIFO rotations, to enable the supplementation of local workforces.

This remains relevant for the resources sector in Western Australia.

More broadly, the FBT system is a source of significant compliance costs on business. Simplification of the system should be seen as a medium term goal but must be balanced with the need to protect the purpose of the FBT system, namely, to increase fairness and protect the integrity of the personal income tax system by ensuring benefits provided in lieu of wages and salary are taxed.

[17] CME, *Cost of doing business study*, February 2013.

[18] DMP, Resource Data Files: Royalty Receipts, www.dmp.wa.gov.au/documents/royaltyreceipts1314.xlsx.

- ***Remote areas***

As the exemptions and concessions applicable for FBT purposes vary depending on whether or not the location is remote, importance is placed on how "remoteness" is determined. A location is remote if it is not in, or adjacent to, an eligible urban area as defined by the 1981 census population information.

A review should consider the applicability of the current definition of remote, irrespective of the year of census data used. Communities have changed significantly over time (both increased and decreased) and what measurements may have been appropriate at the time of introducing remote area definitions may not remain relevant today.

The references to 1981 census populations are a function of the legislation having been introduced in 1986, at which time this was the most recent census. The definition has never been updated. This is possibly because it would be impractical to continually monitor changes in population in order to determine if a location is remote. Despite this certainty however, the current use of 1981 data remains outdated and may not appropriately reflect remote areas, given the changes in population since this time.

CME recommends more recent census data be used to classify areas as 'remote'. To provide certainty to employers, this should only be reviewed on a periodic basis, i.e. every second census, to balance competing objectives of maintaining relevance and stability for business.

- ***Fly-in, fly-out transport***

The exemption from FBT for FIFO flights to remote areas and offshore installations has been a feature of the FBT regime since its introduction in 1986. In 2011 this was extended to remote overseas locations.

In both instances, the exemption was recognised as being necessary and appropriate in connection with FIFO arrangements to overcome the position that such travel would otherwise be regarded as private (in the nature of home to work travel) and would therefore be a taxable benefit if not covered by an exemption.

As confirmed in the Explanatory Memorandum to the Bill introducing the change:[19]

> *Extending the exemption will ensure that Australian residents working for Australian employers in remote areas on fly-in fly-out arrangements are taxed consistently, regardless of whether they are working in Australia or overseas, as well as eliminate any possibility of double taxation on such benefits.*

Transport for FIFO employees incur substantial costs for many resources sector businesses, however is deemed necessary to ensure a skilled workforce is available in remote Western Australian locations. As the exemption itself states, the concession applies where, "having regard to the respective locations of the worksite and the employee's place of residence, it would be unreasonable to expect the employee to travel to and from work on a daily basis."[20]

FIFO transport concessions remain vital for resources companies in remote regions of Western Australia being able to provide choice for workers**;** choice of what job they do, who they work for and importantly of where they choose to live. FIFO and residential employment need to be seen as complementary, not supplementary approaches in a total workforce management package and policy and tax concessions should not be made to interfere or influence these decisions.

CME considers the current concessions for FIFO transport are necessary and appropriate and should be maintained.

[19] Commonwealth of Australia Explanatory Memoranda, Tax Laws Amendment (2011 Measures no. 6) Bill 2011 http://www5.austlii.edu.au/au/legis/cth/bill_em/tla2011mn6b2011324/memo_0.html.
[20] Commonwealth of Australia Explanatory Memoranda, *Fringe Benefits Tax Assessment Bill 1986* http://www.austlii.edu.au/au/legis/cth/bill_em/fbtab1986322/memo_0.html.

- ***Remote area housing***

When FBT was introduced in 1986, remote area housing was not exempt from FBT but was treated as a special category of housing assistance. A housing benefit arises where the accommodation in question is the employee's usual place of residence. In relation to remote area housing, under the rules in place from 1986 to 2000, a choice could be made to either adopt statutory values based on whether or not the accommodation was shared, or to use a value based on a 40 per cent reduction from market value. This reduction was subsequently increased to 50 per cent.

In 1997, an exemption from FBT was introduced for remote area housing provided by a primary producer. In 2000 following a period of consultation, this was extended to an exemption for all remote area housing where the provision of accommodation was necessary and customary in the industry in question.

