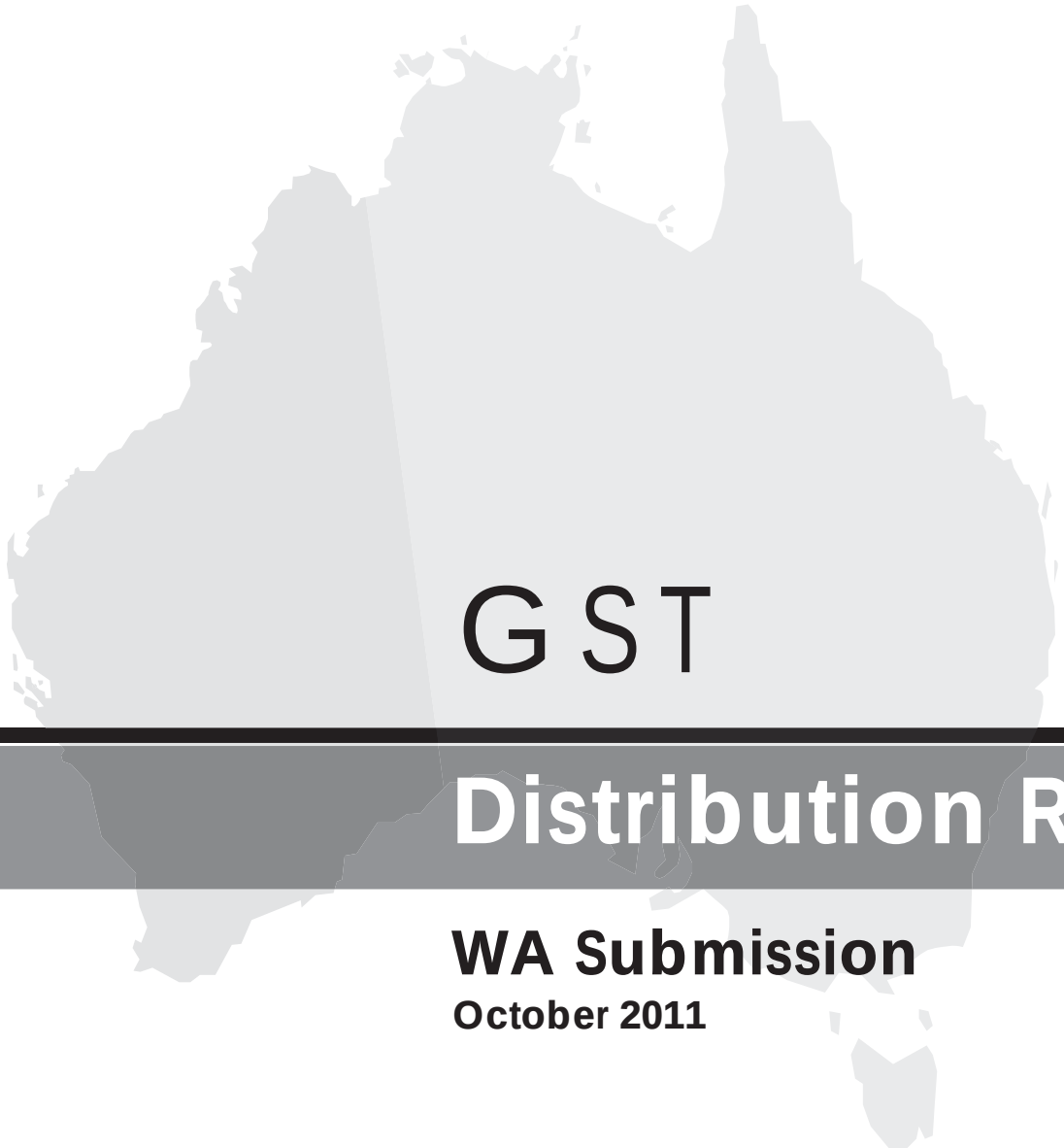
GOVERNMENT OF
WESTERN AUSTRALIA

GST

Distribution Review

WA Submission

October 2011



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Executive Summary

Overview

The current form of fiscal equalisation in Australia is too extreme. It is equivalent to a 100% tax on any excess of one State's fiscal capacity over the average for all States. This would not be considered equitable or efficient in any other part of the national tax and transfer system. Nor is it seen in any other federation globally.

The impacts of extreme fiscal equalisation are similar to those acknowledged for the very high effective marginal tax rates sometimes seen from the interaction of personal income tax with Commonwealth benefit payments. Hard work is penalised rather than rewarded, and welfare dependency is encouraged, to the detriment of national economic and social outcomes.

As a result, fiscal equalisation is no longer the unifying force in the Australian federation that it was intended to be when the Commonwealth Grants Commission (CGC) was established in the 1930s – at which time States such as Western Australia demanded compensation for the costs they incurred from high external tariffs and other protectionist Commonwealth policies.

Instead fiscal equalisation is becoming a divisive influence, undermining public understanding and support for the Federal system. The wheel has turned full circle.

Barrier to structural adjustment

The Australian economy is currently going through a period of structural adjustment, in order for national income to be maximised in an environment of record high terms of trade and a strong Australian dollar, driven by growth in emerging and developing economies. But fiscal equalisation is inhibiting the free flow of labour and capital across regions and industries to where they will be most productive.

Western Australia has limited capacity to fund the large scale public investment needed to support the future growth of the resources sector – including in ports, roads, rail, water, electricity and allied social infrastructure and services. With dwindling GST revenues, growth in State debt will become unsustainable without severely constraining investment, posing a central risk to national economic performance and living standards.

Examples of Western Australian Infrastructure Projects

Mid-West Energy Project (Southern Section)

The Mid-West Energy Project (Southern Section) involves the construction of a 201 km 330kV transmission line from Pinjar to Eneabba, the purchase of a line from Eneabba to Three Springs and the upgrade of the existing Neerabup to Pinjar transmission line. The total estimated capital cost of the project is approximately $409 million. It will initially support the Karara iron ore project, and later other Mid-West mining and renewable energy developments and community power needs.

The State Government will have to provide the capital for this project upfront, impacting adversely on the State's net debt, which in turn will limit the State's capacity to fund other investments.

Utah Point

The Multi-User Panamax Berth at Utah Point is a $305 million facility that opened in 2010. It has a capacity of about 18 million tonnes per annum, and is able to accommodate Panamax and small Cape size vessels of up to 120,000 dead weight tonnes. The State has contributed more than $190 million for the construction of the berth. This investment was required to facilitate exports from current and emerging junior iron ore producers, which will bring significant economic benefits.

Browse LNG Precinct

The proposed Browse Liquefied Natural Gas (LNG) Precinct will consist of LNG processing facilities and associated infrastructure (with an LNG production capacity of up to 50 million tonnes per annum), and would be located in the vicinity of James Price Point – approximately 60 km north of Broome. Woodside Energy Limited, on behalf of the Browse LNG Development Joint Venture participants, was appointed as a Foundation Proponent for the Precinct under a Preliminary Development Agreement signed in October 2009.

The construction of the gas hub is expected to cost approximately $30 billion, to be paid for by the private sector. However, approximately $123 million in additional funding will be required to build an access road (which would not be recognised by the CGC).

Ashburton North

The State Government is creating a new strategic industrial area at Ashburton North, near Onslow, for the development of natural gas projects and associated industries in the North West. The resource projects to be underpinned by the infrastructure include Chevron's Wheatstone project and BHP Billiton's Macedon project. The creation of Ashburton North will also help support the State's domestic gas supply. A $330 million upgrade is needed for the North West Coastal Highway to meet additional traffic demands.

The majority (around 70%) of the mining royalties raised in Western Australia that could be invested in services and infrastructure to help Western Australia attract labour and private sector capital are instead redistributed to other States on starkly different economic adjustment paths.

These are not just the views of the Western Australian Government. They are consistent with those put by many independent and eminent economists and academics (some of whom go further), as the following quotes highlight.

> *The fiscal redistribution has therefore largely lost its purpose. It is now a form of middle class welfare, in which Western Australian miners subsidise Tasmanian greenies and arts festivals in South Australia. And worse, it is positively counterproductive.*
>
> *Western Australia's challenge, for example, is to attract labour. One way to do so is by using growing royalties to improve services, increasing Western Australia's relative attractiveness as a place to live. Yet large chunks of those royalties are redistributed away, undermining that adjustment.* Henry Ergas (Professor of Infrastructure Economics at SMART Infrastructure Facility, University of Wollongong; Senior Economic Advisor at Deloitte Access Economics), The Australian, 27 May 2011.
>
> *In recent decades Western Australia has been treated very shabbily by the taxation arrangements of the Australian federation. Successive State governments of all political persuasions have invested substantial State funds in infrastructure to attract investment in resource industries, only to see Canberra cream off the lion's share of revenue from those projects through its de facto control of both company and personal income tax.*
>
> *None of this infrastructure has been adequately or fairly supported from Canberra, nor have there been proper returns to Western Australia for this significant contribution that it makes to the balance of payments, current account and general standard of living in southeastern Australia.* Kenneth Wiltshire (Professor of Public Administration, University of Queensland; ex-Commonwealth Grants Commissioner), The Australian, 23 May 2011.

… the results are strongly suggestive that fiscal capacity equalisation in Australia is inconsistent with the efficiency in migration case for inter-State transfers, creates strategic behaviour, may have long-run dynamic efficiency effects and does not necessarily achieve inter-state equity. Jeff Petchey (Head of Research, School of Economics and Finance, Curtin University; recent appointee to the Commonwealth Grants Commission), Fiscal Capacity Equalisation of the Australian States, The Australian Economic Review, Volume 44, Issue 2, June 2011.

… while its rationale has shrunk, HFE [horizontal fiscal equalisation] has expanded, going well beyond the goals set for it in the 1930s (which aimed mainly at ensuring a uniform minimum, rather than achieving equality) … We have reviewed the grounds conventionally given as justifications and found them seriously wanting. Although they are inherently difficult to quantify, we suspect any positive effects of HFE are more than outweighed by the distortions. Henry Ergas and Jonathan Pincus (Visiting Professor of Economics at the University of Adelaide; ex-Productivity Commission), Reflections on Fiscal Equalisation in Australia, draft paper presented at the State Funding Forum organised by Australian School of Business, University of New South Wales, September 2011.

… the nation is risking its future prosperity by ignoring the needs of Western Australia's resources boom.

The East Coast – where majority of the country is based – is so narrowly focused it is failing to realise that its own economic growth would be stifled unless attention turned West, Mr Salt said.

The unprecedented growth in the resources sector now accounts for almost one-quarter of the national gross domestic product, with most of that coming from WA.

But the State faces a critical skills shortage, with at least 150,000 more skilled workers needed to ensure the $380 billion in planned mining projects come to fruition, and is juggling the need to fund infrastructure needed for future growth with other state-demands. …

"What's required is an understanding that what's happening in the West is a national priority. This is clearly where future prosperity is going to be coming from in Australia and we need to deliver labour, skills, infrastructure services and national building.

"That requires a level of effort and commitment that surely goes beyond the capacity of 2.5 million people. The riches of the North-West are spread across the entire country; therefore the responsibility of building the riches should be shared or spread across the continent." Bernard Salt (KPMG Partner and head of KPMG's Property and Demographic Advisory Group; Adjunct Professor at Curtin Business School, Curtin University), WAtoday.com.au, 6 October 2011.

Inequity and inefficiency

From a broader equity perspective, Western Australia has made a net contribution to Commonwealth finances for many years – now standing at $14 billion per year. Yet apart from the difficulties the State Government faces in funding infrastructure to facilitate economic growth, reflecting in part the asymmetrical equalisation of all of the revenues but not all of the costs of economic development, the State's indigenous communities are among the most disadvantaged in the nation.

Decades of sound economic management, such as bearing substantial costs and risks to help develop the nation-building North West Shelf project, have helped to make Western Australia an engine room of the national economy. Yet the fiscal returns are mainly equalised away, including without recognising the need to improve low service standards in remote areas that are home to some of Australia's largest export industries and most disadvantaged Indigenous communities.

Fiscal equalisation also fails to produce intergenerational equity. In particular, equalisation of royalties encourages expenditure on current State services (despite the revenues deriving from the depletion of non-renewable resources), to the detriment of future generations. Furthermore, improvements in fiscal equalisation methods over time are only applied prospectively. For example, only recently has there been any allowance for the impact of population growth on social infrastructure requirements.

Perverse outcomes

As well as producing extreme overall outcomes that are inequitable and a barrier to the structural adjustment needed to maximise economic and social outcomes nationally, the process for arriving at these outcomes has many perverse consequences.

One of these relates to Western Australia's efforts to price more fairly and efficiently the minerals it owns on behalf of the State community, by phasing out certain long standing iron ore royalty concessions. Incredibly, under current fiscal equalisation arrangements, well over 100% of the increase in royalty revenue could be redistributed to other States.

Another relates to the incentive for State Revenue Offices to improve compliance with the States' major taxes, in the interests of taxpayer equity and sustainable funding for community services. Western Australia can currently lose up to $5 in GST for each $1 generated by additional compliance effort.

Complexity, bias and lack of transparency

Fiscal equalisation methods are notoriously complex. This detracts from the transparency of the process, together with stakeholder confidence in the outcomes. Yet complex methods are not necessarily more 'accurate' (i.e. in terms of measuring differences in States' underlying revenue raising capacities or expenditure needs), including because the data available to support such methods is often of poor or unknown quality, and judgement continues to play an important role.

The outcomes of the fiscal equalisation process are also biased to what can be more readily quantified. Assessments of States' relative 'needs' considered to be of lesser reliability are often discounted – despite the fact that the assessments are just as likely to under-estimate as to over-estimate needs. Other areas of differential needs are not assessed at all, including infrastructure to support future economic growth, national parks expenses and gambling revenues.

In this context, Western Australia has calculated that flaws in the current fiscal equalisation methods cost the State over $2 billion per year.

Reform options

The solution to many of these issues lies substantially in reducing the severity of the current equalisation arrangements.

Western Australia recommends as an immediate 'fix' the introduction of a GST-share 'floor' of 75% of a State's population share of the GST pool – marginally above Western Australia's current share.[1] The impact on other States' current budget forward estimates of GST revenue would be small.

Complementary reforms should include (see also the Recommendations below):

- discounting the extent to which mining revenues are included in the fiscal equalisation process (as occurs in Canada);
- limiting the extent to which a State's GST share can fall in any one year;
- allowing States to agree among themselves (should they wish) on a GST distribution outcome; and
- simplified methods based on broader indicators of underlying differences in States' relative needs.

[1] This proposed floor takes into account Western Australia's North West Shelf grants (in lieu of royalties). In their absence, we consider that the floor should be 85%, which would also be an appropriate floor for all other States.

Reform of fiscal equalisation will contribute to a more productive, internationally competitive Australian economy that can adjust more seamlessly to changing circumstances. The Commonwealth Government will reap a 'fiscal dividend' through increases in its broad tax bases and reductions in welfare payments. As owner of the 'fiscal equalisation system', it needs to facilitate reform as a national imperative.

Recommendations

Major framework reforms

Recommendation 1 – Floor on relativities

A central reform must be a relativity 'floor' of 75% (based on current arrangements).[2]

Recommendation 2 – Discounting the mining revenue assessment

The mining revenue assessments (including North West Shelf grants in lieu of royalties) should be discounted by 50%, as occurs in Canada.

Recommendation 3 – Limiting annual falls in GST 'relativities'

A State's GST relativity should not fall by more than one percentage point in any year.[3]

Recommendation 4 – States to be able to agree among themselves on a GST distribution outcome

The fiscal equalisation system should allow a group of States, if they wish, to agree among themselves on how their aggregate share of the GST pool is allocated (while not affecting outcomes for non-participant States).

Improving the existing framework

Recommendation 5 – Improving the assessment of States' relative needs

(a) The major gaps in the current fiscal equalisation assessments should be addressed (e.g. facilitating economic development, servicing national parks, recognising low Indigenous socio economic status).

---

[2] Or 85% if the Commonwealth Government were to renege on North West Shelf grants being paid to Western Australia. The 10% difference is smaller than the resulting increase in Western Australia's relativity and takes into account that Western Australia should retain somewhat more than its current equal per capita share of these grants (post equalisation), consistent with the costs and risks it took on to develop the North West Shelf project. The 85% floor would apply to other States. In its presentations to the Review Panel, the CGC has noted that different floors could apply to different States.

[3] If the mining assessments are discounted by 50% as recommended, then the mining assessments could be excluded from this calculation.

(b) The potential in the current mining assessment for huge shifts in grants from royalty policy changes should be eliminated, and the assessment made more transparent.

(c) The fiscal equalisation 'operating rules' should be reviewed for greater clarity of the intended objectives.

(d) Assessments should be based on broad underlying drivers of differential needs – with less attention paid to detailed differences in State policies (e.g. detailed tax laws and modes of service provision).

(e) Simplicity should be vigorously pursued on the basis of improving the reliability of assessments, rather than by adopting mechanical 'thresholds' to reduce the detail in the assessments.

(f) Fiscal equalisation should continue to recognise cost (as well as demand) differentials in State spending requirements, for equity and efficiency reasons.

In relation to (d) and (e), a move towards 'global' revenue and expense assessments – involving a small number of aggregated categories assessed on the basis of measures of the broader underlying revenue or cost drivers – should be thoroughly explored.

A 'global' assessment would be less susceptible to changes in individual State policies. For example, if a State alters its mining royalty rates, there will be limited impact on the revenue assessments because mining royalties only account for about 7% of total State general government revenues (despite the mining redistribution equating to 75% of the total revenue redistribution).

Introduction

Western Australia welcomes the Review of the GST Distribution. We consider that there is no more important post-war task in the Australian Federation than the reform of the GST distribution system, to restore confidence in financial relationships and remove impediments to structural adjustment and growth.

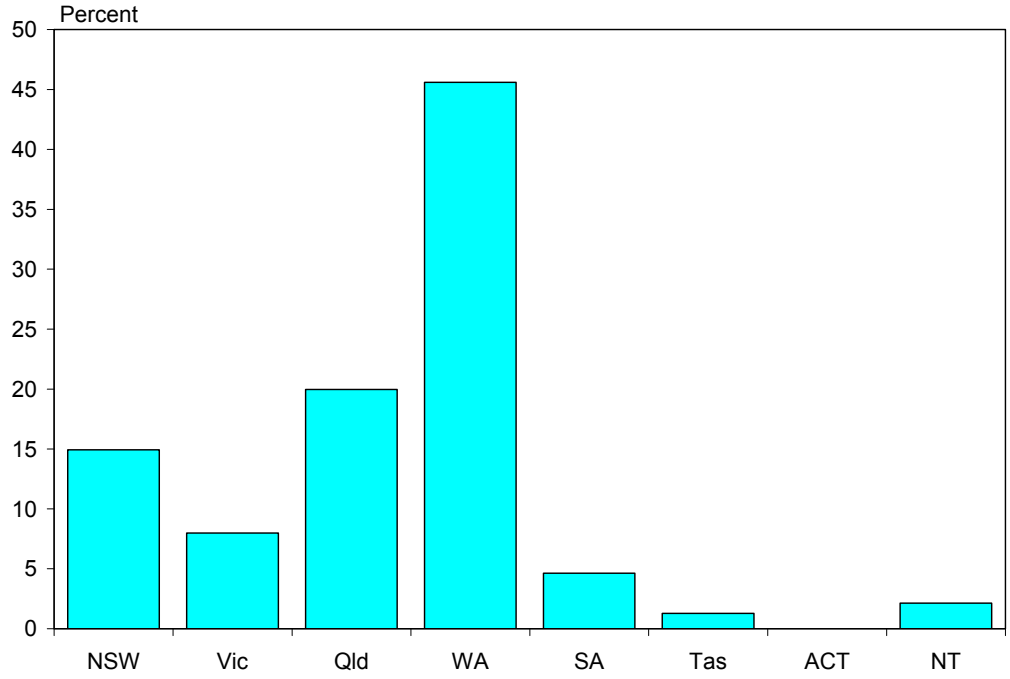
Despite barriers resulting from central government policies over many decades that supported industries in the nation's south east, Western Australia has developed to the point where it is now the economic engine room of the Federation. With currently only just over 10% of the population, Western Australia is responsible for:

- around 45% of the value of national merchandise trade exports (for the year to July 2011);
- a trade surplus of $86 billion, compared with a trade deficit for the rest of Australia of around $55 billion (in 2010-11);
- 32% of the value of projects under construction or planned in Australia (from the June 2011 Access Economics Investment Monitor); and
- a $14 billion net fiscal contribution to the Commonwealth's budget to support Commonwealth services to the rest of the nation (in 2009-10 – see Chapter 1).

