Department of Treasury and Finance
Government of Western Australia

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Mr J R Quigley MLA
Chairman
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Dear Mr Quigley

INQUIRY INTO FUNDING ARRANGEMENTS FOR WESTERN AUSTRALIAN INFRASTRUCTURE PROJECTS

Thank you for your letter of 8 March 2007 inviting me to provide a submission relating to the above inquiry.

Please find attached a submission prepared by the Department of Treasury and Finance.

Yours sincerely

Timothy Marney
UNDER TREASURER

21 May 2007

Enc.

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DEPARTMENT OF TREASURY AND FINANCE SUBMISSION ON FUNDING ARRANGEMENTS FOR WESTERN AUSTRALIAN INFRASTRUCTURE PROJECTS

The Department of Treasury and Finance (DTF) considers that there is a case for greater Commonwealth support for economic and social infrastructure in Western Australia.

Much of the revenue growth for governments that is being generated by Western Australia's economic boom is actually benefiting other States rather than being available to fund infrastructure in Western Australia. This reflects the Commonwealth's dominance of taxation in Australia and the fact that the benefits from its expenditure programs (including grants to the States) are not allocated according to where its revenues are derived. Indeed, the Grants Commission process for allocating GST grants effectively redistributes a large proportion of Western Australia's own revenue growth to other States.

Reflecting this general environment, this submission will detail six rationales for greater Commonwealth infrastructure assistance, which in brief are:

- the Grants Commission process has reduced the State's capacity to fund its own infrastructure, as it is equalising away much of the revenues to the State from the current economic boom, while not adequately recognising the costs faced by the State to provide services and infrastructure for its growing economy;

- Commonwealth investment in Western Australia is likely to achieve good returns for the nation – Western Australia is already providing a net $5 billion annual contribution to the Commonwealth budget;

- to avoid skewing investment decisions away from projects that mainly benefit the rest of the nation financially, the Commonwealth needs to contribute a commensurate share of the project costs;

- there is evidence that Commonwealth support for Western Australia is low, compared with what it is doing in other States and also in terms of its performance in its own areas of responsibility (e.g. telecommunications, indigenous community development and income tax provisions);

- Commonwealth equity or debt guarantees could help Western Australia finance public infrastructure that would otherwise threaten the State's credit rating; and

- Commonwealth industry assistance could more effectively be provided through infrastructure grants (that can benefit a range of businesses) rather than firm-specific assistance.

The case for greater Commonwealth assistance, and ways of achieving better Commonwealth funding outcomes, have largely been set out in the Green Paper *Framework for the State Infrastructure Strategy* (pages 55 - 62) and in the *Discussion Paper on Commonwealth-State Relations*. Copies of these documents have been forwarded to the Inquiry.

However, it is proving difficult to engage the Commonwealth on the principle that it should provide more infrastructure support for Western Australia. In this regard, after proposing the establishment of a National Export Infrastructure Fund in January 2007, the Treasurer wrote to the Federal Treasurer, inviting him to come to Western Australia and witness Western Australia's growth challenges first hand.

In response, Mr Costello indicated that:

- he had met major resource companies on many occasions;
- the Commonwealth has provided significant funding for roads and other projects;
- the Commonwealth Government "will not ... take over the Western Australia State Government responsibility for infrastructure"; and
- Western Australia was well placed to meet its expenditure responsibilities.

The following sets out in detail the case for more Commonwealth funding support, and mechanisms to achieve this objective. A number of projects are specifically referred to as highlighting the difficulties faced by Western Australia.

A. Why the Commonwealth Should Provide More Funding Support

1. *The Grants Commission process has reduced the State's capacity to fund its own infrastructure*

To some extent, the State's recent run of large budget surpluses has obscured the need for greater Commonwealth funding support, and indeed made it more difficult to argue the case with the Commonwealth. However, the delayed effects of the Commonwealth Grants Commission process for determining States' GST shares will see most of the benefits from Western Australia's strong revenue growth redistributed to the other States.

- The Grants Commission's principle of horizontal fiscal equalisation (HFE) means that States (such as Western Australia) with above average growth in capacity to raise their own revenues will have their GST grants reduced (with a corresponding increase in grants for other States), ensuring that growth in revenue raising capacity is equally distributed across all States.

