GOVERNMENT OF
WESTERN AUSTRALIA

GST

Distribution Review

Western Australia's Submission in response to the First and Second Interim Reports

August 2012

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Further information or enquiries related to this report may be obtained by emailing info@treasury.wa.gov.au

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Introduction

Western Australia is concerned that the Panel's enthusiasm for reform of Horizontal Fiscal Equalisation (HFE) may have waned since the start of the Review.

HFE reform is a complex subject, with many conflicting views and potential short-term winners and losers. Therefore, it is easy to dismiss major change as too difficult. However, getting the balance of equity and efficiency right (together with simplicity, transparency and predictability) is extremely important for Australia's future.

The current system of HFE strives for full equalisation of States' capacities to provide the same level of services to their existing populations. However, in practice it does not achieve this and therefore cannot be considered equitable, while at the same time its dampening impact on economic development incentives and market dynamics is ignored.

Australia's HFE is rife with uncertainties and judgements that err on the side of redistributing more GST grants from Western Australia than should occur under full equalisation. Furthermore, a number of well-credentialed economists with no affiliation to this State have suggested that the objective of full equalisation is inappropriate.

On both counts, HFE is inhibiting the State's capacity to attract the labour and other resources needed to support shifts in Australia's economic comparative advantage. If reformed, increased population mobility could also help bring about equality in (per capita) capacities to provide State services, as the new economic equilibrium is reached.

In the absence of HFE reform, Western Australia will not be able to sustain the public sector investment necessary to support further growth in its resource sector and other sectors best placed to take advantage of the economic transformation occurring in Asia.

The overall result will be a less prosperous Australian economy, less able to afford (among other things) the large investments in health, disability services, education and indigenous communities proposed or necessary to boost social outcomes.

With this as a backdrop, Western Australia's final submission assesses the spectrum of options for reform and makes the following recommendations.

Recommendation 1 – Equal per capita (EPC) distribution, with appropriate transitional arrangements and Commonwealth support funded from its fiscal gains from reform

In the long term, GST grants should be distributed on an EPC basis among all States. This is the joint position of all 'donor' States. The Commonwealth should fund any additional subsidies to the current 'recipient' States. The Commonwealth would decide the level and conditions of financial support to balance equity and efficiency goals.

An EPC distribution would be transparently fair, simple, predictable and non-distortionary. National Gross Domestic Product and Commonwealth revenues should increase significantly on the back of the productivity gains that such reform would bring, providing the wherewithal to assist recipient States.

Recommendation 2 – Partial equalisation based on a smaller grant pool

A majority of the GST grant pool (60%) should be distributed on an EPC basis, with the remainder of the pool distributed on a HFE basis.

This option would achieve a better balance between equity and efficiency objectives (noting also that the current HFE does not deliver well on equity).

This option could be part of a transitional arrangement under Recommendation 1, with the portion of the pool distributed on an EPC basis increasing over time to 100%.

Appendix A addresses a list of misconceptions floated during the course of the Review. Appendix B provides supplementary information for the assessment of reform options. Appendix C includes the results of economic modelling of the national benefits of increasing Western Australia's capacity to accommodate structural adjustment (more conceptual modelling is outlined in Appendix B section 5 *The inefficiency of HFE*).

Chapter 1

Outcomes and principles that should guide reform of the GST distribution

Desired Outcomes

Western Australia considers that three key outcomes should be sought from the GST Distribution Review.

1. The GST distribution should help facilitate Australia's economic potential.

As set out in the Introduction to this submission, and also discussed in the first feature box in Chapter 2, the GST distribution system should facilitate rather than inhibit structural adjustment in the Australian economy – the movement of resources (labour and capital) to their most productive use.

In so doing, HFE should recognise the challenges and cost pressures (not just the revenue benefits) resulting from strong economic growth opportunities, including all those relating to the provision of social and economic infrastructure and remote services.

In this regard, Western Australia supports the Review Panel's view in its First Interim Report that "current arrangements do not appear to recognise mining related infrastructure costs, mining expenses and economic development costs appropriately" (page 137).

In addition, the GST distribution system should aim to preserve the incentive and productivity advantages of the Australian federation. These come about through:

- competitive pressures on autonomous States, which provide incentives to keep taxes low, services efficient (and reflective of community needs and priorities) and regulation balanced in terms of social and economic objectives; and
- the capacity to test and demonstrate innovative approaches, together with the incentive to balance the upside risks (if success is achieved) against downside risks (if the approach fails) and take corrective action expeditiously.

These incentives can be reduced if, for example, "major errors in economic management that lead to sustained low growth in a way that hurts a state's ongoing ability to raise revenue can be compensated" (Prime Minister and Treasurer Joint Media Release, 30 March 2011).

2. All States should have the capacity to provide services equitably.

While the Grants Commission's current implementation of HFE reflects a version of equity[1] that is often accepted without question, it is inequitable if States are: rewarded for poor policies; penalised for success; have to shoulder an excessive burden of the cost of structural adjustment; or cannot improve low standard indigenous community services due to a lack of fiscal capacity. Accordingly, a broad perspective is required.

Notably, an alternative description of HFE (that we support) is included in recent Commonwealth Budget Papers: "HFE provides the necessary budget support so that all States have the capacity to provide services at a comparable standard, while ensuring that the interstate transfers are not so large that they would significantly distort economic behaviour and reduce productivity growth" (e.g. Budget Paper No. 3, 2012-13, page 123).

Similarly, the Review Panel has noted in its First Interim Report that "both international experience and Australia's own past practice show that something considerably less than pursuit of absolute equality between jurisdictions can result in a fair outcome" (page 22).

3. HFE should provide States with the ability to plan with certainty.

States currently face uncertain outcomes from Grants Commission method reviews and annual updates. It is difficult for them to plan for sustainable provision of services under these conditions. Similarly, it is difficult for States to invest in potentially contentious regulatory reform or expensive and risky infrastructure if the returns are subject to unknown HFE outcomes.

This was illustrated in 2012-13, when Western Australia lost an estimated $662 million in GST grants compared to the previous year, or $843 million compared to if its share of the GST pool had remained fixed – much more than we had been able to forecast.

Principles

In seeking these outcomes, we consider that options for reform of Australia's HFE system should be measured against the guiding principles of equity, efficiency, simplicity, stability and predictability, and practicality (similar to those listed in the Review's terms of reference).

[1] Essentially that States should be given the budget capacity to provide the same standard of services (being the average of actual standards) if they make the same effort to raise revenues from their own sources and operate at the same level of efficiency (albeit this is very difficult to measure).

Equity

Equity (or fairness) can mean a number of things, including:

- the degree to which persons with similar needs and financial circumstances are treated similarly;
- the intrinsic equity of a State receiving back (in GST grants) a reasonable proportion of what its residents have contributed (to the GST pool)
  - in this regard, Western Australia is projected to receive back only about $1.5 billion of a $6 billion contribution to the GST pool in 2015-16 – a loss of $4.5 billion; and
  - this intrinsic inequity is exacerbated by the fact that, overall, the Commonwealth takes about $15 billion more out of Western Australia each year than it puts back in;[2]
- the Grants Commission's current objective of equalisation of States' budget capacities, based on average State policies, but noting that this does not consider
  - the impact of differential State policies on their economies; and
  - the difference between States' actual tax bases (i.e. as legislated) and services and the broader 'underlying' tax bases and service outcomes they are targeting;[3]
- the degree to which true policy neutrality is achieved, so that (for example) States are not penalised for good economic management, tax reform or improved services; and
- intergenerational equity – the extent to which decisions taken now have regard for the interests of future generations
  - for example, the current equalisation of mining royalties tends to reduce accountability for using these royalties sustainably, such as through infrastructure enhancement or long term investment funds.

Efficiency

Efficiency primarily means avoiding distortions to economic decision making, so as to maximise technical and allocative efficiency in the economy.

The inefficiency of HFE stems from the disincentive effects of the majority of a State's fiscal benefits from economic development or improved returns from minerals being redistributed to other States; the lack of equalisation of all of a State's costs of facilitating

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[2] See, for example, pp103-105 of Western Australia's Budget Paper No.3, 2012-13. Most other States receive a substantial net subsidy from the Commonwealth.

[3] Which may mean that the average policy (based on legislation and actual service provision) does not reflect the balance of equity and other considerations that States target, but manifest differently across States depending on the individual circumstances of each State (e.g. land values to which land tax is applied may better reflect capacity to pay in some States than others).

structural adjustment; and the barrier posed by HFE to labour and capital mobility – when service standards in less productive regions are subsidised by more productive regions.[4]

Lack of policy neutrality (i.e. grants potentially being affected by differences in State policies – including pro-development policies) is inefficient as well as inequitable.

The same can be said of full equalisation, which amounts to a 100% tax on above average fiscal capacity, and is far more extreme than seen either in other federations or other parts of Australia's tax and transfer system. Apart from inhibiting structural adjustment, this also reduces incentives for hard work and good policy choices.[5]

Simplicity

We define simplicity in terms of the number of 'moving parts' in the system, the resources expended to maintain the system (i.e. administrative overhead), and the ease with which it can be understood and therefore debated. In the context of reform of the GST distribution, two distinct approaches are useful to consider.

Firstly, the HFE system could be reformed into a simpler process as a whole, with fewer data requirements, or simply fewer variables. An example of this form of simplicity would be to move towards an EPC GST distribution.

