21 November 2017

Commissioners Karen Chester (Deputy Chair) and Jonathan Coppel
Productivity Commission
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Dear Commissioners

I write in response to your request submissions addressing the Commission's Draft Report on Horizontal Fiscal Equalisation, subsequent to our submission on the Terms of Reference.

Executive Summary

- The issue of lagged payments under the HFE system must be given greater priority in the final report, particularly as to how it relates to better enabling mining dependent states like Western Australia to avoid sharp falls in GST revenues following mining boom collapses.
- It is unclear as to why the Commission is advocating to change a decades old system of HFE to alleviate the current financial pressure on Western Australia after it ran 14 consecutive budget surpluses up until 2014/15 concurrent with a ten-fold increase in mining royalty revenue.
- Australia's relatively consistent prosperity across states and territories may be unique compared to other federations but that is actually a positive attribute and demonstrates our egalitarian values which are highly regarded by other nations.
- There is an inadequate focus on how states like South Australia which benefit from HFE are still willing to vigorously pursuing mining and gas developments and other industries such as nuclear waste storage which are unequivocally going to reduce our GST payments in the long run.
- Business SA acknowledges the Productivity Commission is a respected independent statutory body and the final report recommendations must be based on a solid body of evidence demonstrating how the entire country will benefit from changes to HFE, particularly in the long run, in accordance with the objectives of the *Productivity Commission Act 1998*.

Should you require any further information or have questions, please contact
Andrew McKenna, Senior Policy Adviser, on (08) 8300 0000 or andrewm@business-sa.com.

Yours sincerely,

Anthony Penney
Executive Director, Industry and Government Engagement

Key Policy Points

1. The Draft Report does a solid job of articulating the history of HFE and how it has benefited all states and territories over the long run, including through previous mining cycles. However, this needs to be communicated more clearly in the Commission's final recommendations. At present, the draft recommendations do not adequately reflect the history of HFE and the benefits the system has shared across Australia over the past four decades, not to mention the decades before which still featured many aspects of fiscal equalisation between states and territories.

2. Business SA wishes to acknowledge our support for the independence of the Commonwealth Grants Commission (CGC) and the necessity of having them conduct the process of HFE without political interference. If HFE were adjusted to some other level other than full equalisation, including a reasonable level, this would bring subjectivity to the role of the CGC and political interference would naturally follow. The CGC was established in 1933 and the fact that most Australians have never heard of them speaks to their ability to do their job in a competent fashion and stick to their core mandated objective of recommending how revenues from the GST should be distributed to the states and territories to achieve HFE.

3. As per section 8(1)(a) of the *Productivity Commission Act 1998* (the Act), the Commission is bound to ensure its recommendations have regard to the need to improve the overall economic performance of the economy through higher productivity in the public and private sectors in order to achieve higher living standards for all members of the Australian community. Unfortunately, what is recommended in the Draft Report appears inconsistent with this requirement of the Act.

4. Business SA is concerned that if the PC makes its recommendations on HFE in the final report, there would be strong pressure on states such as South Australia which stands to lose at least $256m per annum, to increase state based taxes which are inherently less efficient than the GST, as outlined in both the Tax White Paper discussion paper and the previous federal Henry Tax Review. If the PC is going to adhere to its mandated objective of 'encouraging the development and growth of Australian industries that are efficient in their use of resources, enterprising, innovative and internationally competitive', how can this be achieved when some states are going to look to raise inefficient state based taxes such as payroll tax and insurance taxes. South Australia already has a well above average tax effort in land tax, the most efficient of all state taxes and the PC needs to be careful about the unintended consequences of its final recommendations.

