Chamber of Commerce and Industry WA

ABN 96 929 977 985
T: (08) 9365 7555
E: info@cciwa.com
W: www.cciwa.com

23 October 2018

Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Committee

Submission to Senate Inquiry – Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018

Every state and territory can do more to get ahead but no state or territory should be left behind. This is the principle that underpins reforming the GST distribution. The amendments outlined in this legislation will benefit the Australian economy and every Australian stands to benefit.

The principle of horizontal fiscal equalisation (HFE) has merit. States and territories (states) have different capacities to deliver services, which is acknowledged through the GST distribution process. However, equalising to the leading state – the current objective of HFE – has significantly reduced incentives for states to encourage economic growth and has diminished GST revenue stability for the leading state. In particular, the current system has been susceptible to extreme volatility as the leading state's capacity varies which has created revenue instability for all states.

This was evident when Western Australia's GST share fell to 30 cents in the dollar as a result of successfully developing its own resources. Western Australia was left with just 11 per cent of its own iron ore royalties while the remainder was redistributed to other states. Western Australia was effectively punished with less GST for creating vast amounts of wealth for Australia, raising the standard of living for all Australians and creating thousands of jobs in the process.

It is now clear that a key incentive for promoting economic development was inadvertently removed by the objective of equalising to the leading state. Likewise, non-leading states have a diminished incentive to develop their own respective economies or undertake reforms that encourage efficiency, as first highlighted by CCIWA[1] and confirmed by the Productivity Commission.

The current objective of HFE is to raise the service delivery capacity of each state up to that of the leading state, before distributing any remaining GST equally on a per capita basis. This level of equalisation diminishes incentives for states to make difficult political and policy decisions that promote economic development, because they know they will receive a significantly diminished amount of GST if their own source revenue increases through the development of under-utilised industries. Recipient states know that they will always have their capacity to deliver services raised to the leading state's level through the GST distribution, regardless of their own industry development efforts.

[1] CCIWA Submission and Post-Draft Submission to the Productivity Commission HFE Inquiry

180 Hay Street, East Perth
Western Australia 6004
PO Box 6209, East Perth
Western Australia 6892
Chamber of Commerce and Industry of Western Australia (Inc)
ARBN 099 891 611
Incorporated in Western Australia

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Reforming the distribution formula of the GST is in the national interest and can stimulate national economic growth by strengthening development incentives for all states. CCIWA's preferred reform option is to change the equalisation objective from the leading state to that of the average of all the states. This would create the greatest incentive for all states to develop their own economies.

The Productivity Commission agreed with CCIWA's assessment that the current equalisation objective was not in the national interest and hindered economic growth. Equalising to the average was the solution recommended by the Productivity Commission in its final report[2]. CCIWA was the only organisation to recommend this reform solution.

The proposed legislative change to equalise to the higher of New South Wales or Victoria will minimise the adverse effects of outlier outcomes, such as a mining boom, from the equalisation task. It will also restore Western Australia's incentive to develop its own economy. Given Western Australia accounts for more than 40 per cent of Australia's merchandise exports it is critical that the State is strongly encouraged to continue to develop its natural resources.

CCIWA does not believe that a guarantee of 'no state is worse off' is necessary. The independently modelled projections in the Productivity Commission's final report highlight a likely case of projected relativities for all states. This, combined with the additional funding to be injected into the GST pool each year by the Commonwealth Government, demonstrates that no state will be worse off than their current forecast relativity (as per their own budget assessments) than they will be if the proposed legislation is passed.

The proposed legislated guarantee could prove to be an expensive liability for the Commonwealth Government. In effect, it transfers the risk of a diminished GST share away from the leading state other than New South Wales or Victoria (currently Western Australia) to the Commonwealth Government in the instance of an outlier event, such as another mining royalties boom for Western Australia. It is yet to be established why each state should receive the per capita equivalent of a mining royalty boom that is experienced by an outlier state, given Western Australia alone would wear the costs of regulating the mining activity and providing essential infrastructure.

Although it is important for all states to benefit from rising standards of living across the nation, the extreme results delivered by equalising to the leading state has diminished incentives to the point of detriment to the national economy.

CCIWA recommends that the proposed legislation be passed by the Senate as it achieves the primary objective intended by the reform, which is to restore stability and predictability in the system. CCIWA's Chief Economist, Rick Newnham, would be pleased to give evidence to the Senate Inquiry in person.

Yours sincerely,

Chris Rodwell
Chief Executive Officer

[2] Productivity Commission Horizontal Fiscal Equalisation – Inquiry report

Chamber of Commerce and Industry WA

SUBMISSION TO THE PRODUCTIVITY COMMISSION

Horizontal fiscal equalisation

Chamber of Commerce and Industry of Western Australia

SUMMARY

The principle and scale of horizontal fiscal equalisation (HFE) of Australian states and territories has significantly reduced incentives for national economic growth and has diminished GST revenue stability for the leading state. Reforming the distribution formula of the GST is in the national interest and can stimulate national economic growth. A multi-faceted solution is proposed that grows the GST pie over the long term and leaves no state worse off in the next two years.

THE PROBLEM

HFE raises the service delivery capacity of each state up to that of the leading state, before distributing any remaining GST equally on a per capita basis. This equalisation diminishes incentives for states to make difficult political and policy decisions that promote economic development, because they know they will receive a significantly diminished amount of GST if their state-based revenue increases through the development of under-utilised industries. Recipient states know that they will always have their capacity to deliver services raised to the leading state's level through GST distribution, regardless of their own industry development efforts.

PROPOSALS

The Chamber of Commerce and Industry of Western Australia (CCIWA) proposes that the GST be reformed to create greater incentives for states to contribute to national economic growth. The models proposed include partial equalisation (reducing the overall distribution between states by either discounting a portion of revenue or equalising to a pre-determined level of acceptable services) and the 'Alberta model' of excluding a portion of mining royalties. These proposals ensure that every Australian citizen lives in a state that has the capacity to deliver an acceptable standard of services, while also restoring strong incentives for states to promote economic development.

RECOMMENDATIONS

CCIWA's recommendations will create GST revenue stability for the leading state and strengthen incentives for all states to fully develop their industries and boost national economic growth.

1. Immediately introduce a 0.70 ratcheting relativity floor for all states. The floor should be introduced at WA's current relativity and increased each year WA exceeds that floor, until the floor reaches 0.7. Based on WA Treasury relativity forecasts, no state's GST relativity would be impacted as a result of the floor in the next two years.
2. Implement partial equalisation over a transition period to strengthen incentives for states to develop their industries. This can be phased in over time and will stimulate national economic growth, growing the GST pie.

ABOUT THIS SUBMISSION

This submission is made on behalf of the business community in Western Australia. The Chamber of Commerce and Industry of Western Australia has more than 9,000 members who employ more than 300,000 people. A full list of industry groups who support this submission can be found on the signing page.

This submission will address how the current GST distribution principle of HFE has removed reliability in GST revenue and has substantially weakened economic growth incentives for state governments.

CCIWA does not believe the current WA budget deficit or debt is attributable to the existing GST distribution model. This submission acknowledges that WA governments have consistently increased spending beyond revenue growth against a backdrop of falling GST revenue forecasts produced by WA Treasury, and it is this overspending that has led to the current structural deficit. It is recommended that the Productivity Commission also separate the issue of WA state finances from this review of the GST by focusing on economic growth.

HORIZONTAL FISCAL EQUALISATION HAS MERIT

The principle of horizontal fiscal equalisation has merit. It ensures every person living in Australia has access to an acceptable standard of service delivery capacity as provided by the leading state, regardless of where they live. It takes into account natural challenges faced by each state, called disabilities, (i.e. differences in costs of delivering services) and natural advantages in revenue (i.e. presence of natural resources). The principle of having an acceptable standard of service delivery across the nation has served Australia well and is a fundamental principle of federation. HFE has also been adopted around the world with varying degrees of equalisation.

A key feature of HFE is that each state's determination of capacity be policy agnostic, meaning no state should be rewarded or penalised for the policy choices of their state government. This is important to avoid incentives for states to 'game' the system to attract more GST by lowering taxes – HFE achieves that goal to some extent, but the unintended bi-product of this approach is that if a state makes a policy decision to prevent development of a resources sector, the GST system ignores this decision and the potential revenue it could bring, and concludes the state must need more GST.

The original intent of HFE is unintentionally producing perverse incentives for state governments which hinders national economic growth. While HFE and full equalisation are intended to promote equality and prosperity across the nation, their application has extended far beyond the original intent, with vastly greater redistribution occurring than was originally envisaged. A more optimal outcome can be achieved by equalising less and incentivising growth more.

CCIWA believes the GST system can be adjusted to increase economic growth whilst maintaining the original intent of HFE, which is to ensure an acceptable level of service delivery standard for each state can be achieved. Reforming the GST system to re-introduce incentives for states to develop their industries will stimulate new business growth and job creation, spreading greater prosperity across the entire Australian community.

National economic growth brings with it prosperity that is shared by all Australians. Prosperous and growing Australian businesses create jobs, new technology and improve economic productivity which benefits all.

It is more important that Australia's businesses and overall economy are strong than it is for each state to have absolutely the same capacity as the leading state – it is economic growth and productivity that drives increases in prosperity, not equality in service delivery capacity. The GST distribution is only a zero-sum game in any given single year but not over the long run. By equalising the states to a lesser degree, national economic growth can be stimulated and the GST 'pie' can be grown incrementally larger.

UNDERSTANDING FULL EQUALISATION

The size of the equalisation task is growing as states begin to diverge in capacity. The potential growth of some states is higher than others, which can be due to a combination of both natural and created competitive advantages such as geography, natural endowments or industry development. What is clear is that the scale of redistribution is growing over time as the potential growth rates of states diverge.

There are two ways to view the current process of GST distribution, which describe the same method in separate ways.