Secondly, albeit less ambitiously, the current system could be improved with simple modifications. This could take the form of simplifying revenue assessments through the use of broad indicators, or placing a 'floor' under GST shares or grants.

Stability and predictability

Stability refers to the volatility in a State's GST share. Predictability relates to whether States' can reliably forecast HFE outcomes.

HFE outcomes should be stable and, perhaps more importantly, predictable over the long term if they are to support long-term decision making and reform by governments.

Practicality

We define practicality as the technical difficulty and sensitivity of achieving the desired reform objective in a transparent fashion (i.e. so that the achievement of the reform objective can be verified by well informed independent reviewers). This extends to the complexity of issues to be resolved in implementing the reform.

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[4] This is most evident when the productive regions are suffering from labour and other resource shortages to further develop their internationally competitive industries – the structural adjustment issue in the Australian economy.

[5] While lack of policy neutrality can be a disincentive or penalty for hard work or good policy choices, full equalisation (even under conditions of policy neutrality – were these achievable) could be seen as removing any positive incentive or rewards for such.

Chapter 2

Assessment of Reform Options

This chapter provides Western Australia's assessment of the spectrum of GST distribution reform options that have been proposed to date (including by Western Australia), using the five principles elucidated in Chapter 1.

1. No change

Equity rating – poor

The current system lacks equity, including because:[6]

- it is not 'policy neutral', including in the sense that 'hard work' that boosts a State's fiscal capacity (e.g. tough decisions on development approvals) is penalised and poor performance that limits a State's fiscal capacity is compensated (see earlier quote from Prime Minister and Treasurer Joint Media Release, 30 March 2011);
- it is too extreme, being a 100% tax on any above average fiscal capacity, including that attributable to 'hard work';
- it is not based on the facilitation of equitable public policy outcomes (such as improving services to indigenous communities);[7]
- it is asymmetrical in that all of the revenues from economic development (e.g. resource development) are equalised, but some of the associated costs borne by State governments go unrecognised (see further detail under Option 5 – Direct recognition of economic development needs; and Appendix B section 1 *Mining related economic development needs*);

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6 For further detail see also Appendix B: section 1 *Mining related economic development needs*, section 3 *The questionable equity of the current HFE principle* and section 4 *Flaws in the achievement of full HFE*; and Western Australia's October 2011 Submission: Chapter 2 and Appendix C).

7 This is even more of a problem under the 'average policy' used by the Grants Commission, which is based on States' revenue legislation and actual service provision, rather than the broader 'underlying' tax bases and service outcomes that States are targeting (see page 5).

- many other assessments have gaps and arguable merit (e.g. welfare and housing; rural/remote water subsidies). Full HFE, even if desirable, is not achieved. An excessive redistribution occurs unless all the major influences are reasonably captured; and
- the full equalisation of mining royalties reduces the incentive for the mining States to seek an adequate (i.e. equitable) return for the community from their minerals, and encourages the immediate consumption of these royalties (by all States) to the detriment of future generations (see also Option 6 – Discount mining revenue assessment)
  - while Western Australia has nonetheless proceeded with further reforms to its iron ore royalties announced in its 2011-12 Budget, this was on the clear understanding that the GST distribution system would also be reformed. It has also since announced the establishment of a Future Fund for a portion of its royalties.

Efficiency rating – poor

The current system is not efficient as it does not provide capacity for structural adjustment, in terms of the infrastructure and services that will attract labour and capital to more productive regions. For Western Australia, this unrecognised capacity is estimated at $1.6 billion per annum (see Appendix B section 1 *Mining related economic development needs*). Additionally, incentives to pursue economic reform and pro-development policies are blunted.

Structural Adjustment

A feature of structural change in the Australian economy is a surge in resource-sector investment and exports as a share of GDP (on the back of a terms of trade 'boom' fuelled by rapidly-developing Asia's demand for resources), with spill-overs to the services sector (through a substantial increase in real income), and a contractionary effect on sectors such as 'standardised' manufacturing (through a high $A exchange rate).

To the extent that the growth sectors reflect Australia's comparative economic advantage, facilitating a shift in labour and capital to those sectors should be in the national economic interest.

While Western Australia's mining industry is one such sector, partly reflecting quality resource endowments, the State's proximity to Asia should also contribute to a permanent post-resources 'boom' competitive advantage (over other States) in the export of education, foodstuffs, professional services and more specialist manufacturing – the demand for which is expected to rise by virtue of higher Asian incomes.

Furthermore, the still relatively low GDP per capita in the Asian region suggests that its growth, though potentially volatile in the short term, will be strong and ongoing for many years, providing opportunities for Western Australia and the nation that need to be taken.

In this context, the following case made for paring back the current GST redistribution by Professor Henry Ergas[8] should not be ignored.

> *As Asia's growth increases the value of … minerals, labour should flow to the resource States from other parts of the country. Providing better public services than the other States and charging lower taxes is consequently crucial for the resources States to attract people. But fiscal equalisation undermines their ability to do so. … The most dramatic impacts are on Western Australia …*

The capacity for Western Australia to provide better public services or lower taxes per person relative to other States (from reducing HFE) should only be a transitionary one, while the State attracts an increased share of the national population (such that its resources wealth is shared directly by more people). But the economic benefits would provide for better services or lower taxes nationally by the end of the adjustment period.

Western Australia is concerned that its capacity to help facilitate structural adjustment in the national interest is hampered not only by the current full equalisation objective, but by evidence (included in our October 2011 submission and again in this submission) that implementation flaws in the pursuit of this objective result in a substantially greater redistribution of Western Australia's grants than should occur under full equalisation.

Western Australia submits that the need for policies and reforms that facilitate rather than inhibit structural adjustment, with a view to creating more wealth rather than redistributing existing wealth, is also plain in the following facts and figures.

- Western Australia's still very low share of the national population (10.6%), compared to its 33% of Australia's land mass (35% of Australia's coastline), 30% share of national investment projects currently under construction or committed, and 46% contribution to Australia's exports.
- Labour shortages constraining the growth of our otherwise internationally competitive resource-based industries, contrasting with relatively high unemployment (5.4% vs 3.5%) and low participation rates (65% vs 69%) in other States and Territories (collectively).
- The low rate of interstate migration to Western Australia, forcing the State to turn overseas for workers, with international immigration dominating interstate migration to Western Australia by a factor of about six.
- Social costs of increased reliance on fly-in fly-out workers for mining operations (both locally and in workers' normal places of residence), and pressures on local government services in mining towns not matched by an increase in the rate base.
- Economic modelling (presented later in this submission) which indicates that giving back to Western Australia even half of the GST redistributed to other States (in 2014-15) could increase Australia's future GDP by 1.5% or around $19 billion per year. The associated annual boost to Commonwealth revenues would be in the order of $4 billion (in real terms), similar to the total HFE subsidy for recipient States.

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[8] Professor of Infrastructure Economics/Senior Economic Adviser, SMART Infrastructure Facility, University of Wollongong/Deloitte Australia (published in *The Australian* on 11 June 2012).

There has been some questioning of the significance of HFE incentive effects, while a South Australian commissioned report by Independent Economics claims to show small efficiency benefits from HFE. These issues are addressed in Appendix B section 5 *The inefficiency of HFE*. In summary, we consider that:

- the Independent Economics modelling has a range of shortcomings and technical mis-specifications that invalidate the results (both the claimed efficiency of HFE and the claimed inefficiency of cost equalisation);
- disincentives created by HFE are not principally about 'gaming' the Grants Commission's methods (though this is important in a few areas – see below) but rather the ability of States to run sustainable budgets with reasonable service provision regardless of their success in improving economic growth. Conversely, States that want to take hard decisions to improve economic growth cannot sustainably offer significantly lower taxes or compensation for 'losers'. States cannot 'finance' economy-enhancing infrastructure improvements from resultant tax growth. States can also take 'lazy' decisions to increase taxes or reduce services to repair their budgets without worrying about the consequences for productivity;
- while States obviously do have a continued incentive to exploit their mineral resources (subject to concerns about adverse impacts on the environment and alternative economic uses of the land), the financial constraints on Western Australia due to the equalisation of revenues from mining developments limits the State's ability to support mining industry expansion through improved infrastructure and expansion of communities. The mining industry is high risk for States, because activity is often in remote areas and future prospects are subject to high market variability. Placing maximum cost and risk on individual companies, and taking an incremental approach to development, is not consistent with the broader public interest of allowing the mining industry to expand sustainably in the long term; and
- indicative calculations suggest increases of several percentage points of GDP in the long term from improving rates of migration to more productive States and incentives for States to be more pro-development.

In a number of revenue areas where the revenue base is concentrated in a few States or strongly tied to State policies (mining royalties, land tax, conveyance duty, motor vehicle stamp duty) there are particularly significant opportunities for States to manipulate GST grant shares through policy decisions (see also Appendix A section 3) – sometimes referred to as 'grant design inefficiency'.

Simplicity rating – poor

The methods currently used are indisputably complex, often rely on very specific data collections, and require copious judgement.

Stability/predictability rating – poor

Even over the budget forward estimates period States' GST shares are difficult to forecast, which severely limits a State's capacity to develop longer term economic development plans.

Practicality rating – poor

While 'doing nothing' could be considered practical, the current system has undergone 30 years of review and is still highly experimental, with much argument and dispute among the States and the Grants Commission. This will continue if there is no change following this Review.

2. Nominal grant maintenance

The current HFE system could be modified to ensure that no State receives less GST revenue, in nominal terms, than in the previous year (assuming growth in the GST pool). The Review Panel has proposed this as a 'softer' alternative to a GST share or relativity[9] floor (which would limit relativity reductions to those able to be absorbed by pool growth).

