Government of **Western Australia**
Department of **Treasury**

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Hon N Greiner AC, Hon J Brumby and
Mr B Carter
GST Distribution Review
Treasury Building
Langton Crescent
PARKES ACT 2600

Dear Messrs Greiner, Brumby and Carter

GST DISTRIBUTION REVIEW

I write to you in relation to the Commonwealth Treasury's submission to the GST Distribution Review. I feel compelled to respond ahead of the Panel producing its interim report, given the weight that may be attached to it, relative to other submissions generally, and to Western Australia's competing views and perspective specifically.

In so doing I do not wish to question the objectivity of the submission, but note that the current Commonwealth Grants Commission (CGC) process is one where States, such as Western Australia, can draw on more hands-on experience to identify flaws and reform options than can the Commonwealth, which has traditionally relied on the CGC as the 'independent arbiter'.

The Commonwealth Treasury submission's first key point is essentially that although Western Australia's share of the GST in 2011-12 is only 72% of an equal per capita share, this rises to 95% if all Commonwealth grants to the States are taken into account. However, this ignores the following:

- If relativity comparisons are to be widened beyond the GST, then they need not stop at drawing in other grants to the States, but could also take into account the State-of-origin of other Commonwealth taxes (i.e. apart from the GST) and the State-of-destination of other Commonwealth spending (i.e. apart from grants to the States).

  On the basis that in 2009-10, Western Australia contributed about $39.7 billion to the Commonwealth budget and received back only $26 billion (source: Government of Western Australia Budget Paper No. 3 2011-12, pp86-87), Western Australia's relativity in that year was only 0.65 (and will likely be significantly less in 2011-12).

- Contributing to the Commonwealth Treasury's calculation of a 95% 'relativity' for Western Australia is the inclusion of North West Shelf grants. However, the State Government incurred large costs in supporting the development of that project, which (unlike all of the revenues) have never been 'equalised'.

- The substantial reductions in Western Australia's share of GST grants that are still 'in the pipeline', with our currently projected relativity of 33% in 2014-15 being equivalent to a share of total Commonwealth grants of about 70% of an equal per capita share - a 'shortfall' of more than $3 billion.

The Commonwealth Treasury submission also concludes that redistributing mining royalties is expected to improve economic efficiency. We understand this to be based on the argument that people may otherwise be encouraged to migrate to resource rich regions to access better services or lower taxes funded by royalties, even though they may be less productive in those regions.

However, the submission notes the alternate view that "The absence of HFE can be efficiency-enhancing for a federation if it encourages individuals to move to an area where they will be more productive. For example, during a resources boom, a worker may move to a mineral resource-rich area where wages are higher, in recognition of a relatively high marginal product of labour".

Which view should prevail depends on whether labour is currently optimally allocated in Australia. Our submission argues that labour is not optimally allocated, and that a (long-running) process of structural adjustment is underway. We consider that the equalisation of Western Australia's royalties is slowing structural adjustment by reducing efficient migration into the State.

In addition, we consider that the Commonwealth Treasury submission has not properly understood the Garnaut/FitzGerald finding that large efficiency losses could result from inadequate equalisation of the costs of economic development - consistent with Western Australia's submission, which refers to the associated asymmetry in the CGC's assessments.

The Commonwealth Treasury submission responds, in part, that the CGC does equalise some of these costs. However, apart from excluding costs such as up-front State investment in transmission lines, ports and water supply etc (which would be under-supplied if left to the private sector) and 'political' costs, the CGC recognises costs only on a 'standardised' basis (i.e. above average effort in facilitating economic growth is not equalised) – whereas actual revenue bases are equalised.

The Commonwealth Treasury submission also appears to ignore the fact that equalisation of mining royalties reduces incentives for States to develop their resources and price them appropriately (as the fiscal benefits are largely equalised away).

While the impacts of asymmetry in the CGC's assessments and disincentives for development are inherently difficult to quantify, this does not mean that they are immaterial. Even if the impacts were 'at the margin', the cumulative impacts over time may be substantial. It is this cumulative impact which underlies the Garnaut/FitzGerald report's suggestion that such impacts may reduce GDP by one or two percent.

The Commonwealth Treasury submission is similarly dismissive of concerns that equalisation can significantly distort State policies. However, Western Australia's submission points (in particular) to the extreme distortion caused by the mining assessment, which could see Western Australia lose much more in GST share than it gains in royalty revenues by pricing its minerals more appropriately.

Possibly related to this, the Commonwealth Treasury submission indicates that the Review provides an opportunity for governments to identify any efficiency-enhancing reforms which have not proceeded because of fiscal equalisation. In this regard it has previously noted that Western Australia has chosen to proceed with its reform of iron ore royalties despite the draconian equalisation consequences.

However, Western Australia's submission makes it clear that the decision to proceed with this reform is in the context of a firm expectation that fiscal equalisation will also be reformed. The unsustainability of the current system is further highlighted by the fact that Western Australia could (perversely) make a net fiscal gain by reducing its royalty rate on 'lump' iron ore[1].

The Commonwealth Treasury submission suggests that "coordinated reform" will address the fiscal equalisation disincentive for economic reform. However, this is the 'central planner' perspective, that effectively sees States as an impediment to national efficiency. It effectively denies one of the key benefits of federalism, that long run efficiency is best served by the opportunities provided for competition and innovation among States.

The Commonwealth Treasury submission also gives no recognition to the intergenerational inequity concern arising from the full equalisation of States' mining royalties, whereby only the mining State (which retains only a minority of the revenue) has any direct accountability for ensuring that the revenue is reinvested so as to generate benefits to the community after the minerals are exhausted.

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[1] Such that lump iron ore would be reclassified as a low royalty rate mineral for the CGC's purposes. The associated gain in GST share for Western Australia (at other States' expense) could more than offset the loss of royalty revenue.

From a broader equity (and efficiency) perspective, no recognition is given to the current extreme nature of fiscal equalisation, which is equivalent to a 100% tax on above-average fiscal capacity. As Western Australia's submission points out, in other parts of the national tax and transfer system this would be seen as destructive to incentives for hard work and good choices, or conducive to welfare dependency.

In terms of reform options, the Commonwealth Treasury submission seeks to undermine the case for relativity floors by suggesting that they would impact adversely on both simplicity and predictability, other than for States that benefit from a floor. However, these impacts would be marginal, particularly compared to the equity and efficiency benefits. The CGC's own submission to the Review demonstrates how floors could be applied.

Finally, I note that the Commonwealth Treasury submission appears to be at odds with statements by the Commonwealth Government when announcing the Review in March this year, which acknowledged *inter alia* that the current GST distribution system penalises States for economic growth and rewards economic underperformance.

I trust that these comments, which are limited to some of the more significant areas of contention in the Commonwealth Treasury's submission, can be given careful consideration by the Review panel.

Yours sincerely

Timothy Marney
UNDER TREASURER

12 December 2011