5. Business SA would like to reiterate that the fiscal capacity of each State and Territory differs due to a number of factors, including but not limited to demographics, urban density and distribution of population. In terms of raising tax revenues, unfortunately South Australia is most disadvantaged by its ageing population which manifests in a much lower workforce participation rate of 61.8 percent compared with the national average of 65.1 precent[1]. For Western Australia, this figure is currently 68.1 percent and even 20 years ago was still averaging around 66 percent while at that stage, South Australia was averaging around 61 percent, only just below its current rate.[2] This suggests such indicators are more dependent on structural differences between States rather than relative economic performance at any given point, including through commodity cycles.

[1] ABS, Labour Force (September 2017), www.abs.gov.au
[2] ABS, Labour Force (September 2017) – rates from mid 1997, www.abs.gov.au

6. Business SA requests the Commission include the following 'actual' State Budget outcomes[3] from Western Australia in its final report:

2000/01 - $167.1 million cash surplus and total public sector net debt of $4.381 billion

2001/02 - $197 million cash surplus and net debt of $4.491billion

2002/03 - $254 million cash surplus and net debt of $4.497 billion

2003/04 - $799 million cash surplus and net debt of $4.194 billion

2004/05 - $1.192 billion cash surplus and net debt of $4.001 billion

2005/06 - $2.265 billion cash surplus and net debt of $3.179 billion

2006/07 - $2.254 billion cash surplus and net debt of $2.984 billion

2007/08 - $2.507 billion cash surplus and net debt of $3.634 billion

2008/09 - $318 million cash surplus and net debt of $6.688 billion

2009/10 – $831 million cash surplus and net debt of $9.896 billion

2010/11 – $1.604 billion cash surplus and net debt of $12.03 billion

2011/12 – $649 million cash surplus and net debt of $14.53 billion

2012/13 – $249 million cash surplus and net debt of $18.19 billion

2013/14 – $719 million cash surplus and net debt of $20.75 billion

2014/15 - $431 million cash deficit and net debt of $23.374 billion

2015/16 - $2.037 billion cash deficit and net debt of $27.86 billion

2016/17 - $3.914 billion cash deficit (forecast) and net debt of $33.838 billion (forecast)

Over the last 17 years, WA has successfully managed to achieve 14 consecutive budget surpluses and only in the last three years has dipped into deficit territory. There is no underlying fundamental rationale to amend Australia's HFE system which has served us well for over 40 years because one State jurisdiction forecast a GST floor being introduced which avoided the need to make difficult decisions to adjust to falling mining royalties.

[3] 'Actual' results taken from subsequent Western Australian State Budgets except for 2015/16 and 2016/17 which are estimates from Budget papers, http://www.ourstatebudget.wa.gov.au/Previous-Budgets/

If Western Australia had adequately managed its $14 billion in budget surpluses over the 14 years preceding 2014/15, it would not be in the situation of having to lobby its perceived unfair treatment in relation to HFE distributions of the GST. Furthermore, the CGC estimated that growth in iron ore royalties resulted in Western Australia retaining an extra $7 billion in the six years to 2015-16 than it would have under a fully contemporaneous HFE system. Had this money been adequately reserved to mitigate against future declines in GST revenue, Western Australia would not have run budget deficits over the past three years.

Accordingly, the Commission should reconsider its draft conclusion that HFE now embodies an undeliverable ideal which only serves to reinforce the misconception that Western Australia's current predicament has no relationship to the financial management of previous governments.

7. From Business SA's perspective, the Commission has not delved deep enough into explaining exactly how Western Australia came to be in their current position, rather focusing on how to move forward from here.

   As we have previously stated, the Commonwealth Grants Commission decided to cut Western Australia's GST share back in 2005 and in the 2005/06 Western Australian State Budget, the Western Australian Government forecast its share of GST revenues to decline over the forward estimates period, due to faster growth than other States in its own source revenue capacity. At the time, the State Government also advised that 'experience shows that the annual change in Western Australia's share can be significant and difficult to predict'. Subsequently in the 2006/07 Western Australian State Budget, the Government advised it 'based its decisions on the budgetary capacity expected to be available over the medium to longer term, rather than the temporary/cyclical nature of the current revenue position'.