Equity rating – small improvement on current

This reform option would still allow GST relativities to vary over time, but more smoothly than at present. Any equity impact from not achieving the Grants Commission's version of HFE is likely to be small, bearing in mind its multitude of equity deficiencies. If anything, this option would counteract some of those deficiencies in a small way.

Efficiency rating – moderate improvement on current

This option could enhance incentives for States to improve their economies and achieve a fairer return from their mineral resources, to the extent that it limits the extent to which the increased fiscal capacity is redistributed to other States in at least the short term.

Simplicity rating – similar to current

Nominal grant maintenance would be simple to implement, notwithstanding that it leaves in place the existing complex system.

Stability/predictability rating – significant improvement on current

This option could significantly improve stability and predictability, potentially for all States. This was evident in Western Australia in 2012-13, when its GST grant allocation fell by $662 million compared to 2011-12 ($843 million compared to if its share of the GST remained unchanged), at a time when expenditure pressures reflect an economy growing by 6% and population by nearly 3% (easily the fastest of any State).

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[9] A State's relativity is its GST grant share divided by its population share of the GST pool.

Practicality rating – high

This option, with little additional administrative effort, provides scope to improve the efficiency and predictability of the current system with little redistributive impact.

3. GST relativity floor

Western Australia's October 2011 submission recommended as an 'immediate fix' a GST relativity floor of 75% of an EPC share of the GST pool for any State. This is still considered to have merit.

As acknowledged in the Review Panel's interim report, a relativity floor could be a 'back-end' way of addressing the same deficiencies that a discount to the mining assessment (see Option 6 below) could address.

Equity rating – moderate improvement on current

As in the case of a nominal GST grant floor, any equity impact from not achieving the Grants Commission's version of HFE is likely to be small, bearing in mind its multitude of existing equity deficiencies. However, a fairer outcome would result for Western Australia.

Efficiency rating – moderate improvement on current

This option would provide improved capacity for structural adjustment and economic development incentives for Western Australia. Although only higher floors would be likely to be relevant to other States in the foreseeable future, the national economic flow-on benefits from the improvements for Western Australia could be substantial (see Appendix C and Appendix B section 5).

Simplicity rating – similar to current

Like nominal grant maintenance, a relativity floor would be simple to implement, notwithstanding that it leaves in place the existing complex system.

Stability/predictability rating – moderate improvement on current

This option could significantly improve stability and predictability, albeit only for Western Australia in the foreseeable future. Nonetheless, Western Australia looks set to continue to be the State most impacted by instability and unpredictability in the near term.

Practicality rating – high

Like nominal grant maintenance, this option, with little additional administrative effort, provides scope to improve the efficiency and predictability of the current system with little redistributive impact.

4. Simplify revenue assessments

Simplification of the revenue assessments could involve the use of broad 'global' indicators or measures of States' overall tax/royalty raising capacities, rather than attempting to quantify what can be raised by each State if it applies the average of all States' actual/existing taxes and royalties.

For example, differences in Gross State Product (GSP) per capita could be considered to adequately reflect differences in States' capacities to collect most own-source revenues, including State taxes and mining royalties (see Chart below), notwithstanding current deficiencies in GSP data (which is often subject to significant retrospective revisions).

On a more limited basis, assessments of States' differential capacities to raise State tax revenues could be based on general indicators of the size of each tax base, ignoring the exemptions and progressives scales typically applied in practice – which may have questionable equity and efficiency rationales.

Equity rating – small to moderate improvement on current

Offers some scope to improve the overall equity of the assessments.

Efficiency rating – small to moderate improvement on current

A global indicator of tax/royalty capacity such as GSP would particularly help to address the present disincentive to extract an appropriate return to the community from mining (through royalties), and assist in the development of the mining industry.

More generally, it would virtually eliminate opportunities for States to manipulate their revenue assessments through policy decisions. However, 'hard work' that improved economic growth generally would still be penalised.

Simplicity rating – small to moderate improvement on current

By reducing, for example, the amount of data needed to support the revenue assessments, simplicity would be improved.

Stability/predictability rating – small to moderate improvement on current

A global tax/royalty indicator is likely to provide greater benefits in this area than ignoring the exemptions and progressive scales typically seen in State taxes, albeit there would be continued uncertainty in relation to States' relative economic performance.

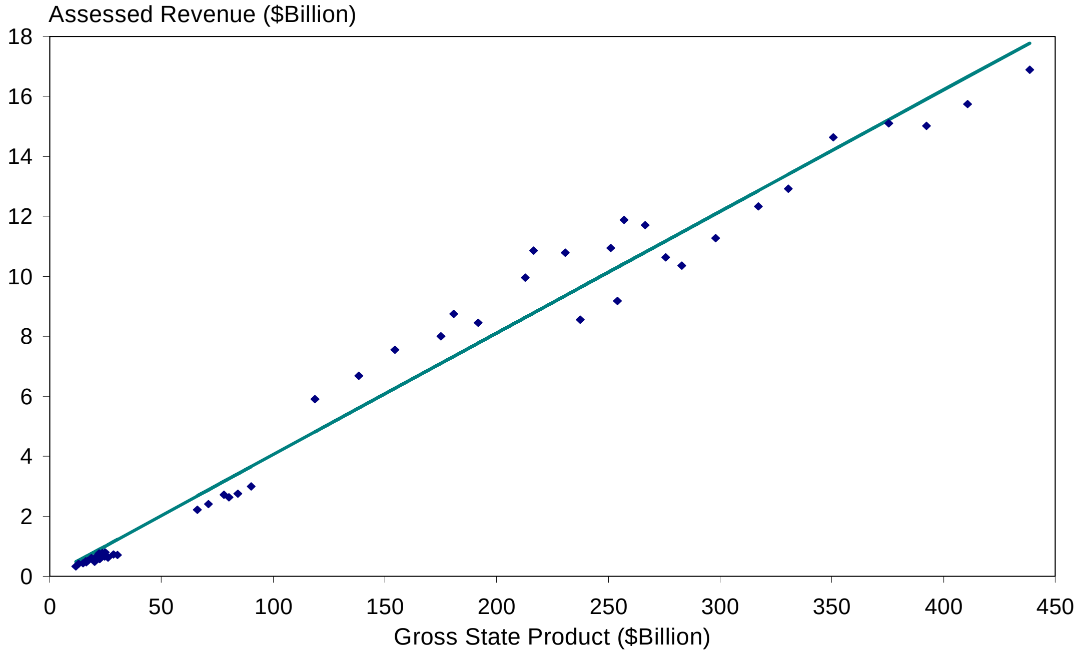
Practicality rating – unclear

While an agreed approach should be fairly simple to implement, overall practicality remains unclear as the extent of simplification and choice of any global indicator would be expected to attract vigorous debate.

In this regard, the global indicator approach is likely to result in the largest changes in grant distribution and therefore be the most contentious, but also offers the greatest benefits across most of the reform criteria.

RELATIONSHIP BETWEEN ASSESSED REVENUE AND GSP

All States and Territories, 2005-06 to 2010-11



Source: Western Australian Department of Treasury analysis using ABS and Commonwealth Grant Commission data.

5. Direct recognition of mining and other economic development needs

The economic development needs that should be directly recognised by HFE are those which reflect Australia's international comparative economic advantages and exist differentially across States (as opposed to being common to all States – such as the need for competitive education and tax systems).

This reform would directly address the asymmetry that all of the revenues from mining development are currently equalised, but not all of the costs incurred by State governments in supporting such development are similarly 'shared'. As a result excessive redistribution occurs, even relative to the existing 'full equalisation' objective.

For example, since 2010 the Grants Commission has applied an improved capital assessment, but it is restricted to the general government sector, and does not take into account the cost of providing infrastructure in advance of demand in emerging or rapidly growing economic regions – nor the risk that the expected demand may not materialise.

In this regard, multi-use infrastructure such as power, port, rail/road, water and allied social infrastructure often needs to be provided by government (to support resource development), because private sector proponents have little incentive to plan and scale the infrastructure to meet future demand growth from other users.

Infrastructure (including social infrastructure) must generally be provided in advance of full demand utilisation, as it is not economic to grow capital in small increments.

This characteristic of infrastructure investment in emerging economic regions makes full cost recovery through feasible or efficient (i.e. benefit-based) user charges over time unlikely. Western Australia's October 2011 submission estimated the opportunity cost of initial under-utilisation (of both economic and social infrastructure) to be in the order of one quarter (or more) of the optimal construction cost.[10]

Low rates of return on State government investments in public enterprises are likely to partly be a reflection of this issue.

The uncertainty of future demand is a substantial risk in Western Australia's high-economic-potential regional areas (this will be less of an issue in more mature economic regions), particularly given the uncertain market conditions inherent in the mining industry. This risk substantially increases the effective cost of social and economic infrastructure.

We estimate a total cost of around $900 million per year for Western Australia in excess of the per capita average across all States for the combined impact of under-utilisation and risk (acknowledging that this is difficult to quantify).[11]

In Appendix B section 1 *Mining related economic development needs* we provide:

- examples of infrastructure projects Western Australia is undertaking or considering, where issues of catering for uncertain future demand are a major factor. It is often impractical to expect existing or sequential new users to pay a premium for excess infrastructure capacity or the risk of eventual under-utilisation. The financial constraints imposed by HFE also necessitate a focus on cost recovery and private sector provision, which can under-value public good aspects of economic development; and
- information on other difficult to quantify unrecognised government costs of directly supporting development in Western Australia, including the cost of improving local government services and community amenities; costs flowing from fly-in-fly-out arrangements; high district allowance and housing costs; and high unit capital costs (the Grants Commission uses only a recurrent cost proxy which does not reflect the volatility of capital costs).

