GOVERNMENT OF
WESTERN AUSTRALIA

GST

Distribution Review

Supplementary Terms of Reference

WA Submission

March 2012

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Introduction

The Western Australian Government is concerned by the changes made to the terms of reference for the GST Distribution Review. Of particular concern are changes relating to the treatment of State royalties, and the infringement on the independence of the Review Panel imposed by the revised terms of reference.

It is obvious that it is inherent in the new terms of reference that a State should be penalised by the Commonwealth Government for changing royalty rates applicable in that State.

Commonwealth Treasurer the Hon Wayne Swan MP described the instructions to the Committee in these terms:

> *I have written* [on 17 November] *to the Review Panel formally expanding the Review's terms of reference to include a full examination of ... options relating to the interaction between horizontal fiscal equalisation and state tax reform.*

In a contemporaneous letter from the Prime Minister to Mr Oakeshott MP it is now public that this was described as the Committee having been directed by a new terms of reference to *"look at a mechanism to penalise and discourage those states which undertake any further royalty increases."*

In relation to these matters, it is a well accepted fact that States have a constitutionally based right to levy royalties. While royalties might be characterised as serving a similar purpose to taxation, they are, in reality, the price paid by the extractive industry for the resource which is constitutionally owned by the people of the State in which the resource is located.

Notwithstanding recent comments made by the Prime Minister to the effect that royalties do not support growth in the mining sector, the actual facts are that royalties are a key feature of virtually every successful resources economy. For example, since the current royalty regime has been in place in Western Australia, the State's mineral production has increased in value from just over $2 billion in 1981 to approximately $69 billion in 2010. In light of this fact alone, the assertion that royalties do not support growth in the resources industries could readily be concluded to be nonsense.

Given there is no real evidence to suggest royalty regimes fail to support growth in the mining sector, an alternative rationale for the recent instructions to the GST Review Panel to look at a way to penalise royalty increases is that royalty increases are not inefficient but, rather, that they have become inconvenient for the current Commonwealth Government in the context of its undertaking to rebate their value to all companies that may accumulate liabilities under the Minerals Resource Rent Tax (MRRT).

In any event, any move by the Commonwealth Government to penalise a State from exercising its constitutional right not only raises significant constitutional law issues, but also can only be to the detriment of the Australian community, federation and nation.

The Western Australian Government is also concerned with the impact that the changed terms of reference will have on the independence of the Review Panel.

The Review Panel will now be asked to:

> *examine the incentives for States to reduce Minerals Resource Rent Tax (MRRT) or Petroleum Resource Rent Tax (PRRT) revenue through increasing State mineral royalties.*

The difficulty with these directions is that the Review Panel is also being told that in examining this issue that they *"will be guided by"* a conclusory proposition which is subject to differing views, but represents the Commonwealth's settled position, notably that, *"the Minerals Resource Rent Tax and Petroleum Resource Rent Tax provide a more efficient approach to charging for Australia's non-renewable resources than mineral royalties".*

The only plain interpretation of the new directions is that the independent review set up by the Federal Government to find a way to *"a simpler, fairer, more predictable and more efficient distribution of the GST"* finds itself instructed to reach any conclusion it considers proper so as long as it accepts and acts upon the Commonwealth's preferred position that the MRRT is more "efficient" than State royalties.

Given that the Commonwealth has directed the Review Panel to proceed by accepting this proposition as unquestionable can only mean that the Review Panel is being directed to conclude that the States should be penalised for changing royalty rates.

Any move by the Commonwealth Government to penalise a State for the proper exercise of its constitutional rights raises grave concerns about the effective operation of the Australian federation, and can only be to the long term detriment of community outcomes.