Given the housing shortages in remote areas of Western Australia, particularly in the Pilbara region, over the past decade, employer provision of housing remains both customary and necessary as an attraction and retention tool for employment in the Western Australian resources sector.

The FBT exemption for remote area housing benefits should remain unchanged.

- ***Remote area accommodation assistance other than provision of housing***

The remote area concessions for benefits other than the direct provision of housing have been largely unchanged since introduced in the late 1980s. Accommodation assistance other than housing owned or leased by an employer typically falls into the categories of rent, mortgage interest reimbursement and purchase assistance.

The FBT concessions associated with these benefits are slightly different, as the following examples illustrate:

- Reimbursements of remote area rent are subject to a 50 per cent reduction in taxable value based not on the value reimbursed, but the cost to the employee.
- Reimbursements of remote area interest are subject to a 50 per cent reduction in taxable value based on the amount reimbursed.
- Reimbursements of purchase costs such as stamp duty or the deposit for the property are eligible for a 50 per cent reduction in taxable value. However the resulting value may be spread over a longer period if the employer has an option to repurchase. If the repurchase occurs, a range of further benefits or "negative" benefits may arise.
- In addition, a 50 per cent reduction in taxable value is available for residential fuel and remote area holiday transport. The residential fuel provision refers to electricity and gas, but not water.

Remote area housing is a significant benefit provided to encourage residential living in remote areas. It is a crucial component to many who chose to reside in remote areas and can have a dramatic impact on the cost effectiveness of this choice.

Remote area housing benefits are a deliberate policy position to provide further incentives to encourage residential living in remote areas and should remain.

- ***Zone tax offset***

The original provision was introduced in 1945 and provided a tax deduction for qualifying individuals as many allowances provided to offset the higher cost of living in applicable locations were absorbed into higher tax payments.

The zone rebate amounts are between $57 and $2,295 (base values) with a potential to increase if the taxpayer is entitled to other rebates (e.g. the dependant spouse tax offset). The value of the zone rebate has been significantly eroded over time and currently does not provide an incentive to people to make their homes in regional Western Australia.

To qualify for the zone tax offset, the individual must have lived or worked in a remote area for 183 days or more during the current income year (not necessarily continuously). The rebate can be received by workers not ordinarily residing in remote areas who spend more than 183 days in regional areas. This is not the intent of the provision.

The 2015-16 Australian budget outlined changes to this provision to limit rebate only to workers who genuinely reside in remote areas. While CME does not consider it is good policy to announce changes to policy without considering the broader context of the review underway, **it considers a review of the zone tax offset is required to ensure it delivers a genuine financial incentive to workers residing in remote areas.** The rates of the offset should also be reviewed to ensure they remain appropriate for their purpose.

FBT summary

With the nature of the resources sector in Western Australia transitioning from construction-led growth to export-led growth, there are significant challenges being faced by resources companies to continue to attract investment.

The mining sector is currently faced with countless increasing production costs, and a change to FBT exemptions are likely to have serious consequences on future investment and future projects being developed. The large increase in costs if the exemption was removed or substantially changed would result in job losses, decreases in production output and most likely, mine closures.

This outcome would be damaging for both the regions in where mines operate, but more significantly, for the broader regions and state and national economies.

Importantly, change or removal of the FBT exemptions will not encourage a greater residential population in remote Western Australia – it will simply make it more costly for businesses to operate.

CME opposes any changes to the current treatment of FBT concession as they apply to FIFO practices.

FIFO is a key mechanism for spreading the benefits of the resources sector across Australia. It is also critical in ensuring there are enough employees to operate mines in rural and remote areas. It provides choice for employees who prefer to live in metropolitan areas yet work in the resources industry.

Any consideration of changes to the current FBT exemptions must consider the economic, financial and social ramifications impacting the broader resources industry.