All up, as shown in the following table, Western Australia estimates its direct unrecognised 'needs' to be as high as $1.6 billion per year, or up to 40% of its assessed 'excess' mining revenue capacity.

[10] Based on a consultancy by Dr Jeff Petchey and others.

[11] See Appendix B section 1 *Mining related economic development needs*. This is a revised estimate compared with that used in our October 2011 submission, reflecting updated data and methodology refinements.

ESTIMATED WESTERN AUSTRALIAN NEEDS UNRECOGNISED BY THE CURRENT HFE ASSESSMENTS	
	$m per annum
Providing economic and social infrastructure in advance of demand	870
Support for local governments and community amenities	500
Using actual capital costs rather than a recurrent proxy	100
Fly-in fly-out workers	100
High labour demand and accommodation shortages in Western Australia's remote areas	40
Total	**1,610**

Pressures on the Western Australian budget from strong economic growth fuelled currently by the mining and energy sector are pervasive. These unmet pressures are in most of the key portfolio areas, including health, education, transport, energy, planning, police, State development, housing, tourism, and fisheries. Most can be attributed in some degree to resource sector growth or other economic development opportunities.

The major pressures are not universally concentrated in the mining regions. Many are in Perth (including congestion alleviation), which is a major hub for servicing the resources sector and other industries well placed to exploit opportunities from Asia's growth.

The nature of Australia's current HFE means that substantial unmet needs are not reflected in the calculation of States' GST grant shares.

Whether by directly or indirectly filling gaps in the Grants Commission's current assessments, or by paring back the full equalisation objective, inroads could be made into unmet need in the provision of the gamut of State government infrastructure and services in Western Australia, that would help facilitate necessary structural adjustment.

Equity rating – improvement on current

Filling assessment gaps in the current HFE process would improve fairness.

Efficiency rating – improvement on current

This option would provide States like Western Australia and Queensland with more incentive to support resource development and greater capacity to help facilitate structural adjustment in the national interest.

Simplicity rating – reduction on current

Economic development assessments are likely to be complex, adding to the already substantial number of moving parts in the HFE process.

Stability/predictability rating – similar to current

As economic development needs are growth related (which tends to be variable across States over time), this reform is unlikely to improve stability/predictability.

Practicality rating – may be intractable

Assessing economic development needs poses large conceptual and data challenges. Apart from quantification difficulties, policy neutrality may be difficult to achieve (i.e. a State may have an incentive to 'over-spend' on economic development if actual spending is 'deductible' for HFE purposes).

6. Discount the mining revenue assessment

A discount could be applied to the mining assessment to achieve multiple objectives; such as 'financing' associated economic development costs; addressing intergenerational issues; improving incentives; and providing capacity in the mining States for structural adjustment. In the absence of other major reforms, Western Australia recommends the discount be set at 50%.

Importantly, a discount that indirectly 'finances' the currently unrecognised but hard-to-quantify costs of enabling or supporting mining production needs to occur just to bring HFE in this area 'back' to full equalisation (i.e. the current redistribution in relation to mining exceeds full equalisation as only the revenues are already fully equalised).

As set out under Option 5 above (and in Appendix B section 1), Western Australia estimates these costs to be as high as $1.6 billion per annum. This alone would be sufficient to justify nearly all of the proposed 50% discount to the current redistribution of mining revenues.

A 50% discount would also reflect the Canadian precedent, adopted as part of a reform program in 2007 which recognised *inter alia* that full inclusion of resource revenues in the Canadian equalisation system would reduce incentives for Provinces to develop or price their natural resources in an efficient manner. This is clearly just as applicable in the Australian context.

Equity rating – improvement on current

Equity benefits arise from:

- implicit recognition of mining-related economic development needs (addressing the current asymmetry);
- more consistency with the low level of equalisation of non-mineral endowments in the current HFE process; and

- improved inter-generational equity – the current assessment encourages consumption rather than investment of royalties, as States receiving a share of royalties in the form of higher GST grants do not see them as proceeds from the sale of finite assets.

Efficiency rating – improvement on current

A mining assessment discount improves efficiency as it provides capacity for resource States to facilitate structural adjustment, and improves incentives both to develop the mining industry and to extract an appropriate return for the community.

In relation to incentives, our October 2011 submission noted (pp26-27) how the disincentive impact of HFE is compounded by vertical fiscal imbalance. Using the Gorgon gas project as one example, most revenues will accrue to the Commonwealth in the form of company, rent and personal income taxes, while the small revenues to Western Australia (e.g. payroll tax) are largely equalised away to other States.

After also taking into account the unequalised costs incurred by the State in supporting such projects, the net budget impact on the State is potentially negative.

Western Australia's October 2011 submission also demonstrated how:

- removal of an iron ore 'fines' royalty rate concession could generate a loss of GST share significantly exceeding the increased royalties; and
- conversely (and perversely), a reduction in Western Australia's 'lump' iron ore rate could generate an increase in GST share that more than offsets the loss of royalties.

Simplicity rating – similar to current

Discounts are simple to implement and avoid difficulties in directly quantifying economic development needs, albeit the overall HFE process is not simplified.

Stability/predictability rating – improvement on current

Improved stability/predictability is envisaged as mining revenue assessments account for a large proportion of the HFE redistribution.

Practicality rating – high

This option provides scope to improve the equity, efficiency and predictability of the current HFE system with no additional administrative effort other than deciding an appropriate discount factor.

Shared Position of Queensland and Western Australia

Queensland and Western Australia each consider that the equalisation of mining revenues is especially in need of reform.

Reform should include a substantial discount being applied to the mining revenue assessment, partly to recognise currently unequalised costs of enabling or supporting mining production (including infrastructure costs), but also to:

- preserve incentives to develop the mining industry and price minerals appropriately (these are currently diminished by the large redistribution of increases in royalties);
- provide increased capacity to help facilitate economic structural adjustment, in the national interest; and
- recognise issues associated with resource deposits being finite assets (owned by the States).

New South Wales, Victoria, Queensland and Western Australia jointly propose the GST be distributed on a population share basis, with the Commonwealth taking responsibility for funding the additional assistance required for States with lower fiscal capacities to ensure no State is worse off.

In the absence of this reform, Queensland and Western Australia propose the discount for the mining assessment be set at 50%, consistent with the Canadian fiscal equalisation system.

7. Partial equalisation based on a smaller grant pool

Under this option, relativities would apply to only a proportion of the GST pool, and the remainder would be allocated on an EPC basis.

Western Australia considers that a majority of the GST grant pool (60%) should be distributed on an EPC basis, with the remainder of the pool distributed on a HFE basis.

Equity rating – improvement on current

This option addresses the inherent difficulty of quantifying full HFE (i.e. recognising all needs, achieving policy neutrality etc), and would produce less extreme outcomes. Commonwealth assistance to States that lose grant share would ensure equitable outcomes for all States and Territories.

Efficiency rating – improvement on current

This option provides improved incentives, and more capacity for States with the greatest economic potential to facilitate structural adjustment. The Commonwealth will have an incentive to develop an appropriate policy on the level and conditions of additional assistance for the smaller States that balances equity and efficiency considerations (including incentive and structural adjustment considerations).

Simplicity rating – similar to current

This option would be relatively simple to implement, but the existing complex HFE process would remain (albeit a significant EPC share may motivate development of simpler methods to allocate the remainder of the pool).

Stability/predictability rating – improvement on current

Improved stability/predictability would result from a partial EPC distribution.

Practicality rating – improvement on current

Further consideration may need to be given to how relativities would apply to the HFE component of the GST pool. Otherwise, this option is a way of achieving better equity and efficiency outcomes with no significant increase in complexity.

8. Partial equalisation based on minimum standards

This option would apply a uniform discount across all assessments (revenues and expenses) based on the average across expense categories of the minimum level of effort of States in each expense category. It is also one of the transitional measures proposed in the joint donor States' submission.

Equity rating – improvement on current

This option again helps to address the inherent difficulty of quantifying full HFE, while still ensuring every State has the capacity to achieve a 'reasonable' standard of services. This is more in keeping with the original objective of HFE as set out in the Grants Commission's 1936 report (page 140): "special grants … should be determined by the amount of help found necessary to make it possible for a State by reasonable effort to function at a standard not appreciably below that of other States". This report went on to propose (page 143) appropriate levels of discounted expenditure standards and increased taxation levels for special grant States.

Efficiency rating – improvement on current

This option provides improved incentives, and greater capacity for the resource States to facilitate structural adjustment, albeit to a lesser degree (in at least the short term) than under Option 7.

Simplicity rating – similar to current

This option would be simple to implement, but the existing complex HFE process would remain.

Stability/predictability rating – improvement on current

Improved stability/predictability would result, albeit to a lesser degree (in the first instance) than under Option 7.

Practicality rating – high

This option can achieve improved equity and efficiency with no additional complexity.

9. EPC distribution of the GST pool, with appropriate transitional arrangements and Commonwealth support funded from its fiscal gains from reform

This is the preferred long-term reform option of the four donor States. An EPC distribution of GST revenue would need to be accompanied by transitional arrangements and Commonwealth assistance to all or some of the current four recipient States/Territories.