Western Australia remains on a steep growth trajectory, evidenced by jobs growth of 214,800 (or 33%) over the 10 years to 2010-11 (accounting for 16% of jobs created nationally over the same period); 165% growth in Gross State Product (GSP) over the ten years to 2009-10 (compared with 94% growth in national Gross Domestic Product (GDP)); and population growth of 22% over the ten years to 2010 (compared with 17% nationally).

Figure 1

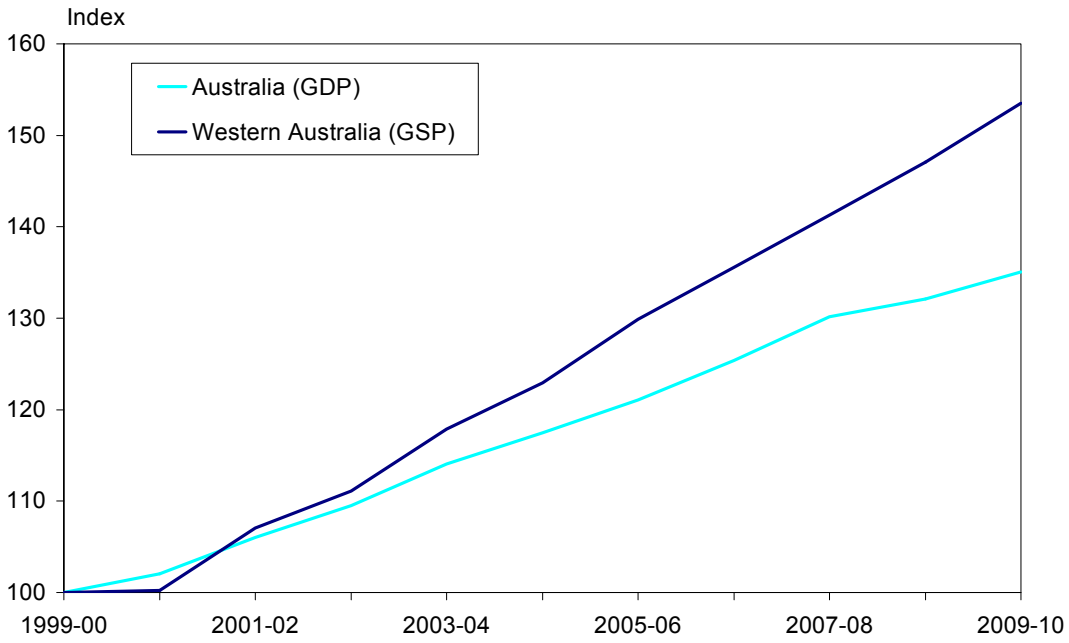
SHARE OF AUSTRALIAN MERCHANDISE EXPORTS BY STATE
YEAR TO JULY 2011



Source: Australian Bureau of Statistics.

Figure 2

ECONOMIC GROWTH
INDEX (1999-2000 = 100)



Source: Australian Bureau of Statistics.

Despite this success, the major changes currently underway in the Australian economy have highlighted serious weaknesses in the horizontal fiscal equalisation (HFE) methodology, and consequent need for reform if Western Australia is to continue to play its full part in improving the nation's well being.

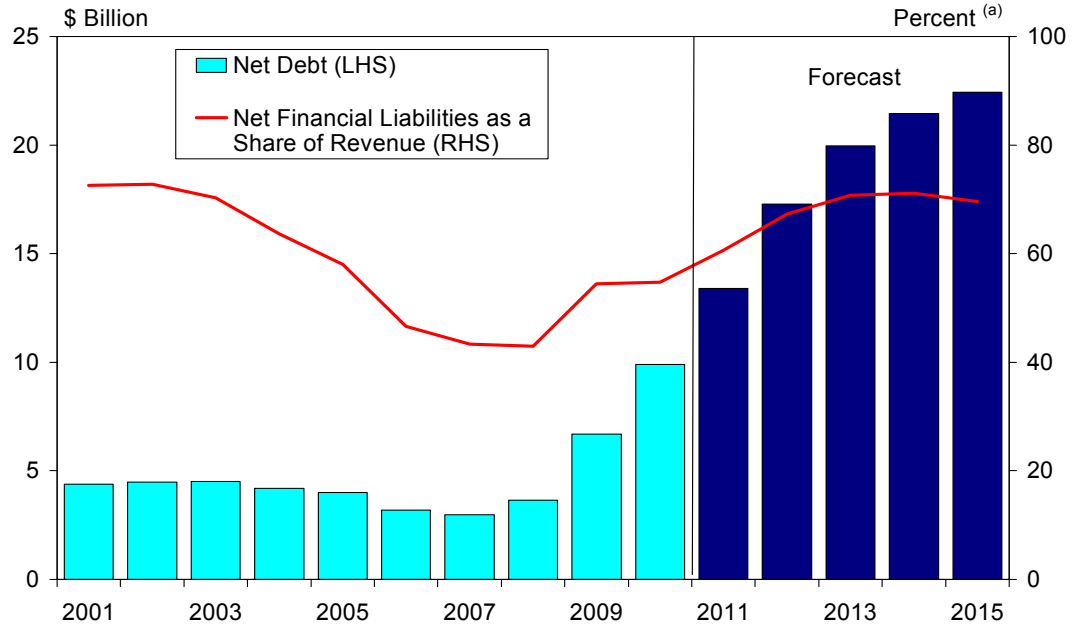
Notwithstanding the increased revenue streams from economic growth, the rapid expansion of the mining industry in Western Australia, with accompanying population growth, has created substantial budget pressures for the State, particularly in terms of the infrastructure necessary to support this expansion.

The State Government's budgets have sought to balance the twin objectives of sustainable finances, while expanding and improving services and infrastructure to facilitate the State's economic growth opportunities. To finance its massive capital investment program, the State has had to generate substantial operating surpluses, as well as undertake additional borrowings.

The recent and prospective decline in Western Australia's GST share, which is by any measure extreme, has damaged public confidence in the equalisation system and put the State's development potential at risk. In the short term, the decline is being covered by debt growth, but this is not sustainable in the longer term.

Figure 3

NET DEBT AT 30 JUNE
WESTERN AUSTRALIAN TOTAL PUBLIC SECTOR

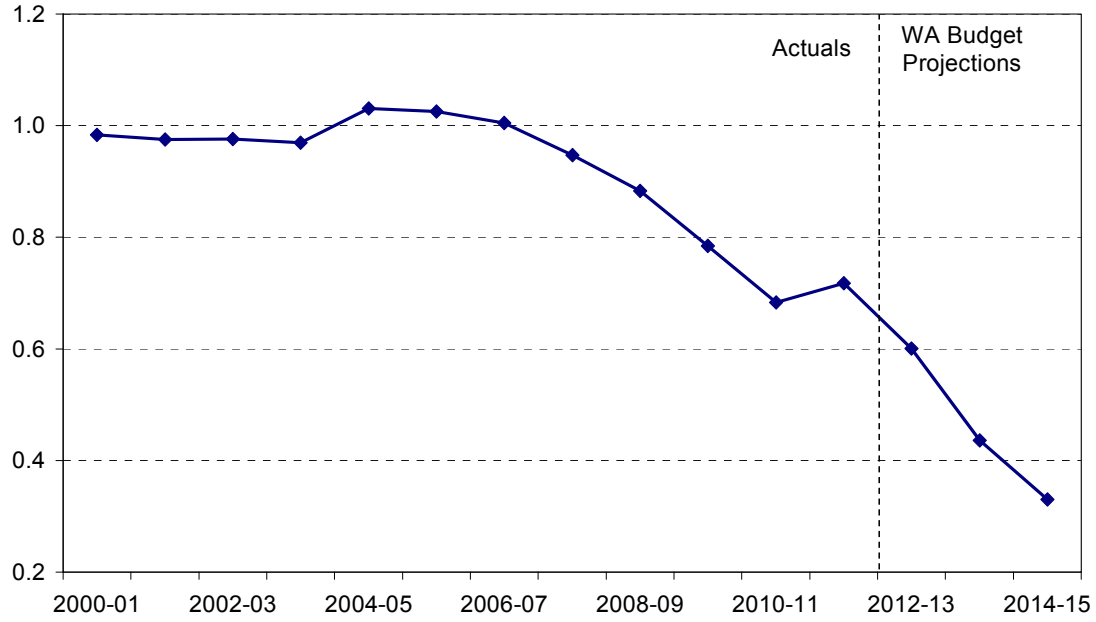


(a) For the total non-financial public sector (total public sector excluding public financial corporations).

Source: Western Australian 2011-12 State Budget.

Figure 4

WESTERN AUSTRALIA'S GST RELATIVITY[(a)]



(a) Western Australia's GST relativity is its share of the GST grants as a proportion of its population share.

Source: Commonwealth Grants Commission and Western Australian Department of Treasury projections.

Western Australia's share of the GST has been in free-fall since 2006-07. Its current GST relativity (72% of its population share in 2011-12)[4] is already by far the lowest ever experienced by any State – no other State's GST relativity has fallen below 85% since the introduction of the GST.

Western Australia estimates that its GST relativity will decline to 33% by 2014-15, mainly due to strong growth in mining royalties – particularly in 2010-11 when royalties grew by 79% (driven mainly by a doubling in iron ore royalties). This growth reflects strong prices, rising domestic production and the State Government's reform of royalty rates in relevant State Agreement Acts.

None of the royalty growth in 2010-11 has yet entered the CGC's (lagged) historical three year average calculation used in determining the GST relativities. It will not have a full effect on Western Australia's GST relativity until 2014-15. Yet over the period 2010-11 to 2014-15 Western Australia's GST grants are projected to be $12.3 billion lower than if the State received an equal per capita share of the GST.

[4] A State's relativity represents its share of the GST grants as a proportion of its population share.

This submission aims to show that reforms to HFE are needed from multiple perspectives – equity, efficiency (including promoting structural change and economic development), simplicity and transparency. The chapters on these topics flesh out the issues and summarise conclusions. The reform options chapter seeks to present a way forward.

Chapter 1

Western Australia's Contribution to the Federation

It is a common misconception that Western Australia has only recently become a 'donor' State in the Australian federation. Although its share of Commonwealth general purpose grants (now primarily the GST) first slipped behind its population share only as recently as 1997-98, Western Australia has been making a net contribution to Commonwealth finances since the mid 1980s.

Furthermore, and while still accepting that Western Australia has a role in assisting relatively disadvantaged States, the historical net Commonwealth support for Western Australia was effectively compensation for Commonwealth policies – particularly tariffs – that penalised primary industry-based/export-focussed States in the earlier years of federation to the benefit of protected manufacturing sectors of the East.

Disadvantaged in the early years of federation

In the early years of federation, the less populous states of Western Australia, South Australia and Tasmania noted that they were disadvantaged in a number of ways (Commonwealth of Australia 1983, pp. 7-8):

- their primary production-based economies, which were exposed to global competition, were adversely affected by tariffs that increased their input costs and led to some countries imposing retaliatory tariffs on imports from Australia;
- interstate free trade hampered the growth of secondary industry (in the less populous States) by facilitating 'dumping' by New South Wales and Victorian manufacturers; and
- the Commonwealth's *Navigation Act and Conciliation and Arbitration Act* resulted in artificially high freight rates and wage costs respectively, placing export oriented States at a competitive disadvantage.

These disadvantages led to the provision of Commonwealth financial assistance on a somewhat ad hoc and even opportunistic or disingenuous basis. For example:

> *In 1929 Western Australia approached the Commonwealth seeking an increase in the level of the grant from $600,000 to $1,200,000. The Bruce Page Government offered $900,000 on condition that the State ceded the north-west to the Commonwealth. This offer was rejected and negotiations were then abandoned* (Commonwealth of Australia 1983, p.9).

Ultimately, the CGC was established to put financial assistance for disadvantaged States on a more systematic basis (Commonwealth of Australia 1983, pp.12, 16).

Of particular relevance to Western Australia, in 1938 the Commonwealth placed an embargo on the export of iron ore from Australia. Although at least partly reflecting the national security threat posed by Japan, the Commonwealth also supposed that Australia had insufficient reserves to export. Lang Hancock, who subsequently discovered massive deposits of iron ore in Western Australia's Pilbara region (in 1952), described how:

> *… the Bureau of Mineral Resources in Canberra and Dr Argot, the head of it, said, 'Hancock's talking through his hat, we've done a magnetometer survey of all that area and there is nothing there.*[5] (Commonwealth of Australia, 2003, p.11,959)

Following an extended period of industry lobbying, the export embargo was lifted by the Commonwealth in 1960, with the Western Australian Government subsequently lifting a ban on the pegging of iron ore claims.

The Western Australian Department of Treasury undertook analysis of the economic impacts of Commonwealth tariffs and other industry assistance in the early 1990s. This analysis was based on work undertaken by the Industry Commission for Australia as a whole, and extended to a State by State basis.

The results showed that removal of the then existing industry assistance would result in an increase in Western Australia's GSP of 2.85% in 1988-89, dropping to 1.42% per cent by the end of March 1991 (reflecting a reduction in industry assistance). In proportional terms this was roughly double the estimated benefit for the national economy.[6]

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[5] The Commonwealth Government introduced two programs of reducing industry assistance around this time (May 1988 and March 1991).

[6] For example, because of the adverse impact on its primary/export oriented industries of high Commonwealth tariffs.

With continued reductions in industry assistance, the Productivity Commission indicated in a July 2000 report (Review of Australia's General Tariff Arrangements) that the removal of tariffs would increase Australia's GDP by 0.08%. Nevertheless, Western Australia was still disproportionately disadvantaged – reflecting the importance of the mining industry to Western Australia's economy, the benefits would include higher GSP of 0.21%.

These estimates should be seen as indicative only and likely to be underestimates of the cost to Western Australia of Commonwealth national policies. As noted in a January 2000 submission to the Productivity Commission by the Department of Foreign Affairs and Trade: *Some estimates suggest that … "dynamic gains" could be many times the gains measured by conventional economic models* (Department of Foreign Affairs and Trade, 2000, p. 11)

Contributor in the later years

While the GST is a highly visible form of redistribution of resources across States, other Commonwealth fiscal policies also have the effect of shifting resources between the States. States with higher incomes and business profits contribute more to total Commonwealth taxes, while those with younger and healthier populations draw less on health benefits and social security.

The Western Australian Department of Treasury annually estimates the net redistribution arising from all Commonwealth fiscal policies. The table below summarises the results using the latest available data (for 2009-10), separately identifying the (relatively small) 'GST-only' component. The methodology is described in Appendix A.

Table 1

NET REDISTRIBUTION OF RESOURCES 2009-10				
	GST only		Total Resources	
	$m	$ per capita	$m	$ per capita
New South Wales	1,187	165	980	136
Victoria	1,091	198	-1,373	-250
Queensland	178	40	-1,222	-273
Western Australia	**1,170**	**515**	**13,723**	**6,044**
South Australia	-998	-610	-5,974	-3,653
Tasmania	-731	-1,445	-3,204	-6,336
Northern Territory	-1,897	-8,321	-2,931	-12,858
Total	-	-	-	-

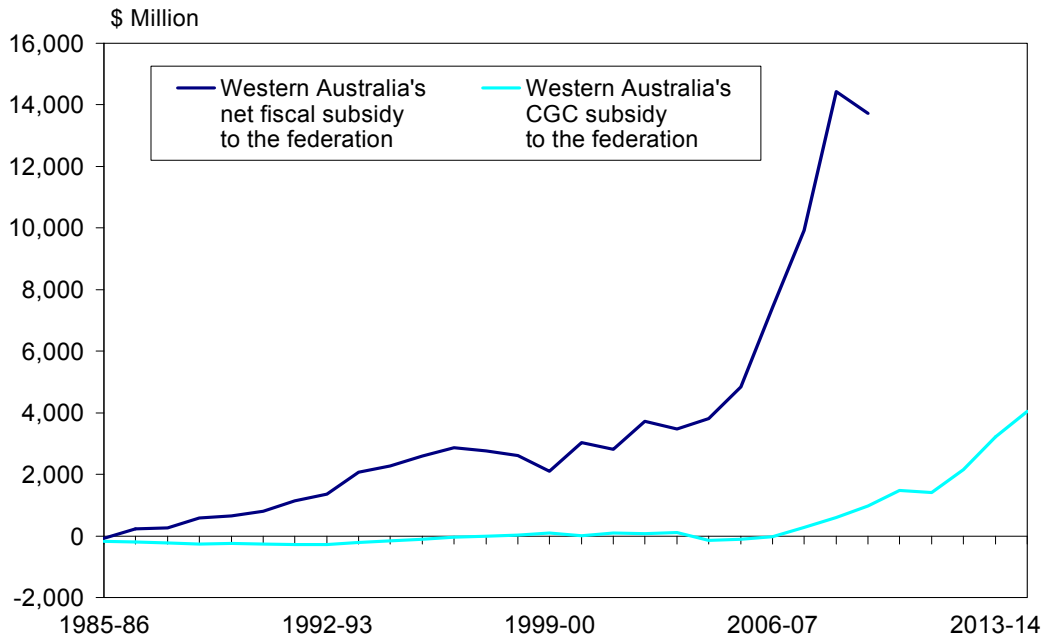
Source: Western Australia's 2011-12 Budget Paper No.3, *Economic and Fiscal Outlook*, p. 86.

Western Australia provides a $13.7 billion net fiscal contribution to the federation (all other States except New South Wales are subsidised). This is driven by the high level of Commonwealth revenue derived from Western Australia (company tax, personal income tax and petroleum extraction revenue), together with the low draw on Commonwealth social security and health benefits by Western Australian residents. This contribution far exceeds the contribution made by our relatively low GST share.

Figure 5 shows that Western Australia has been providing a net contribution to the federation since the mid 1980s, with the amount increasing substantially over the years. Western Australia's growing economic strength, the Commonwealth's proposed mining tax and the State's falling share of GST revenues are likely to see its net contribution to the federation continue to grow substantially.

Figure 5

WESTERN AUSTRALIA'S NET CONTRIBUTION TO THE FEDERATION [(a)]



(a) Data to calculate Western Australia's net fiscal subsidy are currently only available to 2009-10. CGC subsidies (i.e. GST revenue shortfalls relative to the State's population share) are available to 2011-12. Later CGC subsidies are State Budget projections. The reduced net fiscal subsidy in 2009-10 primarily reflects the impact of the global financial crisis on Commonwealth revenue collections (which are disproportionately raised from Western Australia).