- This process occurs with a significant time lag, as the Grants Commission uses a five year average of data on States' fiscal circumstances, and there is a two year gap between the most recent data and the current year. For example, GST grant shares for 2007-08 will be based on the data period 2001-02 to 2005-06.

- The time lag in picking up the strong growth in Western Australia's revenue capacity relative to other States does not carry any long term financial benefit for the State, as the delayed cuts in GST grant shares are offset by the fact that the cuts are applied to a growing GST pool.

- The Grants Commission has cut Western Australia's 2007-08 GST grant share by $291 million, and this is forecast to increase rapidly. By 2010-11, Western Australia's GST grant share is forecast to be $1.4 billion less than if the 2006-07 per capita grant shares had been maintained.

The Grants Commission's HFE principle and methods recognise expenditure needs as well as revenue capacity. Indeed, Western Australia receives around $900 million in extra annual GST funding on account of its above average costs of providing services, although from 2007-08 this will be more than offset by a reduction in GST funding on account of the State's above average capacity to raise revenues. However, DTF considers that the Grants Commission's methods significantly understate Western Australia's service provision costs. In particular:

- while the Grants Commission recognises depreciation costs, it does not recognise any of the costs of financing infrastructure growth to cater for the State's rapid population and economic growth. These costs are much higher in high growth States than low growth States;

- the Grants Commission does not recognise the cost of State initiatives that are specifically aimed at promoting economic development (such as multi-user infrastructure or geological mapping programs);

- the Grants Commission process does not give States the capacity to provide uniform quality services across the State. Rather, it only recognises 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, it must levy higher taxes to do so;

- the Grants Commission is significantly under-recognising wage pressures in Western Australia from the current economic boom, due to a combination of out-of-date data and method deficiencies;

- the Grants Commission has discounted the higher demands on public health services in Western Australia due to the lack of GPs in remote areas;

- the Grants Commission has not fully recognised the subsidies provided by Western Australia to rural and remote communities to ensure affordable electricity services; and
- the Grants Commission's allowances for costs in remote areas significantly understate cost pressures in these areas (e.g. distance from small regional centres is given more weight than distance from major cities).

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 anti-avoidance provisions rather than just stronger property market activity. As a result, Western Australia's GST share has been cut too much.

The Grants Commission is reviewing its methods, and is due to report its findings in 2010. Throughout the review, DTF (with assistance from State agencies) will provide written submissions to the Grants Commission, and participate in meetings chaired by the Grants Commission, aimed at addressing the above shortcomings. Western Australia's needs will also be highlighted to the Grants Commission when it visits the State in 2008.

However, while the Grants Commission is recognised as an impartial umpire, the issues are complex and subject to often-conflicting submissions from eight States and Territories. In addition, the Grants Commission is now required to simplify its processes, which may limit its capacity to address some of the issues. Accordingly, it is unclear whether Western Australia's GST share will improve after 2010, and there is significant risk that it will decline.

In summary, the Commonwealth needs to provide assistance to Western Australia to recognise the capacity constraints on Western Australia imposed by the Grants Commission process.

2. *Investment in Western Australia is good for the nation*

Western Australia is a young, booming economy with considerable untapped potential. Investment in the State is likely to yield a relatively high return for the national economy.

The latest available data, as analysed by DTF, shows that Western Australia is already contributing a net $5 billion to the Commonwealth budget in 2005-06, up from $4 billion in 2004-05. Further increases are expected in later years.

In 2005-06, the Commonwealth derived $30 billion in taxes and other revenues from Western Australia, while expenditure for the benefit of the State totalled only $25 billion, a difference of $5 billion. In per capita terms, Western Australia's net contribution to the Commonwealth budget far exceeds that of the other two contributors (New South Wales and Victoria), as shown in the following table.

REDISTRIBUTION ACROSS STATES THROUGH THE COMMONWEALTH BUDGET

2005-06

	$m	$ per capita
New South Wales	5,386	792
Victoria	518	102
Queensland	-2,264	-565
Western Australia	**4,965**	**2,445**
South Australia	-3,800	-2,454
Tasmania	-2,378	-4,879
Northern Territory	-2,428	-11,854
Total	0	0

Note: 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.

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.

In effect, the taxes raised from the booming Western Australian economy are helping to fund Commonwealth services and benefits in other States and income tax cuts for all Australians.