It is envisaged that Commonwealth assistance would be paid for (at least in the medium-to-long term) by the fiscal dividend from reform. In this regard, reform could add significantly to GDP (see Appendix C and Appendix B section 5), and likely more revenue to the Commonwealth budget than the current subsidy received by the recipient States.

A variant of this option would involve the Commonwealth taking full responsibility from its own budget for all of the GST funding currently received by the Australian Capital Territory (ACT) and the Northern Territory (NT), leaving the full GST pool for allocation on an EPC basis (or other agreed basis) among the six States.

In this regard, Professors Henry Ergas and Jonathan Pincus (Visiting Professor of Economics, Adelaide University) observed in their 2011 submission to the Review that the expansion over time of HFE, even while its rationale has shrunk, may have suited the Commonwealth as two major beneficiaries – the ACT and NT – were originally financed directly by the Commonwealth.

An alternative to transitional arrangements would be a new revenue source to fund assistance for disadvantaged States. This could extend to reform of the GST itself. All States (including Western Australia) are now suffering financially from low and volatile growth in the GST pool, reflecting a number of factors – including the growth of on-line shopping in combination with the exemption for low value imported goods.

Equity rating – improvement on current

This option provides for continued assistance for weaker jurisdictions where needed.

Efficiency rating – improvement on current

State incentives for economic development are maximised. The Commonwealth will have an incentive to develop an appropriate policy on the level and conditions of additional assistance for the smaller States that balances equity and efficiency considerations (including incentive and structural adjustment considerations).

Simplicity rating – improvement on current

As GST funding transitions to EPC, there will be greater incentives to simplify the HFE process. The opportunity also exists for the Commonwealth to provide any necessary assistance on a simple basis.

Stability/predictability rating – significant improvement on current

This option maximises stability/predictability.

Practicality rating – improvement on current

If the Commonwealth is prepared to take up the challenge of this reform, it would deliver on its objectives of a fair, efficient, simple and predictable funding system (unlike the impossible-to-quantify full HFE objective).

In this regard, consider the following conclusions by Ergas and Pincus in their 2011 submission to the Review.

> *Social and economic conditions in contemporary Australia substantially weaken the equity arguments for fiscal equalisation beyond equal per capita grants.*
>
> *The same factors [including inter alia the barriers to the movement of people between States] also greatly weaken the applicability of efficiency arguments for fiscal equalisation of the extreme Australian kind.*

Consider also these comments made by Judith Sloan (Honorary Professorial Fellow at the Melbourne Institute of Applied Economic and Social Research at the University of Melbourne) in *The Australian* on 24 April 2012.

> *The current arrangements penalise States that innovate and provide services efficiently, while rewarding the incompetent laggards. The answer is relatively straight forward. Abolish the CGC and redistribute the GST revenues on an equal per capita basis. This would include an element of redistribution … because people in more prosperous States spend more on a per capita basis …*

Professor Sloan goes on to say that if EPC is out of the question, then the focus should be on providing fiscal equalisation for the purpose of facilitating minimum standards of services, not the average.

10. Donor States arrangement

This option would involve splitting the GST pool into a 'donor' States component (about 80%) and a 'recipient' States component. The donor States (New South Wales, Victoria, Queensland and Western Australia) would agree the distribution of their share of the pool among themselves.

Alternative sharing arrangements among the donor States could start with EPC, but also have regard (for example) for relative GSP per capita (as a global measure of their respective fiscal capacities) and/or long-run historical average shares adjusted in some way for 'structural' economic and fiscal changes.

Donor States that would lose grant share in the near term would need to be satisfied that these losses are effectively offset by simplicity, predictability or economic efficiency benefits, and/or that longer term grant share impacts could be neutral or even positive. However, no such arrangement has been agreed.

Equity rating – possible improvement on current

Equity among donors would depend on the nature of the agreement, but a mutually agreed arrangement to replace the HFE process could in principle be expected to improve equity, provided the negotiations are fully informed.

Efficiency rating – possible improvement on current

This would depend on the nature of the agreement, but a more economically efficient outcome could be expected. Efficiency issues relating to recipient States would remain unaddressed.

Simplicity rating – improvement on current

It could be expected that the donor State arrangement would be simpler than present arrangements. The recipient States' GST distribution process would also be simplified, as the HFE model could treat the four donor States as a single State.

Stability/predictability rating – improvement on current

It could be expected that the donor State arrangement would be more stable/predictable than present arrangements.

Practicality rating – unclear

Reaching agreement among the donor States is likely to be a challenge.

11. Exclusion of selected Commonwealth grants from the HFE process

In its interim report, the Review Panel identified two other reform options it sees as having most merit in relation to the HFE treatment of Commonwealth capital payments.

The first option is to equalise all capital payments, but over a longer timeframe to recognise the lasting nature of the asset being funded. Western Australia is comfortable with this concept, as it recognises the long-term benefits relating to capital payments.

However, this is already consistent with the current HFE approach, and is more an implementation issue rather than a reform.

Secondly, the Review Panel has suggested equalisation for most capital payments, but excluding capital payments for nationally significant projects. This reform is assessed as follows.

Equity rating – reduction on current

One of the key problems with this option is the underlying assumption that the Commonwealth will allocate funding on a national interest basis. A former Federal Government Finance Minister has highlighted the problem of 'pork-barrelling'.[12] This will continue to leave States like Western Australia with the burden of facilitating structural adjustment, possibly in direct opposition to Commonwealth priorities.

Another question is whether sound national interest criteria can be developed. Federations potentially produce better community outcomes than unitary States partly because central planners lack the 'omniscience' to be effective, while federations reveal imperatives more clearly through market-type forces.

While the Commonwealth has promised to provide at least $2 billion from the Regional Infrastructure Fund to Western Australia (spread over 11 years and representing only a small fraction of the mining tax revenues projected to be sourced from this State), this may simply be offset by a reduction in Western Australia's share of other Commonwealth funding (e.g. grants from the Commonwealth's 'nation building' funds).

This promise also needs to be considered in the context of an earlier pre-election promise from the current Commonwealth Government to dedicate up to $100 million per annum from future Gorgon and/or Pluto LNG royalties to a Western Australian infrastructure fund. There is as yet no sign that the Commonwealth will honour this promise.

Western Australia notes that the Grants Commission currently has the option of excluding capital grants from its assessments (e.g. where they relate to needs not assessed by the Commission), and supports the continuation of this approach.

Efficiency rating – reduction on current

Issues are similar to the discussion under Equity.

[12] Lindsay Tanner slams politics of spending, The Australian, 23 March 2012.

Simplicity rating – similar to current, or worse

This option does not address the complexity of the HFE process, and adds a new decision rule (i.e. whether a grant is for nationally significant projects) which may require further bureaucracy and adds a further element of judgement.

Stability/predictability rating – similar to current

Commonwealth grants are not generally a large source of redistribution in the current HFE model. Predictability would not be helped by possible uncertainty about the treatment of Commonwealth grants received by a State.

Practicality rating – similar to or worse than current

It may be difficult to meaningfully decide which grants should be classed as for nationally significant projects. In addition, the current unachievable full-HFE principle remains.

12. Tying part of the GST to economic development activities or tax reform

The Review Panel's interim reports flagged the idea that a portion of the GST could be tied to development of the mining industry (where needs are difficult to assess under the HFE process) or encouraging tax reform.

The Second Interim Report also suggests that States should share the resource revenue base with the Commonwealth, to address the issue that an increase in State mining royalties (e.g. on iron ore) could reduce the Commonwealth's mining tax revenues.

Equity rating – reduction on current

The major problem with tying parts of the GST is the poor precedent it sets. In effect, it encourages the Commonwealth to avoid its responsibility to financially support major reform issues that it benefits from. This is an inequitable outcome.

Efficiency rating – reduction on current

The efficiency advantages of federation (see the report by Twomey and Withers[13] cited on page 73 of our October 2011 Submission) are already being compromised by too much Commonwealth control over revenue bases, facilitating tied funding to the States that has little or no rationale in terms of public good spill-overs.

Simplicity rating – reduction on current

These measures would not address the complexity of the existing system, but would add a new set of rules and bureaucracy to the allocation of the GST.

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

Stability/predictability rating – similar to current

This option leaves the volatile existing system substantially unchanged.

Practicality rating – poor

Tying the GST to particular measures is a guaranteed way to complexify issues, due to the concerns it would generate. In addition, the quantification of mining economic development needs remains a difficult task.

Comparison of Reform Options

The following table summarises Western Australia's analysis of reform options. Ratings are for the system as a whole (not just add-ons). A 'cross' reflects a poor rating. Where a reform option has little impact the default rating is a cross – as applies to the 'No change' option. A tick reflects an improvement on the base case ('No change').

COMPARISON OF REFORM OPTIONS					
	Equity	**Efficiency**	**Simplicity**	**Stability**	**Practicality**
No change	✗	✗	✗	✗	✗
Nominal maintenance	✓	✓	✗	✓	✓
GST relativity floor	✓	✓	✗	✓	✓
Simplify revenue assessments	✓	✓	✓	✓	?
Direct assessment of mining and other economic development needs	✓	✓	✗	✗	✗
Discount mining royalties	✓	✓	✗	✓	✓
Partial equalisation using a smaller grant pool	✓	✓	✗	✓	✓
Equalise to minimum standards	✓	✓	✗	✓	✓
EPC distribution with transition and Commonwealth assistance from fiscal gains	✓	✓	✓	✓	✓
Donor State arrangements	?	?	✓	✓	?
Exclude some Commonwealth grants from HFE	✗	✗	✗	✗	✗
Tie parts of the GST	✗	✗	✗	✗	✗

This table highlights that 'No change' is not an acceptable option.