Chapter 1

Objectives of the Review Panel

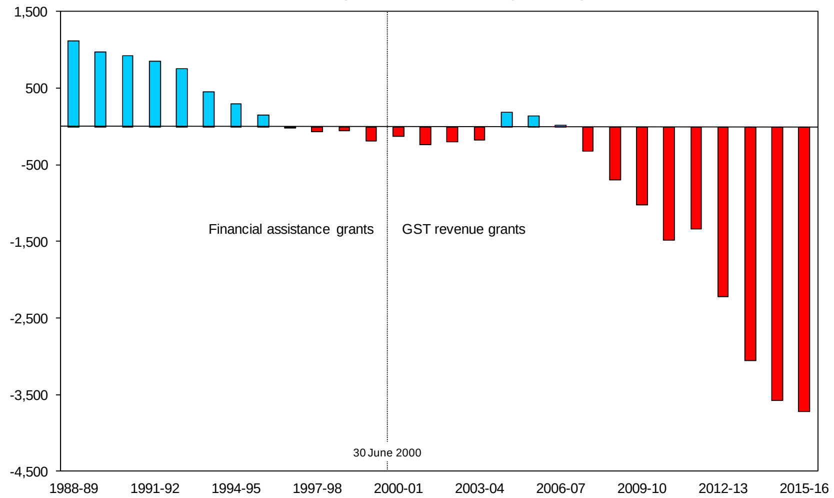
With regard to the three specific 'objectives' that the Review Panel has been asked to examine and achieve by making recommendations on possible changes to the form of 'equalisation', Western Australia's views are summarised as follows.

6A(a) ensure that HFE does not provide a disincentive to State tax reform

Horizontal fiscal equalisation (HFE) should be as policy neutral[1] as possible to ensure that it does not provide a disincentive to tax (and mineral royalties) reform. HFE reforms proposed in Western Australia's October 2011 submission to the Review, including a GST-share 'floor' and 50% discount to the mining royalty 'assessment', are consistent with this objective.

Such measures would also ensure that HFE is less extreme, and uncertain. They would help address significant infrastructure-financing challenges for Western Australia, with the HFE subsidy now paid by the State set to increase dramatically over the coming years (significantly exceeding subsidies received post the period when they were effectively compensation for high Commonwealth tariffs).

Fiscal Equalisation Subsidy received by Western Australia (a)
2011-12 present value terms ($million)



(a) Difference from equal per capita share of GST/financial assistance grants, budget balancing assistance and special revenue assistance.

[1] That is, grant shares should not be influenced by States' policy choices on revenue raising and spending.

6A(b) utilise HFE to provide incentives and disincentives to promote future State policy decisions which improve the efficiency of State taxes and mineral royalties

HFE should not be used coercively in this way. Rather, enhancing the policy neutrality of HFE will ensure strong incentives are in place to achieve this objective – as States will then bear the full consequences of their policy choices.

Providing the Commonwealth with increased coercive powers through the GST distribution is not consistent with the 2009 *Intergovernmental Agreement on Federal Financial Relations* and would more readily allow it to push through policies that are not in the best interests of the Australian federation. The pressure needs to be on all governments (Commonwealth and State) to design good policy, revise poor policy, and negotiate with each other in good faith to achieve better outcomes for the nation.

While we consider that there is no role for using specific GST incentives or penalties to further Commonwealth policy aims, if such actions were to be contemplated, they should be recommended by fully independent bodies and limited to where there are no other signals or mechanisms for governments to improve policy. This would help ensure that the incentives/penalties reflect the national interest.

6A(c) examine the incentives for States to reduce MRRT or PRRT revenue through increasing State mineral royalties

Western Australia does not consider that States have incentives to reduce MRRT (or PRRT) revenues through increasing royalties (on iron ore, coal or petroleum assets). In this regard, Western Australia's recent iron ore 'fines' royalty rate increases will remove long-standing concessions that are no longer warranted, and were previously foreshadowed.

States' decisions to increase royalties will be driven by ensuring a fairer return to the owners of the resources (the State community), rather than by any malicious intent of depriving the Commonwealth of revenue.

Royalties (including those returned to the community through Western Australia's Royalties for Regions program) help fund the infrastructure required to support resources sector growth. In this regard, Western Australia will continue to take into account the overall adequacy of the State's revenues (including from the GST and the Commonwealth's promised Western Australia Infrastructure Fund[2]) to meet infrastructure demands.

The Commonwealth Government says that the MRRT will ensure all Australians share in the benefits of 'Australia's' resources, but ignores the existing redistribution that occurs through both the GST arrangements and the collection and spending by the Commonwealth of income and company tax from the resource sector. It could have worked with (rather than against) the States to improve the overall return to the community from the States' mineral resources.

[2] To be financed from Gorgon and/or Pluto LNG project PRRT revenues.

Chapter 2

Triggers for the Additional Terms of Reference

This chapter considers the three apparent triggers for the additional terms of reference.