More details of this analysis are provided in the 2007-08 State Budget Paper No. 3, Economic and Fiscal Outlook, Chapter 2 (under the section heading *Issues in Public Sector Finances – The redistribution of the fiscal benefits of Western Australia's resources boom within the Australian federation*).

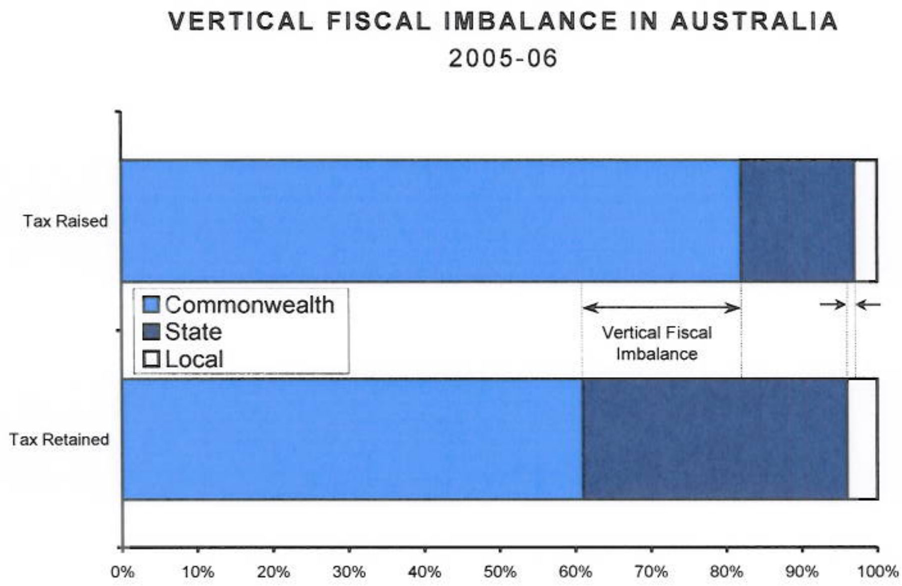
Increased Commonwealth investment in Western Australia, to help ensure that appropriate economic and social infrastructure is in place to facilitate ongoing development, would help sustain and increase Western Australia's net contribution to the Commonwealth budget (and hence the rest of Australia) in future years.

3. *Incentives*

A feature of the Australian federation is the Commonwealth's dominance of tax raising, far in excess of its own spending requirements, and the consequent need to pass a significant proportion of these taxes to other governments to help them fund their expenditure responsibilities.

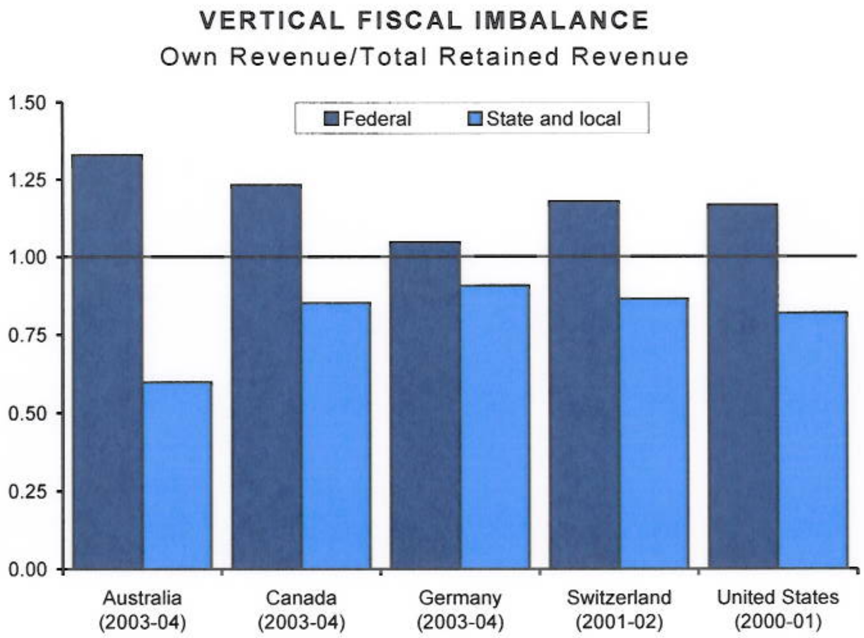
For example, as shown in the following chart, in 2005-06 the Commonwealth raised 82% of taxes and State governments only 15% of taxes (the remaining 3% were raised by local governments). After accounting for intergovernmental transfers, the Commonwealth retained 61% of taxes for its own use, the States 35% and local government 4%.