Source: Commonwealth Budget Papers and Western Australian Department of Treasury.

Chapter 2

Equity – How Fiscal Equalisation Currently Fails

The equalisation principle applied by the Commonwealth Grants Commission (CGC) is essentially an equity (or fairness) concept applied at the State government level, under which richer States subsidise the poorer States so that each has the capacity to provide the same standard of services to its people (e.g. health, education and law and order) without imposing higher taxes. More specifically, the CGC currently defines equalisation as follows (Report on GST Revenue Sharing Relativities – 2011 Update, p. 31).

> *State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.*

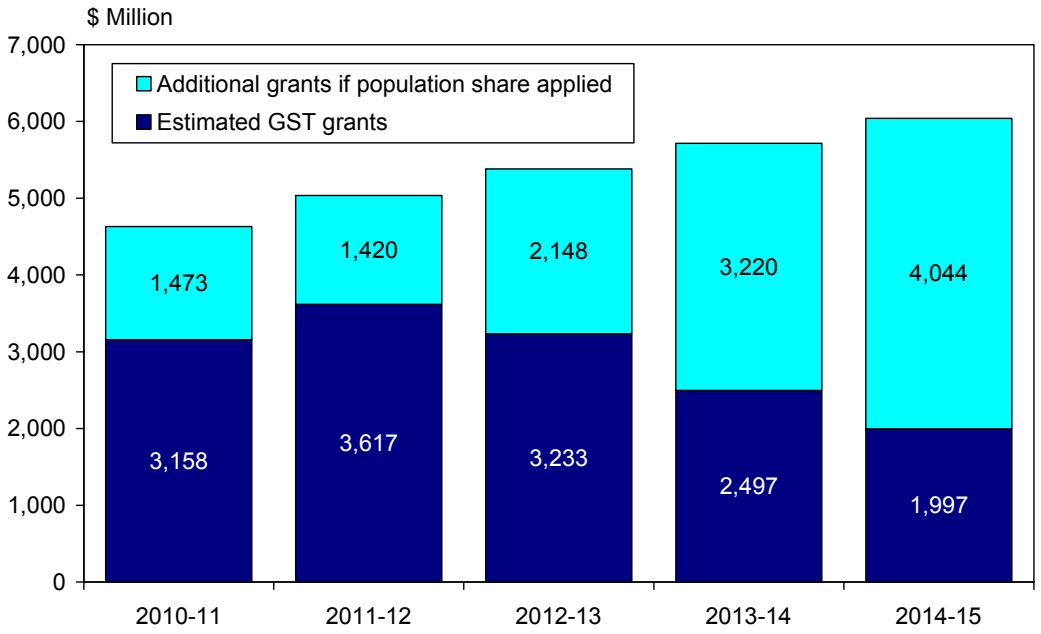
Inequity of the low return of GST revenues to Western Australia

As noted in earlier, Western Australia currently receives only 72% of its population share of the GST pool, where population shares are broadly representative of the contribution each State's people make to the GST pool through their consumption. Having regard for the lags in the equalisation process and recent growth in mining revenues, it is projected that the 'return' to Western Australia will decline to about 33% in 2014-15.

The balance of the amount that Western Australians contribute to the GST pool is the subsidy provided to other States. This subsidy is estimated to be $1.4 billion in 2011-12, rising to $4.0 billion in 2014-15.

Figure 6

WESTERN AUSTRALIA'S ESTIMATED GST REVENUE GRANTS



Source: Western Australian 2011-12 State Budget and 2010-11 Annual Report on State Finances.

Notwithstanding the equalisation objective, such a low return to Western Australia is considered manifestly unfair, particularly after taking into account the large subsidy already provided by the State through the Commonwealth budget more generally, the effort that Western Australia has made to develop its natural resource endowment (and thereby to raise revenue from its own sources) and substantial shortcomings in the equalisation methodology.

The 'glue that binds the federation'?

Equalisation has been referred to as the 'glue that binds the federation', on the basis that the evenness of services and taxes that it facilitates across States (including in the face of the indiscriminate effects of national monetary, fiscal and regulatory policies) has a unifying effect. However, this presumes a consensus among both donor and recipient States that the redistributive outcome is acceptable.

There has generally been acceptance by donor States (including New South Wales, Victoria and Queensland) that they need to subsidise the Northern Territory, and to a lesser extent Tasmania and South Australia. However, the subsidy now provided by Western Australia is becoming so extreme that equalisation (at least in its current form) is no longer supported by all participants.

Australia's comprehensive equalisation is currently equivalent to a 100% marginal tax rate on any above-average fiscal capacity (see Chapter 3 on Efficiency). No one would ever consider a 100% marginal tax rate on above-average personal or corporate income to be fair, particularly as above-average income has often been achieved through hard work and good choices.

Accordingly, equalisation has become highly divisive. The problem of extreme results was also recognised by the Commonwealth Treasury in its advice to the current Commonwealth Government following the last Federal election (Commonwealth Treasury 2010, p.17):

> *… recent focus on the Commonwealth Grants Commission methodology, including the impact of Western Australia's growing prosperity, has placed pressure on the principle of horizontal fiscal equalisation, a key element of federal financial relations since the 1930s.*
>
> *… growing pressures on horizontal fiscal equalisation may require consideration of whether adjustments are needed to ensure sustainability of the arrangements into the future.*

Broader redistribution through the Commonwealth budget

Chapter 1 on *Western Australia's Contribution to the Federation* details the large subsidy Western Australia provides through the Commonwealth budget, estimated to be $14 billion per year.[7] This includes the State's disproportionate contribution to Commonwealth taxes (exceeding its own State taxes by a factor of about six) and low 'draw' on social security payments.

Yet, Western Australia has social and economic needs that it can't afford to tackle effectively. The circumstances of Indigenous people in Western Australia are among the worst in the nation, Western Australia's power costs are high, and substantial infrastructure needs to be put in place to facilitate future economic growth. Accordingly, it is difficult for Western Australians to understand why they should receive back far less GST revenue than they contribute.

Unequalised differences in effort to develop resource endowments

Successive Western Australian governments have worked hard and borne substantial fiscal and political costs (and/or risks) to develop the State's natural resource endowment (and enhance economic growth generally), including through:

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[7] In 2009-10 terms. Includes a GST subsidy of about $1.2 billion in that year. As previously noted, Western Australia has been a 'donor' State since the mid 1980s. Prior to that, the State received net support from the Commonwealth to help compensate it for certain disadvantages of federation, particularly high external tariffs and regulation of the labour market that favoured secondary/non-export industries.

- a pro-development economic, legal and regulatory framework, encompassing industrial relations, property rights and environmental management;
- facilitation of land access, development agreements and timely delivery of necessary economic and social infrastructure; and
- provision of research and information dissemination services (e.g. geological surveys).

Successive Western Australian governments were active in securing the necessary agreements with mining companies for the development of the State's iron ore industry. This included helping to overcome obstacles such as posed by Commonwealth migration policy. Current day Commonwealth obstacles include the proposed resource rent and carbon taxes.

In the 1970s and 1980s the State 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.

- 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). Appendix B provides further information on the North West Shelf project.

The potential impact of poor government performance is discussed in a study by Jeffrey Rae (2002, pp. vii-viii):

> *While size and location factors are likely to have some bearing on a country's economic performance, the quality of its institutions and policies are vastly more important in explaining the performance of peripheral economies.*

Tasmania's unsatisfactory institutions have contributed to its dismal performance. The electoral system of proportional representation, for instance, has tended to deliver minority government. This, and the independent character of Tasmania's upper house, resulted in a reluctance by governments to address issues no matter how urgent they became.

Poor public policy also contributed to the dismal performance by creating an economic environment unattractive to business.

- *Government spending and borrowing have been excessive, and there have been poor returns on investment in State-owned enterprises.*
- *Tasmania has the second most severe taxation system of the Australian states and the burden falls heavily on business.*
- *Excessive regulation has stifled innovation and competition. This is most pronounced in the environmental area where there has been a perception that Tasmania is opposed to economic development.*

Under the current GST distribution system slow-growth States can receive the benefit of higher funding and therefore better standards of State services by 'doing nothing'. Indeed, the major fiscal beneficiary of the success of Western Australia's resources sector over the last several years has been New South Wales, reflecting its effective population-based share of the additional mining revenue capacity.

This highlights how the equity and economic efficiency impacts of fiscal equalisation are inextricably linked. With no adjustments made for differences in State's economic development efforts, it detracts from incentives for States to grow their economies, or encourages 'welfare dependency'[8]. The outcome is a reduction in national economic welfare, including a lower GST pool for all States.

Intergenerational inequity

Mineral resources, like other endowments such as agricultural land, climate, natural beauty and water, are a foundation for economic development. However, unlike other endowments, HFE equalises mining endowments across States.

As a result, the resource State cannot retain its endowment (after conversion from minerals to cash in the form of royalties) for investment to secure its future (unlike other endowments). From a national perspective, the resource endowment, after redistribution across the nation, ends up largely supporting consumption rather than investment for future generations.

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[8] In the same way that very high actual or effective marginal personal income taxes discourage hard work or increased labour force participation.

In this context, only the State with the resource has an incentive to use it to secure its future. The only equity justification for equalising any mining royalties is that State Governments are likely to use some of the royalties for consumption rather than development for the future, even if fully retained by the State.

If equalisation of royalties is reduced, non-resource States may receive smaller GST grants 'now', but more in the future than would have otherwise been the case – to the extent that the resource State has been able to invest royalties to help build a stronger economic base, including for when the minerals have been exhausted (with the fiscal returns from a stronger economic base being shared by all States).

The current form of equalisation practiced in Australia also fails to produce intergenerational equity in the sense that changes by the CGC over time to the methods it uses for assessing differences in States' revenue capacities and expenditure needs (including to correct past methodology shortcomings) are only implemented prospectively.

For example, an appropriate allowance for the impact of population growth on the requirement for State provision of new social infrastructure was only introduced in the CGC's 2010 Review of equalisation methods, and has not been applied retrospectively. Prior to this, the revenue benefits from Western Australia's economic growth were shared across the nation, but the State had to meet the full cost of the infrastructure required to service the associated population growth.[9]

Additionally, in the 2010 Review, the CGC changed from an historical five-year averaging process to a three-year averaging process, which disrupted the achievement of equalisation over time (as some years were not fully equalised). This issue was recognised by the CGC as an important factor in the 1999 Review, but ignored in the 2010 Review. Over the period 2010-11 to 2014-15, this disruption to equalisation is estimated to cost Western Australia around $2 billion.

It should be noted that consistent time lags in the CGC equalisation process (whether three or five years) are not normally particularly significant in net present value terms, particularly as the lagged GST relativities are applied to a larger 'current day' GST pool. However, changes to these lags can have significant costs that are never recovered.

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[9] Western Australia's social infrastructure investment requirement (including roads) is currently around $140 million per annum greater than the national average (based on CGC data).

The future (e.g. next 20 years and beyond) is likely to see continued changes in HFE methods, and State and Commonwealth government policies, as the global environment changes and Australia becomes more reliant on international competitiveness rather than 'rents' (or unearned benefits) from its natural endowments (which have arguably allowed Australia to escape major penalties for a centralist and inflexible approach to intergovernmental relations generally).

This 'future risk' needs to be taken into account in the current design of HFE to ensure that outcomes are equitable over time. For example, the risk that mining rents will not be so rigidly equalised in 30 years time (to maximise incentives in a world that includes highly competitive mining development in East Africa) means that mining rents should not be fully equalised now, to avoid intergenerational inequity between States that develop their resources at different times.

Entrenching low service standards

The GST Distribution Review Issues Paper notes that the current equalisation process equalises State governments' fiscal capacities to enable comparable government services to be accessed in comparable locations in different States (e.g. capital cities) but not across locations (e.g. capital cities versus regional/remote areas), and asks if equalisation therefore limits equitable access to services.

Underpinning this question is the fact that the current equalisation 'standards' incorporate the historical average level of services actually provided across regions (classified by degrees of accessibility or remoteness). States have historically provided lower standards of service in more remote regions, including to Indigenous communities suffering high levels of disadvantage and unmet need.

Unfortunately, a State which seeks to introduce new regional service policies that are more reflective of changing community values and shifts in the geographical base of economic activity would effectively need to reduce the standard of services provided to its city residents, which any State is likely to be loathe to do. Therefore, equalisation tends to entrench inequitable access to services in more remote areas.

Western Australia is currently investing 25% of its mining royalties in improvements to regional infrastructure and services, under the *Royalties for Regions (RfR)* program. However, while all of Western Australia's mining royalties are being equalised by the CGC, other States share very little of the service improvement costs funded from the RfR program.

Procedural inequities

While the current equalisation principle may seem straightforward at first glance, the above discussion has highlighted various in-principle inequities, which Western Australia considers are compounded by a range of practical difficulties. Indeed, the Garnaut/FitzGerald Review concluded that equalisation is not possible in practice. For example, it stated that (Garnaut and FitzGerald, 2002, p.158; p.172):

> *It is virtually impossible to separate State policy from State disabilities …*
>
> *… the quality and inventiveness of the CGC's people and work have so far prevented a dysfunctional system from collapsing. In reality, the CGC and agencies administering SPPs have been given an impossible job. Genius in implementation has postponed, but cannot avoid, realisation of the need for fundamental reform.*

Some more specific difficulties, which inevitably produce inequities (through higher/lower GST shares than otherwise) and/or inefficiencies, are as follows.

Separation of policy from disabilities

The CGC currently strives for 'policy neutral' GST distribution outcomes by compensating States only for underlying, as opposed to policy-driven, disabilities or needs. It is integral to the CGC's objectives that GST shares should properly capture needs while not being directly affected by a State's choice to provide an above or below average level or quality of services, or to make an above or below average revenue raising effort. However, average policy can be difficult enough to define in principle, and is nearly always difficult to measure reliably in practice. Hence, separating policy from disability or needs can be difficult, including where a revenue base or service delivery cost factor is significantly confined to a minority of States. Important expenditure examples include:

- the Indigenous assessments, where issues of poor quality data, Census self-identification, socio-economic status (SES), remoteness and history (e.g. stolen generation, community dislocation) make it very difficult to establish reliable 'average policy' and disability measures
  - the CGC largely assumes that Indigenous people (as identified by the Census based self-identification estimates) living in geographic regions that have similar levels of remoteness have similar levels of needs (despite evidence of variation on grounds other than remoteness);[10]

[10] In its hospital assessment, the CGC does measure the SES of Indigenous households in geographic areas, but based on the SES of all households in those areas. This can be quite misleading, as it attributes the SES of the general community to the Indigenous community in each area.

  - Western Australia is also directly disadvantaged by the quality of Census counts, as set out in the feature box below;

- the dispersion assessments, where data is poor and costs in remote areas vary widely depending on economic circumstances

  - Western Australia has a virtually unique set of circumstances that lead to very high costs in its remote areas (e.g. the buoyant mining sector competes with the public sector for staff and drives high wages and other costs in remote areas) – it is therefore difficult for the CGC to determine an 'average policy' assessment of Western Australia's remote area costs;

- the power and water cost assessments, where it is difficult to establish a standard policy for high costs in rural/remote areas, reflecting data limitations, the variety of States' circumstances and the limitation of significant high costs to a small number of States

  - for example, rural/remote water costs are a function of water availability (including distance of communities from the water sources), water quality and the size of communities, among other factors. Western Australia's costs are far higher than the national average, but there is limited data to enable an assessment of these costs by the CGC (as noted in its 2010 Report[11]); and

- assessing economic development needs is made difficult by the variety of States' circumstances, and difficulty of distinguishing between 'good' State policy (i.e. that promotes sustainable development) and 'bad' State policy (i.e. that perpetuates economic weakness).

When measuring the relative (per capita) size of States' revenue bases, there are at least four problems.

- Firstly, in the mining assessment, significant iron ore production is limited to one State and black coal production to two States – so that a change in royalty policy relating to these minerals in one of these mining States can drive a change in the assessed relative revenue capacity (and hence GST shares) of all States.

- Secondly, the CGC examines only the legal incidence of taxes (and royalties), not the full range of 'capacity to pay' issues that State governments consider.

  For example, the CGC assumes that the capacity to pay land tax can be measured by the legal incidence of land tax, which is on land values. However, evidence suggests that States reduce land tax rates when land values are increasing rapidly.

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[11] The CGC noted that "… the data are far from complete or comprehensive. Important pieces of data, such as the importance of community size and water availability/quality in determining average State subsidies cannot be imputed. Also, water subsidies appear to be affected by many factors which cannot be captured in a simple assessment" (2010 Report, Volume 2, p 297).

Although not explicitly recognised in State policies, some underlying measure such as income or rental returns on land may be closer to the actual revenue base that is being exploited – for which there is some support from analysis of the relationship between State income, land prices and land tax collections (Western Australian Department of Treasury and Finance 2009).

- Thirdly, the CGC does not make any adjustment for the economic impact of different tax efforts and service standards/efficiency levels by State. To be policy neutral, the CGC would have to reduce the measured revenue bases for States that are putting in above average effort to develop their economies through sound taxing/spending policy, and increase the measured revenue bases for States that have made below average effort.
- Fourthly, the CGC's reliance on State revenue base data creates problems of comparability across States in terms of differences in compliance effort, legislation/regulation and limitations of States' data systems, all of which affect States' apparent revenue bases. The land tax assessment is particularly susceptible to these factors (e.g. to differences in compliance effort in terms of identifying liable taxpayers and ensuring that land is properly valued).

ABS Indigenous Population Estimates

As estimated by the ABS, Western Australia's share of the national Indigenous population fell from 14.4% at the 2001 Census to 13.7% at the 2006 Census, reducing Western Australia's GST grants by around $50 million per annum.

The ABS preliminary estimate of Western Australia's Indigenous population share at the 2006 Census had actually been 15.1%, but this was revised down to 13.7% after the ABS adopted revised methodology for finalising its population estimates. A key issue for the ABS was estimating the Census undercount of Indigenous persons (which it did by using the results of its Census Post Enumeration Survey).

For its preliminary State estimates, the ABS divided Australia into five regions (Western Australia being one) for the purposes of its undercount analysis. However, the ABS was concerned about the high relative 'standard errors' (7.3% for Western Australia). It sought to reduce these by using an Empirical Bayes estimation method, which started with the assumption that there is no *a priori* expectation that any one region will have any worse undercount than any other region.[12]

[12] Technically, the 'true' undercount adjustment Tr for each region 'r' was assumed to be distributed as a normal random variable with the same mean T and same variance A.

However, this assumption is seemingly implausible. Intuitively, it could be expected that the undercount rate would be very high in remote areas of Western Australia, reflecting the difficulty of counting the many small remote communities in the State, and of recruiting Census collectors in these areas in the booming economic conditions that prevailed at the time. In this regard, even after the 'smoothing' impact of the Empirical Bayes analysis, Western Australia's Indigenous undercount rate remained the highest of all States, at 16.6% (compared with 11.5% nationally).

Indigenous school enrolment data (as at 2006) also suggests that the ABS methodology excessively discounted Western Australia's share of the national Indigenous population. Enrolments nationally were 4.4% (for the 6-9 age group) and 6.6% (for the 10-14 age group) below the ABS national Indigenous population estimates (for these age groups), while Western Australia's enrolments were respectively 11.0% and 8.0% above the corresponding ABS estimates of Western Australia's Indigenous population.

