Premier of Western Australia

Our Ref: 59-078107

Mr Alan Raine
A/g Committee Secretary
Senate Economics Legislation Committee
Parliament House
CANBERRA ACT 2600

Dear Mr Raine

Thank you for the opportunity to contribute to the Senate Economics Legislation Committee inquiry into the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018.*

The Western Australian Government strongly supports the passage of this Bill. The current GST distribution system is broken and needs to change.

The Productivity Commission – an independent umpire – identified significant shortcomings in the current horizontal fiscal equalisation (HFE) system. According to the Productivity Commission, many of these problems are due to the pursuit, above all else, of equal fiscal capacities across the States. As a result, the system is overly complex, does not provide sufficient reward for effort, and can hurt the Australian economy by discouraging major reforms.

Specifically, the Productivity Commission (on page 63 of its Report) said:

> *On equity, HFE does not systematically provide for State Governments to retain a reasonable share of the fiscal dividends of their policy efforts or economic development (without then being equalised away), raising concerns about fairness.*
>
> *On efficiency, there can be material disincentives for a State embarking on significant tax reforms and resource development policies, especially where it is a first mover.*

The implications of these shortcomings are far reaching and, as stipulated by the Productivity Commission, could over time have a material cumulative impact on the economy and community. The current disincentives detract from fairness and from public confidence in the HFE system. It also encroaches on State decision-making, and erodes States' autonomy and accountability for their tax and spending decisions. It can also be corrosive to the Federation.

The concept of reasonable HFE, and what it stands for, is generally accepted, but in practice HFE is not actually achieved. The lack of data for some assessments, the inability to deal with unique circumstances of States, and the large degree of judgement all create bias. As a result, no-one can say that States currently receive an appropriate amount of GST to provide them with the same fiscal capacity to deliver services – that is, the current system even fails on its equity objective.

As noted in Western Australia's submissions to the Productivity Commission inquiry:

- If a State expands its revenue base, it will lose all but its population share of the resultant revenue growth. This gives rise to a 'HFE tax' on growth (around 89% for Western Australia) that reduces a State's incentive to grow its economy. It also reduces its ability to invest in its future.

- The current system therefore encourages governments to increase tax rates (as associated GST losses are no more than 10% of the additional revenue) rather than growing their underlying tax base, given the much larger HFE tax on the latter.

- Western Australia's dominance in producing iron ore and nickel results in an excessive redistribution of any change in the State's royalty revenue from altering the royalty rate.

- If Western Australia wished to raise an additional $1 billion net of GST it has a choice of, for example, raising iron ore royalties by $8 billion or raising transfer duty by $950 million.

A better system is needed, one that allows States to benefit from extra effort, which will in turn grow the national economy.

It is important to note that even though HFE has been a longstanding, generally accepted concept in Australia, the actual objective of HFE has changed at various times since the creation of the Commonwealth Grants Commission (CGC) in 1933.

Western Australia supports reasonable HFE but also supports the notion that the objective of HFE, as a dynamic concept, should be updated from time to time. Consistent with the changes proposed by this Bill, the current objective of HFE should be redefined to allow for trade-offs to be made between equity and efficiency.

While the CGC has considerable discretion over the methodology it adopts and to change that methodology as it sees fit, some of the disincentives that arise from the current system can only be addressed by changing the HFE objective. Method changes by the CGC can help but would not go far enough. Broader reforms are required.

The Productivity Commission recommended a shift to 'reasonable equalisation'. For this, it suggested equalising to a benchmark of the average fiscal capacity of all States, to be phased in over four or eight years. This would involve losses for States other than Western Australia, but at levels the Productivity Commission considered manageable by those States.

The Bill involves a pragmatic compromise option, involving:

- a higher benchmark of the fiscally strongest of New South Wales or Victoria; and
- additional funding to ensure no State is worse off (this includes both a set increase to the GST grant pool and an additional guarantee for any individual State).
  - Importantly, this additional funding is untied funding (like GST revenue) so States can use this funding in a way that takes into account individual State circumstances and ensures States remain clearly accountable for outcomes.

The Bill also includes a floor on GST shares to ensure all States receive at least 75% of their population share of the GST (70% in the earlier years).

While the Bill is expected to give Western Australia lower funding than the changes recommended by the Productivity Commission, Western Australia accepts the reforms as a reasonable and pragmatic response.

The Bill will mean that in any given year, a State that is fiscally stronger than New South Wales or Victoria:

- will not face HFE-related disincentives for further developing its economy;
- will not face such severe time-lag impacts when its GST grants reduce at the same time as its own-source revenues decline (such as after a boom); and
- will not face excessive GST losses from policy choices.

All States will also have a limit on how much can be redistributed away from them through HFE. While the floor is not currently anticipated to come into play once the new benchmark is fully phased in, it nonetheless provides a form of insurance and therefore provides stability against any extreme events.

Other States, including New South Wales or Victoria, will receive protection through the floor if they become sufficiently fiscally strong to receive a GST relativity below 75%.

Notably, the Bill addresses extreme outcomes from this process, while retaining a central role for HFE.

The Bill will not just update and refocus the objective of HFE, but will also address the unique challenges faced in an ever-changing global economy. It will thereby help ensure that the HFE system remains relevant, up-to-date and serve the best interests of all Australians.

I trust that these comments are of some assistance, and I urge the Senate to pass this legislation as soon as possible to provide certainty to Western Australia and other States

Yours sincerely

[redacted]

Mark McGowan MLA
PREMIER

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