These imbalances between taxing and spending across levels of government are known as vertical fiscal imbalance (VFI).



Source: Australian Bureau of Statistics No. 5506.0 and Commonwealth Final Budget Outcome.

VFI in the Australian federation is much higher than in other comparable federations, as shown in the following chart.



Source: International Monetary Fund, Government Finance Statistics Yearbook, 2005

The Commonwealth's dominance of taxation and the resulting VFI reduces incentives for States to promote economic development, as the Commonwealth receives the bulk of the gains to the public purse, which are then allocated nationally. Only some of the gains are passed back to States through grants, and the grants are not directed back to the States that generated the gains. Instead, the grants are distributed on the basis of other (e.g. equity) objectives. The impact of all this for Western Australia can be seen from the $5 billion growth in the State's annual net contribution to the Commonwealth budget over the last twenty years.

- This is shown in Figure 10 of DTF's Discussion Paper on Commonwealth-State Relations (with the addition of figures for 2004-05 and 2005-06 in the recent State budget papers). The 2005-06 net contribution of $5 billion has already been referred to above.

In the case of the GST, a State that grows its economy and strengthens its revenue bases relative to other States is likely to see its grants actually reduced. As observed by Ross Garnaut and Vince FitzGerald in their 2002 *Review of Commonwealth-State Funding Final Report* (page 2):

> "The CGC 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."

This efficiency problem stems from two basic issues with the CGC process.

- The Grants Commission's revenue assessments reflect actual economic performance,[1] but it only recognises costs of providing an average standard of services, and does not consider the effectiveness of State policies. For example, if a State improves economic activity in remote areas by providing an above average level or quality of services, or implementing better policies for regulating or promoting economic activity, the additional revenue flowing from increased economic activity will reduce the State's GST grant share. No allowance is made for the costs of improving services or for the improved policy environment.

- Not all the costs faced by States are recognised by the CGC, even at an average level. Instances of this in Western Australia have been noted above, including the lack of recognition of infrastructure growth financing costs, and costs of promoting economic development.

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[1] The Grants Commission aims to apply an average revenue raising effort to the States' actual revenue bases (although it aims for a consistent definition of revenue bases across States).

Examples of Western Australia's poor returns from resource developments are as follows.

- The Gorgon gas project is forecast to improve national GDP by \$21-31 billion, and the Commonwealth's budget balance by \$11-14 billion. However, after accounting for the cost of servicing the increased population resulting from the Gorgon development, and the redistribution of net revenue benefits by the Grants Commission, Western Australia's forecast net fiscal benefit is only \$300 million. Other States will receive a net fiscal benefit of around \$3 billion. (All figures are in net present value terms.)
- The Commonwealth's net revenues from the Ravensthorpe nickel project are estimated to be almost seven times larger than those of the Western Australian Government. However, the State Government is contributing \$30 million to this project (including in the form of power and water infrastructure, road works and school upgrades), compared to the Commonwealth Government's contribution of around \$11 million.

The disproportionate returns to the Commonwealth and the rest of the nation from Western Australian public investments are likely to result in skewed decision making, with higher priority given to investments where more of the benefit is captured by the Western Australian community.

To prevent such distortions, there needs to be a commensurate sharing between the Commonwealth and Western Australia of the costs of infrastructure projects where a substantial proportion of the benefits accrue to the rest of the nation.

This issue has been recognised by the Commonwealth in the context of National Competition Policy (NCP), and more recently the National Reform Agenda (agreed by the February 2006 COAG meeting), which seeks to improve human capital through improvements in health and education. In these cases, the necessary reforms fall largely under State responsibility, but substantial benefits accrue to the Commonwealth. As with NCP, the Commonwealth has recognised that funding should be provided to the States (if needed) to ensure a fair sharing of the costs and benefits of the National Reform Agenda.

- The NCP provided for payments to States and Territories upon the implementation of NCP reforms. The reason for the payments was that the NCP reforms delivered most of the public sector revenue benefits to the Commonwealth, while the States were responsible for implementing the most significant reforms, in terms of national economic benefits. The NCP payments allowed a portion of the Commonwealth's fiscal benefits to be shared with the States.