Sources: ABS 3238.0.55.001 (Technical Note), ABS 3228.0.55.001, ABS 3101.0 (June 2008), enrolment data provided by the ABS on request, and WA September 2009 Submission on Population Estimates to the CGC 2010 Review.

Failure to equalise all expenses and revenues

There are various expenses (and some revenues) that the CGC fails to equalise, biasing equalisation in favour of assessed areas and against non-assessed areas.

An important example is that, although the CGC equalises royalty revenues, it fails to equalise many State expenditures that support resource development, particularly provision of infrastructure (including both multi-user/economic and social infrastructure) in advance of full utilisation (where the infrastructure cannot be efficiently increased in small increments as development occurs).

This incurs a significant subsidy cost, reflecting the opportunity cost of 'in-advance' provision (and the risk of projected future demand not materialising). Many areas of Western Australia require crucial State investment for the future in port, road, rail, usable land, water and power infrastructure that would be under provided if left to the private sector and/or solely user-pays funding.

This investment has national benefits, as it enables the structural adjustment (i.e. movement of factors of production to where they are most productive) that is needed to optimise the performance of the Australian economy and the welfare of Australians. Hence the cost of this investment should be shared nationally.[13]

Examples of Western Australian Infrastructure Projects

Mid-West Energy Project (Southern Section)

The Mid-West Energy Project (Southern Section) involves the construction of a 201 km 330kV transmission line from Pinjar to Eneabba, the purchase of a line from Eneabba to Three Springs and the upgrade of the existing Neerabup to Pinjar transmission line. The total estimated capital cost of the project is approximately $409 million. It will initially support the Karara iron ore project, and later other Mid-West mining and renewable energy developments and community power needs.

The State Government will have to provide the capital for this project upfront, impacting adversely on the State's net debt, which in turn will limit the State's capacity to fund other investments.

Utah Point

The Multi-User Panamax Berth at Utah Point is a $305 million facility that opened in 2010. It has a capacity of about 18 million tonnes per annum, and is able to accommodate Panamax and small Cape size vessels of up to 120,000 dead weight tonnes. The State has contributed more than $190 million for the construction of the berth. This investment was required to facilitate exports from current and emerging junior iron ore producers, which will bring significant economic benefits.

[13] A 1998 consultancy on behalf of the Western Australian Treasury (Petchey et al., 1998) indicated that if a one percent increase in the scale of construction resulted in a 0.75% increase in costs (due to scale economies), then there was an optimal 14-year period between episodes of new construction for linearly increasing demand (assuming a 4% real discount rate), which we estimate would carry a total opportunity cost of around 26% of the cost of construction for future demand. Greater scale economies increase the opportunity cost (e.g. a 0.60% increase in costs for each one percent increase in the scale of construction yields a 38% opportunity cost.) Western Australia's relative needs depend on the scale economies and its optimal rate of growth, but could roughly be $1 billion per annum, assuming a long term efficient target of 2% per annum above-national-average population growth is efficient for structural adjustment and reducing Western Australia's under-development relative to other States. Unlike other aspects of the CGC's calculations, funding depends on the efficient migration target, rather than an achieved growth level, as it is in furtherance of a long term aim. Initially, growth could fall below the long term target, but as the greater funding for Western Australia slowly works through the system in terms of better services and expanded job and investment opportunities, economic and population growth would ramp up.

Browse LNG Precinct

The Browse Liquefied Natural Gas (LNG) Precinct would consist of LNG processing facilities and associated infrastructure (with an LNG production capacity of up to 50 million tonnes per annum), and would be located in the vicinity of James Price Point – approximately 60 km north of Broome. Woodside Energy Limited, on behalf of the Browse LNG Development Joint Venture participants, was appointed as a Foundation Proponent for the Precinct under the Preliminary Development Agreement signed in October 2009.

The construction of the gas hub is expected to cost approximately $30 billion, to be paid for by the private sector. However, approximately $123 million in additional funding will be required to build an access road (which would not be recognised by the CGC).

Ashburton North

The State Government is creating a new strategic industrial area at Ashburton North, near Onslow, for the development of natural gas projects and associated industries in the North West. The resource projects to be underpinned by the infrastructure include Chevron's Wheatstone project and BHP Billiton's Macedon project. The creation of Ashburton North will also help support the State's domestic gas supply. A $330 million upgrade is needed for the North West Coastal Highway to meet additional traffic demands.

A private sector contribution for critical infrastructure around Onslow mainly relates to needs that are not assessed by the Commonwealth Grants Commission – including local community infrastructure, road degradation expected from the construction phase of the Wheatstone project and a desalination plant.

Some other areas that the CGC fails to equalise are:

- gambling revenues – it is ironic that Western Australia is penalised for increasing royalties (by pricing minerals more appropriately) but would keep all of the additional gambling revenue if it lifted its socially-responsible ban on poker machines; and
- national park expenses – which are likely to be larger in States such as Western Australia with large geographic area, biological diversity in fragile areas and development pressures.

Even for the functions that the CGC does equalise, it often discounts its assessments due to lack of data certainty, and hence only partially assesses those functions. There are problems with discounting for data certainty, which again bias the equalisation outcome.

In this regard, unless it is *a priori* known that the data has a tendency to overstate the relative magnitude of disabilities (which is seldom the case), it is just as likely to result in assessments that are too low as too high. Therefore, indiscriminate use of discounting will tend to understate 'needs'.

Almost every discount currently applied by the CGC results in more GST revenue being redistributed away from Western Australia, because these discounts reduce our expense assessments (which partially offset our losses from the revenue assessments).[14]

Many CGC assessments remain highly questionable after years of review

Despite a series of comprehensive Reviews (1981, 1982, 1985, 1988, 1993, 1999, 2004, 2010), Western Australia considers many of the current assessments to be substantially unreliable. To the extent that the problems are quantifiable, we estimate the cost to Western Australia to be in excess of $2.1 billion per annum (see Appendix C). On this basis alone, we have little confidence that the current equalisation outcome for Western Australia is equitable.

The under-estimation of Western Australia's grant entitlement means that it lacks the capacity to grow its infrastructure and services to fully develop the State's natural endowments in pursuit of high, sustainable and broad-based growth. In addition, the over-estimation of other States' grants is effectively dampening the incentive for factor mobility to Western Australia.

This again highlights how the equity and economic efficiency impacts of equalisation are inextricably linked. Partial and inaccurate equalisation at the State government level, as currently occurs in Australia, detracts from migration incentives and the capacity for States to grow their economies. The outcome includes a lower GST revenue pool for all States.

Conclusion

Specific reform options, including alternative forms of equalisation, to improve both the equity and efficiency of equalisation are discussed in Chapter 6 on *Reform Options*. For the purposes of this chapter, Western Australia concludes that:

- current and prospective equalisation outcomes are so extreme as to destroy any consensus on their acceptability;

[14] The main exception is the 25% discount applied to land tax. However, we consider this discount to be justified, not on data uncertainty grounds (the CGC's justification), but because we believe that the CGC's use of land values as the tax base is conceptually questionable as noted earlier, which overstates differences in tax capacity between States.

- in practice, the current equalisation objective is not, and probably cannot be, achieved. There is likely a large difference between the redistribution determined by the CGC and the 'true' redistribution envisaged by the principle.
  - while much of this reflects data and method issues, there is also an unavoidable 'circularity' problem (i.e. the HFE distribution influences policy outcomes, which influences the HFE distribution) and the lack of full separability of policy and disability; and
- contrary to what it should ideally do, HFE currently delivers neither effort neutrality nor the capacity for States to grow their economies or to facilitate necessary structural adjustment – but does deliver a high risk of intergenerational inequity. These are major equity and efficiency failings.

Chapter 3

Efficiency – Further Failings of Fiscal Equalisation

From an efficiency perspective, Western Australia considers that the tax and transfer system, including the GST redistribution system, should minimise impediments and disincentives to the free flow of resources across regions and sectors of the economy to where they will be most productive. This objective is incompatible with the form of equalisation currently practiced in Australia.

In the context of the issues and questions flagged in the GST Distribution Review Issues Paper, we consider that equalisation currently penalises States for economic success, discourages productivity enhancing reforms, inhibits structural adjustment and detracts from incentives for States to optimally exploit their own source revenue bases and/or to levy taxes (and mining royalties) efficiently.

Reduced incentive and capacity for economic development

The current operation of HFE entails efficiency losses for the nation through both incentive and capacity effects.

Incentive effects

Australia's current equalisation system reduces the incentive for a State to grow its economy (e.g. through its capital works and regulatory policies), as it effectively applies a 100% tax rate on any above-average revenue capacity.

In this regard, a State currently retains only its population share of any increase in its revenue capacity, all else held constant (and after allowing for time lags). Based on projected December 2011 populations, the effective tax rate for each State on any increase in its revenue capacity is as follows.

Table 2

NSW	Vic	Qld	WA	SA	Tas	ACT	NT
67.8%	75.1%	79.6%	89.6%	92.7%	97.8%	98.4%	99.0%

All other States gain (through adjustments to their GST shares) from the 'tax' paid by the State whose revenue capacity has increased, in proportion to their population shares. Accordingly, post the GST redistribution, each State's revenue capacity is equalised at the national average.[15]

These very high taxes on revenue base growth are exacerbated by the asymmetrical nature of the equalisation process in its treatment of growth effort – although the majority of the revenue gains from a State's efforts to improve its economic performance are equalised away, the same does not hold for the associated additional costs (e.g. service and infrastructure improvements).[16]

Notwithstanding that State governments have other incentives to develop their economies (e.g. to enhance the income and wellbeing of the State population by generating employment opportunities), the impact of fiscal equalisation is to dull the incentive of State governments to promote economic and social development. In particular, the equalisation of revenue benefits may:

- reduce the willingness of States to undertake micro-economic reform to improve their economic performance where the reform involves pain for some sectors, particularly if the gains from micro-economic reform are difficult to see;[17]
- reduce the willingness of States to allow developments that involve risks or trade-offs for the community, such as mining activity that may conflict with agricultural and environmental interests (e.g. new coal and coal seam gas projects); and
- reduce the willingness of States to invest in infrastructure to facilitate new industry.

The disincentive impact of fiscal equalisation is compounded by the impact of Commonwealth tax and spending. The higher per capita income generated by a State translates into higher Commonwealth personal and corporate taxation and a lower draw on Commonwealth social security benefits. The Commonwealth's fiscal benefit is then effectively redistributed across all States through reduced Commonwealth tax rates or increased Commonwealth spending (see also Chapter 1).

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15 For example, if Western Australia receives $100 million from an increase in revenue capacity, it retains only $10 million and $90 million goes to others (e.g. New South Wales receives $68 million).

16 Above average expenditure by a State is treated as a policy difference and therefore essentially not equalised, even when it contributes to above average growth in the State's revenue base that is fully equalised. There is a small effect on the expenditure standard, which can work either way depending on whether a State has positive or negative 'needs' for the relevant expenditure category.

17 National Competition Policy Payments to the States were initiated in the 1990s to recognise that the Commonwealth Government would be the major fiscal beneficiary of certain agreed reforms by virtue of its broad tax bases, but States would bear the costs. These payments were subsequently unilaterally abolished by the Commonwealth.

In 2006 the Western Australian Treasury estimated that the Gorgon gas project would improve the Commonwealth's budget balance by $11-14 billion. After taking account of the redistribution of State revenue benefits and unequalised State expenditures in support of the project, Western Australia's forecast net fiscal benefit would be only $300 million. Other States would receive a net fiscal benefit of around $3 billion (Western Australian Department of Treasury and Finance 2006, p. 36)

In this example, the Western Australian Government's budget comes out ahead, but only just. A 2007 election commitment by Federal Labor to return up to $100 million per annum from Gorgon 'royalties' (which accrue exclusively to the Commonwealth) to a Western Australian Infrastructure Fund would significantly improve the business case for State investment, but as yet to be honoured. For other projects, significant State investment requirements could result in a negative net fiscal impact.

In this regard, the North West Shelf project entailed large costs and risks (and limited fiscal returns) for the State, as described in Chapter 2 on Equity. It is conceivable that this nation-building project may not have gone ahead if the impact of fiscal equalisation had been fully appreciated at the time – or would only have gone ahead if a substantially improved sharing of the fiscal benefits had been offered to Western Australia.

New offshore petroleum projects that require State investment in on-shore infrastructure, including the recently announced Wheatstone LNG project (as well as the Gorgon project) contribute no royalties to the State Government. The Commonwealth Government is the exclusive recipient of petroleum resource rent tax revenues, none of which is returned directly to the State.

While quantifying the aggregate economic loss from the fiscal equalisation 'development tax' is difficult, we note that the Garnaut and FitzGerald (2002) report suggested that losses in the order of 1% - 2% of GDP were conceivable (i.e. $12 billion - $25 billion per annum in current dollars).

Capacity effects

The incentive effect is compounded by the failure of HFE to properly equalise capacity. In this regard, Chapter 2 on Equity outlines some of the costs that States incur in support of economic development that are not recognised or only partly recognised by the CGC. In addition, any above-average effort that States have undertaken to develop their economies 'falls foul' of the CGC's limited policy neutrality objective.

The low levels of funding received by Western Australia make it difficult for the State to fund all of the economic infrastructure and services necessary to support major resource projects that will benefit the national economy. To ensure the long-term sustainability of its finances, the State Government has been forced to ration its capital spending in the face of strong demand, leading to projects being deferred or even foregone if they miss windows of opportunity in global markets.

In Chapter 2 we estimate that flaws in HFE, including non-recognition of costs for facilitating future economic growth, are costing Western Australia over $2 billion per annum.

The opportunity cost borne by the nation, in terms of increased output and taxation receipts that are foregone as a result of this rationing of public investment by the State in economic infrastructure, is potentially large[18]. The long term effect of inadequate funding tends to crystallise at times when own-source revenues are weakened as a result of economic downturns or the lagged impact of HFE. Rationing of State investment in economic infrastructure becomes even more acute in these circumstances, which acts to impede economic recovery.

A case in point is the global financial crisis in late 2008. The slump in State revenues necessitated an audit by the Western Australian Government of its capital works program to identify infrastructure projects that could be cancelled or deferred. A total of $1.6 billion of projects in the energy, transport and water sectors was deferred, limiting the Government's ability at the time to respond to the still strong demand for infrastructure necessary to support activity in the resources sector. Health infrastructure worth $400 million was also deferred.

The impact of inadequate Commonwealth funding on the State's ability to support its resources sector is also evident in the nature of the State's submissions to Infrastructure Australia for contributions from the Commonwealth to facilitate specific infrastructure projects. The majority of projects submitted by Western Australia relate to economic infrastructure that would underpin expansion of the State's resources sector. These projects include:

- common-user infrastructure at the Oakajee Port and the Mid West 330kV Line and Renewable Link, which will support the emerging magnetite export industry in the State's Mid West region;
- Gateway WA (Perth Airport and freight access), which is designed to reduce bottlenecks and increase the efficiency of passenger and freight movement into and out of the Airport, in large measure for the benefit of the resources sector;
- Port Hedland Inner Harbour Capacity Enhancements, to support expansion of the iron ore export industry in the Pilbara; and
- South West (Bunbury) Infrastructure, to support export industries using the Bunbury Port.

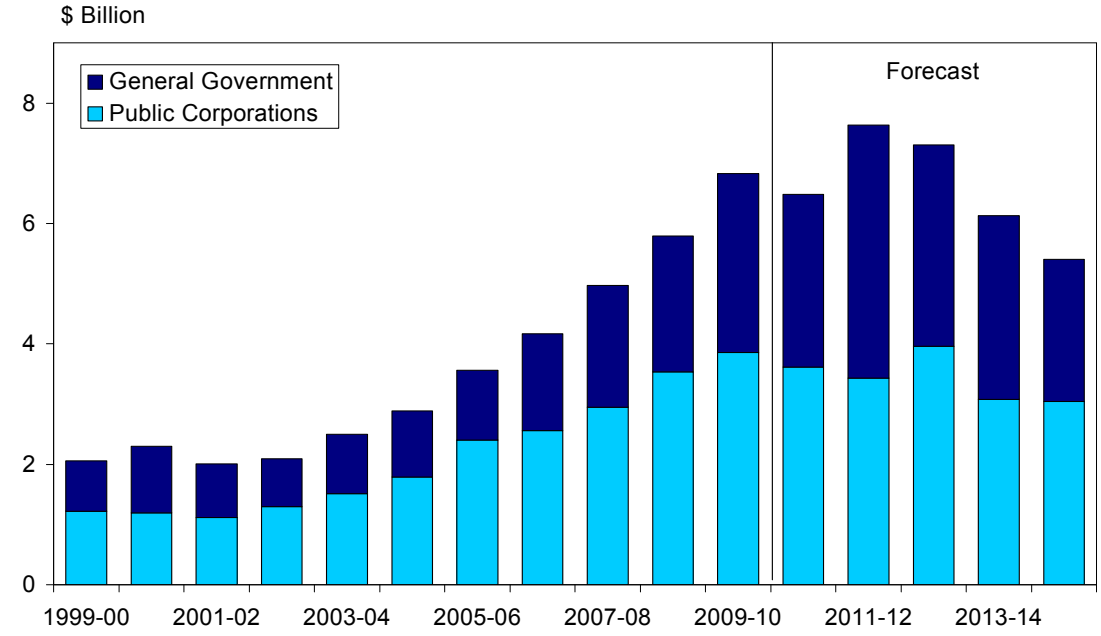
[18] The magnitude of this cost should be considered in the context of the June 2011 Deloitte Access Economics *Investment Monitor* publication, indicating that in addition to $106.8 billion of projects currently committed or under construction in Western Australia, there were potential projects (i.e. those under consideration or possible) valued at $156.8 billion. Western Australia continues to account for a disproportionate share of the national pipeline of projects.

In the absence of sufficient funding, the State will not be able to progress these and other projects with the speed or scope necessary to fully support the resources and related industries that will depend on them. In particular, the continued growth and success of the Pilbara region, from a social and strategic regional development perspective as well as an economic perspective, is crucially dependent on a continuation of high State investment (see Figures 7 and 8) that will be difficult to achieve under current financial constraints.

The full equalisation of States' actual revenue bases and lack of assessment by the CGC of infrastructure support for future economic development place much importance on the Commonwealth providing direct economic infrastructure payments to States. However, Commonwealth budgetary constraints may result in an inadequate level of assistance, and there is a risk that the available assistance may not be allocated to areas of greatest national economic return.

Figure 7

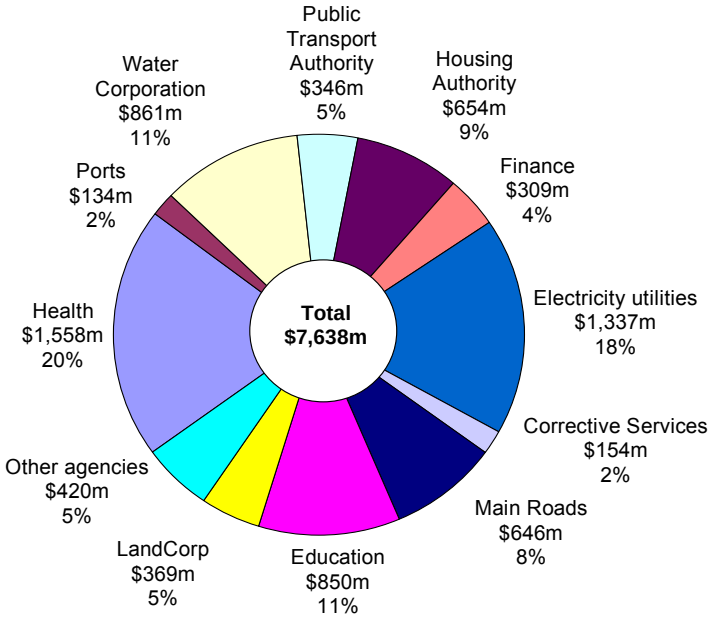
WESTERN AUSTRALIA'S ASSET INVESTMENT PROGRAM
TOTAL PUBLIC SECTOR



Source: Western Australian 2011-12 State Budget.