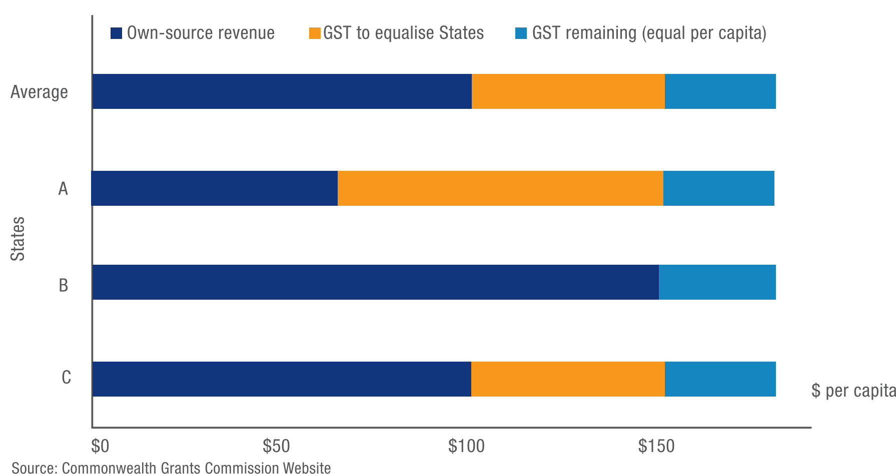
1. Equalising to the 'average'

"GST revenue is first distributed on a population basis, raising the fiscal capacity of all states equally. Then there is a redistribution to achieve equalisation – from states with above average capacity to those with below average capacity."[1]

2. Equalising to the leading state

"GST revenue is first distributed to bring the initial fiscal capacities of all states to that of the strongest. The remaining GST is then distributed equally among all states."[2]

To understand how the GST distribution has created perverse outcomes and substantially weakened incentives, it is best to consider the distribution method in the second way – equalising to the leading state. The task and scale of equalising states to the leading state's capacity via GST is depicted below:



Source: Commonwealth Grants Commission Website

Figure: Simplified depiction of GST distribution

[1] 2017 Commonwealth Grants Commission Report
[2] 2017 Commonwealth Grants Commission Report

THE PROBLEM WITH FULL EQUALISATION

HFE attempts to be policy agnostic by ignoring the actual taxation of a state's revenue base and instead applying the national average rate to each state's revenue base. This approach achieves policy neutrality of taxation rates, but fails to consider the role of state government policy in promoting or even allowing the development of the state's revenue base. In other words, the role of government policy impacting industry development is ignored.

As a result, if one state strengthens its revenue base through development of industry it will lose GST. This signaling to state governments has weakened the incentives for states to develop all sectors of their economies. The incentives that once existed for states to promote economic activity so the overall state economy (and national economy) would flourish, have been diminished by the GST distribution – state governments no longer significantly benefit from major growth of their own industries.

For example, by WA Treasury estimates, around 85-90 per cent of any marginal increase in mining royalties are offset by an equal loss in GST revenue.

As one state grows its own revenue capacity through industry development (rather than increased taxes), it only retains a small proportion of that increased revenue. This means that smaller states have a reduced incentive to develop industries that would generate large revenue to their state – particularly if developing said industry would present a political risk.

Considering this, it is difficult to see why any state government that receives a large proportion of its revenue from GST would be inclined to pursue such industry development, knowing that their GST share would diminish if that industry was successful.

HFE SYSTEMATICALLY REDISTRIBUTES FROM HIGH TO LOW PRODUCTIVITY ECONOMIES

The GST distribution has facilitated a consistent redistribution away from high potential growth states – which are actively growing their economies and strengthening their own source revenue– to lower potential growth states. The result is a loss in national productivity from forced redistribution into low growth sectors of the economy.

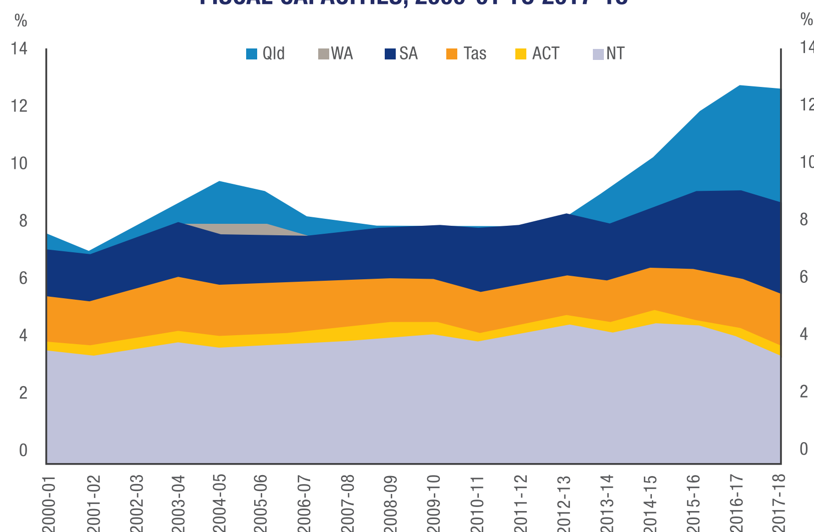
The consistency of redistribution through the GST can be viewed over time since the introduction of the GST in 2000. It can be seen through the sustained distribution away from one set of states towards others.

The Australian Capital Territory, Northern Territory, South Australia and Tasmania are consistent recipients of GST. Queensland is the only state (since the introduction of the GST) that swings between recipient state and contributing state.

New South Wales, Victoria and now Western Australia are consistent net contributors to the GST pool.

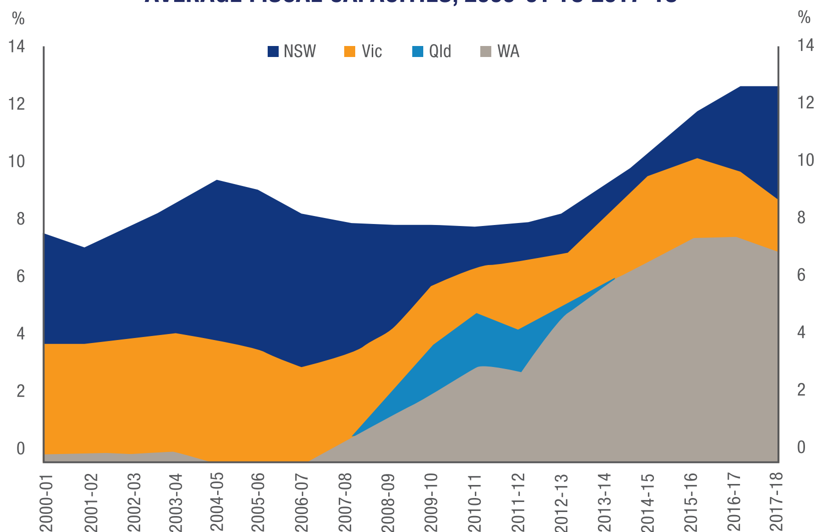
This consistent redistribution completely dispels the notion (and belief of many Australians) that the GST exists to support states as their economises fluctuate through cycles, and that states and territories oscillate between givers and receivers. As their economies move through economic cycles, they fluctuate from net givers to receivers. While the scale of redistribution alters slightly during the cycles, the status of net recipient or contributor does not alter for every state, except Queensland (and WA for a short period).

PROPORTION OF THE GST REDISTRIBUTED TO STATES WITH BELOW AVERAGE FISCAL CAPACITIES, 2000-01 TO 2017-18



Source: Commission calculation

PROPORTION OF THE GST REDISTRIBUTED FROM STATES WITH ABOVE AVERAGE FISCAL CAPACITIES, 2000-01 TO 2017-18



Source: Commission calculation

RELIABILITY AND STABILITY OF GST REVENUE

All states depend on the GST as a source of revenue – when the GST was introduced, it coincided with the removal of several state taxes. The states shifted their reliance from their own consumption taxes to that of the GST, with the acceptance that GST revenues would vary slightly from time to time but would be dependable. It was not foreseen that the scale of redistribution between states would be so vast as it is now.

Nor was it foreseen that as states diverged in capacity, the leading state may receive no GST at all. As the leading state increases its capacity to deliver services more than other states, it is possible that the scale of equalisation task becomes so vast that in the process of raising other states to the leading state's capacity, there is no GST left to distribute to the leading state.

WA came close to a single year relativity of 0.0 when its GST relativity was calculated to be 0.085 for the year of 2013-14. It is likely that as states continue to diverge that relativities of 0 will become a reality for leading states.

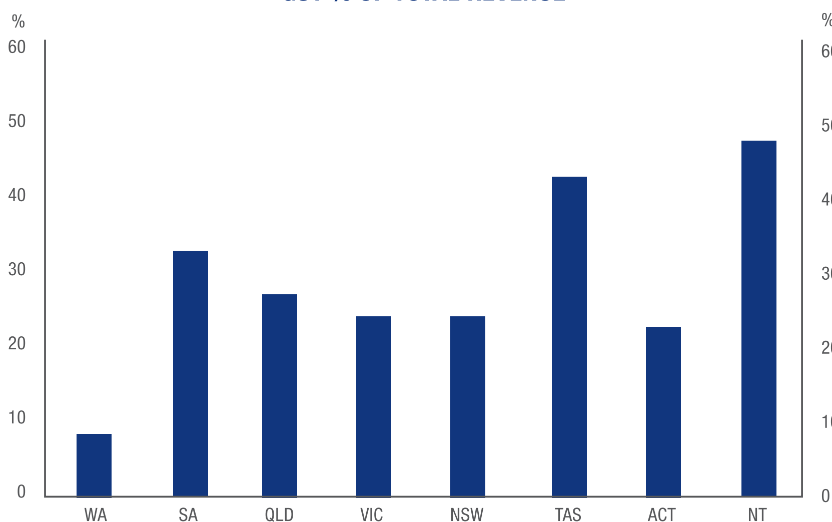
GST TAX REFORM

Tax reform of the GST will be hindered by the leading state if it remains at risk of extremely low relativities.

Incentives for low GST-relativity states to support the broadening of the GST base and increase of the GST rate have been weakened because the benefits of reform would not be shared by those states. In the extreme, any state with a GST relativity of 0.0 would have no incentive at all to participate in tax reform, since none of the proceeds would flow to that state.

Over a 15-year period since the year 2000, more than $13.9 billion was redistributed away from WA compared to its equal per capita share.

