Issues in Public Sector Finances

The redistribution of the fiscal benefits of Western Australia's resources boom within the Australian federation

Overview

The recent and continuing domination of Australia's economic performance by the resource-rich States of Western Australia and Queensland - the so-called two-speed economy - is highlighting the powerful redistributive forces in the Australian federation.

Following a period of sustained growth in its tax and royalty revenue bases on the back of the resources boom, Western Australia's share of GST grants is projected to continue to fall substantially in the period to 2010-11, with a corresponding impact on the State's budget surpluses.

At the same time, Western Australia's net contribution to the Commonwealth budget is rising. In 2005-06, it is estimated that the Commonwealth took $5 billion more out of Western Australia through its own taxes than it put back into the State through grants and other spending. This is up by $1 billion on the previous year, primarily due to increased company taxes from Western Australia.

While it is fair that Western Australia's wealth is shared with other States, the Commonwealth Government, as a major beneficiary of Western Australia's growth, has a responsibility to better support Western Australia's burgeoning service and infrastructure needs, including to help sustain growth and prosperity nationally.

Reforms are also needed to ensure that incentives for State governments to develop their economies are not excessively eroded through the redistribution of the benefits.

Western Australia's Declining Share of GST Grants

The Commonwealth Grants Commission determines States' GST grant shares annually, applying the principle of 'fiscal equalisation' and the latest available data. A State whose revenue bases have grown faster than other States, or whose relative costs of providing a 'standard' level of services have declined, will have its grant share reduced.

However, as grant shares are based on a rolling average of States' circumstances for five consecutive years of historical data, there is a significant time lag between (say) an increase in a State's relative fiscal strength, and the resulting decline in its GST grant share.

The Grants Commission's latest (February 2007) report resulted in a $272 million cut in Western Australia's share of the GST pool in 2006-07 terms, which becomes $291 million in 2007-08. Most of this is due to Western Australia's revenue raising capacity (which is essentially independent of its own tax rates) growing faster than that of the other States between 2000-01 and 2005-06.

Table 9 shows the impact of the Grants Commission's recommendations for all States in 2006-07 terms, both for the latest year and over a longer period. Notably, the latest result for Western Australia is part of a longer term trend that has seen Western Australia's grant share decline by far more, in per capita terms, than any other State's, reflecting Western Australia's strong economic and revenue base growth.

Table 9

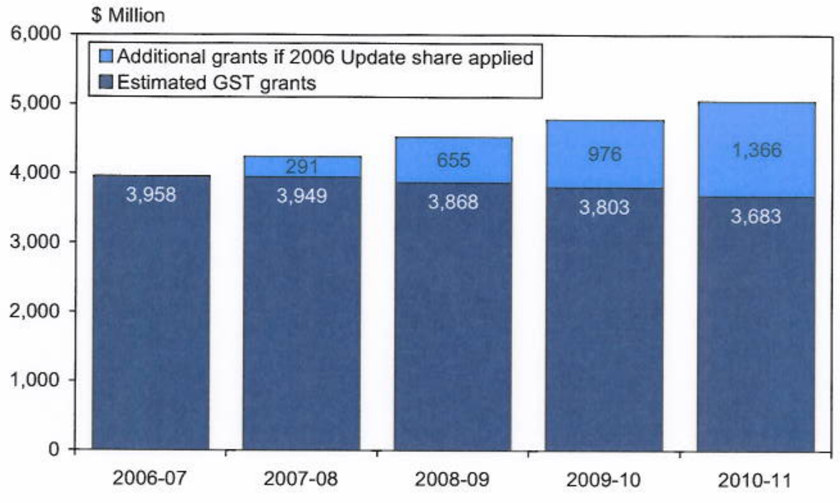
IMPACT OF GRANTS COMMISSION RECOMMENDATIONS
(2006-07 Terms)

	2007 Update		1994 – 2007	
	$m	$ per capita	$m	$ per capita
New South Wales	+277	+40	-132	-19
Victoria	+64	+13	+408	+79
Queensland	-166	-41	-377	-92
Western Australia	**-272**	**-132**	**-757**	**-365**
South Australia	+69	+45	+237	+152
Tasmania	-5	-10	+211	+430
Australian Capital Territory	+13	+40	+196	+592
Northern Territory	+20	+94	+214	+1,029

As the current strength of Western Australia's revenue raising capacity becomes fully reflected in the five data years used by the Grants Commission, Western Australia's GST grant share is forecast to drop from 10.1% in 2006-07 (about the same as its share of the national population), to only 7.5% by 2010-11, equivalent to a loss of $1.4 billion in grant share in 2010-11 (see Figure 13).