Figure 8

WESTERN AUSTRALIA'S ASSET INVESTMENT PROGRAM BY PUBLIC SECTOR AGENCY, 2011-12



Source: Western Australian 2011-12 State Budget.

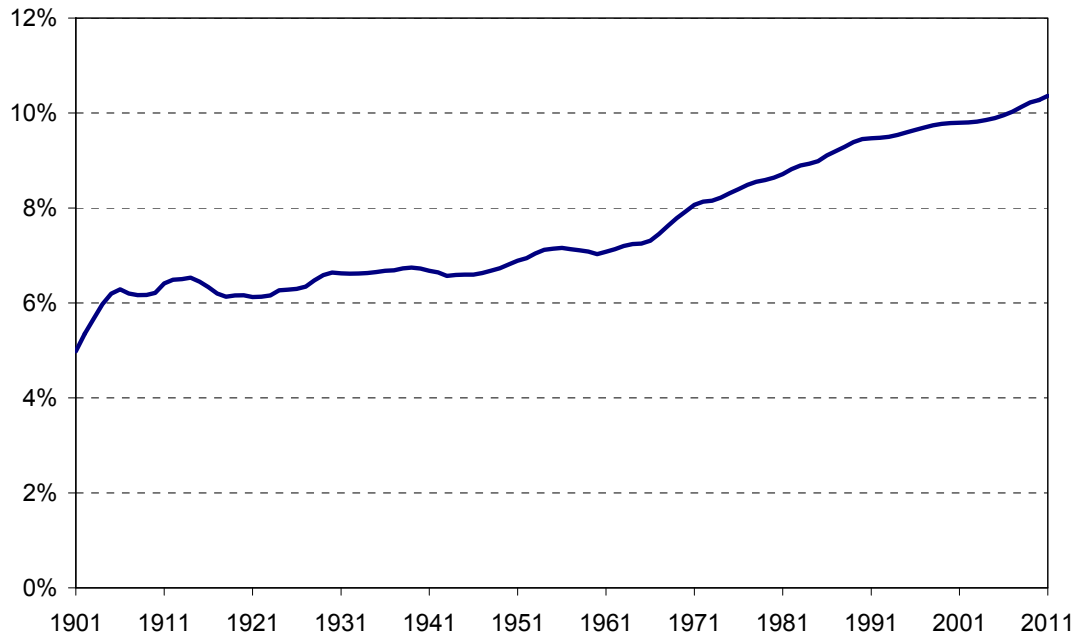
Barrier to structural adjustment

The impact of HFE in terms of not providing incentives and capacity for economic development is most clearly seen in the structural adjustment issue that is now more urgently confronting Australia. As a result of external shocks, seen in the dramatic strengthening of the $A/$US exchange rate and terms of trade (linked particularly to the 'rise' of China), and the uneven geographic spread of natural resources in Australia, the allocation of labour (and accompanying capital) nationally needs to transition to a new long run equilibrium.

Historical evidence also suggests that the Australian economy has not been in long run equilibrium, with the Western Australian economy being relatively underdeveloped, so that the long run productivity of labour in Western Australia has been higher than in the rest of Australia. This evidence includes the trend growth in Western Australia's share of the national population (Figure 9) and high per capita share of renewable and non-renewable resource endowments – reflected in both current value of production (Figure 10) and Western Australia's large mineral reserves.

Figure 9

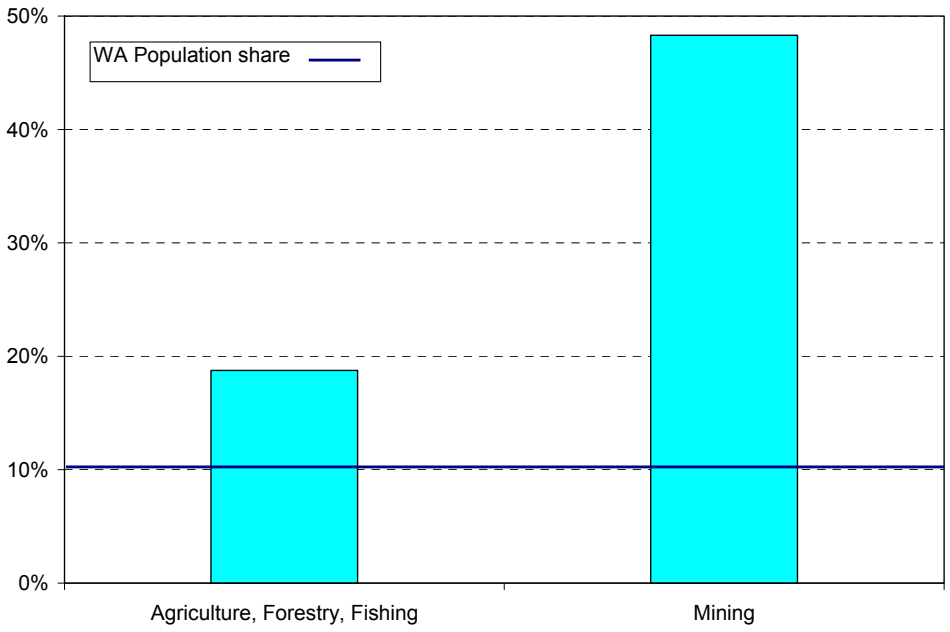
WESTERN AUSTRALIA'S POPULATION SHARE SINCE FEDERATION



Source: Australian Bureau of Statistics. Populations at June each year.

Figure 10

WESTERN AUSTRALIA'S SHARE OF NATIONAL VALUE OF AGRICULTURE AND MINING PRODUCTION, AND POPULATION, 5 YEARS TO 2009-10



Source: Australian Bureaus of Statistics.

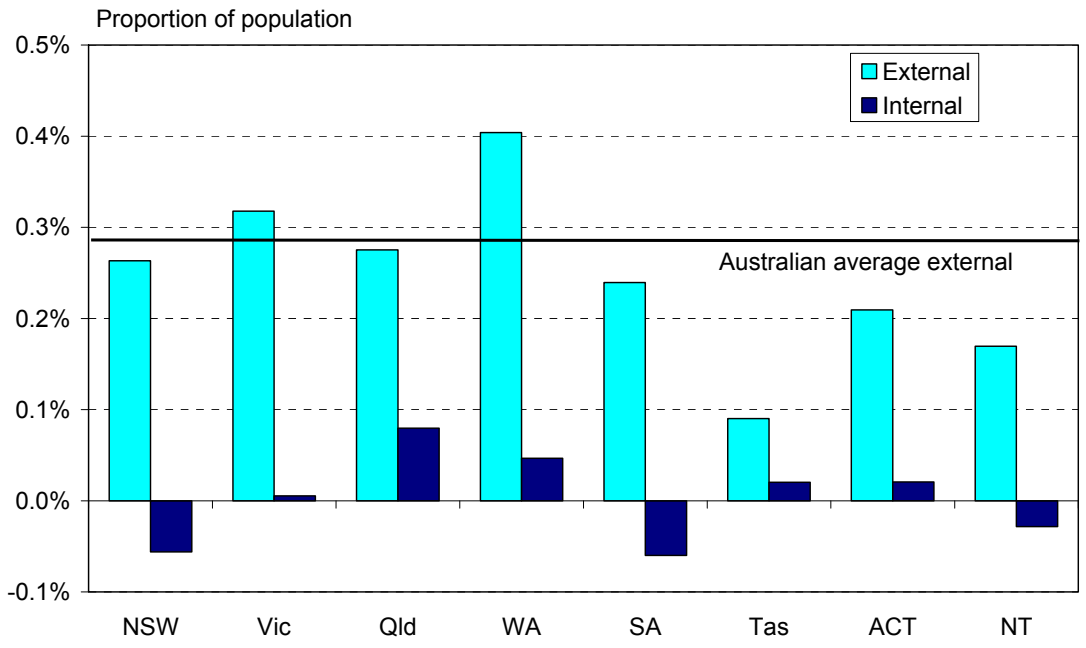
Recent economic developments have effectively moved the long run equilibrium, and increased the imperative for structural adjustment. Maximising Australia's national income requires a shift of labour and capital to States such as Western Australia. However, subsidisation (through the current fiscal equalisation approach) of resource-poor regions tends to counteract the incentive for labour to move to resource-rich regions, and thus prevents or delays the necessary structural adjustment.

In particular, equalisation as currently practiced takes away Western Australia's incentive and capacity to grow its services and infrastructure to attract and absorb high in-migration, as discussed above. As noted in Chapter 2 on Equity, rapid economic and population growth requires significant subsidisation of economic as well as social infrastructure until an economic level of utilisation is reached – but this is not allowed for under the current HFE system.

Western Australia's share of internal and external migration is currently only modestly above average (see Figure 11), suggesting that higher rates of in-migration would be quite feasible if this were accommodated by appropriate reform to the GST distribution. Additional GST funding could assist in expanding water provision, power generation, land/housing availability and general amenities in the Pilbara and Kimberley regions – enabling growth of towns and businesses in these regions while reducing the reliance on fly-in-fly-out workers.

Figure 11

WESTERN AUSTRALIA'S SHARE OF INTERNAL AND EXTERNAL MIGRATION, 3 YEARS TO 2010



Source: Australian Bureau of Statistics.

Perversion of fiscal decision making and reform

Fiscal equalisation currently leaves scope for a State to increase its GST grant share through particular policy choices (involving tax rates or spending effort), which may not otherwise be in the public interest. It has generally been assumed that the potential GST gains are too small to significantly influence States' decision-making, but there are some instances where this is clearly not the case.

Mining royalties

Western Australia faces the extraordinary situation where by 'pricing' its minerals more appropriately in current global commodity market conditions, it could lose more in GST grants than it gains in royalty revenue. Conversely, by reducing certain royalty rates, it could gain more in GST than it loses in royalty revenue – but to the detriment of all other States.

By way of background, for the purposes of measuring States' capacity to raise revenue from (onshore) mining royalties, the CGC currently splits minerals into a 'low royalty rate' category and a 'high royalty rate' category – based on whether a mineral attracted a national average royalty rate of above or below 5% of the value of production at the time of the 2010 Review.

Reflecting that Western Australia accounts for more than 65% of the national 'low rate' value of production, compared to 10% of the national population, any royalty rate increase applied to 'low rate' minerals by Western Australia (assuming no reclassification of minerals) will result in a GST grant loss of around 55% of the additional royalty revenue raised.[19]

Having regard for industry sensitivities to royalty rate increases, this degree of dilution of the royalty revenue gains may alone be sufficient to impact on decision making. Such impacts were described by Professor Ross Garnaut, in a paper on the Commonwealth's proposed mining tax, as "the destruction of State interest in efficient financial management of the resources under their control through horizontal fiscal equalisation" (2010, p. 17).

However, even more seriously, by adjusting its royalty rate up or down, a State may cause a mineral to be reclassified between the 'low rate' and 'high rate' categories, resulting in more dramatic changes in assessed needs.

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[19] Fiscal equalisation has the effect of allocating royalty revenue raising 'capacity' across all States on an equal per capita basis, where 'capacity' is determined by applying the national average royalty rate to the value of production in each State. Other than for exported coal (categorised 'high rate' by the CGC), Western Australia's royalty rates tend to dominate the calculation of the national average royalty rate.

A ‘real life’ example is Western Australia’s decision in 2010 to remove a long standing royalty rate concession available to State Agreement Act producers of iron ore ‘fines’ (BHPB and Rio Tinto) – the concessional 3.75% royalty rate (which reflected a previous era when ‘fines’ were less marketable than ‘lump’ iron ore) was replaced by the general ‘fines’ concessional rate under the Mining Act of 5.625% (which increased the average ‘fines’ rate from less than 5% to more than 5%).

Had this led the CGC to reclassify iron ore fines from ‘low rate’ to ‘high rate’ Western Australia would have faced a loss in GST grants equal to about three times (about $1 billion per annum) the additional royalty revenue raised (about $300 million per annum). In the event the Federal Treasurer (at Western Australia’s request) instructed the CGC not to do so (and the CGC also found extraneous reasons why it should not do so).

However, there remains a risk that a more recent announcement by Western Australia (in its 2011-12 Budget) that it will move to phase out the remaining ‘fines’ royalty rate concession (available to all producers), to align the rate with the lump iron ore royalty rate of 7.5%, will result in the CGC reclassifying iron ore fines to ‘high rate’. Again, this would cost Western Australia more in GST grants than the additional royalty revenue raised.

Although the State Government has chosen (in both cases) to proceed with the royalty changes, this is in the context of the view that the fiscal equalisation system is so broken that the case for reform cannot be ignored.

This is reinforced by the fact that Western Australia could make a net gain, currently estimated to be $80 million per year (previously estimated to be as high as $160 million per year) by reducing its 7.5% ‘lump’ iron ore royalty rate to just under 5% – the $400 million per year loss of royalty revenue would be more than offset by a $480 million gain in GST share. This would come at the expense of the other States.

Ad hoc solutions, such as asking the Commonwealth Treasurer for a special direction to the CGC each time there is a problem, are obviously not the answer, as there is no certainty about the outcome. Indeed, the Commonwealth Treasurer has publicly stated that he does not intend to intervene again, and undertaken to cut direct infrastructure funding to Western Australia to boot – because the announced increase in State royalties would be a credit against the Commonwealth’s proposed mining tax.

It has been suggested that these problems are justification for the Commonwealth Government taking over State royalties. However, that would only serve to exacerbate the States’ already excessive reliance on Commonwealth grants, undermining their sovereignty and fiscal autonomy at the expense of poorer community outcomes under Australia’s federal system.

Tax 'compliance' efforts

Under the current fiscal equalisation arrangements, there are also circumstances where it would even 'pay' a State for its Revenue Office not to raise its tax compliance effort where tax avoidance activity is detected, on the basis that the gain in State tax revenue would be more than offset by a loss of GST grants. Equity between taxpayers would then be a major casualty.

By way of background, the CGC uses State-provided data on the value of taxed land, property transfers and motor vehicle transfers to measure States' revenue bases for land tax, conveyance duty and stamp duty on motor vehicle transfers respectively. If a State increases its compliance effort, the CGC will measure it as having an expanded revenue base.

The CGC would then reduce that State's GST grant by all but its population share of the additional revenue that it would raise from the expansion of its revenue base, calculated using national average tax rates. For example, if Western Australia imposed national average tax rates, it would lose 90% of the additional revenue raised through increased compliance (i.e. all but its 10% population share).

For a State with tax rates below the national average, the proportion of its additional revenue that is lost will be larger. An extreme example is for land tax levied on properties worth less than $1 million in Western Australia. If the Office of State Revenue increases its compliance effort on these properties, Western Australia loses GST grants equal to about five times the additional land tax revenue raised.[20]

Appendix D sets out the estimated impacts of compliance effort on each State's GST grants in detail. Perversely, Western Australia could eventually improve its finances by up to around $140 million per annum by ceasing prosecutions for failure to pay land tax on properties valued at less than $3 million (provided other States did not do likewise).

Tax reform

Victoria has noted, effectively, that a State (acting unilaterally) has no financial incentive from a fiscal equalisation point of view to abolish an inefficient tax for which it is assessed to have above average revenue raising capacity. For example, Victoria's early elimination of certain financial transaction taxes (which all States agreed to ultimately abolish as a condition of receiving GST grants from the Commonwealth) meant that (as a high capacity State for these taxes) it was still losing GST-share on account of these taxes even after it had abolished them.

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[20] Based on the CGC's assessments for the 2009-10 data year.

It is also understood that if New South Wales were to replace conveyance duty with a residential land tax, as proposed (for all States) in the Australia's Future Tax System (Henry) Review, its GST share would decline. This would reflect its high residential land values, whereas its conveyance duty revenue raising capacity has been below average on account of relatively low property market turnover.

Quantification of fiscal equalisation inefficiency

The GST Distribution Review Issues Paper refers to quantitative studies noted in *The Commonwealth Grants Commission: The Last 25 Years* (2008) as suggesting negligible efficiency impacts from fiscal equalisation. The studies quoted in this paper are among the most well known, and were undertaken by two teams:

- Dixon, Madden and Peter, commissioned by the CGC, and published in 1990 and 1993; and
- Dixon, Picton and Rimmer, initially commissioned by the Garnaut/FitzGerald Review of Commonwealth State Funding, and published between 2002 and 2005.

However, the assumptions underlying these studies effectively assume away most of the efficiency issues, and the results are therefore in no way indicative of the efficiency impact of equalisation. More specifically:

- The Dixon, Madden and Peter study assumes an economy in equilibrium and that equalisation is efficient apart only from the equalisation of unit costs of service provision.
- The Dixon, Picton and Rimmer work attempts to apply a general equilibrium framework to model the efficiency of equalisation in Australia. Despite the increased level of sophistication, it is only able to pick up marginal effects that are dependent on the assumptions made. Fundamental limitations include:
  - the national economy is assumed to be in equilibrium;
  - economic activity is essentially assumed to be independent of State government activity; and
  - grant shares are determined exogenously (so the model cannot pick up State 'gaming', nor the impact of migration on grant shares).

A further study by Swan and Garvey (1995) (see also below) focussed on equalisation distortions to State spending and taxing policies. This yielded small net welfare losses on the expenditure side. Revenue side welfare losses were not quantified, but the elasticity of revenue effort with respect to capacity was determined to be 0.16 (that is, every 10% increase in capacity would reduce effort by 1.6%). These results do not reflect the extreme effects noted above in relation to mineral reclassification and tax compliance effort, which were not known to Swan and Garvey.

The academic literature

Efficient migration

An efficiency rationale for equalisation approaches such as Australia's and Canada's was originally put forward by Buchanan (1950). Buchanan argued that differences in the net fiscal benefits provided by the public sector to otherwise identical households should be eliminated on the basis of efficiency considerations, as these differences provide an incentive for households to choose their locations on the basis of fiscal rather than productivity considerations.

Subsequent debate about whether all fiscal incentives were necessarily inefficient (see Musgrave, 1961; Buchanan and Wagner, 1971) led to a more refined approach (see Buchanan and Wagner, 1971; Boadway and Flatters, 1982a; and Boadway, 2004), where inefficient migration across State borders is explained in terms of how the decisions of migrants impact on others, rather than in terms of the direct incentives for migrants:

- An in-migrant to State A contributes a net fiscal benefit to the rest of the State equal to the taxes 'he' pays less the public services he uses. His departure from State B yields a corresponding net fiscal loss. If these don't balance at the point of migration equilibrium (i.e. where households have no incentive to migrate across State borders to improve their net circumstances), migration is inefficient.[21] This can be redressed by an appropriate 'equalisation' transfer between State A and State B, akin to the zero-summing needs assessed by the CGC.

[21] For example, if the net fiscal benefit for State A is greater than the net fiscal loss for State B, then State A could pay State B for its loss and both States be better off if there was more migration into State A.