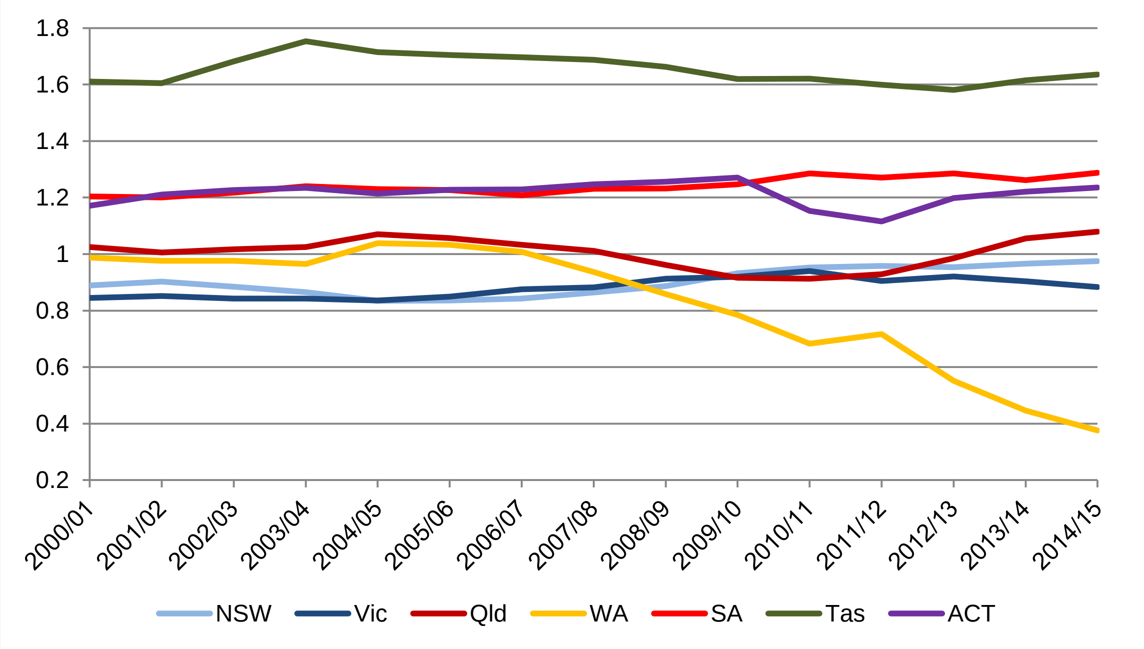
Good and Services Tax

Since its introduction in 2000-01, GST grants have been distributed to the Australian jurisdictions based on recommendations of the Commonwealth Grants Commission (CGC). The CGC are guided by the fiscal equalisation objective and the supporting principles – what States do, policy neutrality, practicality and contemporaneity.

While Western Australia received close to its ‘population share’ for the first eight years after GST introduction, the CGC has calculated Western Australia’s relativity (return per dollar input) will drop to 29.9 per cent in 2015-16 – again hitting a new record low.

This will see Western Australia’s GST revenue fall from $2.5 billion in 2013-14 to just $799 million by 2017-18. By comparison, the lowest distribution in any other jurisdiction since the introduction of the GST was 83.5per cent for New South Wales in 2004-05.

Figure 4: GST grant relativities by Australian jurisdiction[21]



Ironically, if the Western Australian government increased royalty rates, it could lose more in GST distribution than it gains in additional royalty revenue,[22] though this is not a practical outcome given states use their best endeavours to create economic prosperity. This would clearly be a perverse outcome and be to the detriment of other jurisdictions.

While essential reforms are required by the state government to address its spending and underlying structural budget issues, a GST distribution method that facilitates economic growth is an important reform for Western Australia. The current system stymies economic growth by rewarding states unable or unwilling to grow their own revenue bases, while redistributing wealth from states like Western Australia, which still has reform needed.

The case for distribution reform

Redistribution of income is a key tenet of Australia's progressive tax system and there is similarly a need for some level of support to be provided to other jurisdictions. However, the current GST distribution method itself gives rise to the need for support by failing to create the appropriate incentives for jurisdictions to drive and compete for economic growth.

There are several reasons to reform the current GST distribution system.

- *A complex and opaque system*

Jurisdictional governments are required each year to submit lengthy, complex recommendations to annual relativity reviews in relation to 110 assessment criteria. Despite the recommendations, the CGC has acknowledged it rarely changes the distribution method.