Obtaining Commonwealth Parliament Support for the MRRT

The Prime Minister's letter to Mr Rob Oakeshott MP concerning the GST distribution review, with its emphasis on forcible intervention in areas of State constitutional and policy responsibility, contrasts somewhat with Mr Oakeshott's subsequent speech to the Commonwealth Parliament (on 22 November 2011):

> *The Australian and state governments should negotiate an appropriate intergovernmental allocation of the revenues and risk from the resource rent tax. Those are not my words; they are the words of … the Henry tax review of 2009-10. At the time, I supported that recommendation and I continue to agree with it now.*

While Western Australia would not under any circumstances support the finding of the *Australia's Future Tax System* review that State royalties should be replaced by a Commonwealth tax, the additional terms of reference are notably also contrary to the principle of good faith negotiation supported by Ken Henry.

Protecting MRRT Revenue

Rather than respecting the Australian Constitution and the role of all governments in the Australian federation, the Commonwealth has sought to appropriate future mineral rents that constitutionally belong to the States by developing policy in this area without any meaningful negotiation with the States.

In developing its policy on rent-based resource taxes, the Commonwealth has effectively exploited what Western Australia considers to be an unbalanced analysis in the *Australia's Future Tax System* report, to dismiss concerns about the fundamental merits of its policy and unjustifiably denigrate State royalty systems (see also Chapter 4).

Furthermore, in seeking to appropriate State revenues from future mining royalty reforms, the Commonwealth has ignored the national interest by weakening States' already limited revenue raising capacity, limiting their ability to meet growing demands for infrastructure and services and forcing reliance on potentially unsustainable increases in borrowings.

Further centralisation of government revenue raising, and thereby decision making on public sector resource allocation, will weaken Australia's long-term growth prospects. If the Commonwealth were serious about the national interest, it would have negotiated on ways for the States to achieve a fairer price for their mineral resources.

Instead, when Western Australia announced the phasing out of remaining iron ore royalty concessions in its 2011-12 Budget, it was the subject of vociferous criticism by the Commonwealth Government, with financial penalties being flagged for States that raised royalties – including but not just through the GST distribution.

The Western Australia Government strongly defends its responsibilities to ensure that the State community receives an adequate return from its mineral resources, and to generate adequate budget revenues in the face of steeply declining GST revenues and substantial demands for new infrastructure to support economic growth – in the national interest.

State Tax Reform

State tax reform will inevitably involve 'winners' and 'losers', and the Commonwealth will be the major beneficiary of economic benefits flowing from such reforms - through its dominance of taxation (generally) and social security provision. It is therefore appropriate that the Commonwealth provides significant financial assistance to facilitate State tax reform.

Instead, the additional terms of reference issued to the GST Distribution Review Panel implicitly proposes a coercive approach by the Commonwealth to State tax (and resource charging) reform that carries a significant risk of poorer outcomes. This is compounded by the Commonwealth Treasurer being closed to certain broad State tax reform options, that are supported by many independent expert commentators.

In this regard, in media reports in the lead up to the October 2011 Tax Forum, and again (as noted in the Review Panel's supplementary issues paper) in his concluding address to that Forum, the Commonwealth Treasurer made it clear that he wanted State tax reform, but on terms that included *inter alia* no State sharing of the income tax base.

While Western Australia supports reform of State taxes, its first priority is reform of the GST distribution, which is a critical component of the national tax and transfer system and currently inhibits the free flow of labour and capital across regions and industries to where they will be most productive.

Chapter 3

Response to Key Questions in the Supplementary Issues Paper

Does HFE provide a disincentive for States to undertake State tax reform?

Western Australia considers the major barriers to State tax reform to be:

- constitutional constraints (e.g. in relation to States' inability to impose taxes on goods) that limit States' access to fairer or less distortionary taxes;
- the Commonwealth's monopoly on income tax; and
- the sensitivity of redistributional impacts, and associated costs of compensating 'losers' from tax reform.

The Commonwealth Government, working cooperatively with the States, could play a crucial role in breaking down the barriers to State tax reform by (for example) coordinating an inter-governmental approach to such reform, facilitating tax base sharing, and/or helping to compensate 'losers' from tax reform. This was the approach taken in developing the *A New Tax System* reforms announced in 1998, a key plank of which was the introduction of the GST and abolition of a range of inefficient taxes.

Reflecting its dominance of tax raising and social welfare payments in Australia, the Commonwealth stands to be the major fiscal beneficiary from the economic benefits flowing from reform of State taxes. Contrary to the additional terms of reference (6B(c)), it should therefore be prepared to help finance the costs of such reform.