4. *Commonwealth support for Western Australia's needs is low*

There is evidence that the Commonwealth is not providing adequate support for Western Australia's economic and social development needs:

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

- Western Australia's share of the Auslink National Network Program (which is primarily funding for road projects) is only about 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 are hindering 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, nursing homes and funding for local governments (in the latter case, problems are 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);

- Western Australia has 25% of the nation's remote area indigenous population, but Commonwealth assistance falls well short of what is required to deliver improvements in standards of living (and the Grants Commission process makes it difficult for the State to deliver improvements, as Western Australia's revenue growth is mostly equalised away);

- the Commonwealth's Medicare and Pharmaceutical Benefit Schemes are of little benefit to many remote communities due to the lack of GPs in these areas. While average Medicare and Pharmaceutical Benefits were $827 per person in 2005-06, they are less than $100 per person in many rural and remote communities;

- Western Australia's share of Commonwealth assistance for some programs (e.g. food innovation, sports infrastructure) has been very low;

- the current Commonwealth Government has refused to share revenues with Western Australia from any of the prospective new offshore petroleum projects, or to assist with the State's infrastructure growth needs;

- Commonwealth company tax changes introduced in 1999, although since ameliorated, continue to disadvantage the long term high risk developments that are common in Western Australia, by increasing the write-off period for assets;
- the Commonwealth's income tax zone rebates have declined dramatically in real value;
- the Commonwealth government continues to oppose "flow through share" schemes to promote mineral exploration, despite having previously supported tax effective schemes for timber plantations and olive groves; and
- Commonwealth tariffs impose a disproportionately high cost on the Western Australian economy, estimated by the Productivity Commission in December 2000 at 0.21% of Western Australia's GSP (compared with 0.08% of Australia's GDP).

In summary, the pattern of low Commonwealth assistance for Western Australia, combined with Western Australia's $5 billion net contribution to the Commonwealth budget, is another strong argument for more Commonwealth support for Western Australia.

5. Maintaining the State's AAA credit rating

The Government has a target of a 47% net debt/revenue ratio. The Government views this target as an important element in maintaining the State's AAA credit rating.

With the redistribution of Western Australia's revenue gains from its relatively faster growing economy to other States through the Grants Commission process, and the appropriation of most of the gains to the public purse by the Commonwealth, Western Australia faces challenges to maintain debt/revenue ratios below the 47% limit, while expanding public infrastructure (including ports, electricity and water infrastructure) to meet the needs of the community and industry.

The 2007-08 Budget highlights the demands for infrastructure to service the State's growing economy and the pressure being placed on the State Government's ability to finance these projects while maintaining its debt/revenue target of 47% across the forward estimates period.

The Government's capital works program is now at record levels ($5.8 billion for 2007-08, and $21.6 billion over four years), and the State's debt/revenue ratio is forecast to increase from 30% in 2007-08 to 38% in 2010-11. In order to ensure the delivery of priority infrastructure projects, the 2007-08 Budget primarily focuses on meeting increased costs associated with capacity constraints in the construction industry, as well as increased consumer demand for infrastructure services throughout the State.

In this regard, there are likely to be further cost and demand pressures requiring funding consideration in the near future, such as further reinforcement of the electricity network to meet customer demand as well as asset replacement (e.g. the Pinjar to Geraldton 330kva transmission line).

In terms of the need to control debt levels, the State is likely to face difficulties, particularly in delivering commercial infrastructure without crowding out pressing social infrastructure.

Private sector investment in public capital would be an option to overcome this problem, and the Government has signalled the need for private sector participation in a number of projects under consideration, including:

- Oakajee port and rail;
- Fremantle outer harbour port; and
- Pilbara port.

Up until a few years ago, almost all common-user economic infrastructure and most social infrastructure was owned by the public sector. Changing economic conditions and Government policy have increased the scope for private sector involvement in the provision of infrastructure. However, the following limitations exist in using private sector investment:

- private sector investment is only suitable for certain types of projects where a developed public private partnership (PPP) market exists;[2]
- typical PPP projects involve government financial obligations to the private sector, which are reported on the government's balance sheet and form part of the government's net debt;
- the income tax framework presently denies certain deductions and allowances to the private sector on infrastructure where the asset is controlled by a state government; and
- the amount and/or quality of infrastructure that society deems optimal cannot always be provided for by the market, and the government sector will always need to play a major role in providing infrastructure to meet the economic and social needs of the population

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2 PPP projects now represent between 10 and 13 percent of all UK investment in public infrastructure (see World Bank Infrastructure Governance Roundtable, UK, PPP Forum).