The clearly preferred reform is a move to an EPC distribution of the GST pool, with appropriate transition arrangements and Commonwealth assistance funded from its associated fiscal gains.

Other options that rate well (but do not simplify the current system overall, though they do not add any significant complexity) are:

- An EPC allocation of a portion of the GST pool (Western Australia considers that 60% is appropriate);
- discounting mining royalties;
- nominal GST grant maintenance or relativity floors;
- equalising based on minimum standards; and
- discounting the Grants Commission's assessments to reflect a comparable (minimum) standard of services.

The simplification of the Grants Commission's revenue assessments also potentially rates well, but only if sufficiently ambitious, and the practicality of achieving major reform is questionable.

The option of an agreement among donor States is an option whose feasibility is quite unknown at this stage, and for which donor States' appetite is diminished by the need for more holistic national reform of the GST distribution.

We see no merit in tying parts of the GST pool, or selectively excluding capital grants from the HFE process, when far better reform options are available.

Chapter 3

Governance

The First Interim Report has suggested that the HFE process should be subject to periodic review by independent experts or expert bodies.

Western Australia considers that this has merit because it would allow alternate views to be considered, and would make the Grants Commission more accountable.

We also support the proposal in the First Interim Report to separate responsibility for determining the objectives of the GST distribution and the definition of HFE (a role for governments – by consensus) from the responsibility for implementing HFE (the appropriate role for the Grants Commission).

The complexity of HFE is such that, together with the many conflicting view points, there is a risk that this Review and the Commonwealth Government's subsequent decisions will not resolve all issues. In these circumstances, it may be valuable for the Review to consider pathways through which further reform can occur in the future.

Two examples of how the Panel can encourage further reform are discussed below.

Efficiency

There is a wide view among States and academics that the current HFE implementation is a significant drag on the Australian economy. Contrary viewpoints (such as reflected in the recent analysis commissioned by South Australia) tend to reflect (often unstated) untenable assumptions (see Appendix B section 5).

Appendix C reports on modelling that suggests that reducing the annual HFE subsidy provided by Western Australia to other States by $2 billion for five years (which would still involve a substantial subsidy from Western Australia to the other States) could increase national GDP by about 1.5% per annum. (Conceptual modelling in Appendix B section 5 also suggests long term increases in GDP of several percentage points.)

The Garnaut/FitzGerald report – Review of Commonwealth-State Funding (August 2002), suggested that eliminating the disincentive effects of HFE could increase GDP by around 1-2% per annum.

Gains of this magnitude should make reform of HFE an important priority for the nation. By way of comparison, the Productivity Commission estimated that the National Competition Policy reforms of the 1990s increased GDP by 2.5%.[14]

We recognise that our analysis of the efficiency impacts of HFE can only be regarded as provisional.

Given the importance of efficiency to the nation as a whole, if there is no fundamental reform arising from this Review, it would be desirable for the Commonwealth to commission a study of the efficiency impact of HFE. The Productivity Commission would be well placed to undertake such a study, due to its expertise and experience.

Such as review would be solidly based on the work of professionals in the field, would utilise the resources of expert analysts and modellers, and would also allow for all interested parties to make submissions in an iterative learning approach.

Gaps in Full HFE

As discussed in Appendix B, the Grants Commission's implementation of (its questionable objective) of full HFE has gaps. It is biased towards what can readily be assessed, to the exclusion of assessments that are difficult (e.g. economic development costs).

The assessment in Chapter 2 makes clear that there is much scope for the Review to recommend reforms that address these gaps. In the absence of such recommendations, it would be important to ensure that the Grants Commission tackles them.

This would involve a specific direction in the Grants Commission's terms of reference that it seek to address gaps in its assessments, using:

- judgement where necessary when normal data-based quantification is not possible (the Grants Commission to some extent already does this); and
- a national interest approach in assessing areas where State actions have cross-border implications (e.g. economic development).

[14] Productivity Commission, *Review of National Competition Policy Reforms*, February 2005, pXVIII.

Chapter 4

Second Interim Report

Western Australia has always considered the supplementary terms of reference to be inappropriate, and an unwelcome distraction from the main objectives of the GST Distribution Review.

Western Australia is concerned with the apparent acceptance in the Second Interim Report of the possibility of some of the GST being conditional on tax reform. This is inconsistent with the GST being untied and goes against the 1999 and 2009 Intergovernmental Agreements in which States gave up significant own-source revenues in exchange for untied GST grants.

Ultimately, as discussed in Chapter 2, tying the GST to specific measures is not conducive to the equitable and efficient functioning of the federation in the long term, it increases uncertainty, and would make intergovernmental negotiations even more difficult than they now are.

Instead, tax reform incentives should be provided by the Commonwealth. This need not impact the Commonwealth budget. As noted by the Panel in its Second Interim Report, the Commonwealth could fund incentives from the revenue dividend the Commonwealth would receive from reform of State taxes.

In relation to the interaction of the Minerals Resource Rent Tax (MRRT) with State mining royalties, Western Australia strongly rejects any changes that would undermine the States' sovereignty or revenue autonomy and flexibility. This includes mechanisms to penalise and discourage States from undertaking appropriate royalty increases, and trading off royalties against increased reliance on Commonwealth grants.

More generally, Western Australia considers that the analysis of mining taxation in the Henry review was inadequate, and welfare losses cited for State royalties implausible. Scholarly views continue to suggest that the fundamental tenets of the MRRT are misguided. In any event, it is the States' place to make decisions about the development of their resources.

Nonetheless, Western Australia does support the theme in the Second Interim Report of the need for genuine Commonwealth-State consultation and collaboration on matters affecting the federation.

Appendix A

Misconceptions

1. HFE was put in place to assist less well endowed States, and Western Australia and Queensland have benefited from past support by New South Wales and Victoria

The Panel's First Interim Report implies (page xi) that HFE was put in place to assist less endowed States with weaker financial positions. Victoria's recent budget stated that Western Australia and Queensland had benefited from a 'century' of support from New South Wales and Victoria (Budget Information Paper 3, 2012, page 6).

However, in Western Australia's case there was no underlying relative financial weakness prior to HFE, only weakness attributable to Commonwealth protectionist policies (especially tariffs) that were a burden on the Western Australian economy and therefore its finances.

> "The Commonwealth Tariff Board, in its 1924 Report, described Western Australia as being 'on the road to serfdom' under the tariff policy …" (Source: Thomas Musgrave, *The Western Australian Secessionist Movement*, Macquarie Law Journal, 2003)

Grievances concerning tariffs played a pivotal role in the Western Australian secession movement. This ultimately contributed to the Commonwealth Government establishing an independent body, the Grants Commission, to formally administer HFE.

> "Up to 1933 the grants were more or less *ad hoc* and unconditional, but in 1933, they were put on a more business-like basis, largely as a result of the 'secession' movement in Western Australia." (Source: W.G. McMinn, *A Constitutional History of Australia*, pg 176)

Tariffs were designed to protect Australia's manufacturing sector, concentrated in the Eastern States, but Western Australia's economy was primary industry based. Tariffs essentially forced the State's farmers and other primary producers to pay higher prices for manufactured inputs.

> "Whatever the burden of the tariff may be, it is much greater on Western Australia than on any other State." (Commonwealth Grants Commission, *Third Report*, 1936, page 67)

Accordingly, HFE merely helped compensate Western Australia for the tariff burden that supported the economies and finances of States such as New South Wales and Victoria.

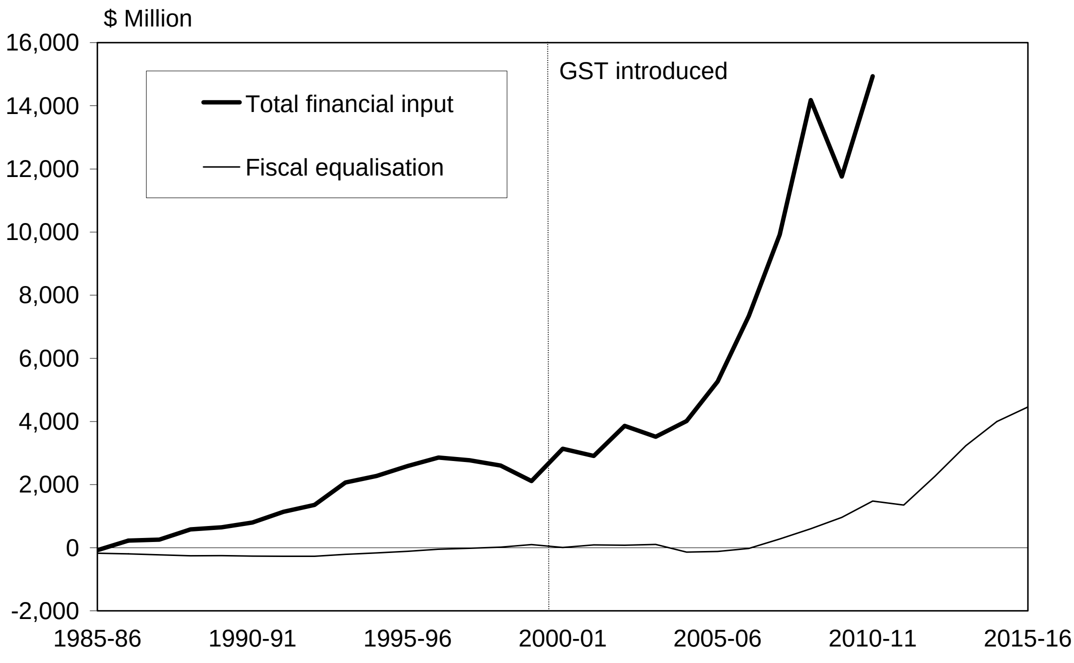
Tariffs remained a burden on Western Australia's economy for many decades. In 1988-89, when sustained tariff reform began, Commonwealth industry assistance was estimated by the Western Australian Treasury (based on Industry Commission modelling for Australia) to be reducing the State's GSP by around 3%.