While not necessarily a key factor, the lack of full policy neutrality[3] of HFE reduces incentives for reform of inefficient State taxes such as stamp duties, as States assessed by the Commonwealth Grants Commission to have 'low tax capacity' (which leads to higher GST shares) have an incentive to preserve the GST subsidy they receive from other States, while States with assessed 'high tax capacity' need to exploit that capacity to provide required services.

[3] Policy neutrality ensures that grant shares are not influenced by States' policy choices on revenue raising and spending.

Although they are not taxes, Western Australia has already noted (in its October 2011 submission to the review) how HFE is currently a major disincentive for States to undertake reform of mining royalties – such as the removal of concessions to ensure a more appropriate return to the community.

In this regard, the removal of a long-standing royalty concession for iron ore fines (no longer justified by global market conditions) could ultimately cost Western Australia more in GST revenues than it will gain in royalty revenues. Western Australia has proceeded with this reform on the basis that HFE in its current guise is unsustainable.

To highlight this point, Western Australia has noted how it could gain more in GST (at other States' expense) than it would lose in royalty revenues by significantly reducing its royalty rate on lump iron ore.

Western Australia also noted in its main submission how improved State tax compliance effort (including in the interests of taxpayer equity) could cost a State more in GST share than it gains in tax revenues, using land tax as one example.

If so, how could an alternative form of GST distribution be designed that would remove (or at least reduce) this effect? Would this alternative arrangement be desirable overall?

HFE should be as policy neutral as possible, to ensure that States bear the full consequences of their choices, and that GST offsets do not provide a disincentive to tax and royalty reform. Recommendations in Western Australia's submission to the GST Distribution Review would be effective in reducing these disincentives, as follows.

- Introducing a GST-share floor (75% for Western Australia[4] and 85% for other States) and/or discounting the mining revenue assessment by 50% would limit the disincentives associated with the extreme redistributive impacts of the current form of HFE (including but not limited to those currently seen in relation to iron ore royalties).
- Placing a limit on annual declines in GST 'relativities' (e.g. one percentage point per year) would allow States to retain benefits from significant reform in the short-medium term, while still allowing increased support in the longer term for States with lesser natural resource endowments.
- Basing revenue 'assessments' on broader underlying drivers of differences in States' revenue raising capacities has the advantage of these assessments being less susceptible to changes in individual or collective State policies, effectively limiting the redistributional impacts of State tax reform.

Another option would be to move to an equal per capita sharing of the GST, with the Commonwealth directly funding the 'needs' of weaker jurisdictions.

[4] Taking into account the State's receipts of North West Shelf grants.

Overall, such reforms would offer a boost to national economic growth, and therefore to the size of the GST pool and other tax bases – the majority of which (in dollar terms) are Commonwealth tax bases. In relation to mining royalties, the intergenerational inequities outlined in Western Australia's main submission would also be reduced.

Several submissions have suggested the use of broader indicators to assess revenue raising capacity. If this was to be done, what indicators should be used?

While not fully addressing the fundamental requirement for a less extreme form of HFE in Australia that is more policy neutral, broad indicators would have the benefit of being simpler, more transparent, less biased towards the easily quantifiable and visible elements of State policies, and less sensitive to changes in individual State policies.

A range of potential indicators from National Accounts and other ABS publications could be considered. For example, indicators based on income or consumption could be used to measure differences in revenue raising capacities of States, rather than assessing differences in legislated tax and royalty bases individually.

However, certain issues would need to be addressed to ensure that broad indicators are appropriate and fit-for-purpose, including the issue of tax incidence 'exporting'.

Overall, Western Australia does not encourage the Review Panel to consider or make recommendations on the use of any specific indicators. This is a task better suited to an organisation such as the Productivity Commission, which could undertake or commission expert analysis and invite submissions from States.

How could the GST distribution be designed in order to provide incentives and disincentives for certain State policy decisions?

Australia's intergovernmental financial arrangements should not be designed to encourage "certain" or prescribed policy decisions, but rather to promote good policy outcomes - at both the State and Commonwealth levels.

Western Australia is extremely concerned at the prospect of the Commonwealth Government further intruding into State policy decisions by determining that certain decisions that suit the Commonwealth's centralist interests should be rewarded or penalised by a higher or lower share of the GST.

Excessive and damaging Commonwealth influence on State policy is already facilitated by the high level of vertical fiscal imbalance (VFI) in Australia compared to other federations.[5] The Commonwealth interferes in State decision making by attaching conditions to the grants it provides for specific purposes, even where there is no cross-border or national-interest justification.