There are also concerns about the data the Commission uses in assessing relativities. The data are not consistent or timely, but are instead, as with the assessment criteria, largely subjective. For example, the CGC relies on Australian Bureau of Statistics data for the assessment of

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[21] Excludes Northern Territory relativities, which are not to scale (all greater than 4.5 since 2001-02), Source: Commonwealth Grants Commission Calculations.

[22] Department of Treasury, *Western Australia's Submission to the Commonwealth Grants Commission's 2015 Methodology Review*, September 2014, p. 39, Government of Western Australia.

onshore mining revenues, which have for a number of years over inflated the processed values reported by Western Australia's Department of Mines and Petroleum.[23]

- *An inefficient system*

Under the current distribution method, efficiency in the operation of the tax system is sacrificed for equity across the jurisdictions. Funds are not necessarily allocated to activities that will deliver the greatest benefit to the national economy.

While redistribution helps the smaller jurisdictions to supply services, the opportunity cost is potentially significant as it directs revenue away from industry development in stronger states, which could build the productive capacity and growth prospects for the nation over the longer term. The inefficiency of the process has also been reflected in empirical studies, which have found the current system distorts allocative efficiency within the federation, as funding to smaller jurisdictions is more likely to be spent in a relatively inefficient manner.[24]

- *A system treating revenue inequitably*

Under the current GST distribution method, the treatment of jurisdictions' own source revenue is inequitable as not all bases of revenue are equalised. The sources of revenue currently subject to equalisation include payroll tax, land tax, transfer duty on conveyances, insurance tax, motor vehicle tax, mining revenue (royalties) and other revenue.

While 'other revenue' is assessed, it does not affect the overall GST relativities. The inconsistent treatment of revenue can create distortions because not all jurisdictions collect revenue from the same sources. Notably, gaming taxes are not included in the equalisation process as the Commission considers each jurisdiction has the same capacity to achieve relatively equal revenue from this source.

- *A system providing disincentives for jurisdictional reform*

The process acts as an incentive for jurisdictions to alter their behaviour to maximise their GST grants. Jurisdictions are not encouraged to grow their own source revenue because this would lead to lower GST grants.

In the relativities formula, 'average policy' is determined on a per capita weighted basis. The larger the jurisdiction, the more influence it has on the average. As a result, these jurisdictions have no incentive to reduce their tax rates as they are penalised for doing so through a reduction in their GST grants. This is because a fall in tax revenue disproportionately impacts on the average, widening the gap between the jurisdiction's outcome and the average.

Reform Options

1. Discount royalties revenue by 50 per cent

Partial removal of royalties revenue from equalisation would recognise the significant cost of developing supporting social and economic infrastructure, typically borne by the state and territory jurisdictional governments, which is an essential enabler of resources sector projects and therefore royalties revenue and economic growth.

In 2012, the Australian Government's panel reviewing GST distribution (the Greiner Review) recommended royalties discounts be considered, although without receiving adequate cost information from the state, recommended only a 3 per cent discount compared to industry and the state government which sought a 50 per cent discount. While not directly comparable in terms of method, Canada's horizontal fiscal equalisation (HFE) system effectively discounts 50 per cent of royalties from equalisation.

[23] Department of Treasury, ***Western Australia's Submission to the Commonwealth Grants Commission's 2015 Methodology Review***, Government of Western Australia, September 2014, p. 42. DMP uses actual royalty returns whereas ABS sources estimates based on export volumes.

[24] Hancock, J. and Smith, J., *Financing the Federation*, The South Australian Centre for Economic Studies, September 2011.

2. Include all jurisdictional own revenue sources

All sources of jurisdictional 'own source' revenue should be included in the equalisation equation. As an example, gaming (gambling) revenue, which is a substantial source for several states and territories, is notably not included in the determination of distribution relativities because the Commission considers all jurisdictions have the same relative capacity to raise gaming revenue.

This unfairly penalises Western Australia on its social policy not to permit the proliferation of gaming machines when states such as Tasmania and New South Wales have enacted anti-mining policies yet still enjoy the re-distribution of other states revenue sources.