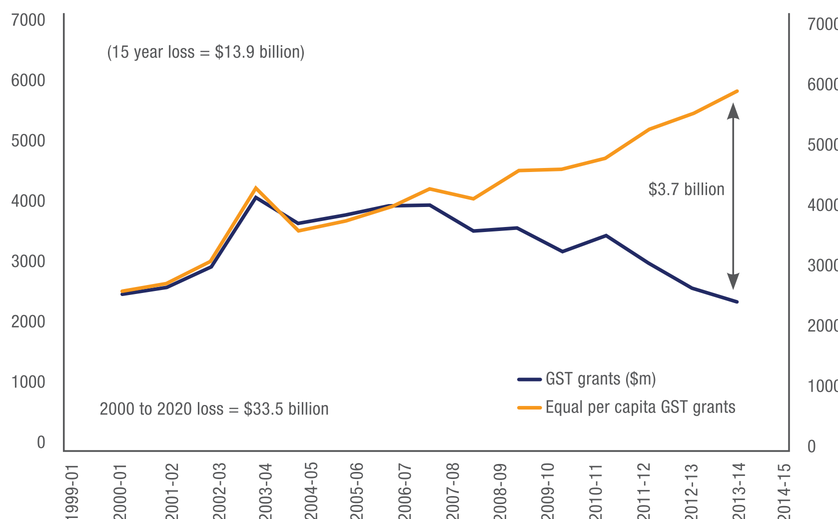
GST % OF TOTAL REVENUE



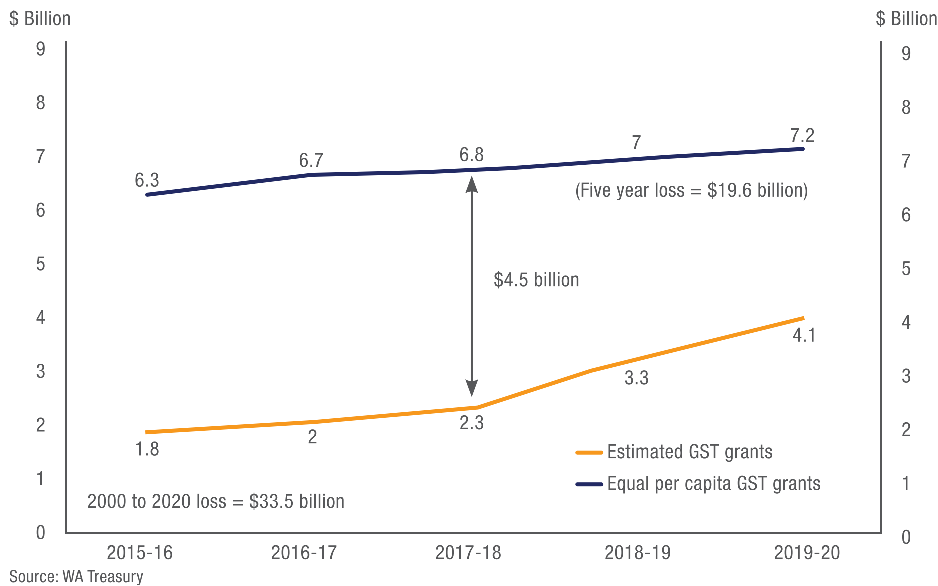
Source: 2015-16 State Budgets

THE SCALE OF REDISTRIBUTION: WA

LOSS IN WESTERN AUSTRALIA'S GST GRANTS COMPARED TO POPULATION SHARE



Over the five year period from 2015-16, a further $19.6 billion is expected to be redistributed away from WA. Between 2000 and 2020, a total of $33.5 billion will be redistributed from the high-growth state of WA to the rest of the country.



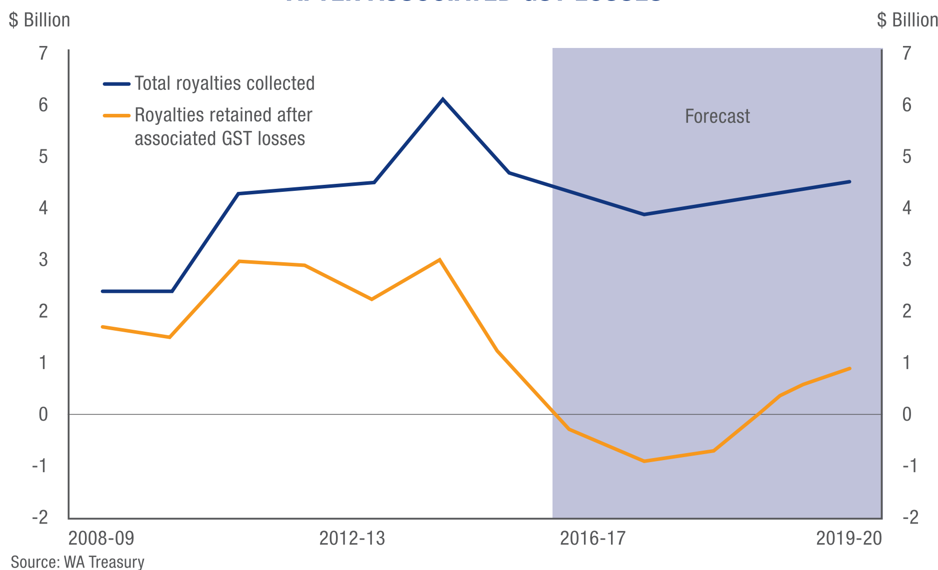


Figure: WA's revenue windfall eliminated by GST redistribution

MINING ROYALTIES – AN ERROR IN POLICY NEUTRALITY

Mining royalties account for the clear majority of GST revenue redistribution between states. This is simply because WA has significantly higher production of natural resources than any other state. The current formula considers New South Wales and Victoria to have very low potential for resource royalties.

A key flaw in the HFE calculation is in considering resource royalty potential – the approach to HFE adopted by Australia's Commonwealth Grants Commission (CGC) only considers actual production of resources, ignoring the revenue potential of resources blocked by policy. This is not consistent with the policy-agnostic approach to HFE demonstrated in relation to other areas of state revenue – it fails the policy neutrality intention because state government policy can block production of industries, with no consequences to that state government's GST revenue.

A state government policy decision to exclude an entire industry blocks any production of that resource and therefore no revenue potential from that sector is considered. The formulae only looks at actual production when considering the revenue base, not potential production. The policy neutrality is achieved in averaging the tax rates across the country, but not the potential production of each state.

While it may seem obvious to consider natural resource reserves as the new base of potential production, doing so would introduce even more problems, given the complexity of determining these reserves and the impact that policy decisions have on exploration activity and therefore resource reserve identification. A state that has a policy to block production of a resource will have a significantly lower level of exploration activity, which directly impacts the reserves identified in that state.

The current 'policy agnostic' process concludes that a statewide moratorium on developing a resource means there is no potential revenue possible from that banned resource, which is an incorrect assessment.

The current assessment of mining royalties does not achieve the policy agnostic test applied to other sources of state revenue.

The states of New South Wales and Victoria would receive less GST if government policy changed and development of on-shore gas was encouraged and fully developed. In this instance, government policy is directly responsible for an increased share of GST and the incentive to develop this revenue base is therefore weakened.

This approach rewards states that leave their natural resources undeveloped with additional GST because, unlike other taxes, the potential production is not identified by the CGC.

REVENUE FACTORS CAUSING DISTRIBUTION 2017-18

Source: Commonwealth Grants Commission

GST AND GOVERNMENT DECISION MAKING

No decision of government is made in isolation – a responsible government will consider the full range of consequences from any significant policy decision including its impact of government revenue streams. For this reason, it is unreasonable to expect any state government has taken a decision on the sole basis on GST revenue impact.

What is conceivable however is that a government would have less incentives to tackle a politically-sensitive policy decision that promotes economic growth, if that decision would reduce their state's GST revenue. If a political battle was required to bring a new industry on stream, but that industry's increased contribution to government revenue would mean a reduction in GST, the political will has been reduced by the GST distribution method.

Coal seam gas is a contemporary example, given it has been banned or hindered by policy in both NSW, VIC and NT. It's emergence as an issue is also after the 2012 Greiner & Brumby Review was published, giving the GST review a new major policy impact to consider.

NSW, VIC and NT have both blocked on-shore gas industry development – either through moratoriums or lack of government support – which has caused these industries to flounder. Not only has this caused a significant shortfall in gas supply to the east coast, but it has not resulted in a reduction in GST revenues to those states.

While it is clear that the decision for those states to ban (or actively not support) the on-shore gas industry has been greatly influenced by environmental activism, the incentive for industry development has been removed. When considering removing a ban of on-shore gas and the political battle that would be required, the government would also consider the net impact of revenue to the state – including the impact removing the ban would have on their GST share.

The Treasuries of these states will likely have each forecasted the incremental impact of a thriving onshore gas industry on their state government's revenues over the forward estimates.

These estimates would show a significantly increased rate of mining royalties, at the expense of subsequently falling GST revenues. This dampens the political will of states to promote industry development because the two together negate much of the benefit – industry development in this instance would generate prosperity through jobs, lower gas prices and more productive industries.

PROPOSALS FOR REFORM

Reform proposals can address the two key issues with the GST distribution under full equalisation of HFE. The first is the lack of stability in GST revenue for the leading state. The second is the weakening of incentives for states to fully develop industries in their economy.

It is important to separate out these two issues as they both need to be addressed by separate reforms.

1. CREATING STABILITY AND PREDICTABILITY

A ratcheting relativity floor

A relativity floor ensures a minimum GST relativity for each state. It provides stability and predictability in the distribution for the leading state, which allows for better long-term planning in states that have strong but volatile own-source revenue (such as WA). It also creates greater incentives for the leading state to agree to GST tax reform, who will have no incentive to agree to spreading the GST base and increasing the GST tax rate if they know the vast majority of the increased funds will be redistributed away from their state. A floor would also ensure that capital remains in the highly productive leading state for re-investment, rather than being redistributed to other states.

The floor could be introduced incrementally, following the current relativity of WA. As the relativity of WA recovers, the floor should be set at WA's current level or at the highest level since the floor was introduced, up until the year that WA exceeds 0.7, at which time the floor should be set at 0.7.

With a floor in place, any state that has a relativity calculated below the floor would be distributed GST first to raise that state's relativity up to the floor. Distribution of the remaining GST would then continue as per usual, raising the weaker states to the leading state's capacity, followed by equal per capita distribution. The Federal Government would not be responsible for funding the gap between a state's relativity and the floor. In recent times, the Federal Government has handed out GST revenue 'top-ups' to Western Australia, given its low GST relativity – this would not need to occur with a ratcheting GST relativity floor.

The proposed floor is in fact funded by the leading state's own redistributed GST. A floor is not funded by the other states. It simply limits the scale of redistribution that occurs under the existing system.

Based on the current WA Treasury estimates of GST relativity, no state would be worse off (compared to the existing arrangements, over the next two years) from the introduction of a ratcheting floor.

A floor also re-instates strong economic growth incentives for states that are at risk of relativities below the floor itself. It also ensures that no state will have their GST revenue collapse, as other revenue sources grow significantly.

2. STIMULATING ECONOMIC GROWTH

Three options are proposed that each restore strong incentives for economic growth.

Partial equalisation to a pre-determined acceptable level of services

Rather than equalising all states to the leading state's capacity each year, all states should be raised to a pre-determined level that represents a minimum standard of acceptable service delivery. This should be a moving level of acceptable services so no state is left behind. The standard could be determined by the pre-GST distribution average of service delivery capacity of all states.