This results in the following problems.

- Accountability for service provision is unclear, with both levels of government blaming the other for service shortcomings.
- Decision making is centralised, so local circumstances and preferences are not taken into account in service delivery.
- The checks and balances of a federal system are weakened, so policy is implemented without rigorous scrutiny.

Twomey and Withers[6] outlined the many benefits of a well-functioning federation, which include:

- limits to the power of any individual government;
- greater choice for voters (as they can vote differently at the Federal and State level, and can move interstate);
- customisation of polices to local circumstances;
- competition among States, which leads to greater efficiency and innovation; and
- more scrutiny of policy decisions (as different levels of government must work together), leading to more measured and appropriate decisions.

Furthermore, Twomey and Withers found that federations operate more efficiently, with a lower percentage of the workforce in the public sector, compared to unitary countries, and a lower proportion of GDP spent by the public sector. They also compared economic growth over fifty years and found that:

- federalism may have increased Australia's annual GDP by $4,507 per capita (in 2006 terms); but
- if Australia were more decentralised this benefit could be increased by at least another $4,188 per capita.

[5] State governments raise a low share of total public sector revenues compared to their share of spending responsibilities, making them heavily dependent upon grants from the Commonwealth.

[6] A Twomey and G Withers (2007), Federalist Paper 1 - Australia's Federal Future: Delivering Growth and Prosperity, A Report for the Council for the Australian Federation.

The difficulties in relation to grants for specific purposes persist partly because of the Commonwealth's failure to fully embrace the landmark reforms incorporated in the 2009 *Intergovernmental Agreement on Federal Financial Relations* (IGAFFR).[7]

While full implementation of the IGAFFR needs to be pursued, reducing VFI through national tax reform would more directly allow the benefits of federalism to be realised (through flexibility, innovation and competition). It is insufficient to just provide revenue raising flexibility for States at the margin, as argued by the Henry review. Each level of government should have access to growing and stable discretionary revenue to finance the substantive fiscal autonomy necessary to deliver the long-term benefits of a well-functioning federation.

In addition to reducing VFI (or alternatively, as a second best option), Commonwealth funding needs to be policy neutral to provide the strongest incentives and disincentives for promoting good decision making by both State and Federal governments.

Enhancing the policy neutrality of HFE will ensure that States bear the full consequences of their policy choices (rather than these consequences being 'diluted' by changes in the GST distribution). More generally, policy neutrality will provide States with strong incentives to develop their economies and optimise their revenue capacity. Better tax and royalty structures will result.

As argued in our Overview, providing the Commonwealth with increased coercive powers through the GST distribution would more readily allow it to push through policies that are not in the best interests of the Australian federation. The pressure needs to be on all governments (Commonwealth and State) to design good policy, revise poor policy, and negotiate with each other in good faith to achieve better outcomes for the nation.

Accordingly, the focus should be on reducing existing HFE distortions, not introducing new ones.

If the method of GST distribution was utilised to provide incentives to promote the efficiency of State taxes and mineral royalties, what specific policy decisions should be targeted?

As discussed in response to the previous question, it is important that the GST distribution not be contingent on prescribed policy decisions. Rather, it should promote good outcomes through policy neutrality. If the Commonwealth sees a national interest need for State policy reform, it should seek this through collaboration, not coercion.

[7] These reforms seek to replace Commonwealth control and prescription in areas of State responsibility with enhanced accountability to the community for the outcomes achieved by Commonwealth and State programs.

In particular, it would be manifestly inappropriate, and potentially unconstitutional, for the Commonwealth to target State policy decisions on mineral royalties. As already outlined, preserving and enhancing State revenues from their mineral resources is important for the national interest - to help fund States' infrastructure needs and to limit the centralisation of government revenue raising and associated policy making and regulation.

Commonwealth policy (as reflected in the Prime Minister's letter to Mr Rob Oakeshott and the additional terms of reference to this Review) to limit States' access to their mineral rights is contrary to the national interest. By contrast, a policy neutral distribution of the GST would complement the national interest by providing States with strong incentives to efficiently increase the community's return from mineral resources to fund infrastructure to sustain future economic development.

In addition, the national interest will not be served by the Commonwealth picking and choosing among the many areas where reforms are needed. This includes (for example) gambling policies, given the social harm done by the proliferation of gaming machines in the community. As we noted in our main submission, it is ironic that Western Australia already suffers a GST penalty if it increases royalties to price its minerals more appropriately, but would keep all of the additional gambling revenue if it lifted its ban on poker machines.