Long term reform – moving to EPC distribution

Distributing GST grants to each jurisdiction proportionate to their population; that is, moving from HFE to equal per capita (EPC) distribution, would lead to a less complex means of distributing GST grants, which is also consistent with the basic principles of an efficient and simplified taxation system.

Fiscal policy should look to reward productivity and this is not currently the case with the growth disincentives under the HFE distribution method. Changing to an EPC distribution method would provide more appropriate economic signals for Australia's jurisdictions.

The four largest states, in New South Wales, Victoria, Queensland and Western Australia indicated their support for moving to EPC distribution in submissions to the GST distribution review in 2012. The Western Australian state government has also indicated it considers members of the Liberal Party of Australia to be increasingly favouring a transition to EPC distribution.

However, the zero sum nature of GST grants distribution means recipient jurisdictions would lose grants revenue to donor jurisdictions and would therefore be highly unlikely to support any move to EPC distribution.

While unanimous agreement amongst the jurisdictions is not required to change the distribution method, in reality, any change would likely require substantial compensation from the Australian government to the recipient jurisdictions. In particular, to the Northern Territory and Tasmania, which rely heavily on GST grants to fund their governments.

Implementing EPC

Based on 2014-15 estimates, it would cost the Australian Government $4.9 billion to 'top up' current recipient jurisdictions to ensure no state is worse off under EPC distribution. Such an approach offers substantial gains in efficiency and reduced complexity, which could also be taken further by a more general approach to reduce reporting burdens.

A potential method of reducing this amount of compensation required in a longer term transition would be to set aside a share of the total GST pool for transitional grants over several years to ease the recipient jurisdictions into the EPC distribution model. This is similar to the proposal by CGC relating to phasing in of iron ore adjustments.

The transitional pool would likely be allocated exclusively to current recipient states in such a way as to top up their GST grants under the EPC distribution method to a level that doesn't result in a substantial one-off hit to their budget (which would otherwise occur over budget period years from the change to EPC distribution for recipient jurisdictions). Part of this pool could also be taken as a set percentage (on a sliding scale each year) of the additional revenue donor states would otherwise receive. The transitional grants pool could be set as a share of the pool and fall over a set time until full equalisation is realised.

Transitioning GST distribution to an equal per capita basis must be a longer term goal of the Government to promote fairness, economic growth and policy neutrality.

State taxes

The Western Australian State Government levies a range of taxes to fund its operation as well as receiving funding from the Commonwealth through a series of specific and general purpose revenue grants.

The State's three most significant taxes are transfer duties, payroll tax and land tax. It is broadly acknowledged by many economists and tax policy theorists certain narrow based taxes are "economically inefficient" although definitions of such vary. Generally, an inefficient tax is one that distorts individuals' behaviour where otherwise they would have made more "efficient" choices.

However other inefficiencies include high compliance costs relative to the revenue collected as well as the encouragement of unwanted and detrimental behaviour. For example having thresholds for payroll tax may encourage economically inefficient behaviour of business to not hire needed employees where this will bring them within the payroll tax matrix.

- ***Payroll taxes***

Abolition of payroll tax should be considered a priority for all state governments given the inefficiencies and distortions this tax creates amongst businesses. There are added layers of complexities for businesses who work across several states and the additional administrative and compliance time incurred does not justify the revenue earned.

In theory however, payroll tax can be an "efficient" form of taxation, equivalent to a consumption tax however in practice given the variety of practical exemptions and concessions in place, this is not the case.

In Western Australia, employers who take on apprentices or trainees are eligible for a payroll tax exemption for the period of the apprenticeship or traineeship. This exemption, which has been in place for some time, has had a positive effect on industry training effort. Payroll tax exemptions are critical to industries in the Western Australian economy that have a heavy reliance on apprenticeships and traineeships.

Despite the practical use of exemptions across the resources sector, from a policy and economic efficiency argument, exemptions distort the system and limit the effectiveness of payroll tax. While a simpler mechanism would be to have a national system without exemptions and a lower overall payroll tax rate, this reform should not be stand alone given the impact it would likely have on smaller businesses currently exempt from payroll tax, and those organisations with a significant number of apprentices/trainees.