Since sustained tariff reform began, Western Australia has been a net HFE 'contributor' in present value terms. It also became an overall net contributor to the Commonwealth budget well before becoming a donor State in HFE terms (which occurred initially in 1997-98). The broader net contribution made by Western Australia to the Commonwealth Budget dwarfed any HFE benefits for Western Australia in this period.

This overall net contribution, which has been estimated and published by Western Australia's Department of Treasury for many years, is the difference between all Commonwealth taxes and other revenues generated from Western Australia (including income and company tax), and Commonwealth expenditures for the benefit of Western Australia (including social security payments).

Based on latest estimates (2010-11), Western Australia's net contribution stands at about $15 billion per annum (with most other States receiving a substantial net subsidy). This contribution will be boosted further by the Commonwealth's MRRT and the State's falling GST share.

CONTRIBUTIONS TO THE FEDERATION BY WESTERN AUSTRALIA



Source: Western Australian Department of Treasury.

2. A relativity 'floor' automatically gives Western Australia higher fiscal capacity than other States

If full HFE were being achieved (including full policy neutrality and recognition of economic development costs), then any State receiving a higher GST grant through a relativity floor would have a higher fiscal capacity than States not on the floor.

However, current method flaws (see Appendix B section 4, *Flaws in the achievement of full HFE*) leave considerable uncertainty as to whether this is the case. In these circumstances, a relativity floor simply limits the extent of excessive redistribution of Western Australia's GST grants, over and above what should occur under full HFE.

Furthermore, any higher fiscal capacity in the short term is likely to be equalised over time by population movements (except, for example, to the extent that non-fiscal natural endowments are more highly valued), which if consistent with necessary structural adjustment should also bring national economic benefits.

3. Distortions to governments' decision making is only a significant issue for mining royalties

Reflecting Western Australia's large per capita mining value of production, its royalty rates have a very significant impact on its GST grant share, which has the clear potential to distort policy decisions. This was so even prior to the Grants Commission's current 'low rate'/'high rate' split that gives the potential for Western Australia to lose more than 100% of a royalty rate increase on iron ore 'fines' through the GST redistribution.

However, contrary to the claim in the First Interim Report, mining revenue is not the only significant case of such 'grant design inefficiency'.

There are also problems in the assessment of conveyance duty, land tax and stamp duty on motor vehicle transfers, where the Grants Commission uses States' own measured taxable values to determine the revenue bases. In these cases, if a State increases its compliance effort, its measured revenue base will increase and it will typically lose the majority of additional compliance revenue through reduced GST funding.

This is most extreme for Western Australian land of less than $1 million in value, where every dollar of additional land tax raised through Office of State Revenue compliance effort would cost about five dollars in lost GST grants to other States.

4. Eurozone problems demonstrate HFE benefits

Some parties have claimed that the need for HFE is demonstrated by the current problems of some of the fiscally weaker members of the Eurozone, such as Greece.

In the short run, Greece would have fewer problems if the Eurozone had been operating HFE, as it would have automatically received more funding to compensate for its poor economic performance.

However, this would have delayed any incentive for Greece to implement economic and financial reforms, such as are now being put in place. Therefore, Greece's economic problems would have continued to grow, with a correspondingly larger subsidy.

5. *Western Australia benefits from HFE time lags*

The First Interim Report claimed that, with its declining relativity, Western Australia gains from the time lags in implementing HFE. This can be refuted with a simple example.

Suppose, in 2011-12, Western Australia receives an additional $100 million in royalty revenue, due to additional production of a mineral. Assume that Western Australia is applying the Grants Commission's assessed national average royalty rate to this mineral.

In this case, the Grants Commission will assess an additional GST grant loss for Western Australia of about $90 million in the 2011-12 data-year (i.e. Western Australia will lose all but its approximate 10% population share).

However, this $90 million loss is converted to a relativity, using the 2011-12 GST grant pool, which is then applied (as part of a three-year average) to the larger GST grant pools in 2013-14, 2014-15 and 2015-16. Using the latest Commonwealth Budget projections of the GST grant pools (and States' population shares), our GST grant losses would be:

2013-14	$34 million
2014-15	$36 million
2015-16	$38 million
Total	**$108 million**

The total nominal loss of $108 million exceeds the assessed loss of $90 million due to the effective indexation of the loss over time by 20%. This offsets the interest benefit of the time lag in the redistribution.

6. *Western Australia 'agrees' on the equalisation of North West Shelf General Revenue Assistance (GRA)*

The First Interim Report (page 81) states that *"there seems to be agreement throughout consultations and in submissions that other GRA … should be included in the GST share calculations."*

Western Australia in fact does not agree with the equalisation of 'other GRA', due to the inclusion of North West Shelf grants under other GRA. Specific mention was made of this in Western Australia's October 2011 submission (page 13, with additional detail provided in Appendix B). In particular, the following points were made:

- In 2010 net present value terms, the cost of Western Australia's assistance to the North West Shelf project (e.g. payment of subsidies to the State's power utility to help cover the losses it initially incurred under crucial 'take or pay' gas contracts) is estimated to be around $8 billion.

- Western Australia receives a post-equalisation annual return of about $100 million (i.e. through special Commonwealth grants sharing North West Shelf project royalties), while other States (who shared none of the costs or risks) receive around $900 million per annum (courtesy of equalisation).
- At the time, the current system of equalisation was in its infancy, and its consequences potentially not fully appreciated by State governments (whereas today they are more likely to have a significant bearing on decision making).

Western Australia played a pivotal role in securing the development of the North West Shelf gas project through agreements, financial assistance and infrastructure provision. This project helped to provide the energy needed to develop other State resources and established Western Australia as a prospective location for natural gas development in the face of significant global competition.

7. Western Australia's share of grants is not really low if a broader measure is used

The Commonwealth has claimed that Western Australia's relativity is much higher when it is calculated on the basis of total Commonwealth grant funding (most recently, on page 124 of its 2012-13 Budget Paper No. 3, where Western Australia's 2012-13 relativity is given as 0.88 on this broader basis, compared with the GST relativity of 0.55). However, this ignores the following.

- Even on the Commonwealth's basis, Western Australia's relativity would fall to 0.701 by 2015-16, using the Commonwealth's latest Budget estimates.
- The Commonwealth includes North West Shelf royalties in its calculation, which is considered unfair for the reasons outlined in the previous section. If the North West Shelf royalties are excluded, our relativity will fall to 0.616 by 2015-16.
- While the relativity figure may be higher if other grants are included, the overall shortfall from an equal per capita share for Western Australia remains very high.

WESTERN AUSTRALIAN GRANTS

	Western Australia's relativities			Shortfall from equal per capita ($b)		
	GST only	GST plus other grants, excl. NWS	GST plus all other grants	GST only	GST plus other grants, excl. NWS	GST plus all other grants
2012-13	0.551	0.781	0.884	2.3	2.1	1.1
2013-14	0.390	0.706	0.799	3.3	3.0	2.1
2014-15	0.291	0.612	0.702	4.0	4.0	3.1
2015-16	0.305	0.616	0.701	4.2	4.3	3.3

Source: Derived from Commonwealth 2012-13 Budget estimates.

Furthermore, the broadest analysis of Commonwealth 'support' for Western Australia would compare all Commonwealth expenditure for the benefit of Western Australia (not just grants) with all Commonwealth revenue sourced from Western Australia (including company, income and resource rent taxes).

As noted above, the latest Western Australian Department of Treasury analysis shows a $15 billion deficit or 'take' by the Commonwealth from Western Australia, in 2010-11. Most other States receive a substantial net subsidy from the Commonwealth.