What would be the appropriate institutional arrangements for determining the State policy to which the incentives would be targeted and assessing States' progress?

Consistent with our response to the previous two questions, the GST distribution arrangements should not involve any targeted incentives or penalties to further Commonwealth policy aims. However, if any such incentives or penalties were to apply, we consider that these:

- should be recommended by fully independent bodies (i.e. with no affiliation to any government); and
- should only be used where there are no other signals for governments to improve policies (such as community 'pressure') or other more appropriate mechanisms to achieve the same objectives. Such mechanisms include enhancing accountability of governments to their communities (e.g. by reducing VFI, reducing prescriptions on grants and more focus on outcomes reporting) and intergovernmental transfers to correct for spill-over benefits (e.g. National Competition Policy payments were designed to address the problem that States bore significant costs in implementing agreed reforms, but the Commonwealth was the major beneficiary of these reforms).

This would help ensure that any incentives or penalties genuinely reflect the national interest, rather than partisan policy.

Do States have an incentive to reduce MRRT or PRRT revenue through increasing State mineral royalties?

To the extent that there is any incentive, this is attributable to the poor design of the MRRT and lack of collaboration with States, rather than the GST distribution. Using the GST distribution to address the flaws with the MRRT would, as noted above, damage States' revenue capacity and autonomy to the long-term detriment of the federation's economic performance.

First and foremost, States' decisions to increase royalties on State-owned minerals will be driven by the objective of ensuring fairer returns to the community, rather than by any malicious intent of depriving the Commonwealth of revenue from its proposed MRRT (through the royalty-crediting arrangements). States cannot increase royalties with impunity, as they need to have regard to the impact on less profitable operations.

A resource-rich State such as Western Australia with substantial infrastructure spending needs may nonetheless have an incentive to increase, say, iron ore royalties to help compensate for the already large net redistribution of wealth out of the State (including through the HFE process) and inadequate support from the Commonwealth's Budget.

More generally, the terms of reference reflect a one-sided view which overlooks that the royalty-crediting arrangements could equally discourage States from reducing mineral royalties. To the extent that this would result in an offsetting increase in MRRT, there would be no benefit to the mining industry and an increase in VFI.

This highlights that the proposed MRRT complicates the States' management of their royalties. The Commonwealth could have instead achieved one of its MRRT objectives – an improved return to the community from natural resources when commodity prices are high – by working with, rather than against, the States.

If there are such incentives, should they be removed, and if so, how?

The best way to address concerns about any such incentives (or disincentives) would be for the Commonwealth Government not to proceed with its flawed mining tax regime - if the regime proceeds, Western Australia would not support any change to the crediting of royalties against the MRRT and PRRT, which has now been settled with the mining industry and reduces the risk of total resource charges exceeding mineral rent.

However, any concerns about States having to increase royalty rates could also be ameliorated by the Commonwealth ensuring that States such as Western Australia are adequately resourced, including through a reduction in the severity of HFE and provision by the Commonwealth of an appropriate level of direct investment (e.g. the promised Western Australia Infrastructure Fund).

What factors influence the structure of States' royalty regimes?

In introducing Western Australia's current royalty regime in 1981, the then Minister for Mines indicated (in a press statement of 13 October 1981) that a return to the State amounting to in the order of 10% of the value of production ex mine offered a basis for a consistent and logical approach to the setting of royalty levels.

He also said that the royalty applied to each mineral would need to take into account factors such as profitability, remoteness of the mines, contribution to infrastructure, nature of the mining operation and difficulty of separation of the mineral from the ore – and on an industry-wide rather than a mine-to-mine basis.

Overall, Western Australia's royalty regime is considered to strike a reasonable balance between the sometimes competing objectives of maximising economic efficiency, fairness, revenue stability, simplicity, and transparency, while also considering the legislative environment practicalities.

Fairness

Royalties should reflect fair compensation by the mining companies to the community for the extraction of non-renewable resources – irrespective of whether a producer is earning its expected level of profit. Resource companies should also be able to receive a fair return for their investment and risk.

Compensation to the current generation must also be balanced with that for future generations. As discussed in the next chapter (in an efficiency rather than fairness context), this may not always be reflected in private sector resource extraction decisions. In this regard, royalties may deter over-production at the expense of future generations.