   After another reduction in Western Australia's GST share in 2007/08, the Government advised in its State Budget that 'Although the State is expecting a significant penalty ($1.4 billion by 2010-11) from a declining share of national GST revenue as a result of the lagged Commonwealth Grants Commission process, surpluses are expected across the forward estimates period. These surpluses provide the capacity for the Government to continue a substantial level of infrastructure investment, with the Capital Works Program worth a record $21.6 billion over the next four years'. The 2008/09 Western Australian State Budget predicted further declines in the GST share as did the 2009/10 Budget which clearly establishes a trajectory of declining GST relativities in accordance with the long embedded system of GST distribution according to HFE.

   As far back as 2011/12, the Western Australian State Budget forecast WA's GST share to decline to 3.5%, approximately its current share of 3.3% which is scheduled to increase to 3.8% in 2017/18.[4] For 2011/12 and the following two years, the Western Australian Government achieved Budget surpluses of $1.617 billion but by 2014/15, total public sector net debt of $14.53 billion in 2011/12 had increased to $23.374 billion as the state ran its first budget deficit this century. While Business SA acknowledges Western Australia started campaigning strongly for a review of the GST HFE system in 2010, it should have been hedging its bets that changes may not occur given the consensus required from the Council of Australian Governments (COAG).

[4] Commonwealth Grants Commission, Report on GST Revenue Sharing Relativities, 2017 Update

8. Business SA acknowledges that in recent years the Western Australian Government has faced increased difficulty managing its own finances as the mining boom subsided and the lag of GST distributions meant the adjustments for Western Australia were delayed through the existing rules which rely on three years of actual data. Having a GST distribution system which is faster to adapt to changing circumstances such as volatile commodity markets would be more likely to mean resource dependent states are able to adjust their budgets to reflect declining mining royalties and associated state tax revenues. Business SA acknowledges the Commission has paid scant attention to the benefits of improving the current system of HFE to avoid the payment lag issues experienced by Western Australia and this should receive a stronger focus in its final report.

   The Commission acknowledging that 'Western Australia's experience has been an unprecedented outlier, exacerbated by earlier budget decisions of the WA Government', provides no substantive evidence to suggest that the current lags within the HFE system should not be considered to mitigate against future impacts on states like Western Australia which are highly dependent on mining cycles. For example, perhaps in future states which experience mining or other extraordinary economic expansions could be forced to establish a GST reserve fund to accommodate for potential shortfalls should such a boom subside.

9. HFE has not discouraged the South Australian Government from actively pursuing development of an unconventional gas sector which is critical to inducing further supply into the gas market, a substantial issue for Business SA's energy intensive members that have seen their gas and associated electricity costs sky rocket in recent years. South Australia has also been open to uranium mining and no other state or territory has actively pursued development of its entire suite of energy resources to the degree South Australia has and it appears inconsistent to change the existing system of HFE to disadvantage states such as ours which are very pro-development across a range of energy and mineral resources.

   The final report of the Productivity Commission must focus more on Western Australia's 'no uranium' condition on future mining leases and unconventional gas ban which begs the question why the rest of the country should accept changes to the current system of HFE when Western Australia is unwilling to explore all its own revenue raising options, particularly when it has known uranium deposits of 226,000 tonnes, approximately 37 times annual national production.[5]

10. Following a policy recommendation put forward by Business SA prior to the 2014 election, the South Australian government to their credit instigated a Royal Commission into the Nuclear Fuel Cycle to explore the costs and benefits of each stage of the nuclear fuel cycle including uranium mining, processing, nuclear power and waste storage. While the citizens jury process ultimately led to both the government and opposition dropping their support for nuclear industry advancement beyond existing uranium mining, the potential benefits to the state from deep geological storage of high level nuclear waste were in the order of $51 billion.[6]It is abundantly clear that HFE was no barrier to the South Australian government exploring options to expand industries such as nuclear and the Commission must recognise this in its final report.