This line of analysis has been used to argue that, at equilibrium, equalisation can broadly be justified on efficiency grounds for differences in revenue capacity (both rents and taxes) and service demands as assessed by the CGC (see Boadway and Flatters, 1982a, 1982b; and Boadway, 2004 for revenue capacity). It has often been claimed that location-specific service costs are not relevant to efficiency-optimising equalisation transfers, but the theory does not support this.[22]

In any case, the Dixon, Madden and Peter study (1990 and 1993 – see above), which (unlike Petchey, 1995) suggests that cost equalisation always detracts from efficiency, found trivial efficiency costs from cost equalisation.

There are caveats to the standard equilibrium analysis, which Western Australia considers makes it impossible to assert that the present CGC approach is in any way consistent with an efficiency enhancing distribution. Petchey (2009) also arrives at this conclusion, based on analysis of a simple two State conceptual model of the economy (which does not cover all the issues below). The key caveats include the following.

- Economies are often not in equilibrium (Australia is a prime example). In this circumstance, as noted by Scott (1950) and Musgrave (1961) (and see also Boadway and Flatters, 1982a), the subsidisation of resource-poor regions may counteract the incentive for labour to move to resource rich regions, and thus prevent or delay the maximisation of national production (as discussed above).
- It is assumed that the State aggregate production functions are independent of decisions on public provision. This is despite States having an integral role in facilitating economic growth – development is impeded without good transport, education and health systems. The assumed independence of production functions profoundly limits the analysis and leads to poor conclusions:
  - incentives for development are not an issue;
  - capacity to fund infrastructure to facilitate future development is not an issue;
  - rents from non renewable resources are 'icing on the cake' to be allocated equitably for consumption, rather than invested for sustainable development; and
  - cost disabilities are just a nuisance (rather than being an integral part of the State's production function) that should not be equalised.

[22] This is addressed in a forthcoming technical paper.

Some more technical issues are as follows.

- Conceptually, the 'migration externality' analysis should apply to all externalities, not just fiscal externalities (this is done by Petchey (2009)). For example, there may be non-fiscal rents to which State residency provides access; economies of scale in production or level of amenities; or diseconomies of scale (e.g. road congestion, increased social dysfunction) – in this case efficiency would call for transfers away from congested States.
- Regional advantages (e.g. due to rents) may be capitalised in local property values, mitigating fiscally induced migration (Boadway, 2004), so the efficiency role of equalisation is lessened. The rapid increase in Western Australia's property values in recent years, if sustained, may be an instance of this.
- Underpopulated federations (again Australia would be a good example) create problems of unstable or non existent migration equilibria (see Boadway, 2004; Boadway and Flatters, 1982a). While this can be addressed through an assumption that migration is not costless, this complicates the efficiency-optimising equalisation transfer (unless a further assumption is made), and the assumption is in any case questionable for countries with high in-migration.
- The 'equalisation' transfers to ensure efficient migration should reflect actual State policies, but this introduces incentive inefficiencies, so compromises must be made[23] (e.g. Boadway and Flatters, 1982a, p. 627, "Note that it is not the tax capacities that should be equalized but actual taxes collected", but "Under full equalisation, the provinces would have little incentive to levy taxes on capital or rents at all"). A further complexity is that, in general, equalisation transfers must be specific to each class of household (e.g. defined by income level), which is impractical.

Impact of fiscal equalisation on State policies

As noted above, the use of average policy standards creates opportunities for States to manipulate or 'game' their grants, at the expense of good social policy. A number of papers have examined this issue.

- Smart (1998) showed that equalisation of taxes provides an incentive to increase tax rates (as the resulting decline in the base is partly compensated by equalisation), and similarly that equalisation of rents provides an incentive to increase tax rates on rents.

[23] The usual compromise is to use standard rather than actual policies.

- Swan and Garvey (1995) and Dahlby and Warren (2003) showed that equalisation provides an incentive for States to increase tax rates in areas of low fiscal capacity and reduce tax rates in areas of high fiscal capacity (the rate change affects the standard rate, which affects the magnitude of assessed differences).[24]
- Kothenburger (2002) and Bucovetsky and Smart (2006) provide analysis to show that equalisation corrects (or partially corrects) for inefficiencies associated with tax competition at the sub national level – but this is not corroborated by Petchey (2009).

Conclusion

In this Chapter we have aimed to show that, contrary to what a superficial view of the available empirical evidence and the literature might seem to suggest, the efficiency impacts associated with the current approach to fiscal equalisation are very significant, and need to be addressed to:

- remove disincentives for improving productivity;
- facilitate structural adjustment in the Australian economy; and
- remove disincentives to efficiently exploit mineral and tax revenue bases.

This would require:

- the equalisation objective of effort neutrality to be fully achieved in practice, to ensure that associated improvements in revenue capacity or reductions in spending needs are not largely lost to other States;
- equalisation to support a redistribution of labour and capital that facilitates maximum economic benefit from the nation's natural endowments (so that States are appropriately developed relative to their natural endowments); and
- removal, to the greatest extent possible, of the ability for States to influence their grants through tax and expenditure policies.

Notably, these reforms are as much about equity as efficiency.

[24] Swan and Garvey also show that there are similar incentives on the expenditure side.

Chapter 4

Simplicity

The CGC's methods are notoriously complex. As also noted in Chapter 5, this detracts from the transparency of fiscal equalisation (together with stakeholder confidence in the system), as only a small number of people with specialist knowledge are able to meaningfully debate the outcomes. The detail required to support complex methods also adds to administration and compliance burdens.

In this Chapter we focus more on the issue of whether the existing complexity contributes to more accurate or reliable achievement of the CGC's stated fiscal equalisation objective (while not resiling from our view that the current objective leads to extreme redistributive outcomes that are not in the national interest), or whether simpler alternatives could actually be more effective.

In the review of its methods reporting in 2010, the CGC was tasked with simplifying those methods. With two notable exceptions, we consider that this was not significantly achieved – largely because the CGC focussed on reducing the level of detail in its assessments by introducing materiality thresholds, rather than on identifying broader underlying drivers of differences in States' fiscal capacities.

The introduction of materiality thresholds potentially involved trading off a reduction in fiscal equalisation for simplification (although 'pluses' and 'minuses' in the redistributive impact for individual assessments and/or States may have been partly offsetting). However, we consider that identification of fundamentally simpler methods could simultaneously achieve more accurate and reliable outcomes.

False precision and bias

The complexity of the CGC's methods and still vast detail generated imply a level of precision that does not stand up to scrutiny, including for the following reasons.

- Availability of sound data is a major constraint to implementing an equalisation principle based on the details of 'what States do' (with respect to service delivery and revenue raising).

- For example, comparisons across States of the higher cost of providing services in remote areas and to Indigenous people are severely compromised by the poor quality (or lack of availability) of data – much of which requires special data collections from States by the CGC[25] (and does not appear consistent across States).

- Another example involves the considerable effort the CGC has expended in trying to measure land values consistently across States as part of its assessment of differences in States' capacities to raise land tax revenues. However, although the legal basis for land tax is land values, the underlying tax base is arguably business or household income.

- Acknowledging the lack of sound data to support some of its complex methods, the CGC often discounts the 'needs factors' or results. It also fails to assess some services/revenues or disability drivers altogether.

  - For example, while the CGC assesses differences in States' revenue raising capacity at a detailed level, it fails to assess some of the expenses that facilitate economic (and associated revenue base) development (see Chapter 2 on Equity and the associated Attachment C for this and other examples).

The current combination of detailed assessments and discounts (or omissions) to acknowledge lack of reliability also leads to bias in the overall redistributive outcome. It effectively assumes that the undiscounted factors/results systematically overstate 'needs', when the reverse is just as likely to be true. As most discounts apply to expense needs[26] , Western Australia is likely to be disadvantaged.

Simplicity and efficiency

As discussed in Chapter 3 on Efficiency, the CGC's current detailed methods can result in States' policy choices having significant impacts on their GST grant shares. Simpler assessments based on underlying drivers of disability are likely to be less affected by these policy choices and therefore less distortionary.

Successes and failures of the 2010 Review

In the 2010 Review, the CGC did reduce the number of revenue and expense categories that it assesses, and the number of separate disability factors used, including as a result of the application of materiality factors (albeit not always in a very transparent way). However, we consider the benefits to be marginal.

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[25] As opposed (for example) to the CGC being able to use existing, quality-assured ABS data sets.

[26] The land tax assessments are an exception.

For example, the assessment of differences across States in the cost of admitted hospital patient services still involves cross-classifying data by age, Indigeneity, remoteness and socio-economic composition (a gender classification has been dropped). The number of age groups has been reduced from thirteen to seven. Overall, the number of population groups has been reduced from 2,080 to 210.

- However, it is still necessary to use a spreadsheet to analyse the impact of each of the 210 population groups. It is not possible to look at the tables produced and pick the driving features by eye. Once an analyst is reduced to relying on spreadsheets, 2,080 population groups can be handled almost as easily as 210 groups.

Nonetheless, the CGC did successfully simplify two methods in the 2010 Review. In both of these cases, instead of trying to 'prune back' the existing approaches, the CGC chose to find a fundamentally different, and simpler, approach.

- The CGC replaced its previous 'debt charges' assessment with a direct assessment of States' differential capital investment requirements. The debt charges assessment involved capital requirements being summed over very long time periods and the methodology did not pick up capital growth pressures. Among other things, the available time series data was not sufficiently reliable for this purpose. The new direct assessment is far simpler to conceptualise and implement.
- The CGC previously assessed the differential impact of Commonwealth and private community health services on the demand for State health services through a complex and indirect disability measure. This was replaced by an approach that was both simpler and more comprehensive (under which estimated Commonwealth and private health expenses are subtracted from an assessed global health expense requirement).

These two examples demonstrate that 'thinking outside the box' is more likely to produce genuine simplification than merely 'chipping away' at existing methods.

In the 2010 Review, the CGC ostensibly adopted a 'top down'/'clean-slate' approach (i.e. it began with broad categories of revenues and expenses and an examination of high level indicators of underlying needs across States) but quickly reverted to detailed approaches similar to existing ones – including on the basis that it could not prove a link between broad indicators and State expenses/revenues.

This would be appropriate if more complex, detailed approaches produced more accurate or reliable fiscal equalisation outcomes. However, as discussed above, we do not consider this to often be the case. Furthermore, the judgement that would need to be exercised under a broad-brush assessment approach may be no greater than for complex, detailed methods.

What should be done

Simplification is essential. Complexity hinders understanding, hides mistakes and generates false assurance of accuracy.

We consider that the simplification goal should be about improving, not trading-off, the accuracy and reliability of fiscal equalisation outcomes. Higher level indicators should be preferred where more detailed methods fail this test (e.g. fail to capture underlying drivers; create bias from selective and discounted assessments; lead to policy influence beyond an acceptable level).

The States were at least partly culpable for the failure of the 2010 Review to achieve genuine simplification. An inevitable consequence of each State's vested financial interests is advocacy for the retention of any detailed method that increases their grant share. The current GST Distribution Review by an independent panel with leadership from the Commonwealth provides much greater opportunity for reform.

Chapter 5

Transparency

In some respects, the fiscal equalisation process is transparent. The CGC publishes extensive documentation of its decisions, and makes the underlying calculations available to the States. However, the complexity of the CGC's methods, and necessary continued use of judgement (e.g. where data is lacking), means that only specialists in the field are readily able to debate the results.

The balance of this Chapter addresses more specific transparency issues.

Operationalising the fiscal equalisation principle

By way of background, the definition of fiscal equalisation developed by the CGC (see Chapter 2 on Equity) is supported by supplementary principles or operating rules to assist its interpretation and implementation. There are currently four of these (see CGC 2010 Review Main Report, Volume 1, pages 35-38), which indicate that equalisation should be implemented through methods that:

- reflect what States actually do – more specifically, the scope of revenues and expenses 'assessed' by the CGC, and the revenue effort and service level 'standards' applied, should reflect the all-States' (population-weighted) average;[27]
- are policy neutral – defined at a high level to mean that "policy differences between the States do not affect the recommended GST distribution";
- are practical – defined to mean that "assessments should be based on sound and reliable data and methods, be well constructed and be as simple as possible while also reflecting the major influences on State expenses and revenues"; and
- are contemporary – defined to mean that "as far as possible, equalisation should reflect State circumstances in the year the funds are used".

[27] As opposed, for example, to reflecting external 'standards' judged in some way to be 'best practice'.

One issue is that the application of these operating rules can conflict. For example, the reliance on standards reflecting the average of what States actually do means that the Commission's methods can never be entirely policy neutral. This particular conflict is material where one State disproportionately affects the national average (e.g. Western Australia with respect to mining royalties and New South Wales more generally on account of its high share of Australia's population).

As a result, trade-offs are required (just as trade-offs may be required between equity and efficiency objectives), but these are not always transparent. A related issue is that the manner in which the CGC applies the operating principles or rules in reaching its decisions is not always clear. The mining royalties assessment; application of the contemporaneity principle/rule; and application of materiality guidelines by the CGC are cases in point.

Policy neutrality and what States do

As discussed in Chapter 3 on Efficiency, the CGC currently classifies minerals as either 'low' or 'high' royalty rate, ostensibly depending on whether the national average royalty rate is above or below 5%. It favoured two aggregated mineral groupings over a more disaggregated mineral-by-mineral approach to balance the apparently improved policy neutrality of the former approach (i.e. aggregation would normally dilute the influence of one State over the national average standards) with the greater 'accuracy' offered by the latter approach.

In doing this, the CGC noted that "The royalty revenues from both export coal and lump iron ore are large enough to satisfy the Commission's criteria [in its 'Assessment Guidelines'] to be assessed in a separate category (CGC 2010, Vol. 2, p. 133).[28] However, we have not done so because we have concerns about the policy neutrality of a category where one or two States dominate the tax base". While we appreciate the CGC's motives in this case, there is a lack of transparency in developing a set of Assessment Guidelines, and then making a judgement to depart from it.

[28] One of the relevant criteria is a rule that separate categories will be assessed where the result from separate categories differs from the result for a single category by more than $30 per capita for any one State.

Furthermore, in pursuit of 'policy neutrality', the CGC overlooked the possibility of one State wishing to raise the royalty rate for a mineral initially classified as low rate, to the extent that the new royalty rate crossed the CGC's 5% royalty rate threshold. The associated distortion was demonstrated when Western Australia sought to remove royalty concessions for State Agreement producers of iron ore fines (from 1 July 2010), lifting the national average royalty rate above 5% for those minerals. This might have been avoided if the CGC had consulted adequately with the States before finalising its mining assessment methodology.[29]

If the CGC had reclassified iron ore fines, Western Australia would have lost GST revenue equal to about three times the additional royalty revenue raised (violating the policy neutral principle).

In considering whether or not to reclassify iron ore fines (in its 2011 Update), the CGC considered the redistributive outcome of the alternate mineral-by-mineral assessment (despite having explicitly rejected this approach in the 2010 Review), with all iron ore assessed as a separate component. The CGC found that this outcome was closer to that of an assessment with iron ore fines retained in the 'low rate' category. Accordingly, the CGC decided to not reclassify iron ore fines.

Western Australia carried through with the removal of the State Agreement iron ore fines royalty concession in the expectation that iron ore fines would not be reclassified, including on the back of seeking a direction to the CGC from the Commonwealth Treasurer to this effect. Nonetheless, the use of this undocumented 'shadow' method by the CGC, and the judgement needed to relate the outcome of this method to the formally published method, was not transparent.

Contemporaneity

The CGC has acknowledged that to achieve contemporaneous equalisation it would need to start with data incorporating forecasts of State revenues and expenditures, and make any necessary retrospective adjustments to equalisation outcomes when actual data becomes available. It has opted for a more practical 'rolling average' of actual data from previous years. Changing the approach to 'contemporaneity' creates the risk of equalisation not being achieved over time, for example, where the averaging period is changed.

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[29] Notably, the CGC originally considered deriving its two category split on the basis of the Australian Bureau of Statistic's fuel (or energy) versus non-fuel categorisation. This would have better served the policy neutral objective – States can influence the national average royalty rate for a mineral but clearly cannot influence whether the mineral is of a fuel/energy character or otherwise. The CGC changed to the high rate/low rate method at a very late stage of its 2010 Review.

As set out in Chapter 2 on Equity, this risk crystallised when the CGC decided to move from five to three year averaging, as an outcome of a review (reporting in 2010) of the methods it uses for meeting its definition of fiscal equalisation. For Western Australia (experiencing a steep downward trend in its annual GST 'relativity') this means that data for two years where its GST relativity was comparatively high will never be reflected in the CGC's averaging calculation.

The importance of equalisation being achieved over time (i.e. avoiding the risks posed by 'chopping and changing' between different averaging periods) was an important discussion point in the CGC's review of methods that reported in 1999. The CGC did not explain in its 2010 report why it evidently no longer attached the same importance to this matter. The consequence is a reduction in the transparency (as well as the equity) of the fiscal equalisation process.

Materiality guidelines

As part of its review of methods reporting in 2010, the CGC introduced a range of materiality thresholds intended to reduce the detail and complexity of its assessments without compromising the extent to which it achieved its equalisation objective. However, it provided little explanation in its final report of how these thresholds had been applied in practice.

As an illustration, one of the materiality tests was intended to drive decisions on disaggregation of categories (i.e. a category would only be disaggregated if the redistributive effect exceeded $30 per capita for any one State). However, the CGC documented none of the associated analysis supporting its decision (for example) not to assess social services as a single category. Moreover, in at least one case (i.e. mining revenue, as discussed above), it decided not to disaggregate, when the materiality test indicated that it should.

In addition, there was a lack of transparency in the CGC's application of its threshold tests for making data adjustments and assessing disability factors.

- The CGC decided that it would only make data adjustments, of its own volition, to improve interstate comparability if the redistributive effect exceeded $3 per capita for any State. However, in supplying data to the CGC, States themselves were able to make small adjustments (also in the interests of improved interstate comparability) that could fail to meet the CGC threshold.
- The CGC decided that it would only assess a disability factor if the redistributive effect exceeded $10 per capita for any State. However, there was sometimes debate about when a disability 'influence' constituted a disability factor or was just part of another factor. This was an important distinction in the case of small disability 'influences', as these would only be assessed if they were part of a larger disability factor.

Selective analysis/documentation

Although the CGC provides much documentation of its assessments, it is nevertheless selective. For example, in the case of the CGC's decision in the 2011 Update to not reclassify iron ore fines (see above), the CGC documented its reasoning for its decision, but made no comment on Western Australia's alternate reasoning (e.g. that a reclassification would represent a gross violation of the policy neutrality principle) supporting the same outcome.

In the 2010 Review, Western Australia argued that estimates of the number of disabled persons from the ABS *Survey of Disability, Ageing and Carers* should be used to assess relative costs of providing disability services, instead of the CGC's proposed number of recipients of the Commonwealth's disability services pension. The choice of dataset had very material consequences, but the CGC did not document its reasons for rejecting Western Australia's proposal.

What should be done

In Western Australia's view, resolution of the transparency issues outlined in this Chapter requires a simpler assessment approach that allows wider and more informed public understanding and debate. Among other things, this requires a clearer set of supplementary principles to guide the implementation of fiscal equalisation (incorporating States views).

Chapter 6

Reform Options

Western Australia considers that bold reform is needed to address the inequity, inefficiency and lack of transparency of the current fiscal equalisation outcomes and process. We propose a GST-share floor as an over-arching reform, together with a number of largely complementary reforms that could be implemented as a package.