In addition, royalty systems should be consistently applied across producers.

Timing and stability of royalty revenues

For Western Australia, the importance of reliable and predictable royalty revenues cannot be over-stated from a budget management perspective, reflecting their significance.

Although adversely impacted by the current form of HFE, early and predictable royalty returns help the State Government to pay for the infrastructure and services required to support resource development. Therefore, royalty systems that are solely rent based are not considered suitable.

Economic impact

The State Government will wish the royalty regime to be internationally competitive (including to minimise the risk of windows of economic opportunity being missed), albeit in the context of the at least equal importance in this regard of quality infrastructure and services provision, low sovereign risk (see below) and natural comparative advantage.

State Governments also reserve the right to offer royalty relief in appropriate on-balance circumstances.[8]

Net revenue retention after HFE

The State Government is necessarily keenly interested in the impact that growth in royalty revenues (from either increases in the base or royalty rates) will have on the State's GST revenue, from a medium-term budget management perspective.

As previously noted, the recent removal of long-standing but no longer economically warranted iron ore 'fines' royalty concessions in Western Australia is premised partly on the assumption that HFE will be reformed.

Sovereign risk

Changes to royalty structures also have regard for any impact on resource producers who have already made investments in the State, and the need for a stable and predictable regime to attract future investment.

Simplicity and transparency

Royalty systems need to be simple for producers and for the State Government so as to minimise the deadweight costs of high administration and compliance burdens and the scope for 'avoidance' of payments (either legally or fraudulently).

The system rules should also be transparent to the community, industry and government so that everyone is aware of the level of royalty being applied and therefore the return the community is receiving for its resources.

Legislative environment

In Western Australia, mineral royalty arrangements are covered by the *Mining Act 1978* (and associated regulations) as well as various State Agreements.[9] In the case of the State Agreements, royalty arrangements are the outcome of negotiations between the State Government and mining company.

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[8] For example, Western Australia amended the Argyle diamond royalty arrangements from the greater of an ad valorem rate of 7.5% or 22.5% of profit to a fixed ad valorem rate of 5% when evidence was presented that the 7.5% rate could prejudice the development of an underground operation (to maximise recovery of the resource). In addition, when a royalty on gold was first introduced, relief was offered to any producer demonstrating that the royalty could cause their mine to close.

[9] State Agreements are essentially contracts between the Western Australian Government and proponents of major resource projects, and are ratified by an Act of State Parliament. They specify the rights, obligations, terms and conditions for the development of a project, and establish a framework for ongoing relations and cooperation between the State and the project proponent. In some cases the State Agreement Act contains specific royalty clauses.

Chapter 4

Claim that the MRRT provides a more efficient approach to charging for Australia's non-renewable resources than mineral royalties

There is much debate in the literature on how best to capture resource rents, including the relative efficiency/inefficiency in practice of rent based taxes versus ad valorem mining royalties. Furthermore, a simple comparison on efficiency grounds alone fails to recognise that royalties such as those imposed in Western Australia are the price paid for the extraction of resource assets owned by the State community.

Given the difficulty of identifying resource rents, the MRRT (and expanded PRRT) make use of accounting rules – but these could inadvertently capture (and therefore tax) more than just resource rents. It would be expected that this and other design features of the MRRT (such as its narrow base and relatively high exemption threshold) would significantly reduce the economic efficiency of that tax.

Commenting on the overall efficiency of the MRRT, Ergus, Harrison and Pincus[10] note that "… the MRRT is likely to be an extremely inefficient tax, more distorting than the RSPT." The final report of the *Australia's Future Tax System* review also acknowledged inefficiencies with the PRRT.[11]

The efficiency of the MRRT could be further eroded if it results in a misallocation of resources between generations (i.e. provides incentives for miners to extract resources more quickly than would otherwise be the case). Royalties may be more efficient in this regard, to the extent that they encourage the deferral of marginal projects until commodity prices are higher or extraction costs lower (due to improved technology).

[10] H Ergas, M Harrison, and J Pincus (2010), *Some Economics of Mining Taxation*, The Economic Society of Australia, Economic Papers, Vol. 29, No. 4, page 378.

[11] *Australia's* Future *Tax System, Report to the Treasurer*, December 2009, Part Two, Detailed analysis, page 229.