This model ensures everyone living in Australia has access to a minimum level of services while encouraging states to develop their own industries to make up for the missing GST revenue and get 'ahead of the pack'. This is a trade-off in equalisation for prosperity through economic growth.

Partial equalisation by excluding 20 per cent of revenue

All states can be fully equalised on their differences in service delivery costs. This accounts for differences in geography, demographics and other cost factors outside the control of the government.

Reducing the revenue equalisation by 20 per cent acknowledges that some revenue sources are outside the control of the state government, such as natural resource endowments. It also reinforces that state government's play a significant role in industry development, which is undervalued in the current system and can be encouraged.

Excluding 20 per cent of revenue from the GST calculation would allow states to keep more of the revenue they generate from industry development, which strengthens the incentive to develop industries and foster economic growth.

The Alberta Model: excluding 25 per cent of mining royalties

Canada has implemented a model that excludes a portion of mining royalties from their equivalent fiscal equalisation calculation. Adopting this model in Australia would address two issues:

- The first is the substantial weakening of incentives to develop natural resources within a state. It addresses this by allowing states to keep more of the resource royalty revenue they generate whilst not rewarding states who do not develop their natural resources with additional GST.
- The second is the failure to achieve policy neutrality in calculating a state government's policy impact on an industry, and the subsequent determination of revenue capacity. It addresses this by discounting the current revenue assessment and acknowledging the impact government policy has on the base.

Canada has excluded 50 per cent of mining royalties from their equivalent calculation which has created strong incentives for growth that could be adopted by Australia.

This submission suggests that 25 per cent of mining royalties would strengthen incentives significantly for states to prioritise resource industry development.

REFORM PROPOSALS NOT SUPPORTED BY CCIWA

Reinstating gambling to the calculation

There is a mistaken view that re-instating gambling revenue in the calculation would increase WA's share of the GST. Gambling revenues are currently assessed on a 'per capita' basis, meaning they have no substantive impact on the distribution of the GST.

Prior to excluding gambling revenue from the GST calculation (introduced in 2010), a state's revenue raising capacity from gambling was calculated by considering the average gambling rate and a state's average disposable household income.

Re-introducing this measure would mean states with a high average disposable household income would receive even less GST, due to their perceived higher capacity to raise gambling revenue. Gambling can cause significant issues for communities and can have an overall negative social impact on society.

Gambling revenues should not change in the assessment.

IMPLEMENTATION

PROPOSAL

It is proposed that the GST be reformed in two stages to address stability in the system and restore strong incentives to encourage national economic growth. No state would be worse off under this proposal in the next two years.

1. **Ratcheting relativity floor of 0.7 (stability) – implemented immediately**

A ratcheting floor should be introduced immediately. The floor would be introduced at WA's current relativity in 2017-18 and be raised in every year that WA's relativity exceeds the floor, up to a relativity of 0.7. On current forward projections of WA's GST relativity, no state would be worse off in the next two years. All states would continue to share the prosperity of WA's resources into the future while the predictability of revenue and confidence in the GST system would also be rebuilt for Western Australia.

2. **Partial equalisation (economic growth) – implemented after the Productivity Commission reports**

The CGC should be directed by the Federal Treasurer in the next Terms of Reference to transition from full horizontal fiscal equalisation to partial equalisation. This should take the form of one of the three options proposed in this submission: equalising to a pre-distribution average; excluding 20 per cent of revenue from the calculation or excluding 25 per cent of mining royalties. Each of these methods would incentivise national economic growth over the long-term.

Partial equalisation could be progressively introduced over a transition period of 5-10 years, allowing state governments to adjust budgets and revenue expectations over the cycle.

HOW A CHANGE WOULD TAKE EFFECT

Floor - immediately

A ratcheting floor could be announced by the Federal Government immediately and can be implemented by the Federal Treasurer directing the CGC through the CGC's next annual Terms of Reference. This measure is outside the terms of reference of the Productivity Commission's review, given it addresses political stability of the system rather than national economic growth or productivity. As such it should be announced immediately.

Agreement from COAG is not required.

Partial equalisation - 2018

The transition to partial equalisation should be announced by the Federal Government after the Productivity Commission has released its final report. The Federal Treasurer can direct the Commonwealth Grants Commission to apply a partial equalisation model in the CGC's next Terms of Reference.

Agreement from COAG is not required.

This submission is signed by: CCIWA Chief Executive Officer

This submission is further supported by the following Western Australian industry associations who represent WA business:

CONTACT

Further details regarding this submission can be obtained by contacting the Chamber of Commerce and Industry of WA.