Major framework reforms

Recommendation 1 – Floor on relativities

Western Australia submits that a central reform must be a relativity 'floor' of 75% (based on current arrangements).[30]

A floor on GST shares would be consistent with other elements of the Commonwealth's tax and transfer system, which limit the redistribution of income to preserve fairness and incentives, including recognising that households should be rewarded for hard work and good choices.

While the other reforms we propose to improve the equity and efficiency of the HFE process (see below) would go some way towards preventing unjustifiably extreme outcomes, we believe that an overarching floor is essential. It would involve no more subjectivity than is already endemic in the HFE system.

A GST share floor provides the incentive and capacity for States to develop their economies in the national interest, in the most transparent way. Such a floor is currently particularly important with respect to Western Australia. The State is now an engine room of the Australian economy, and its continued growth is crucial to maintaining or enhancing the living standards of the Australian population.

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[30] Or 85% if the Commonwealth Government were to renege on North West Shelf grants being paid to Western Australia. The 10% difference is smaller than the resulting increase in Western Australia's relativity and takes into account that Western Australia should retain somewhat more than its current equal per capita share of these grants (post equalisation), consistent with the costs and risks it took on to develop the North West Shelf project. The 85% floor would apply to other States. In its presentations to the Review Panel, the CGC has noted that different floors could apply to different States.

While Western Australia's mining industry is currently very successful, strong global competition is likely to emerge over the medium term. Fiscal constraints due to our declining GST and rising debt are already biting heavily into our program of infrastructure investment, and are a major risk to the State and the nation taking full advantage of windows of opportunity for further sustained growth.

The proposed 75% floor is only marginally above Western Australia's current 72% relativity. If introduced now (as an early outcome of the GST Distribution Review), it would have only relatively small impacts on other States' and Territories' published forward estimates of GST revenue.[31]

Furthermore, based on the analysis we have presented in this submission, fixing all the current HFE equity and efficiency flaws is unlikely to yield a relativity for Western Australia of less than 75% in the foreseeable future.

In particular, although we currently project Western Australia's relativity to fall to 33% by 2014-15, we consider that this is not a true fiscal equalisation result, but the outcome of a set of flaws that particularly discriminates against Western Australia – in terms of lack of recognition of the efforts we have made to develop our economy and only partial recognition of our expenditure needs (including to facilitate ongoing economic development).

Appendix C quantifies some of these flaws at $2.1 billion (in 2011-12 terms), which equates to 42 percentage points in terms of Western Australia's relativity. Adding this to our projected 33% relativity for 2014-15 would bring us to a 75% floor. Appendix C excludes flaws such as the lack of recognition of States' efforts in developing their economies (e.g. the fiscal costs and risks taken on by Western Australia in developing the North West Shelf project).

Recommendation 2 – Discounting the mining revenue assessment

The mining revenue assessments (including the North West Shelf grants in lieu of royalties) should be discounted by 50%, as is done in Canada.

Balancing equity (through assistance to the weaker States) and incentives (through less extreme equalisation) is particularly important for resource developments, where (compared to non-resource developments) a greater proportion of the total 'benefit' to the State is in the form of State government revenues (rather than just more and better jobs for the community), noting that this 'benefit' is actually just a swapping of the mineral asset for cash in the bank.

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[31] For example, using the Commonwealth's published forward estimates of States' relativities (which appear generally close to what most other States use), Western Australia's 2014-15 relativity would be 64.5%. Under a 75% floor, New South Wales could lose $230 million (1.3%) and the Northern Territory $7 million (0.2%) of their total GST grants in that year – of $18 billion and $3 billion respectively.

From an equity perspective, there is a strong case for States to retain a substantial proportion of their royalties:

- it is equitable for States to retain royalties that have resulted from different policy choices or better economic management compared to other States;
- it is equitable for States with mineral resources to have the opportunity to retain a significant proportion of the value of these resources for future development, in the same way that States retain other endowments such as agricultural land, climate, natural beauty and commercial forests for the future;
- it is equitable to have regard to future generations by reducing the risk that limited resources will be squandered (i.e. spent on consumption) rather than used to facilitate sustainable development (only the resource State has a visible incentive to use the resource to promote its future); and
- it is equitable to recognise the risk that after the resource has been exploited, the equalisation 'rules of the game' could change, so that the State does not receive a full equalisation share of resources developed subsequently in other States, or that it will not receive full equalisation for fiscal weakness it may experience in the future following resource depletion.

  This risk is considered significant, as global competitive pressures are likely to grow, ultimately necessitating intergovernmental fiscal arrangements that improve incentives for growth and productivity.

The North West Shelf assessments should also be discounted, to reflect the estimated $8 billion fiscal risk (in 2011 NPV terms) that Western Australia took on to develop this nation building project.

From an efficiency perspective, discounting the mining revenue assessments will:

- give all jurisdictions much more incentive to develop, properly price and efficiently use the benefits of their resources; and
- provide greater incentives for labour migration to Western Australia, and capacity for Western Australia to put in place prerequisite infrastructure to efficiently assimilate this migration.

In summary, a 50% discount of the mining assessments is considered to be a reasonable trade-off between the equity of redistributing mining endowments that are used for improving current services, and the equity and efficiency benefits outlined above that support States' retention of their royalties.

This would be similar to the fiscal equalisation arrangements in Canada, where mining revenues are equalised by no more than 50%. One of the stated reasons is that full equalisation would reduce incentives for Provinces to develop or price their natural resources in an efficient way. Notably, Canada's constitution includes a fiscal equalisation principle defined in similar terms to the CGC's in Australia.

Recommendation 3 – Limiting annual falls in GST 'relativities'

We propose that a State's GST relativity, incorporating the CGC's three year rolling average, not be allowed to fall by more than (say) one percentage point in any year[32] – thereby allowing States to retain significant benefits in the medium term from improvements to fiscal capacity, while still allowing an equity-based adjustment in the longer term.

As opposed to simply extending the CGC's current three year data averaging period (say back to five years), this option provides greater downwards stability in the face of significant changes in fiscal capacity and/or significant method changes. It balances the following competing factors:

- the equity and efficiency of States retaining the benefits of economic improvements that they generate through policy effort; and
- the equity of sharing innate differences in fiscal capacity around the nation.

Recommendation 4 – States to be able to agree among themselves on a GST distribution outcome

The fiscal equalisation system should allow a group of States, if they wish, to agree among themselves on matters that affect the allocation of GST grants among them, including the redistributive outcome (while not affecting outcomes for non-participant States). A fixed split of the GST pool between CGC-assessed States and self assessed States is also recommended under this option.

A free agreement to depart from the CGC process will reflect a view that all parties believe they can do better, helping to ensure a welfare–enhancing outcome. As this submission has sought to highlight, there are many issues to be addressed and balanced in determining a HFE outcome. State negotiations can take into account a wider or narrower range of factors than the CGC.

[32] If the mining assessments are discounted by 50% as recommended, then the mining assessments could be excluded from this calculation.

An option that has previously been floated would be for the CGC to determine grant shares for only the four 'recipient' States (i.e. South Australia, Tasmania, the Northern Territory and the ACT), with the remaining grant pool to be distributed among the four 'donor' States (New South Wales, Victoria, Queensland and Western Australia) on the basis of shares agreed to by those States.

This option would achieve equity in the sense of a consensus among the four donor States on their respective shares of the combined donor States' portion of the GST pool. Assuming a relatively stable agreed distribution, inefficiencies would also be reduced, reflecting *inter alia* that the policies of any one of the larger population States would have less impact on its grant share.

It could also reduce donor States' CGC compliance/administration costs.

To maximise the simplicity benefits of this option, the aggregate per capita grant share of the 'recipient' States should be fixed (as a proportion of the GST pool). In part this can be justified on the basis that their aggregate share has been fairly constant over the last decade (despite the impact of both annual updating and method reviews by the CGC). In addition, this approach would:

- reduce further the impact that the policies of any one of the donor States would have on its grant share;
- reduce further the need for the donor States to put resources into CGC method reviews and annual data updates (the CGC could assess the four smaller population States according to a four-State standard); and
- potentially reduce the complexity of the assessments, as cost influences driven by the larger population States (e.g. urban public transport) would not need to be assessed.

The major barrier to this option is likely to be the four donor States (or other group of States) being able to agree a GST distribution outcome among themselves that would be acceptable to all of them. Members of the GST Distribution Review Panel could conceivably play a role in helping to broker such an agreement.

Improving the existing framework

Recommendation 5 – Improving the assessment of States' relative needs

If the current equalisation framework is retained, we recommend that:

(a) the major gaps in the HFE expenditure assessments be addressed (e.g. facilitating economic development, servicing national parks, Indigenous socio-economic status indicator etc);

(b) the potential in the current mining assessment for huge shifts in grants from royalty changes be eliminated, and the assessment made more transparent;

(c) the fiscal equalisation 'operating rules' be reviewed for greater clarity of the intended objectives;

(d) assessments be based on broad underlying drivers of revenue capacity and cost differences between States, with less focus on detailed differences in State policies (e.g. detailed tax laws and modes of service provision);

(e) simplicity be vigorously pursued on the basis of improving the reliability of assessments, rather than by adopting mechanical 'thresholds' to reduce the detail in the assessments; and

(f) HFE continue to recognise cost (as well as demand) factors, for equity and efficiency reasons.

These recommendations follow directly from the analysis in our submission. We estimate that gaps in the HFE assessments – such as lack of assessment of economic development needs – are costing Western Australia around $2 billion per annum.

Some good features of the current HFE system, which we consider should be retained if the HFE framework itself is retained, are set out in the Appendix E.

Work towards global assessments

In relation to parts (d) and (e) of Recommendation 5, we consider that the GST Distribution Review should recommend that appropriate terms of reference be issued to the CGC to develop a genuinely simpler and more reliable alternative to the current detailed category-by-category assessment of States' revenue and expenditure 'needs', by rigorously considering a minimal number of aggregated categories, with 'needs' for each category based on measures of the broader underlying revenue capacity or cost drivers.

For example, the CGC could adopt a 'global' measure (or measures) of differences in States' underlying revenue raising capacities. Rather than assessing differences in actual legislated tax bases, the CGC could have regard for the fact that the ultimate incidence of most taxes is on income or consumption.

Similarly, a 'global' assessment of differences in States' underlying costs of providing services may be possible. This might still require separate measures for broad cost pressures such as those arising from indigeneity and population location, and for capital and economic development expenditures.

Global assessments would have the following advantages.

- They would be less susceptible to changes in individual State policies. For example, if a State alters its mining royalty rates, there will be limited impact on the revenue assessments because mining royalties only account for about 7% of total State general government revenues (despite the mining redistribution being 75% of the total revenue redistribution).
- They would be simpler. Apart from there being fewer assessments, only broad relationships between the indicator and the revenues/costs would need to be demonstrated. As discussed in Chapter 4, it is not clear that the additional detail in the current revenue assessments meaningfully improves the CGC's achievement of its fiscal equalisation principle.
- Because they are simpler, they would be more transparent. Although the CGC would have to make some high level judgements, these would be very clear, and the methods should be easy to understand.

Appendix A

Net Fiscal Subsidy Methodology

Commonwealth tax and expenditure measures give rise to fiscal transfers between States. Each year, the Western Australian Department of Treasury estimates these fiscal transfers, whereby a State provides a net fiscal subsidy to the federation if total Commonwealth revenues derived from that State exceed total Commonwealth outlays on the State.

A State's net fiscal subsidy is calculated as:

- the value of Commonwealth taxes and other revenues attributable to production and consumption activities in the State; less
- the value of Commonwealth expenditures on the State; less
- the State's share of the Commonwealth deficit.

Revenues

The share of Commonwealth general government revenues contributed by individual States is estimated on the basis of the location of economic activities subject to Commonwealth taxes and other revenue measures. For example, States' shares of:

- personal income taxes are based on estimated receipts in each State on a residence basis, using data from the Australian Taxation Office's *Taxation Statistics*; and
- company taxes are allocated according to gross operating surplus in each State (using data from the Australian Bureau of Statistics' *State Accounts*) with each industry weighted by national company tax paid by that industry (using data from the Australian Taxation Office's *Taxation Statistics*).

Expenditures

Commonwealth expenditures are allocated between the States on the basis of the location of services and the destination of grants and cash benefits, using mainly *State Accounts* data (to estimate the interstate distribution).

For example, the Australian Bureau of Statistics, when compiling its *State Accounts*, produces estimates by State of:

- Commonwealth final consumption expenditure, which is general government current expenditure incurred in providing services to the community - such as defence and administration of social security; and
- personal benefit payments and grants to non-profit organisations.

Deficit or surplus

The Commonwealth deficit (surplus) is allocated between States as it represents an impost on future taxpayers, either through increased (decreased) taxes or reduced (increased) services. Half the deficit (surplus) is distributed according to States' shares of total Commonwealth revenue and half according to States' shares of total Commonwealth expenditure.

Treatment of the ACT

Commonwealth outlays and revenues relating to the ACT are allocated among the other jurisdictions according to population shares. This reflects that the ACT essentially functions as a mechanism for the central government to provide services to the Australian population (and raise the revenues to provide these services), and would not exist as a separate entity if the federation did not exist.

Treatment of defence expenditure

Defence salaries have been allocated according to the location of defence establishments, on the presumption that the benefit to each State is proportional to the size of the defence facilities stationed in each State (in terms of both the implicit commitment to defend each State and the flow on impact on States' economies). Non-salary defence expenditures have been allocated on a per capita basis.

Appendix B

The North West Shelf Project[34]

Scale and development of the project

To put the North West Shelf project in context, it is worth quoting from a 1991 study of the project by Clements and Greig (pp. ii-iii):

> *The North West Shelf Project is the largest resource development project in the history of Australia. The Project involves total investment of $12 billion and, when fully operational, annual exports of LNG and condensate of $2 billion. … An important feature of this study is the use of ORANI to estimate the economy-wide effects of the project. … In a typical year of the production phase, the Project will boost Australian exports by 3 percent, real gross domestic product (GDP) by 1 percent and employment by 69,000 jobs.*

The development of the North West Shelf project proceeded in two major stages:

- the domestic phase (North Rankin A offshore production platform and related infrastructure), which mainly involved the production of natural gas purchased by the (then) State Electricity Commission of Western Australia (SECWA) from 1985; and
- the subsequent export phase, mainly involving the export of liquefied natural gas (LNG) to Japan from 1989. The export phase initially involved construction of LNG infrastructure to use North Rankin A gas production. The export phase has continued to expand (starting with the new Goodwyn A platform in 1994).

The domestic phase was underpinned by 20 year 'take or pay' contracts, signed in September 1980, between the Project Joint Venturers and SECWA for the supply of 414 terajoules per day of natural gas (commencing 1985) – the entire gas output from the domestic phase.[35]

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[34] This material is extracted from Western Australia's Final Submission to the Commonwealth Grants Commission 2004 Review, October 2003, pp. 5-10, with some updating.

[35] The project go-ahead was announced on the same day as the contract was signed.

The 'take or pay' contracts reflected the Western Australian government's determination to secure a substantial gas supply for the State's economic future, and ensure the go-ahead of the North West Shelf project. The Joint Venturers had viewed local sales as uneconomic and secondary to exports, and more as politically necessary than as attractive in their own right – while the first stage (with the take or pay contracts in place) was viable on its own account, it would not make money for the Joint Venturers (Harman, 1983, pp. 32 and 44).

Nevertheless, the domestic contracts with SECWA became the basis for getting the first production platform in place, and was a key factor in helping Woodside Petroleum (a 50% partner in the Project) raise a US $1,350 million limited recourse loan facility to finance over 90% of its share of the development cost.

While the Joint Venturers may have expected that export contracts were not far away (Harman, 1983, p. 44), history proved otherwise. A Memorandum of Interest was signed with eight Japanese electricity and gas utilities in June 1981 (for supply of LNG from 1986), but there were substantial delays in signing a formal sales contract, probably reflecting a number of factors, including: the complexity of LNG contracts; a fall in Japanese demand for LNG (with falling oil prices and more competition to supply LNG); and difficulties encountered by Woodside in financing its share of the export phase after the rescheduling of LNG deliveries (Harman, 1983, p. 46–50).

Export contracts were finally signed with the Japanese utilities in August 1985, for LNG deliveries from October 1989 (North West Shelf Report, 1985). Woodside financed its share of the development costs largely by selling down its share of the export phase to 16.7% and using revenues from the domestic phase (Clements and Greig, p. 115). As noted by Clements and Greig, SECWA's 'take or pay' contracts "were crucial in getting both Phase I and Phase II underway" (p. 10).[36]

Cost of the North West Shelf project to the Western Australian Government

The Western Australian government's expenditure on the North West Shelf project comprised the following.

- SECWA's 20 year 'take or pay' contracts with the Joint Venturers, referred to above. SECWA was contracted to pay for at least 95% of the volume of gas stipulated in the contract (which was in effect the total volume of gas produced by the North West Shelf project in its initial years).

[36] Note that 'Phase I' is the domestic phase, while 'Phase II is the initial export phase using North Rankin A gas production. North Rankin A was built as part of the domestic phase.

- The construction (completed in 1985) by SECWA of the Dampier to Bunbury gas pipeline at a cost of around $1.1 billion, to enable SECWA to deliver gas to the major markets in the South West. (In March 1998, the Dampier Bunbury pipeline was sold to Epic Energy for $2.407 billion, which was below the depreciated 'risk free' present value in 1998 terms of the construction cost.)
- Expenditures on town site development, schools, hospitals, community facilities, roads, etc. These costs have never been officially aggregated.

Even before the signing of the 'take or pay' contracts in 1980, it was apparent that the forecasts of gas demand in the Pilbara and South West on which the contracted amounts were based were overstated.[37] In the following years, it became clear that contractual arrangements would need to be modified to avoid a financial collapse by SECWA and a stalling of the development of the North West Shelf project.

In March 1985, under an Agreed Statement of Principles (ASOP), the Commonwealth and State Governments and the Joint Venturers agreed to "share the pain" which was forecast to be borne by SECWA as a result of the contract.

- In return for SECWA agreeing to set aside price redetermination rights for five years, the Joint Venturers agreed to certain modifications of the pricing arrangements in the South-West and to assist in marketing gas to the Pilbara region. These arrangements[38] resulted in a forecast benefit for SECWA of $305 million in 1985 net present value (NPV) terms.
- The Commonwealth agreed to waive in favour of Western Australia (for on passing to SECWA) its share of royalties payable on the domestic gas phase of the project, estimated as having a value of $70 million (1985 NPV terms) over the 20 year life of the agreement. The Commonwealth Grants Commission has excluded these revenues from its assessments.[39]
- The State Government agreed to provide an estimated $245 million (1985 NPV terms) assistance to SECWA, comprising domestic gas phase royalties with an estimated value of $145 million (1985 NPV terms) and a further $100 million (1985 NPV terms) from its existing levy on SECWA gas operations.

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[37] *The Implications of the North West Shelf Gas Sales Agreements*, A Statement by the Minister for Minerals and Energy the Hon. David Parker, B.A., M.L.A. (Western Australian Government), 23 August 1985, third and fourth text pages. In particular, Pilbara gas demand collapsed with the closure of two iron ore pelletising plants.

[38] Including some changes agreed by Alcoa, a major gas customer of SECWA in the South West.

[39] On 30 June 2000, the Commonwealth paid Western Australia $79.1 million to settle its remaining 'share the pain' liabilities. This move was initiated by the State with the intention of eliminating the large costs of administering the payments by both levels of Government that would have otherwise continued until 2004-05. The figure of $79.1 million represents the agreed net present value of the estimated future Commonwealth share of DOMGAS royalties.

