THE 2018 CHANGES TO THE DISTRIBUTION OF GST REVENUE AMONG THE STATES & TERRITORIES: THE WORST PUBLIC POLICY DECISION OF THE 21ST CENTURY (SO FAR)

ADDRESS TO THE NATIONAL PRESS CLUB, CANBERRA

8TH MAY 2024

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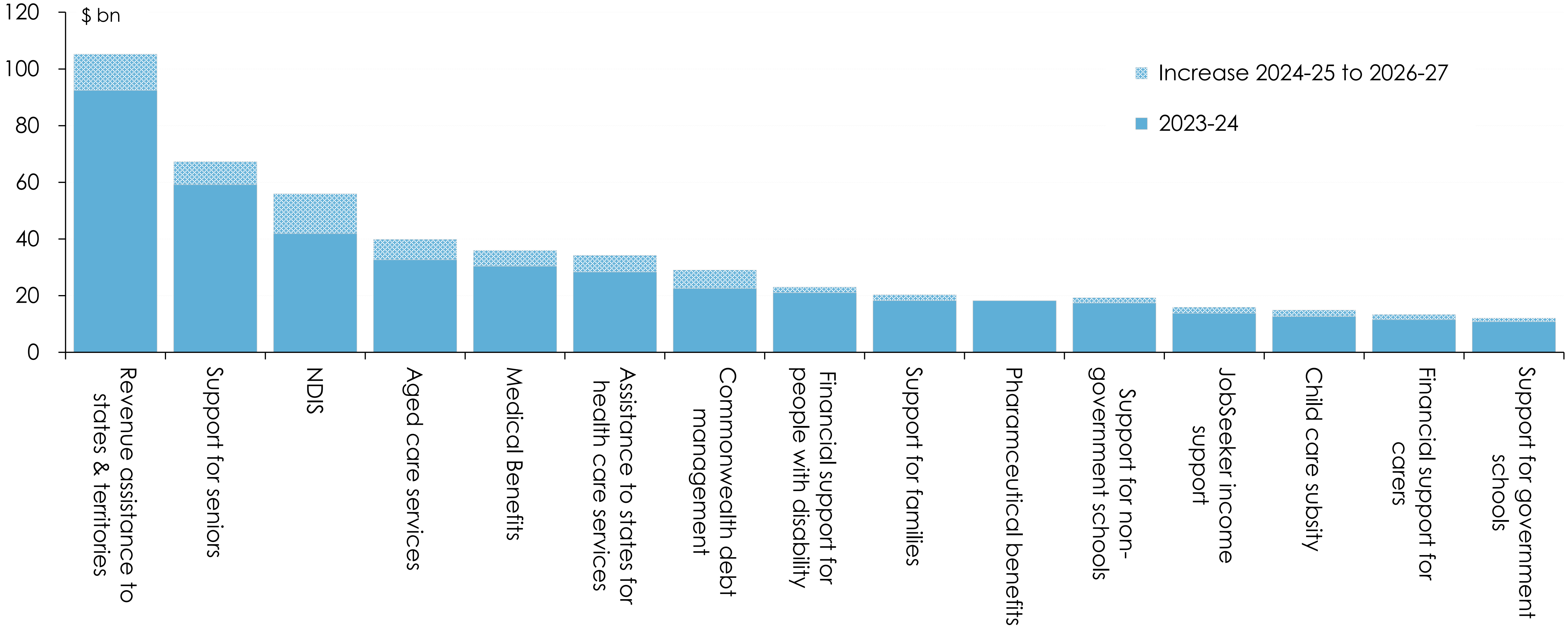
INDEPENDENT ECONOMICS

The distribution of GST revenue to the states and territories is – by a wide margin – the largest single spending program in the Federal Budget …

The 15 largest expenditure programs in the Federal Budget



Source: Australian Government, 2023-24 Budget Paper No. 1: Budget Strategy and Outlook, Table 6.3.1, p. 202.