MEDIA CONTACT

SUPPORTING DOCUMENTATION

IMPACT ON 2017-18 GST DISTRIBUTION FROM PROPOSALS DISCUSSED IN THIS SUBMISSION

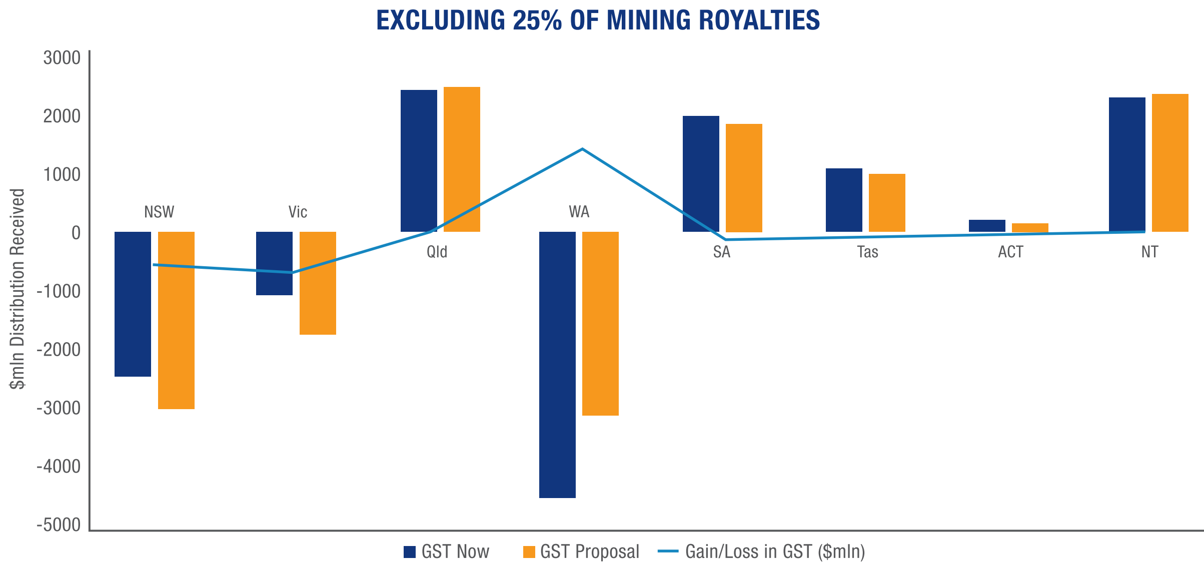


Figure: The Alberta Model

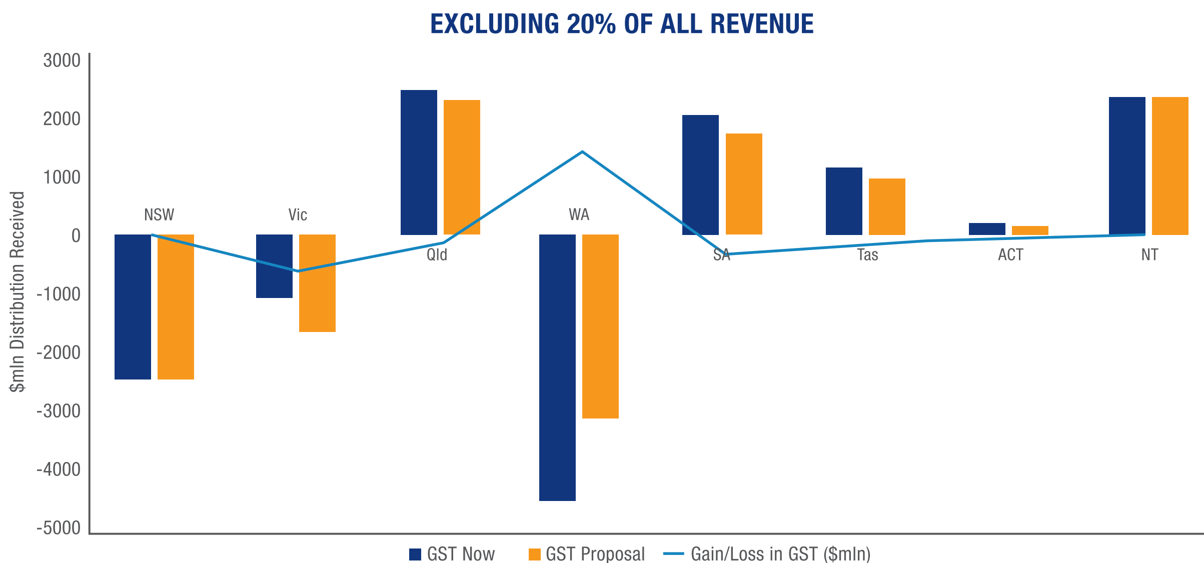


Figure: Partial Equalisation

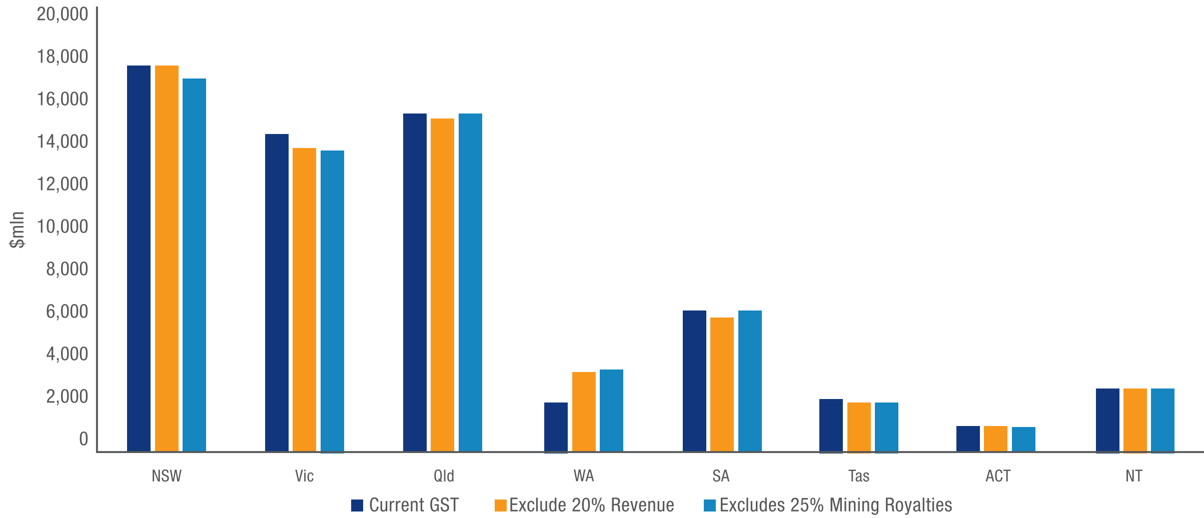


Figure: Impact of proposals on absolute GST distribution

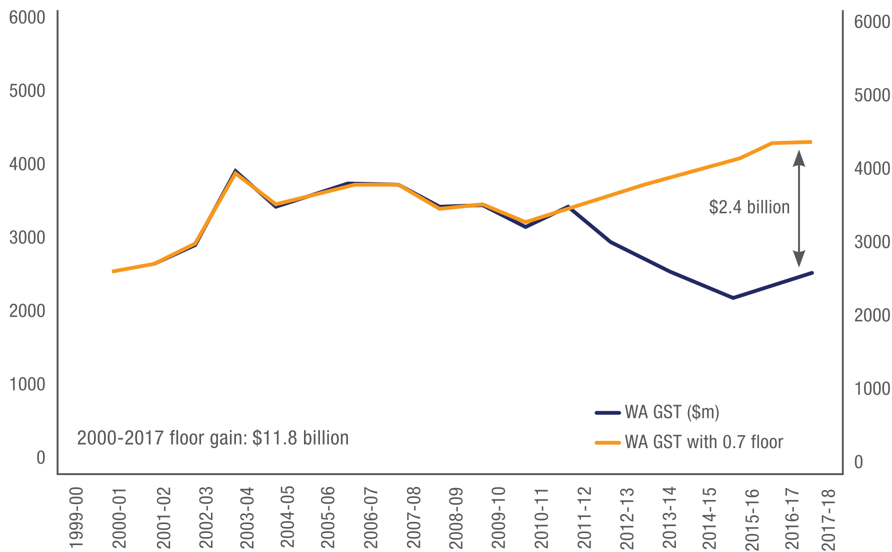


Figure: Impact of 0.7 relativity floor on WA's GST receipts

POST DRAFT SUBMISSION

Horizontal Fiscal Equalisation

Chamber of Commerce and Industry of Western Australia

SUMMARY

The Chamber of Commerce and Industry of Western Australia (CCIWA) strongly welcomes the Productivity Commission's draft report on Horizontal Fiscal Equalisation. The draft report has supported many of the conclusions outlined in CCIWA's submission.

CCIWA proposed in its initial submission that Horizontal Fiscal Equalisation (HFE) has merit and should be retained, but the extent of redistribution had become too large and the system should be reformed to create greater incentives for states to contribute to national economic growth. The Productivity Commission has agreed that Horizontal Fiscal Equalisation has merit and should be retained, however the equalisation task of raising each state's capacity to the leading state is now unsustainable.

CCI's proposal to equalise to the average of the states ensures that every Australian citizen lives in a state that has the capacity to deliver a reasonable standard of services, while also restoring strong incentives for states to promote economic development. This is in line with the draft conclusion and recommendation of the Productivity Commission which CCIWA supports.

DEFINING REASONABLE EQUALISATION

CCIWA strongly supports equalising to the average (ETA), as we proposed in our first submission, and rejects equalising to the second leading state or to the average of the donor states, as these proposals have fatal flaws which are described in this submission. Equalising to the average will achieve a high level of equity among states, ensuring every state has at least the average capacity to provide services, whilst improving efficiency in the system. These changes will ensure a robust and flexible system into the future.

It is therefore strongly proposed that the Productivity Commission recommend in its final report that reasonable equalisation be defined as equalising to the average – this will allow for maximum durability and efficiency whilst maintaining equity for all states.

PRINCIPLES FOR TRANSITION ARRANGEMENTS

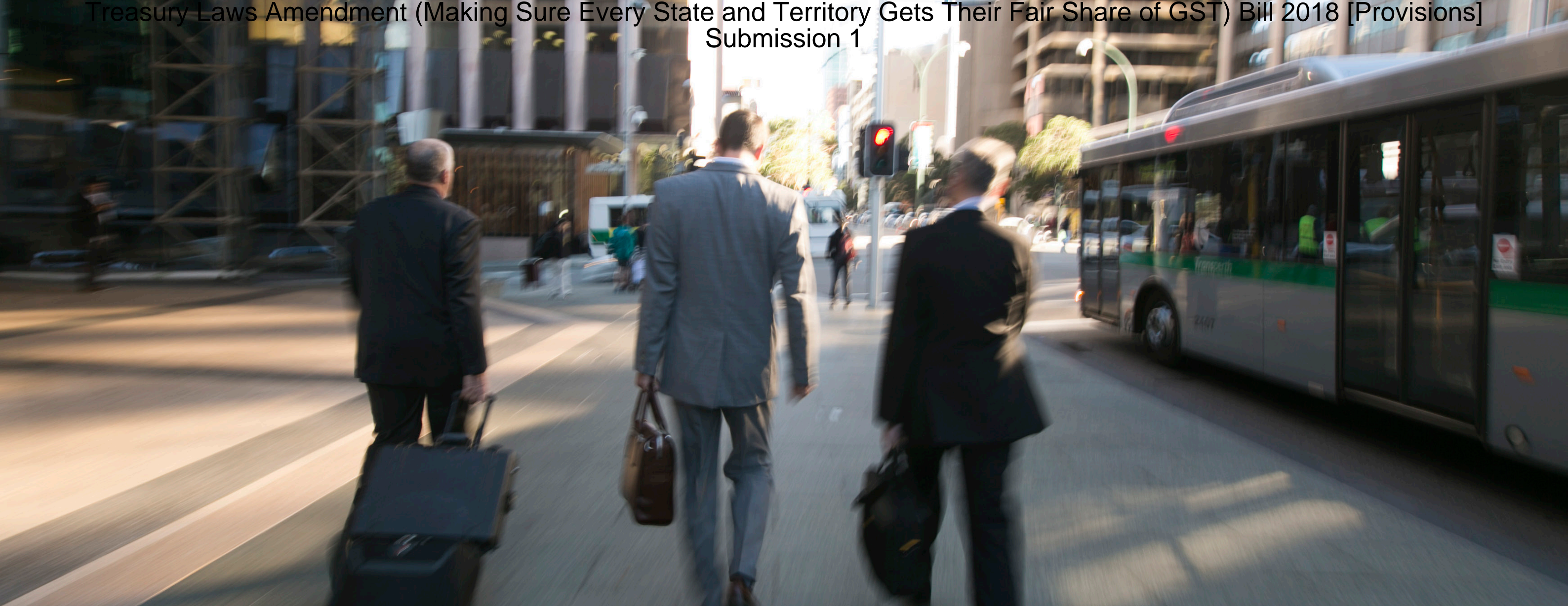
CCI has used the following criteria to determine the most suitable transition arrangements:

- **Fair:** every Australian should continue to expect a high standard of services from their state government.
- **Pro-growth:** States should be rewarded, not punished, for growing their own economy.
- **Durable:** The new distribution method must last and each state should be able to rely on their forward estimates of GST revenue.

RECOMMENDATIONS

1. It is recommended that the Federal Government immediately implement equalisation to the average.
2. The Federal Government should allocate $5.07 billion over 3 years to top-up payments. With these top-up payments, no state will be worse off over the forward estimates[1].

[1] Each State's actual GST revenues would be expected to fall within the historical forecasting error of +/-6% of GST revenue.



PRODUCTIVITY COMMISSION DRAFT REPORT

THE ISSUE WITH FULL EQUALISATION

Full equalisation raises the service delivery capacity of each state up to that of the leading state, before distributing any remaining GST equally on an equal per capita basis. This equalisation diminishes incentives for states to make difficult decisions that promote economic development, because they know they will always be raised to the same level of service delivery capacity as the leading state, regardless of whether they develop their underutilised industries or not. The trade-off of efficiency to achieve a very high degree of equity is damaging the national economy.

REASONABLE EQUALISATION SHOULD BE DEFINED AS THE AVERAGE OF ALL STATES

CCIWA strongly welcomes the Productivity Commission's finding that the current system struggles with extreme circumstances, and this is corroding confidence in the system [Figure 1]. CCI agrees with the conclusion of the Productivity Commission that equalising to the fiscally strongest state means the redistribution task is too great for any jurisdiction to bear, and is volatile at times of significant cyclical and structural change.

Given that durability of the system through volatile and significant cyclical and structural change has been highlighted as a high priority for the proposed level of "reasonable equalisation", it is recommended that both equalising to the second strongest state and equalising to the average of the donor states be dismissed in the final report. Under the current method of HFE, there is no incentive for any State to improve its capacity since the GST pool is distributed to top-up all states to the leading state's capacity. We discuss the merits of each proposed equalisation point in terms of the marginal incentives it creates for each state to improve its own capacity and the durability of the system under extreme circumstances.

Equalising to the average of all states ensures each state has 'skin in the game'. ETA creates positive marginal incentives for each state to increase its own capacity, since improvement in any state's capacity raises the equalisation point. A continuous marginal benefit for developing a state's own capacity is introduced, compared to a relative fixed point of equalisation (such as the leading state) where improvements in capacity are traded off with GST revenue. Efficiency is increased as all states contribute to progression of the average, rather than the equalisation point being a fixed point or the responsibility of a subset of states which the remaining states cannot influence and therefore have nothing to gain by raising capacity. This is an important difference in incentives created by equalising to the average compared to full HFE, equalising to the second leading state or equalising to the donor states.