8. Western Australia contributes a low per capita share of GST

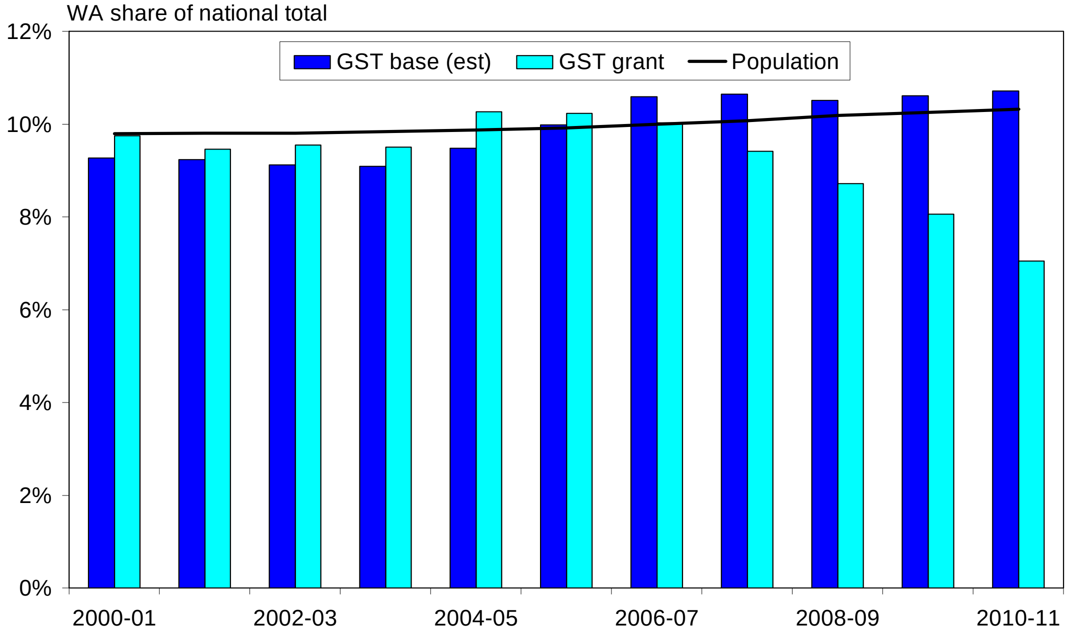
The First Interim Report (page 17) makes the extraordinary claim that Western Australia's per capita contribution to the GST pool is likely to be lower than average, because the export mining industry is a large share of Western Australia's economy, and does not pay GST – but claims GST input tax credits.

However, the GST is essentially a tax on end-of-line consumption in Australia. Hence it is relevant consumption in each State (including dwelling construction and tourism) that determines the amount of GST generated by economic activity in each State (though the State of payment is influenced by the location of company head offices).

The following chart shows the Western Australian Department of Treasury's estimate (using ABS data on consumption) of the share of GST generated in Western Australia compared to our population share.[15] Over the last five years, Western Australia has in fact generated more than its population share of GST.

[15] Western Australian estimates of the GST base use a similar method to those used by the New South Wales and South Australian Treasuries.

WESTERN AUSTRALIA'S SHARE OF GST BASE AND GRANTS



Source: Western Australian Department of Treasury.

Thus, with a relativity of 0.55 in 2012-13 (declining to 0.31 in 2015-16 according to Commonwealth projections), or a GST share equal to 55% of its population share, to say that Western Australia is getting back 55 cents in the dollar would be an over-estimate (as this assumes that Western Australia only contributes to the GST pool in proportion to its population).

In 2010-11, although Western Australia's per capita relativity was 68.3%, on a true State-of-origin basis, Western Australia received back an estimated 65.8%. Having regard for the dramatically higher growth in retail trade in Western Australia (10%) compared to other States (less than 4%) in 2011-12, the extent to which we do in fact make a disproportionately high contribution to the GST can be expected to increase significantly.

Appendix B

Supporting Information for the Assessment of Reform Options

This appendix is confidential.

Appendix C

Modelling Economic Impact of Redirecting GST Grants to Western Australia

As discussed in the body of this submission, and elaborated on in Appendix B, there are substantial unmet demands on the Western Australian Government to provide the necessary infrastructure (and services) to facilitate economic development (including as part of the necessary structural adjustment in the national economy).

This Appendix describes a modelling exercise undertaken by the Western Australian Department of Treasury, examining the potential national economic benefits from reducing the extent to which GST grants are redistributed from Western Australia to other States, using the MMRF-Green model.

The model

MMRF-Green is a multi-sector dynamic model of the Australian economy developed by Monash University, covering the six States and two Territories. It models each region as an economy in its own right, with region-specific prices, region-specific consumers, region-specific industries etc, and is able to determine the impact of region-specific economic shocks.

Simulation design

Specifically, we tested the effects of reducing the redistribution of GST grants to the rest of Australia from Western Australia by $2 billion (in real terms), for each of the five years 2012-13 to 2016-17 (similar to the revenue Western Australia would expect to retain from a 50% discount to the mining revenue assessment for GST grants paid in this period)[26].

The grant impact on other States was assumed to be in proportion to their existing GST grants. We further assumed that the Western Australian Government would invest the $2 billion per annum in additional infrastructure (and that State infrastructure spending would be similarly reduced in other States).

A key aspect of the analysis is the flow-on impact for the private sector from public sector investment, and how this varies between States.

[26] Note that this would still leave Western Australia receiving increasingly less than its population share of GST grants.

In this regard we began by examining the historical ratio of private sector gross fixed capital formation (excluding dwelling investment and ownership transfer costs) to State and local government sector gross fixed capital formation, over the ten years to 2010-11 (sourced from the ABS National Accounts).

	Average 2002-03 to 2005-06	Average 2006-07 to 2010-11
Western Australia	5.8	6.8
Rest of Australia	4.7	3.4
Difference	1.1	3.4

This data shows that, in the last five years, private investment has strengthened relative to State public investment in Western Australia, but weakened in 'Rest of Australia'. This would reflect the impact of strengthening commodity prices on mining-related investment (and generally weaker prospects in non-mining areas), rather than a strong 'causality link' between public and private investment.

Nonetheless, the existence of a causality link is particularly evident in the current phase of growth in the resources sector, where mining companies have increasingly expressed caution about proceeding with certain planned but as yet uncommitted investments due to escalating costs and risks (e.g. BHP Billiton, concerning its Port Hedland 'Outer Harbour', Olympic Dam and other expansion projects).

In this environment, a boost in State spending on (for example) transport, energy, water and community facilities would help alleviate the financial costs and risks faced by mining companies. Accordingly, it is considered that public investment would have a much stronger effect on private investment in Western Australia (where there is the most underlying private investment pressure) than in 'Rest of Australia'.[27]

We have estimated this effect by reference to the long-run relationship between private investment and public investment in Western Australia compared with 'Rest of Australia'. This was determined using the average over 15 years (i.e. 1996-97 to 2010-11) of the ratio of private investment in each year to average State and local public investment over the preceding 10 years (all investment measured in real terms). By comparing private investment in each year to average public investment over a long prior period (10 years) we aimed to better pick up the facilitation impact of public investment. By averaging the investment ratios over a long period (15 years), we aimed to abstract from short-term economic fluctuations. The length of the time periods is constrained by the availability of historical ABS national accounts data on a State basis.

[27] In this regard, the Deloittes Access Investment Monitor highlights that Western Australia has long dominated the private sector pipeline of potential investment projects nationally, which is in the hundreds of billions.

The difference between the Western Australia and 'Rest of Australia' averaged ratios is around 3½. While this is a long-run relationship, we have considered that it would reasonably apply in the short run in the current conditions where mining companies see much long run investment potential but are constrained by current uncertainties.

On this basis, we have assumed that each additional dollar of public investment in Western Australia would attract around three[28] more additional dollars of private investment than would occur in other States, with a one year time lag. We note that a longer time lag is not expected to materially affect the results (apart from timing).

Accordingly, accompanying the $2 billion annual additional public investments in infrastructure in Western Australia, we have added $6.4 billion (in real terms) in private investment for Western Australia (assumed to occur in export-oriented industries) in the following year, for each of five years. At the same time, we deduct $2 billion per year of State investment, but no private investment, from 'Rest of Australia'.

The $2 billion annual additional public investments in Western Australia over five years (and corresponding reductions in other States) were assumed to occur specifically in the energy and transport sectors, over the period 2012-13 to 2016-17. The additional private sector investment (in Western Australia) occurs over the period 2013-14 to 2017-18.

Results

The modelling results are shown in the following table, in terms of changes from the base case projection. The first part of the table shows the changes in dollar terms. The second part expresses these changes as a percentage of the base case parameters.

The results indicate a potential increase in national annual GDP of about 1.5% after the end of the GST grant transfer adjustments and lagged private sector investment impacts.

Clearly these results depend upon the assumptions used and the limitations of the model. However, they are significant and strongly support the HFE reform case. At the very least, they form a basis for further independent research into HFE efficiency impacts.

[28] To be exact, we have used a factor of 3.2, slightly less than the calculated long-run factor, which provides some conservatism.

NATIONAL ECONOMIC IMPACT OF REDUCING THE REDISTRIBUTION OF GST GRANTS FROM WESTERN AUSTRALIA BY $2 BILLION PER YEAR OVER FIVE YEARS

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
			$ billion change from base case				
GDP	-0.4	9.6	12.1	14.8	17.1	19.1	18.6
Investment	-0.5	12.7	13.5	14.2	14.5	15.1	6.0
Consumption	-0.6	6.4	8.1	10.0	11.8	14.1	12.3
Exports	0.3	-7.5	-6.4	-5.5	-4.5	-4.8	5.1
Imports	-0.3	4.8	5.5	6.2	6.7	7.4	4.2
			Percentage change from base case				
GDP	-0.03	0.79	1.00	1.22	1.40	1.55	1.50
Investment	-0.07	3.54	3.74	3.90	3.92	3.98	1.60
Consumption	-0.10	0.97	1.23	1.50	1.74	2.09	1.84
Exports	0.10	-2.54	-2.02	-1.61	-1.21	-1.19	1.61
Imports	-0.10	1.62	1.82	2.01	2.10	2.25	1.26

Using these results and the long term tax/GDP ratio for the Commonwealth Government, a 50% discount to the mining assessment could be expected to boost GDP by in the order of 1.5% or $19 billion per year in real terms (after full implementation), and Commonwealth tax revenues by in the order of $4 billion per year in real terms – similar to the current full HFE subsidy to recipient States.