Reform to payroll taxes should be considered in consultation and agreement with the states.

- ***Transfer duties***

Transfer duties are highly inefficient and distortionary taxes as they are based on transactions, and fail the basic principles of good tax design as they are narrowly based.

Given their distortionary nature, they lead to inefficient outcomes as businesses and households change their behaviour to avoid the tax. This type of behaviour-shifting incentive allows the allocation of resources to activities where they are not most efficient or productive, generating a less then preferred economic outcome.

Stamp duty on the purchase of properties discourages turnover and potentially restricts mobility which has been a key concern of Western Australian resources businesses for a number of years and still remains. The decision for individuals to relocate across states to benefit from skilled labour shortages, for instance, would be impacted by the economic impost of stamp duty on the transfer of properties. This has been an additional impediment to Western Australia being able to attract skilled workers to the State throughout prior boom times[25].

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[25] See comment on transfer duties in Economic Regulation Authority *Inquiry into Microeconomic Reform, Final Report* June 2014 https://www.erawa.com.au/inquiries/industry-and-resources-inquiries/microeconomic-reform-2014

Land tax could also be considered an "efficient" form of tax, however again due to thresholds and exemptions there will always be distortions on behaviour to not act in the most economically efficient manner.

The land-rich provisions in the stamp duty legislation create inequities for mining companies in Western Australia as most mining companies hold tenements with a market value exceeding $1 million. CME has long recommended these provisions be brought into line with other states (for example by increasing the threshold from above $1 million and excluding exploration tenements from the definition of land).

Broadening the payroll tax or land tax bases to offset a decrease in transfer duty rates would not be viewed as genuine taxation reform nor would it necessarily remove any of the inefficiencies it is seeking to improve.

Fundamentally, taxes should be easily administered and monitored, simple, predictable and equitable. In order to have state based taxes meet these principles without having significant detrimental impact on the state's revenue base, there needs to be genuine taxation reform at both a state and federal level to address this national issue with a focus on broadening the taxation base at a state level.

Currently the States have few taxes available for them to levy to generate the revenue required to fund its recurrent expenditures. Broadening the taxation base available to states will assist in addressing the growing fiscal imbalance in the federation.

CME recommends the Federation White paper look at the fiscal imbalance between the states and Australian government to determine a more efficient allocation of the tax base.

- ***Local government ratings***

Local government rates are another example of an additional layer of tax surrounded by uncertainty which have the capacity to significantly impact the relevant ratepayers.

Given the variety of increases witnessed across local government ratings in recent years, CME surveyed member companies to ascertain the change in total value of rates payable, driven by the combination of changes from unimproved value (UV) to gross rental valuations (GRV) ratings, changes in rates in the dollar levied, and changes in underlying valuations of assets, from 2011-12 to 2013-14. CME subsequently collated data on the same variables for 2014-15, where possible.

Twenty one companies, varying broadly in terms of commodity, company size and stage of project operations, provided responses to the survey. Respondents were operating in 29 shires with over 531 rateable interests, 430 of which were able to be analysed.[26]

Survey results indicate the change in total value of rates payable for the 351 UV rated interests across up to four years ranged from -77 per cent and 860 per cent, with an average increase of 20 per cent per interest.

The change in total value of rates payable for the 79 GRV rated interests across the same period ranged from -88 per cent and 2,408 per cent, with an average increase of 124 per cent per interest. In absolute terms, the total revenue increase was a significant $9,540,784 across the period for the 79 GRV rated assets.

However, what can be observed throughout is the variability in increases across commodities and local government authorities and the significant revenue raised by local governments in Western Australia.

Similar to the above recommendation, **local government fees and charges should be considered as part of broader tax and revenue distribution recommendations in the Federation White paper to ensure simplicity, uniformity and efficiencies**.

[26] Some respondents grouped several interests, whereas others reported them separately. 101 interests were excluded due to missing data, interests being relinquished, interests rated for less than a year etc.

Royalties

A royalty is not a tax; it is a consideration for a transfer of ownership of property. In contrast, a tax is unrequited. However, a royalty is a legislatively backed compulsory charge by government and therefore has similar characteristics to a tax.