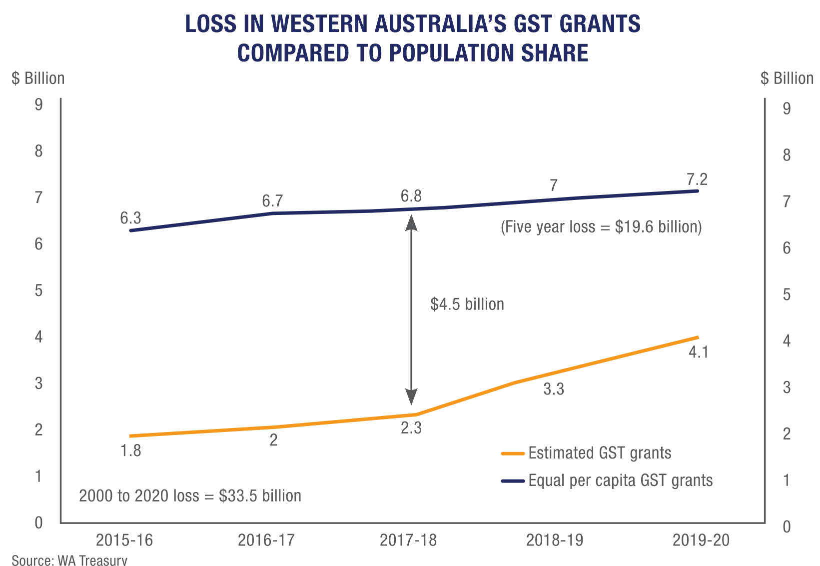


Figure 1: Full equlisation is unsustainable and has eroded confidence in the system.

Equalising to the second leading state and average of donor states is flawed

A fatal flaw in equalising to the leading state is that if the leading state pulls too far ahead of the other states then the equalisation task becomes too great, eroding confidence in the system.

Equalising to the second leading state means that the point of equalisation does not move if the leading state continues to pull ahead of the pack. There will be no benefit in terms of GST revenue for other states as the leading state moves relative to other state capacities. This diminishes equity in the system compared to ETA.

Likewise, it is foreseeable that if both the leading state and second leading state were to simultaneously strengthen ahead of the pack the same problem as the current system would occur – the equalisation task would continue to be too great. For example, a future mining boom could see revenues in the two resource rich states of Western Australia and Queensland pull ahead of the other states.

Equalising to the donor states is also flawed. It is possible that only one state will be above the equalisation point, leaving the task of equalisation at risk of being too great. Whilst the leading state will always be included in defining the point of equalisation the recipient states will not. Recipient states will not have an incentive to increase capacity so long as they remain recipient states. Any improvements in capacity will be traded off with GST revenue. Recipient state incentives are diminished given they have no 'skin in the game'. Increased capacity will take them closer to the point of equalisation rather than incrementally moving the point of equalisation up as they progress.

Equalising to the second leading state or to the average of the donor states is not sustainable under extreme circumstances and should be dismissed.

Equalising to the average of the states allows for the most flexibility in the system, maintains equity across all states, and maximises incentives for states' development.

Stability and predictability increases by equalising to the average

Predictability of GST revenues for all states will be much greater as forecasting the point of equalisation becomes easier [Figure 2]. The average of all states will not be moved significantly by large swings in capacity from donor or leading states, making forecasting more reliable for all states.

Stability of GST revenues will also increase as extreme circumstances have a diminished impact on the average of the states. This was a major concern raised by some states.

Equalising to the average will increase growth incentives as well as improving the durability, predictability, and stability of the GST distribution system. It is strongly recommended that the Productivity Commission's final report adopt equalising to the average as the recommended point of equalisation given the benefits this approach highlights.

STRUCTURAL CHANGE IN RELATIVITIES

The recent change in WA's capacity is structural. The major factor for WA's falling relativity is a significant change in iron ore royalties. Given the task of equalising to the leading state, this has caused major strain on the system that will not abate in the foreseeable future.

As per CCIWA's letter from Chief Economist Rick Newnham to Deputy Chair of the Productivity Commission Karen Chester on 24 October (attached), the increase in WA's iron ore production, and therefore royalties, will be sustained for several decades. The increase in capacity is structural. The key driver of WA's own revenue capacity volatility will come from iron ore price fluctuations [Figure 3]. This means WA's capacity will remain far beyond other states and the equalisation task will continue to be far beyond a sustainable level.

The structural change in WA's iron ore production and therefore the ongoing large equalisation task means the current strain on the system will also be sustained. The GST formula must be changed as a result – the system will not rebalance on its own.

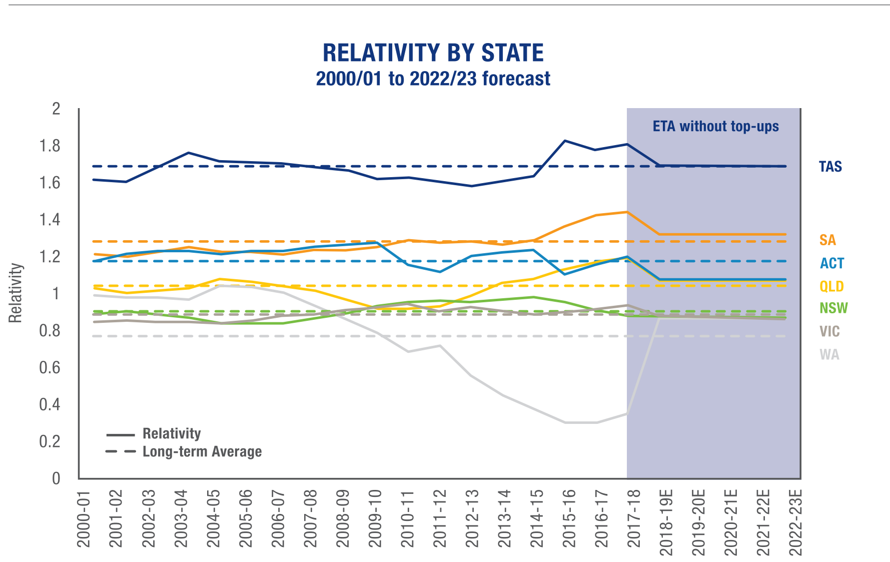


Figure 2 : ETA will return states to their long-term average relativity

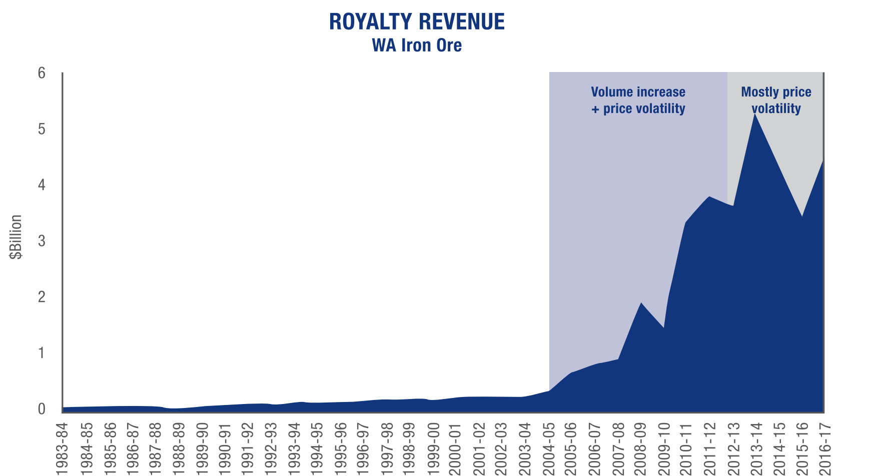


Figure 3: Sustained increase in WA's iron ore royalties puts permanent strain on the current system

TRANSITION ARRANGEMENTS

The objective for transition arrangements is to ensure that every state can continue to rely on the GST as a reliable revenue source whilst adopting the principle of equalising to the average as soon as practically possible.

There are four key factors in transition:

1. Implementation date;
2. Transition length;
3. Pace of adjustment; and
4. Compensation during transition.

Implementation date

Given the negative impact on the national economy through the inefficiency created by full equalisation it is recommended that reasonable equalisation, to the average, be implemented immediately.

It is expected that the Federal Treasurer will announce relativities for all states in March 2018.

When the Federal Government tables the Productivity Commission's report it should also announce the implementation of ETA. It should simultaneously direct the Commonwealth Grants Commission to implement ETA which would affect the relativities from the year 2019-20. This allows for the Federal Budget to reflect the transition top-up payments required for a three-year period from 2019-20.

Transition length

The transition period for implementation should be across the forward estimates. This ensures a 3-year implementation from 2019-20 for all states so they can adequately prepare for the full effect of the changes beyond the forward estimates whilst ensuring a swift implementation.

Pace of adjustment

It is possible to have an accelerating implementation (e.g. 25%, 50%, 75%, 100% between leading state equalisation and ETA implementation). This was considered and modelled by CCI but is not recommended. Should the Federal Budget for top-ups be limited then pacing could be considered as the next best option.

Compensation

The Federal Budget should 'top-up' state government budgets during an implementation phase. This submission focusses on determining a reasonable amount of compensation.

NO TRANSITION ARRANGEMENTS

If ETA were to be introduced from 2018-19 some states would be negatively impacted compared to their current forward estimates of GST revenue [Figure 4].

Given the immediate impacts that ETA implementation would have on state budgets it is recommended top-up payments be paid by the Federal Government to the states during transition.

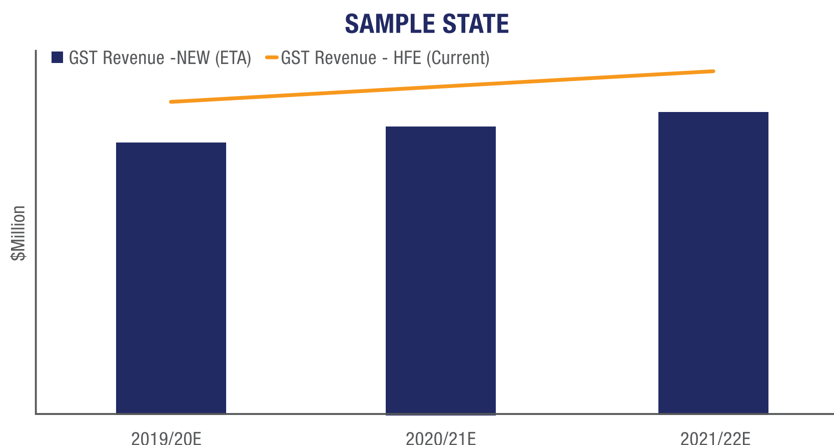


Figure 4: Shortfall of revenue in an example state from immediate implementation with no transition arrangements.

THE FEDERAL GOVERNMENT SHOULD USE ITS OWN BUDGET TO TOP-UP A PORTION OF THE EXPECTED SHORTFALL IN STATE GOVERNMENT REVENUE.

TOP-UPS

The Federal Government should use its own budget to top-up a portion of the expected shortfall in state government revenue over the forward estimates. This ensures no state has a major short-fall in revenue over the forward estimates period.