Figure 13

FORECAST GST GRANTS AND GRANTS COMMISSION CUTS



Source: Department of Treasury and Finance estimates.

Flaws in the Grants Commission Process

While the Grants Commission comprehensively 'equalises' differences in States' revenue capacities, its current methods significantly understate Western Australia's service provision costs, including in the following areas:

- the Grants Commission does not recognise costs of State initiatives specifically aimed at promoting economic development (such as multi-user infrastructure and geological mapping programs);
- while the Grants Commission recognises depreciation costs, it does not recognise any of the interest costs of financing the infrastructure investment needed to cater for the State's rapid population and economic growth;
- the Grants Commission does not give States the capacity to provide uniform quality services across the State. Rather, it recognises only the extra costs of providing services in remote areas at the standard that these services are currently provided (based on national averages);
  - if Western Australia wishes to improve services in remote areas to facilitate economic development or respond to community demands for better services, it must levy higher taxes to do so;
- the Grants Commission is significantly under-recognising wage levels in Western Australia's economy, due to a combination of out-of-date data and method deficiencies; and
- the Grants Commission has not fully recognised costs in remote areas, due to distance from the capital city, higher demands on public health services from a lack of general practitioners, and the cost of subsidies to ensure affordable electricity services.

In addition, the Grants Commission has not fully recognised that some of the revenue derived from Western Australia's stamp duty provisions reflects its stronger policy on anti-avoidance rather than just stronger property market activity.

Ross Garnaut and Vince FitzGerald highlighted the adverse impact of the Grants Commission's processes on economic efficiency in their 2002 *Review of Commonwealth-State Funding Final Report* when they observed the following:

> "The [Grants Commission's] approach distributes the revenue benefits from economic development around the nation, without similarly sharing many of the costs of economic development borne by State governments. … Equalising away the fiscal effects of a State's good or poor economic performance dulls incentives for growth promoting policies." (page 2)

The Grants Commission has commenced a review of its current methods that will report in February 2010. However, issues surrounding the incentive effects of equalisation are likely to be particularly difficult to address without abandoning the current system altogether and fashioning an alternative system of assisting the financially weaker States.

Redistribution of Resources across States by the Commonwealth Budget

The distribution of GST revenue grants among the States by the Grants Commission according to 'equalisation', rather than 'State of origin' principles, is only one way in which Australia's federal system shifts resources from the richer States to the poorer States. The Commonwealth budget actually does much more.

The booming Western Australian resources sector has delivered windfall company and offshore petroleum tax revenue to the Commonwealth, helping to fund Commonwealth services and benefit payments (e.g. unemployment benefits) in other States, and income tax cuts for all Australians.

Commonwealth revenue from sources such as company tax, income tax and petroleum resource rent tax far exceeds the States' taxes (the Commonwealth collects about 80% of taxes nationally), and is used to finance expenditure (including welfare payments and Commonwealth services, as well as grants to the States) without regard to where the revenue was raised.

States with higher incomes and business profits contribute more to total Commonwealth taxes, while those with younger, healthier populations draw less on social security and health benefits. The net redistribution of resources from each State arising from all Commonwealth fiscal transactions is its 'net fiscal subsidy' to the federation.

The Department of Treasury and Finance performs an annual estimation of States' net fiscal subsidies, details of which are set out in Appendix 12: *Calculating States' Net Fiscal Subsidies*. Results using the latest available data (for 2005-06) are shown in Table 10, together with the 'GST-only' subsidies for comparison purposes.

Table 10

REDISTRIBUTION OF RESOURCES

2005-06(a)

	GST only (b)		Total Resources	
	$m	$ per capita	$m	$ per capita
New South Wales	2,494	367	5,386	792
Victoria	1,549	306	518	102
Queensland	-861	-215	-2,264	-565
Western Australia	**-301**	**-148**	**4,965**	**2,445**
South Australia	-759	-490	-3,800	-2,454
Tasmania	-683	-1,401	-2,378	-4,879
Northern Territory	-1,439	-7,025	-2,428	-11,854
Total	-	-	-	-

(a) Estimates calculated by allocating all Commonwealth outlays and revenues relating to the ACT among the other States according to population shares. This approach reflects that, if the federation were to cease to exist, it is unlikely that the Australian Capital Territory would continue to exist as a separate entity.

(b) Difference between GST revenues raised from economic activity in each State and GST grants paid to the State.