There is no settled position in the literature on this 'intergenerational' efficiency (or equity) issue. This appears to have been largely ignored in the *Australia's Future Tax System* review, apart from a reference to the 'Hotelling Rule' determining an optimal rate for exploiting non-renewable resources by reference to the market's required rate of return.[12]

The Hotelling Rule responded to concerns about the potential over-exploitation of non-renewable natural resources. It primarily seeks to answer the question of how much of a resource should be consumed now versus 'stored' for the future, and effectively suggests that this could be left to market forces. There is no discussion in the *Australia's Future Tax System* report of the issues around the Hotelling Rule, such as:

- the difficulty that economists have found in reconciling the theoretical Hotelling Rule with actual experience (e.g. historically commodity prices and *in situ* values have not grown as expected), including the potential for market failures such as insecure property rights;[13] and
- the debates around the appropriateness of using the market's required rate of return (i.e. risk-free return plus risk premium) to regulate socially optimal extraction of non-renewable resources, taking into account the interests of future generations.[14] Climate change policy has also put the social optimality of the market rate of return under the spotlight.

Uncertainty about the future also has significant implications for firms' profit-maximising behaviour in relation to capital investment and the design of a resource rent tax, which were not considered by the *Australia's Future Tax System* review. As noted by Hausman:[15]

> *… the effects of uncertainty are of fundamental importance to the evaluation of sunk and irreversible investments since the investor typically has the option to wait until some of the uncertainty is resolved.*

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12 Ibid, page 218. More specifically, the optimal extraction path is one along which the *in situ* value of the resource increases at an interest rate equal to the rate of return available on alternative investments (adjusted for risk).

13 See for example:

T Kronenberg (2008), *Should We Worry about the Failure of the Hotelling Rule?*, Journal of Economic Surveys, Vol. 22, No. 4, pages 774-793;

J Krautkraemer (1998), *Nonrenewable Resource Scarcity*, Journal of Economic Literature, Vol. 36, No. 4, pages 2065-2107;

G Gaudet (2007), *Natural Resource Economics under the Rule of Hotelling*, address delivered at the 41st annual meeting of the Canadian Economics Association; and

R van Veldhuizen and J Sonneman (2012), *Nonrenewable Resources, Strategic Behaviour and the Hotelling Rule: An Experiment*, www.fee.uva.nl/creed/pdffiles/NonrenewableResources.pdf - this recent paper argues that the relative abundance of many non-renewable resources may have induced producers to overextract, as computing a dynamically optimal production path for an abundant resource may be infeasible, non-salient or suboptimal from a cost-benefit perspective. It is argued that producers in this circumstance should focus more on other aspects of the extraction decision problem, such as strategic behaviour.

14 See for example Krautkraemer, pages 2091-2099.

15 J Hausman (2010), *Analysis of the Taxation of Rent: Mineral Industries in Australia*, www.sites.google.com/site/jh2010tax/rspt-paper, pages 6-7.

> *This option to wait means that it is not economically rational to undertake an investment until the opportunity cost of extinguishing the deferral real option is more than offset by the present value of the expected profit stream.*
>
> *… To remain neutral the option value … would need to be included in the tax calculation*

For example, unless the resource rent tax arrangements properly reflect the value of deferral real options, companies will place too little value on obtaining better information (e.g. on future prices or mineral prospectivity), as they do not receive the full value of that better information on an after-tax basis.[16]

Hausman notes that the investment cost adjusted for deferral option value can be 2 to 3.4 times the size of the actual capital investment, and that the then Rudd Government's proposed Resource Super Profits Tax was not neutral because it did not reflect this option value.

[16] See examples in Hausman, pages 6-8. Hausman also notes that the prospect of changes to tax arrangements may give rise to increased uncertainty that will decrease investment.

Conclusion

Western Australia considers it inappropriate that in the new terms of reference it is inherent that a State should be penalised by the Commonwealth Government for changing royalty rates applicable in that State, which unfortunately may also compromise the independence of the Review Panel.

Any move by the Commonwealth Government to penalise a State for the proper exercise of its constitutional rights raises grave concerns about the effective operation of the Australian federation, and can only be to the long term detriment of community outcomes.

The Commonwealth Government's credibility in claiming superiority of its MRRT over State royalties on economic efficiency grounds is diminished by both its revenue motives and its preparedness to spend vast amounts of taxpayers' funds supporting the car manufacturing industry where Australia has no competitive advantage.

Ultimately Western Australia has full confidence that the three independent GST Review Panel members will find it problematic to be told by the Commonwealth Government what propositions of fact they should accept as true and thereby what conclusions they should reach.