100% GST Revenue top-up

If the Federal Government were to top-up 100% of any losses the states may incur under ETA, compared to their current forward estimates, it would cost the Government $11.2 billion [Figures 5 & 6].

This would ensure every state government has absolute certainty in their expected future revenue during transition [Figure 7].

This is the ideal method of transition as it allows for the immediate implementation of a new GST formula that more strongly encourages national economic growth whilst giving absolute certainty to each state budget over the forward estimates. This method however will be quite costly for the Federal Government.

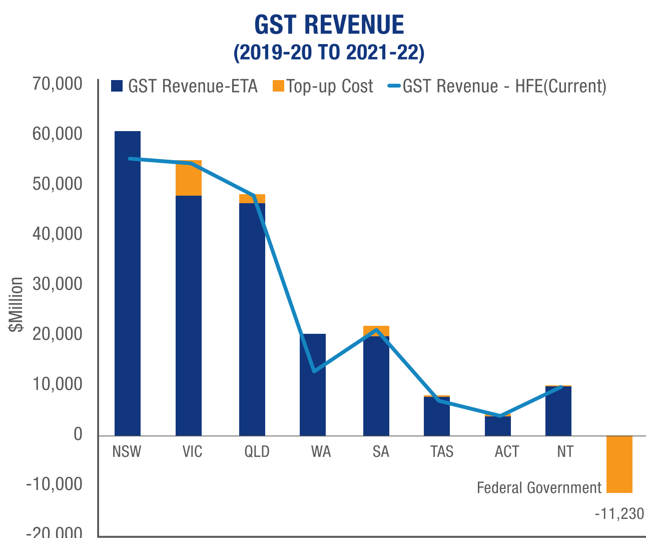


Figure 5: GST revenue by state with 100% top-up of all states

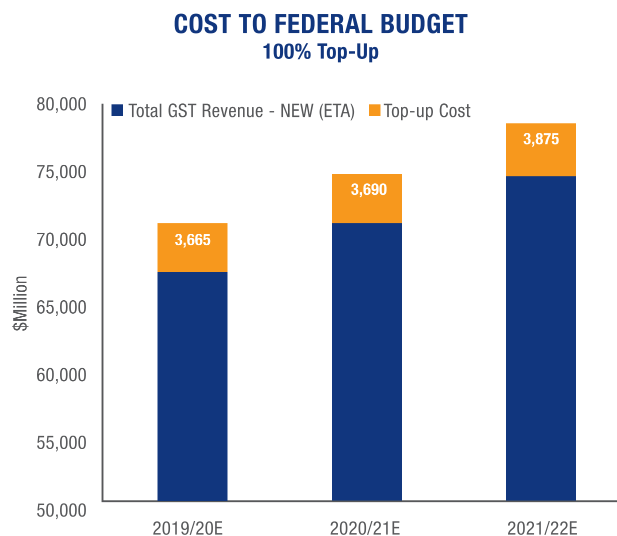


Figure 6: Cost to Federal Budget of 100% top-up

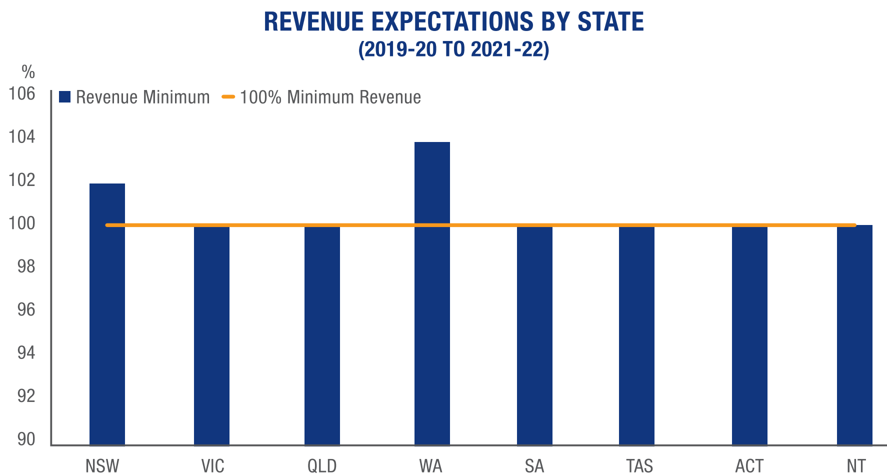


Figure 7: 100% minimum revenue top-up for all states

TOPPING-UP GST WITHIN THE FORECAST ERROR

It is recommended that the Federal Government top-up all state budgets across the forward estimates to within the historical average GST forecast error. This should be based on each state's 2017-18 budget forecast of GST for the years 2019/20 to 2021/22.

The average forecast error of state government forward estimates to actual GST revenue between 2009/10 and 2015/16 was +/-6% [Table 2].

State governments have become accustomed to managing a 6% variance in revenue expectations and therefore it is reasonable for the Federal Government to top-up revenues to within the 6% band of forecast error.

The recommended top-up level is 95% of forecast expected revenue which is within the 6% forecast error band.

The Federal Government can top-up every state government's forward estimates of GST revenue to a minimum of 95% for $5.07 billion [Figures 8 & 9]. This equates to each state receiving at least 98.35% of their total revenue over the forward estimates. Every state, except one, will receive >99% of their expected revenue.

With a 95% top-up, no state will be worse off by implementing equalising to the average over the forward estimates, given the normal variance in GST forecast to actual revenues seen historically.

RECOMMENDATION 2:

The Federal Government should allocate $5.07 billion over 3 years to top-up payments. With these top-up payments, no state will be worse off over the forward estimates compared to the usual forecast error for states.

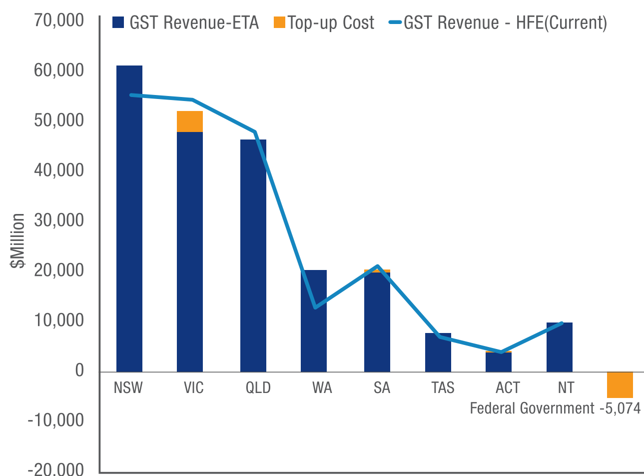


Figure 8: 95% GST Revenue Top-up by State

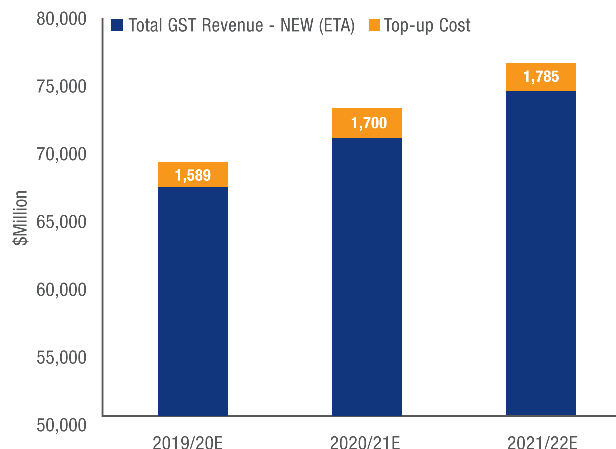


Figure 9: 95% top-up cost to Federal Budget.

Table 1 displays how much revenue each state should expect to receive, compared to their current forward estimates, with a 95% GST revenue top-up.

TOTAL REVENUE EXPECTATIONS WITH 95% GST TOP-UP	
NSW	102%
VIC	>99%
QLD	>99%
WA	104%
SA	>98%
TAS	>99%
ACT	>99%
NT	100%

Table 1: 95% GST revenue top-up for each state.

OTHER TOP-UP AMOUNTS

The Federal Government can choose to top-up each state government's budget to a minimum percentage of each state's forward estimates of GST revenue. For example, ensuring no state's GST revenue falls below 90% of their current forward estimates would cost the Federal Government $1.4 billion [Figure 10].

STATE COMPARISON - ROOT MEAN SQUARE ERROR (RMSE)							
Forecast Horizon	**NSW**	**VIC**	**QLD**	**WA**	**SA**	**TAS**	**Average**
1 YR BEHIND	2.5%	0.7%	0.5%	0.5%			1.1%
SAME YEAR	4.2%	3.8%	3.9%	4.8%	3.5%		4.1%
1 YR AHEAD	6.2%	2.7%		15.3%	5.7%	7.2%	7.4%
2 YR AHEAD	6.9%	3.0%		28.3%	5.9%	8.5%	10.6%
3 YR AHEAD	5.7%			19.1%	6.5%	7.8%	9.8%
Average RMSE (across all forecast horizons)	**5%**	**3%**	**2%**	**14%**	**5%**	**8%**	**6.1%**

Table 2: Variation in actual and forecast GST revenue.