In recent years the concept of PPPs has been extended to embrace innovative ways of the public and private sectors working together to improve the delivery of infrastructure and ancillary services to the community. However, a good relationship between the private and public sectors is necessary, and this will require a clear identification of the needs of both parties. The private sector needs to be confident that it will be protected in relation to:

- Government decisions that would change the earning capacity of the activity;
- realistic assignment of infrastructure access rights to third parties; and
- potential loss of intellectual property and information.

While increasing private sector participation in public infrastructure is desirable, given the limitations, options that would help safeguard Western Australia's AAA rating would be for the Commonwealth (which is ultimately responsible for the problem through its design of Commonwealth-State financial arrangements) to:

- guarantee borrowings used to finance important public infrastructure; or
- provide equity capital for these projects.

6. Commonwealth approach to industry assistance is not working well

The Commonwealth's approach to industry assistance appears to focus on providing financial incentives to individual businesses. This has major weaknesses.

- The project proponent will use it to maximise its own benefits, rather than necessarily putting in place the infrastructure that would yield maximum benefits for the community as a whole through facilitating the development of other (possibly competing) projects.
- Experience shows how difficult it is to 'pick winners'. For example, the Commonwealth has offered assistance to a succession of Burrup Peninsula projects that have not proceeded (Methanex, Syntroleum and GTL Resources).
- There is a lack of transparency in the decisions about which businesses receive assistance and which do not. Unpredictability about eligibility makes it difficult for businesses and governments to plan around Commonwealth assistance with any confidence.

By contrast, the State Government focuses on assistance through the provision of common-user infrastructure that assists a number of businesses. It leaves the State with some residual benefit in the event that a project fails. It also involves a better degree of transparency in the decision-making process, as it is usually aimed at assisting more than one business at a time.

In summary, there are likely to be national welfare benefits from the Commonwealth putting greater focus on infrastructure assistance rather than assistance to individual businesses.

B. Mechanisms to Enhance Infrastructure Funding Outcomes for Western Australia

Achieving improved Commonwealth support for infrastructure in Western Australia will require significantly improved collaboration between the Commonwealth and Western Australia.

Important aims are to better understand each other's needs and priorities, and seek ways to achieve mutually beneficial outcomes.

Possible mechanisms would include:

- having a well-developed plan for infrastructure. The Commonwealth is more likely to support proposals that are part of a coordinated infrastructure investment program whose component projects can be shown to meet sound cost-benefit criteria and provide good value to the community
    - the State Infrastructure Strategy (SIS), which will map out Western Australia's major infrastructure projects over the next 20 years, will play a significant role in this regard. Development of the SIS is being overseen by a Reference Group of major stakeholders comprising representatives from the private sector and all tiers of government. This will help ensure that the projects identified in the SIS are those that will provide the greatest net benefit to the State and the nation as a whole;
- developing a process for systematic engagement with the Commonwealth on infrastructure funding issues, to improve the Commonwealth's understanding of why the State is seeking a greater role from the Commonwealth, and why there is a need for funding mechanisms such as the Treasurer's proposed National Export Infrastructure Fund;
- developing an analysis of the distribution of costs and benefits of infrastructure projects for Western Australia and other jurisdictions that has broad acceptance in the professional community; and applying this analysis to major infrastructure projects that are likely to have significant cross-jurisdictional benefits;

- opening a dialogue with the Commonwealth on major projects as soon as possible, to make the Commonwealth aware of the relevant issues as they affect the national interest and the Commonwealth's own policy objectives, and to provide sufficient time for the Commonwealth to complete its own analysis and due diligence process. The recently established Western Australian Government Office in Canberra can assist in opening the dialogue;
- working in line with processes already agreed between the Commonwealth and States, such as COAG and the Ministerial Councils;
- using existing Commonwealth assistance programs as fully as possible;
- seeking Commonwealth assistance for State infrastructure proposals that have widespread community support – the Commonwealth may be more reluctant to support projects where it perceives community division; and
- building community understanding of issues in the Australian Federation and seeking community support for greater Commonwealth infrastructure support.

Department of Treasury and Finance

May 2007