Source: Department of Treasury and Finance estimates, using a range of data sources including the Commonwealth *Final Budget Outcome* publications and Australian Bureau of Statistics Nos. 3101.0 and 5220.0. Results are based on the latest available data. In some cases, data has been proxied by escalating earlier data using relevant economic indicators.

In 2005-06, it is estimated that the Commonwealth derived $30 billion from Western Australia, while expenditure for the benefit of the State (including future benefits from the Commonwealth surplus) totalled only $25 billion, a difference of $5 billion. In per capita terms, Western Australia's contribution was substantially larger than the other two net contributors (New South Wales and Victoria).

This result was despite Western Australia receiving more GST revenue grants than it contributed to the pool in that year (which should no longer be the case by 2007-08).

Table 11 provides an estimated breakdown of the components of Western Australia's net contribution over the last three years. This is based on the extent to which Western Australia's share of each area of revenue and spending exceeds or falls short of its population share, and highlights the rapid growth in company and petroleum taxes from Western Australia.

Table 11

COMPONENTS OF WESTERN AUSTRALIA'S NET CONTRIBUTION TO THE COMMONWEALTH

Relative to Western Australia's Population Share

	2003-04	2004-05	2005-06
	$m	$m	$m
Personal Income Tax	146	567	538
GST collections	-239	-191	-181
Company Tax	**940**	**1,067**	**1,893**
Fuel Excise (net of rebates)	473	365	362
Taxes and Royalties on Petroleum Extraction [(a)]	**725**	**1,155**	**1,290**
Commonwealth Services [(b)]	674	865	985
Personal Benefit Payments	544	580	645
Grants to State and Local Governments [(c)]	173	-114	-191
Other	-181	-321	-376
Total	**3,255**	**3,973**	**4,965**

(a) Net of the share of North West Shelf royalties passed on to Western Australia by the Commonwealth.
(b) Departmental expenditures, including defence.
(c) Includes GST revenue grants. Excludes North West Shelf royalties paid as grants to Western Australia.

Source: Department of Treasury and Finance estimates, using a range of data sources including the Commonwealth *Final Budget Outcome* publications and ABS Catalogue Nos. 3101.0 and 5220.0. Results are based on the latest available data. In some cases, data has been proxied by escalating earlier data using relevant economic indicators.

Again, it is only fair that Western Australia should help the rest of the nation, particularly as it was a net financial beneficiary of the federation in earlier years. However, there is evidence that Western Australia's subsidy is too large, as a consequence of inadequate Commonwealth support for its economic and social development needs:

- the Commonwealth's own spending (excluding grants to governments) on infrastructure in Western Australia is consistently lower than in other States (e.g. $340 per capita in 2005-06, compared with $480 per capita in other States);

- as noted above, Western Australia's share of GST grants is not fully reflective of its needs;

- Western Australia's share of the Auslink National Network Program of grant funding (which is primarily funding for road projects) is only 10.7%, which is much less than the State's 22% share of roads included in the Auslink National Network, and 34% contribution to national merchandise exports;
- below-average levels of Commonwealth service provision in rural and regional areas of Western Australia hinder economic development, by making it more difficult for resource developers and supporting businesses to attract and retain skilled staff:
  - particular areas of concern are telecommunications and funding for local governments (exacerbated by the requirement to pay even wealthy local governments a share of available grants, and the lack of real per capita growth in the grant pool); and
  - furthermore, the Commonwealth's income tax zone rebates have declined dramatically in real value;
- Western Australia has 25% of the nation's remote area indigenous population, but Commonwealth assistance falls well short of what could be considered a reasonable contribution towards delivering significant improvements in standards of living;
- the Commonwealth's Medicare and Pharmaceutical Benefit Schemes are of little benefit to many remote communities due to the lack of general practitioners in these areas. While national average Medicare and Pharmaceutical Benefits were $827 per person in 2005-06, they are often less than $100 per person in many rural and remote communities;
- Western Australia's share of a number of the Commonwealth's discretionary programs has been very low (e.g. food innovation, sports infrastructure); and
- the current Commonwealth Government has refused to agree to share revenue with Western Australia from any of the prospective new offshore petroleum projects (e.g. Gorgon), or to assist with the State's infrastructure growth needs.

Western Australia's remoteness from Canberra almost certainly counts against its particular needs being fully recognised. To the extent that Western Australia is a young economy with untapped potential, improved Commonwealth support and investment in the State is likely to yield a relatively high return for the national economy.