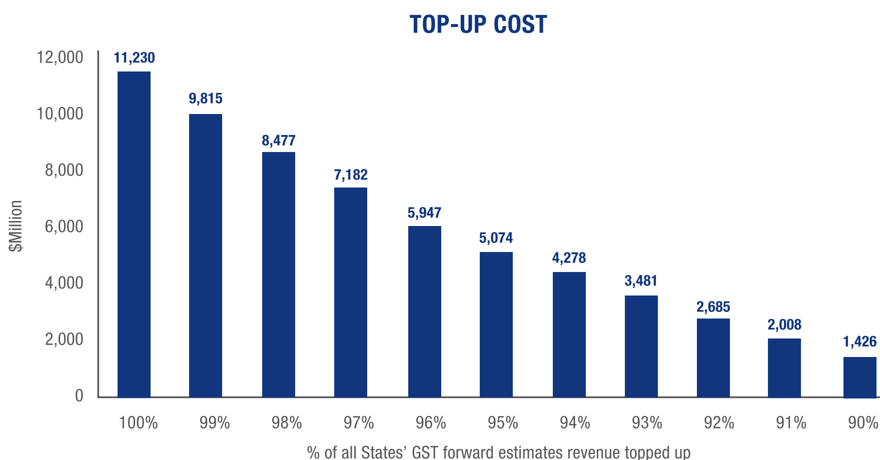


Figure 10: Cost to Federal Budget of Top-up minimum when transitioning to ETA

ABN 96 929 977 985
T: (08) 9365 7555
E: info@cciwa.com
W: www.cciwa.com

24 October 2017

Deputy Chair
Productivity Commission
Level 12, 530 Collins Street
MELBOURNE VIC 3000

HFE INQUIRY: STRUCTURAL INCREASE IN WESTERN AUSTRALIA'S IRON ORE PRODUCTION

Dear Commissioner

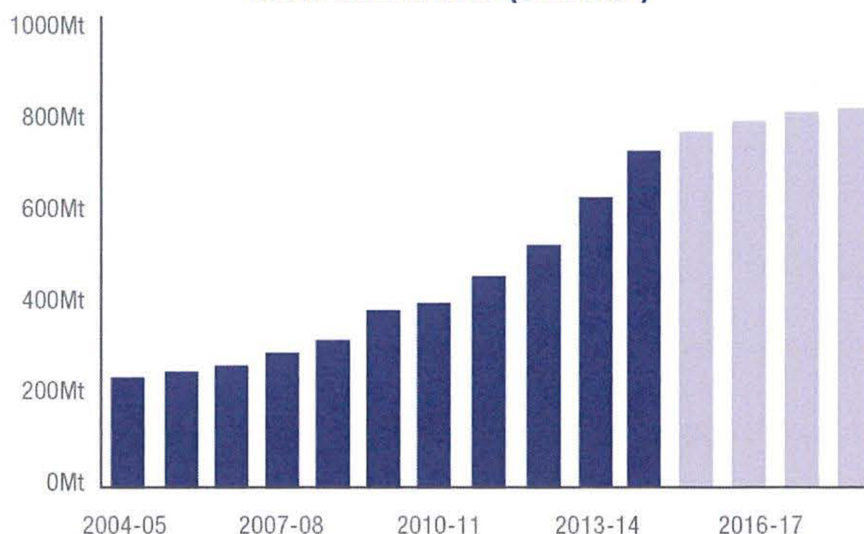
Western Australia is setting a new normal for its royalties income given a structural increase in iron ore production.

As the world's largest iron ore producer and exporter, WA accounted for 38 per cent of global production and over half of world exports in 2016. Rising at an annual average rate of 12 per cent since 2005-06, WA's iron ore sales have grown by 514 million tonnes in the ten years to 2016.

This growth is expected to continue in the future as mine construction and expansions are completed and our economy shifts from the investment to the production phase of the resources boom, but the rate of increase is forecast to be slower than the past ten years.

While the resources sector's contribution to the greater Australian economy has retreated from its peak in 2011, WA's iron ore sales are set to continue making their mark and are forecast to increase to 830 million tonnes by 2019-20.

The unprecedented boom in commodity prices and WA iron ore exports from the mid-2000s to late-2011 resulted in WA's iron ore production value reaching a new high and a new plateau, one that is significantly higher than its pre-boom average.

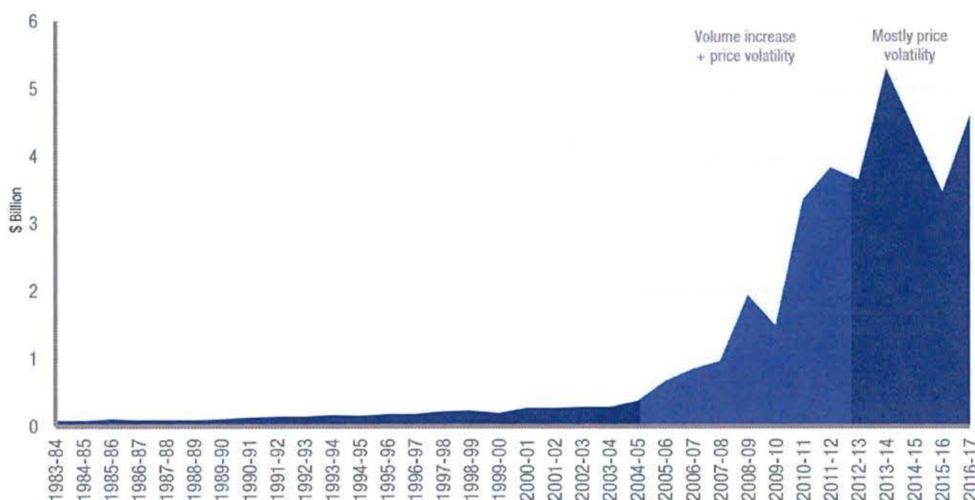


Note – Forecasts start in 2015-16
Source: WA Department of Mines and Petroleum, Resource Data Files; and WA 2015-16 Mid-year Financial Projections Statement.

Even as iron ore prices decline, the value of iron ore exports should hold above the levels prior to the mining boom thanks to rising production which is expected to peak in late 2019.

The value of Western Australia's iron ore sales rose 11 per cent to $55.1 billion in 2016, compared with annual average growth of 14 per cent over the past ten years.

WA received over $4.6 billion in iron ore royalties revenue over 2016/17, accounting for over 80% of WA's royalty revenue.



Source: Department of Mines, Industry Regulation and Safety

WA's iron ore production has reach a steady plateau. With an estimated 63 billion tonnes of iron ore reserves, WA could sustain its current production for another 76 years.

WA's iron ore giants – Rio Tinto, BHP Billiton, and Fortescue Metal Groups – are showing no signs of slowing down either. The trio produced over 760 million tonnes of iron ore in the last year.

Led by Rio Tinto, the nation's top three exporters plan to add about 170 million tonnes of new capacity, and are studying investments in infrastructure and equipment to boost export capacity to their long-term targeted rates. Fortescue expects to spend almost US$1.5 billion on a replacement for its outgoing Firetail operation.

In recent years, Rio Tinto has invested over US$14 billion in Pilbara mines and infrastructure growth, increasing production by more than 50 per cent and expanding port operations to 360 million tonne capacity.

Rio Tinto's US$338 million Silvergrass iron ore mine officially opened last month and is on track to deliver its first production of 21 million tonnes per annum (Mt/a). Last year Rio fully commissioned the Nammuldi Incremental Tonnes project which provides 10 million tonnes of high-grade, low phosphorus ore annually.

Mines like West Angelas Deposit F and Yandi Oxbow, which are presently in development, will provide high quality, low cost options to sustain existing production levels by contributing over 90 million tonnes per annum. Feasibility studies undertaken for Koodaideri, Rio's potential $2.2 billion major greenfield replacement mine, predict 40 million tonnes per annum of iron ore available from 2021.

Rio Tinto has also completed expansions at Cape Lambert and Dampier, increasing the capacity of these ports to 360 million tonnes. By 2018 capacity at Port Hedland – the world's largest bulk export port – could reach 495 million tonnes.

180 Hay Street, East Perth
Western Australia 6004
PO Box 6209, East Perth
Western Australia 6892

Chamber of Commerce and Industry
of Western Australia (Inc)
ARBN 099 891 611
Incorporated in Western Australia

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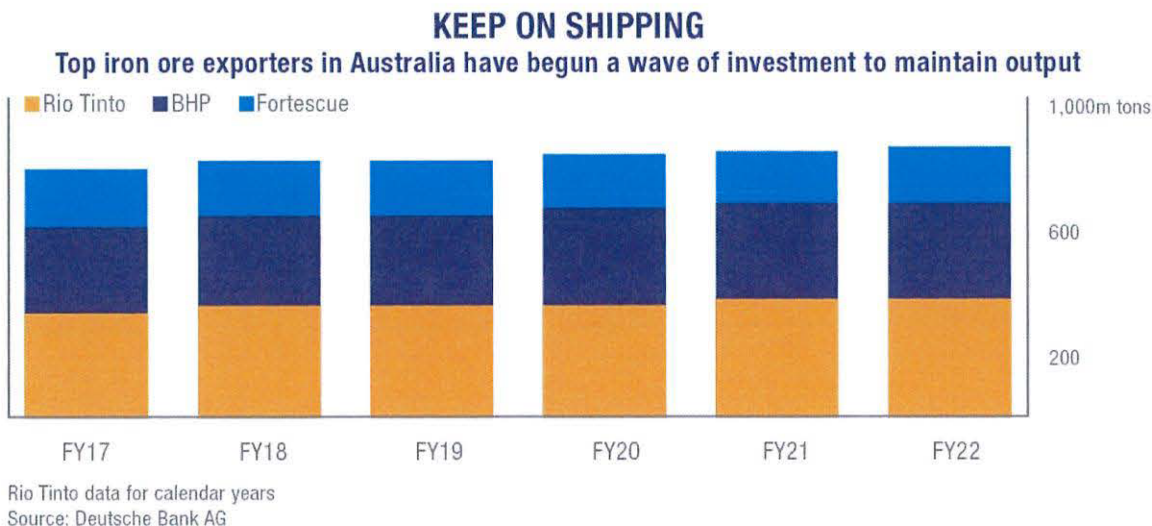
BHP's Jimblebar mine saw record iron ore volumes of 136 million tonnes in the first half of 2017 with their total production topping at 231 million tonnes last year.

Looking to the future, BHP forecasts its iron ore production at 239-243 million tonnes for the 2018 financial year. Continued productivity increases and improved reliability across the supply chain means that BHP will be able to support 290 million tonnes per annum capacity by the end of 2019 financial year.

Fortescue have achieved a 20 per cent improvement in productivity since 2012 by deploying new technology at their mine sites. Earlier this year, they announced the expansion of this technology across all their mines in the Solomon Hub to further improve productivity.



Rio Tinto data for calendar years
Source: Deutsche Bank AG

Deutsche Bank predicts consistent capital investment from Australian iron ore exporters over the next five years to keep up with production. Considerable improvements in macroeconomic conditions across advanced economies should see iron ore demand grow, driven by demand for manufactured goods and increasing replacement requirements.

Over the past decade, WA iron ore producers have invested tens of billions of dollars in new mines and associated infrastructure in response to growth in Chinese steel production. Forecasts of a slowdown in China's steel industry are proving to be misplaced with iron ore producers predicting continued consistent demand from China, as well as further supply from low-cost producers and new entrants in the market.

Western Australia's iron ore industry remains globally competitive with high quality reserves, low cost production and established, long-term markets in China, Japan, Korea and Taiwan.

Given the information provided it should be clear that WA's iron ore royalties will be sustained at their current level. In future, the volatility in WA royalty income will be largely from price changes rather than from production volume changes.

I trust you find this useful.

If you have any further questions please contact me on [redacted].

Kind regards,

Rick Newnham
Chief Economist

180 Hay Street, East Perth
Western Australia 6004
PO Box 6209, East Perth
Western Australia 6892

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of Western Australia (Inc)
ARBN 099 891 611
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