The overall benefit to SECWA was estimated to be $620 million (1985 NPV terms). Despite this, SECWA was still forecast to incur annual deficits of around $50 million over the period 1985-86 to 1997-98 on its North West Shelf gas operations, before hitting break even in 1998-99.

Altogether, the forecast State losses (from the $245 million assistance package, and SECWA deficits on gas operations) total around $8 billion in 2010-11 NPV terms.

In summary, the Western Australian government provided a massive investment to ensure the go-ahead of the North West Shelf Project in 1980.

While the North West Shelf Project is yielding some return on the State's investment (through a share of royalties), around 90% is reallocated to other States by the Grants Commission.

Commonwealth-State royalty sharing arrangements

Up until 1 July 1990, Commonwealth-State royalty sharing arrangements in offshore areas were governed by arrangements agreed in 1967 (and implemented through Commonwealth and *State Petroleum (Submerged Lands) Acts),* which specified that a State would receive 60% of royalties paid on primary production licenses, and 68% of royalties from secondary production licenses (issued to fields with substantial reserves, such as the North West Shelf). These arrangements reflected the Constitutional uncertainty at the time about rights to petroleum in offshore areas.

In 1976, the High Court decided that the Commonwealth has sole jurisdiction from the low water mark. Nevertheless, the royalty sharing arrangements were continued by the Fraser government in the spirit of 'new Federalism', except that, under the 1979 *Offshore Constitutional Settlement*, the rights to 'territorial seas' (i.e. within the three mile limit) were vested in the States under section 51(38) of the Constitution. (The North West Shelf is well outside the three mile limit.)

Western Australia (through the North West Shelf) and Victoria (through Bass Strait) were the only substantial beneficiaries of the royalty sharing arrangements outside territorial seas.

In 1990, the Federal Labor government decided that, from 1 July 1990, the royalty regime in offshore areas (outside territorial seas) would be replaced by a Petroleum Resource Rent Tax (PRRT). Interim Bass Strait royalty sharing arrangements with Victoria would continue for two years, pending the outcome of PRRT revenue sharing discussions with the States. (Subsequently, the Federal Government decided that it would not share PRRT revenues with the States, and the Victorian royalties were replaced by a special revenue grant before being rolled into financial assistance grants).

Importantly, however, the Federal government also stated that "In recognition of the special circumstances applying to existing activity in the North West Shelf, the Government has decided to retain the excise and royalty arrangements currently applying in that area".[40] The 'special circumstances' were not spelt out. Retaining a share of North West Shelf royalties was and remains essential for Western Australia in view of the State government's substantial and pivotal expenditure on the development of the North West Shelf Project (as outlined above).

The Federal government has always subsequently refused to share PRRT revenues with Western Australia.

[40] Commonwealth Budget Paper No. 1, 1990-91, page 4.7.

Appendix C

Problems with the 2010 Review Methods

(Excluding Mining and North West Shelf Revenues)

This Appendix briefly describes what Western Australia sees as some of the major problems with the Commonwealth Grant Commission's current methods, together with the 'ballpark' estimated adverse annual impact on Western Australia's GST share.

Rural/remote water subsidies ($150 million)

The current assessment recognises far lower cost pressures than previously, partly because it fails to reflect the substantial costs of piping water to areas without adequate local water supplies. The CGC did little work on this assessment, and commenced this work too late to obtain required data from most States. *The estimated cost is based on comparisons with the 2004 Review methodology and the outcome of an actual per capita assessment.*

Welfare and housing services ($80 million)

The current assessment is based on numbers of recipients of Commonwealth benefits, which are of limited relevance. In particular, the use of disability pension recipients ignores the ABS measure for incidence of severe/profound disability – which shows a very different pattern among States.

Land tax ($115 million)

The CGC uses land values as the revenue base, but States have regard for capacity to pay, as demonstrated (for example) by States generally reducing land tax rates as land values increase, and analysis of the relationships between land tax collections, State income and land values. This problem is partially offset by a 25% discount to the assessments, introduced because of data quality concerns. *The estimated cost uses State final demand as the revised revenue base.*

Discounting ($261 million)

The CGC frequently discounts its assessments, due to concerns about data quality or relevance, which introduces a systematic bias (in practice, poor quality data may understate, as well as overstate, States' needs). Leaving aside land tax, the discounts almost all reduce Western Australia's expense needs – and hence increase the redistribution of GST grants away from Western Australia. *The estimated cost reflects the cessation of all discounts, other than land tax.*

Infrastructure built in advance due to lumpiness of capital ($1,000 million)

The CGC assumes that infrastructure is built as the demand arises, but in practice this may be uneconomic – so States build infrastructure in advance of the demand and bear the opportunity cost of the initially unutilised capacity directly (tax subsidy) or indirectly (user charging cross-subsidies). These costs, however they are eventually recovered, represent a permanent unavoidable overhead of providing for growth and ongoing structural adjustment in the Australian economy (to allow factors of production to move to where they are most productive) – see footnote 13 in the Equity chapter.

Reflecting the national spillover benefits (i.e. optimisation of the national economy and Australian welfare), these costs should be shared nationally. *The estimate allows for an anticipated 2% above national population growth in Western Australia if economic growth were to not be fettered by the limitations of HFE. It is significantly understated, as it fails to take account of the fact that Western Australia is likely to have an above-national average proportion of its growth infrastructure in high cost areas, as these areas are where the resource-driven economic expansion is mainly occurring.*

National Parks and Wildlife – lack of assessment ($48 million)

The CGC discontinued its assessment of Western Australia's above-average spending needs for national parks and wildlife services, despite our large park areas, biodiversity hotspots and development 'threats'. This is a national public good activity. *The estimated cost for Western Australia reflects the latest assessment by the CGC* before the assessment was discontinued.

Indigenous population estimates ($50 million)

The CGC uses ABS population estimates which undercount Western Australia's indigenous population. The undercount reflects quality problems with the 2006 Census, compounded by poor analysis of the State-by-State undercounts. *The estimated cost for Western Australia reflects (among other things) consideration of previous Census estimates and student enrolment data across States.*

Differences in Indigenous disadvantage across States ($300 million)

The CGC assumes that indigenous persons are equally disadvantaged across the nation in comparable areas (apart from an indirect socio-economic status measure for hospitals that may produce perverse results). However, Western Australian indigenous people are considered to suffer higher disadvantage (reflecting in part the higher incidence of recent separation and dislocation), as shown by their hospital use, their higher funding in the State education budget and their higher imprisonment rates. *The estimate assumes a 20% increase in the indigenous cost weight for Western Australia.*

Justice – influence of crime propensity on police numbers ($16 million)

The CGC assumes that only 50% of police expenses are driven by the propensity of the population to commit crimes. However, the *National Indigenous Expenditure Report* supports a 75% weight.

Services to industry – regulation ($120 million)

The 2010 Review method reflects self-assessment of disability influences by each State (with attendant moral hazard), using unclear CGC guidelines. *The estimate reflects the previous CGC assessment.*

Transport subsidies (not able to be quantified)

The assessment is not based on a 'standard' service/charging policy, and there is no quantitative support for the proposition that net operating subsidies (adjusted for policy) in the largest Australian cities are higher in per capita terms. The capital assessment is simplistic.

Cost of employing and housing staff in areas of high economic development (not able to be quantified)

High wage pressures in the Pilbara region, due to competition from mining companies, are not recognised. Nor are high housing costs, which are comparable to Perth's most expensive inner suburbs, with rents often exceeding $2,000 per week.

Appendix D

Impact on Grant Shares of Additional State Tax Compliance Effort

Under current arrangements, States with a higher per capita capacity to raise tax revenue will receive less than their equal per capita share of GST (while those with lower capacity will receive a higher GST share), all else being equal. The CGC uses various measures of tax bases, including:

- payroll tax – ABS wage data;
- conveyance duty – States' data on property transfers;
- land tax – States' data on land holdings;
- insurance tax – Australian Prudential Regulation Authority (ARPA) data on value of premiums paid on general, life and compulsory third party insurance;
- stamp duty on motor vehicle registration and transfers – States' data on the value of dutiable vehicles; and
- gambling tax – number of persons in the State.

The CGC multiplies these tax bases by the national average tax effort (i.e. national revenue divided by national tax base) to calculate capacity in each State, thereby seeking to largely remove the impact of policy differences between States.

As a general rule, if a State raises additional tax revenue, the impact on its GST grant will depend on whether or not this revenue is associated with an increase in the tax base as measured by the CGC. If so, it will effectively lead to a large redistribution of the additional tax revenue (through adjustments to GST shares).

Additional tax revenue from improved compliance effort by one State will be associated with an increase in that State's tax base where the CGC relies on State-supplied data (e.g. on property transfers) to measure the tax base.

In this case, a State would lose all but its population share of the additional revenue raised, if it applies the national average tax rate. If the State has a higher (lower) than average tax rate, then it will retain more (less) than its population share.

In theory, the CGC would recognise an increase in the tax base through improved compliance as an increase in effort (a policy difference – which the CGC generally tries to abstract from), rather than capacity. However, in practice, the CGC has no effective way to measure compliance effort.

Where additional revenue from compliance effort does not affect the tax base, because the CGC measures the tax base using independent data (e.g. ABS wage data), the impact on a State's GST grant will be small (there is some impact as the additional revenue increases the national average tax rate).

The estimated impact of additional compliance effort on each State's GST grants is shown in the Tables at the end of this Appendix. These tables show the proportion of tax revenue raised that is lost through reductions in GST grants over time. For each State, the impact shown is based on the assumption that only that State increases its compliance effort.

As shown in these tables, increased compliance effort for stamp duty on motor vehicles, conveyance duty and land tax results in a significant loss in GST revenue share. This is because additional revenue is associated with an increase in the tax base as measured by the CGC. We determined the impact of compliance effort for conveyance duty and land tax using a State specific 'average' property transfer/land holding in each of the CGC's property value ranges.

If additional compliance effort targets payroll tax or insurance tax, the grant impact will be minor, because the revenue base is calculated from independent data. Other taxes (e.g. gambling tax) are assessed on an equal per capita basis, and therefore additional compliance will have no impact on GST grant shares.

Even though the CGC discounts land tax assessments by 25%, the loss of GST revenue for Western Australia for this tax is far greater than 100% (as shown in Table 5) for most property values. This is because Western Australia's land tax rates are relatively low compared to the national average. For example, for land valued at less than $1 million, the revenue we raise from additional properties being taxed is less than one seventh of what we would raise based on the average of land tax rates in other States.

It should be noted that if additional compliance effort results in a land holding being re-valued to a higher value, then the net grant impact will be the difference between the dollar grant impact at the higher value and the dollar grant impact at the lower value.

It should also be noted that the estimated losses in the attached tables will vary if States change their tax rates relative to each other, and if the CGC alters its methods (which are reviewed every five to six years).

Table 3

ESTIMATED GST IMPACT OF UNILATERAL INCREASE IN COMPLIANCE EFFORT (GRANT LOSS AS A PROPORTION OF ADDITIONAL TAX REVENUE COLLECTED)

	NSW	Vic	Qld	WA	SA	TAS	ACT	NT
Payroll tax	1.8%	0.3%	-2.1%	2.3%	-1.6%	-0.6%	0.1%	-0.2%
Insurance tax	3.8%	-1.5%	-1.0%	-0.4%	-0.1%	-0.5%	-0.1%	-0.2%
Stamp duty on motor vehicles	69%	71%	88%	85%	90%	105%	100%	107%
Conveyance duty	See Table 4							
Land tax	See Table 5							
Other taxes (e.g. gambling)	0%	0%	0%	0%	0%	0%	0%	0%

Notes: Negative losses imply a revenue gain.

Table refers to the change in GST 'needs' assessed by the Commonwealth Grants Commission. Grant impacts are spread over subsequent years, but in net present value terms equal the percentages shown.

Estimates are based on the Grants Commission's latest year of data (2009-10) as per its 2011 Update (released February 2010).

For stamp duty on motor vehicles, the estimates assume that additional compliance effort will identify additional vehicles of similar value distribution to those already taxed. This distribution will vary among States.

Table 4

ESTIMATED GST IMPACT OF UNILATERAL INCREASE IN COMPLIANCE EFFORT (GRANT LOSS AS A PROPORTION OF ADDITIONAL TAX REVENUE COLLECTED)

CONVEYANCE DUTY

Property value	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
$0m – $0.1m	87%	76%	82%	72%	75%	83%	87%	91%
$0.1m – $0.2m	60%	101%	66%	87%	64%	79%	70%	71%
$0.2m – $0.3m	79%	69%	94%	95%	64%	86%	74%	83%
$0.3m – $0.4m	82%	58%	115%	95%	60%	79%	84%	93%
$0.4m – $0.5m	84%	56%	113%	93%	58%	81%	68%	78%
$0.5m – $0.6m	73%	61%	114%	85%	69%	98%	78%	75%
$0.6m – $0.7m	69%	64%	112%	87%	77%	114%	86%	82%
$0.7m – $0.8m	69%	65%	107%	87%	78%	113%	86%	86%
$0.8m – $0.9m	70%	66%	105%	86%	79%	116%	86%	85%
$0.9m – $1.0m	70%	66%	103%	86%	78%	117%	86%	85%
$1.0m – $1.1m	70%	67%	99%	86%	81%	121%	86%	86%
$1.1m – $1.2m	69%	68%	97%	86%	82%	122%	85%	97%
$1.2m – $1.3m	69%	69%	93%	86%	81%	123%	84%	89%
$1.3m – $1.4m	68%	71%	92%	86%	82%	124%	83%	91%
$1.4m – $1.5m	68%	72%	91%	87%	82%	125%	83%	99%
$1.5m plus	66%	79%	92%	80%	84%	131%	76%	102%

Notes: Table refers to the change in GST 'needs' assessed by the Commonwealth Grants Commission. Grant impacts are spread over subsequent years, but in net present value terms equal the percentages shown.

Estimates are based on the Grants Commission's latest year of data (2009-10), as per its 2011 Update (released February 2010).

Estimates assume that, within a given value range, additional compliance effort will identify additional property transfers of similar nature and value distribution to those already taxed. This distribution will vary among States.

For properties in the $1.5 million plus range, the grant loss will decline as the property value increases (the numbers shown relate to an average property value among transfers taxed in that range).

Table 5

ESTIMATED GST IMPACT OF UNILATERAL INCREASE IN COMPLIANCE EFFORT (GRANT LOSS AS A PROPORTION OF ADDITIONAL TAX REVENUE COLLECTED)

LAND TAX

Land holding value	NSW	VIC	QLD	WA	SA	TAS	ACT
$0.3m – $0.4m	97%	39%	245%	459%	33%	13%	8%
$0.4m – $0.5m	35%	79%	76%	459%	51%	19%	16%
$0.5m – $0.6m	31%	108%	64%	490%	58%	23%	22%
$0.6m – $0.7m	26%	107%	89%	486%	47%	24%	23%
$0.7m – $0.8m	28%	106%	69%	532%	46%	28%	28%
$0.8m – $0.9m	28%	105%	61%	555%	41%	28%	30%
$0.9m – $1.0m	28%	103%	55%	561%	38%	29%	31%
$1.0m – $1.5m	30%	94%	54%	313%	31%	31%	37%
$1.5m – $2.0m	33%	87%	50%	221%	26%	34%	43%
$2.0m – $2.5m	36%	80%	52%	190%	26%	37%	48%
$2.5m – $3.0m	37%	78%	53%	144%	27%	41%	54%
$3.0m plus	45%	52%	79%	75%	31%	38%	74%

Notes: Table refers to the change in GST 'needs' assessed by the Commonwealth Grants Commission. Grant impacts are spread over subsequent years, but in net present value terms equal the percentages shown.

Estimates are based on the Grants Commission's latest year of data (2009-10), as per its 2011 Update (released February 2010).

Estimates assume that, within a given value range, additional compliance effort will identify additional land holdings of similar nature and value distribution to those already taxed. This distribution will vary among States.

There is no impact for land holdings of value below $0.3 million.

The Northern Territory is not included as it does not collect land tax.

For land holdings in the $3.0 million plus range, the grant loss will decline as the land holding value increases (the numbers shown relate to an average land holding value among holdings taxed in that range).

If compliance effort results in a the lower value land holding being re valued to a high value, then the grant impact will reflect the loss at the higher value range minus the previous loss at the lower value range.

Appendix E

Good Things About the Current System that Should be Retained

Despite the many concerns with the current system of distributing GST revenue grants, presented in this submission, there are good features of the system which we would like to see retained.

GST is 'untied' funding

The GST is available to States for whatever purpose they deem appropriate, and there are no conditions to meet in order to obtain the funding.

This is an important feature that should be retained. It gives State Governments funding to meet the needs of their residents in a way that best suits their State.

The GST grants, like the previous Financial Assistance Grants, are needed to help fill the gap between the expenditure responsibilities and tax powers of States, which arose particularly when the Commonwealth took over State income taxes in World War II. In the absence of adequate tax powers, untied grants to the States give Australia the best chance of achieving the advantages of a federation.

The continuing popularity and relevance of federal systems of government reflects their significant advantages over centralised systems. These include:

- competitive pressures on governments to improve their performance and innovate;
- a capacity to test innovative approaches at a regional level;
- a capacity to tailor policies to suit local circumstances;
- governments that are closer, and hence more responsive, to the people they represent; and
- dispersing power among governments to limit potential abuse of power.

These considerations are backed up by empirical evidence which suggests that federal countries have better long term economic performance than unitary states. A 2007 report for the Council for the Australian Federation states that:

> *In the last 50 years, federations have consistently out-performed unitary states in economic terms. The more decentralised the federation, the better the performance. Research suggests that federalism may have increased Australia's prosperity by $4,507 per head in 2006 and that this amount could be increased by another $4,188 or even more if Australia's federal system were more financially decentralised.* (Twomey and Withers 2007, p. 5)

To address genuine national interests and externalities, the Commonwealth can use National Partnership payments and other payments (e.g. Commonwealth own-purpose spending). However, the chequered history of tied grants well illustrates the dangers of excessive States' reliance on these sorts of grants. Funding has expanded or fallen reflecting shifting policy priorities and fiscal circumstances. One of many notorious examples was the Commonwealth introducing a dental program in 1993-94, only to abolish it a few years later, leaving the States to manage the difficult decision of whether to reduce dental services or fill the gap by redirecting funding from other priorities.

Even under the reforms instituted from 2009 under the *Intergovernmental Agreement on Reform of Federal Financial Relations* there has been a proliferation of short term (and often relatively low value) arrangements with limited focus on meaningful sustainable outcomes, and creating substantial administrative overheads.

The CGC is independent

As a statutory body, the CGC makes impartial recommendations. These governance arrangements are seen internationally as highly desirable, and compare well to the ad hoc decision making processes relating to many National Partnership Payments.

The CGC should be more accountable, as discussed in the *Transparency* chapter of this submission, but it should remain apolitical.

The CGC operates a consultative process

The CGC generally operates in a highly consultative way, and with a high degree of transparency in its consultation. For example, the 2010 Review involved an iterative process where the CGC each year issued discussion papers, held meetings and took submissions (made available to all parties).

This gives all States multiple opportunities to have their case heard.

The CGC releases extensive documentation

The CGC publishes considerable detail on its assessments, and also gives the States access to copies of its underlying spreadsheets. In cases where errors are found in the CGC's calculations, it will pro-actively advise all States.

Although there are deficiencies in the documentation, as discussed in the Transparency chapter of this submission, the documentation compares very favourably with other funding arrangements.

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