11. Business SA reiterates that since 2015, the South Australia Government has abolished stamp duty on business transfers and is part way through implementing the abolition of stamp duty on commercial property transfers. Given South Australia's move to abolish stamp duty on commercial stamp duty is not recouped under HFE, it is hard to see how the current system of HFE has acted as a disincentive to State's progressing tax reforms. The Australian Capital Territory (ACT) has gone even further with tax reform by transitioning away from stamp duty with a broad based land tax.

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[5] Government of Western Australia, Department of Mines, Industry Regulation and Safety, website

[6] Nuclear Fuel Cycle Royal Commission Report, Page XV, May 2016

The Commission's Draft Report advises there is 'scope' for HFE in its current form to discourage major tax reform but there is no analysis of where states like South Australia and the Australian Capital Territory have actually implemented progressive tax reforms under the existing system. If the Commission is to recommend permanent changes to the current system of HFE which has served Australia well for decades, it cannot be on the basis of what might happen, it must consider the evidence of what has happened.

12. The Commission has not presented any substantive evidence as to how the country as a whole would benefit from a system of HFE which only equalises to the second strongest state. Business SA will not support any proposed changes which are not evidence based, particularly if the end result is to strip $256 million per annum from South Australia's GST payments[7] by equalising to the second strongest state. While this only represents 1.3% of current state government revenue, if you deduct the costs of critical core services including police/legal/correctional, emergency, health and education ($10,506 billion), $256 million represents 3% of remaining revenue.

    The business lobby, led by Business SA, has only just defeated a state based bank tax and it is clear that if South Australia loses GST, then our State Government will look to raise taxes, including on business, and the impact to a state already facing significant economic challenges with the exit of auto-manufacturing and high power and gas prices will be significant.

13. The Commission has pointed to Australia's system of HFE providing more equalisation than any other federation but provides no evidence as to why having less equalisation leads to better public policy outcomes. For one, there are considerable variations in sub-national economic indicators across North America, both in Canada and the United States and there needs to be a deeper focus in the final report as to what outcomes the Commission believe are actually desirable.

    In Canada where full equalisation between provinces does not occur with 50% of mining revenue withheld, the current unemployment rate in Alberta is 6.7% versus 12.7% in Newfoundland & Labrador, one being a mining dependent jurisdiction and the other being more reliant on fishing and forestry.

14. In general, the Commission does not pay enough attention to the level of mining royalties received by the Western Australian government, the primary driver of its low GST relativity. All tables showing GST payments to states should be totalled with mining royalties and other state revenue sources, including payroll tax, to provide a more complete picture of what sources of revenue states and territories have actually received over time.

    The South Australian Government submission to the Draft Report provides a very useful table on page 6 which clearly demonstrates why this information is so important to justify the lack of evidence for change, particularly as Victoria has lower per capital revenue that Western Australia, including the GST, and is actually the state arguing the strongest for the current system to be maintained.

[7] Commonwealth Grants Commission, Submission to PC Draft Report, Page 5

15. Business SA has advocated for a review of the current rate and base of the GST in order to progress tax reform, particularly the eventual abolition of payroll tax. Any such future reform of the GST will require the agreement of COAG and the Commission's review needs to be undertaken in a manner which is fair to all States and Territories to ensure any future changes to the rate or base of the GST have the best opportunity to succeed. While Business SA would not support any changes to impose a floor in GST distributions, remove any portion of mining royalties from its calculations or equalise only to the 2nd highest or average state, we would be open to supporting changes which enable GST distributions to adapt faster for mining dependent States on the wrong side of a commodity cycle.

    A prosperous Western Australia is also good for South Australia but we are mindful of embedding long term changes to the HFE system which are reactionary to the current commodity cycle. Western Australia too has benefited over the longer term from HFE and all States and Territories need to look beyond the existing GST distributions.