Internationally and within Australia, the overwhelming majority of royalties are based on the value of mineral production – not volume, seemingly influenced by the greater degree of revenue stability. This remains true despite the impact increasing volumes have had on value of certain commodities in recent times. Australian States have generally responded to rising profitability by lifting royalty rates since 2006-07, including Western Australia which has raised royalty rates for mineral commodities throughout this time, most notably for iron ore fines in 2012 and 2013.

Conversely, the Western Australian government has also been supportive of the industry and its ability to pay concerns throughout the recent downturn in commodity prices, announcing temporary royalty relief for iron ore produces and the finalisation of a broader mineral royalty rate analysis concluding no increases for any commodities.

States have increased royalty rates, to such an extent that royalties have increased faster than profits over recent years, increasing the effective royalty rate on minerals nationally.[27]

While the differences in the design of royalties and tax regimes between different jurisdictions and states makes direct comparisons difficult, resource companies do strategically assess the attractiveness of similar projects across jurisdictions when weighing up all economic factors prior to confirming a final investment decision. This strategic comparison is not only at an international level, but also undertaken across domestic jurisdictions.

Policy

Royalty policy reviews undertaken by state and territory governments have typically nominated revenue stability as a separate assessment criterion, additional to the core principles of equity, economic efficiency and administrative efficiency.[28]

The Henry Tax Review's[29] preliminary documents harshly criticised state ad valorem mining royalty systems on economic efficiency and equity grounds. It expressed a strong preference for royalty or de facto royalty systems based on economic rent or resource rent.

While this concept appears popular in economic literature, the practical application to shift away from ad valorem systems would prove costly and troublesome for government and industry.

It is very difficult for a tax or royalty system to deliver all tax policy principles desired. The current Western Australian system provides a higher level transparency and predictability. It provides stability and predictability for government and industry which is key to getting the balance right between revenue raising and ability to attract capital for projects into the future.

The analysis of policy objectives will show that some ideals are mutually exclusive; it is near impossible to have pure economic efficiency combined with the level of revenue stability required by a resources rich government. However many tax policy principles including stability and predictability, simplicity, differentiation, and resource based are met to a large degree with the current Western Australian royalty regime.

Critically for the Government, an ad valorem royalty rate delivers a return to the State regardless of cost structures or commodity prices with expansions and production growth in projects often delivering a greater return to the state. Importantly, it allows the Western Australian government to appropriately manage and govern the commodities within its state.

The Western Australian government, as the owner of the resources, should maintain taxing rights over its commodities.

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[27] From Minerals Council of Australia data based on ABS, State Budget Papers, BREE, Deloitte Access Economics estimates.

[28] See Northern Territory of Australia, Minister for Mines and Energy (1981), Bradley (1986), Australian and New Zealand Minerals and Energy Council, Royalty Working Party (1991), Australian Ministerial Council on Mineral and Petroleum Resources (2006).

29 Henry, K., others (2008a), Architecture of Australia's Tax and Transfer System, Canberra: Commonwealth of Australia, August

Given the detailed royalties review recently undertaken in Western Australia, CME does not recommend any changes to state royalty systems should be considered.

Conclusion

The Government's goal of lower, simpler and fairer taxes recognises the reality that taxes distort economic choices and incentives and have negative consequences for economic growth.

Policy settings, particularly the taxation system, are crucial to attracting the investment needed to develop Australia's minerals resources. Reform is required for Australia to maintain its cost competitiveness in an increasingly tough economic environment, and to continue to be a viable option for investment against the pressure from lower cost resources jurisdictions eager to incentivise mining development in their regions.

This review is an opportunity for the Australian government to highlight its priority areas for reform and development, and seek a mandate from the Australian public to implement change to drive and facilitate Australia's economic growth and future prosperity.

The sustainability of the resources sector should remain a key element in this vision.

CME welcomes the broad review into Australia's tax system and looks forward to ongoing consultation with the Australian government throughout the Discussion paper, Options paper and White paper processes.

If you have any further queries regarding the above matters, please contact Shannon Burdeu, Manager – Economics & Tax, on (08) 9220 8514 or s.burdeu@cmewa.com.

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