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… and its long-standing purpose has been corrupted by the changes made to it in 2019, at the behest of Western Australia

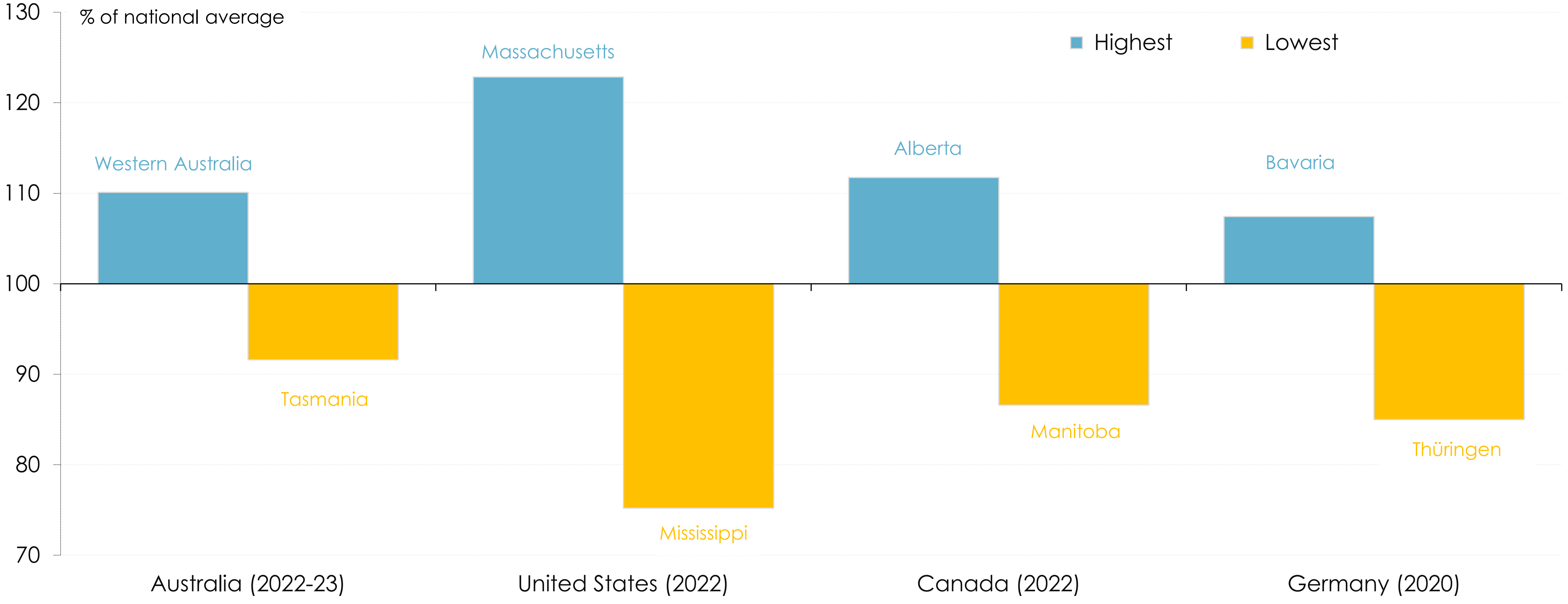
- From 1981 through 2000, 'general purpose grants' (aka 'financial assistance grants') from the Commonwealth to the states and territories were distributed in accordance with principles of 'horizontal fiscal equalization' (HFE), as determined each year by the independent Commonwealth Grants Commission
  - the objective being to ensure that each state and territory had the same 'fiscal capacity' to provide public services of similar quality and standard whilst levying similar burdens of state taxation (though whether they chose to do so was up to them)
- The 'Intergovernmental Agreement' underpinning the introduction of the GST in 2000 (along with the abolition of a range of state taxes) stipulated that revenue from the GST would be distributed in the same way
- The fundamental objective of HFE was originally promulgated in the mid-1930s, after the 1933 'Wexit' referendum
  - and for almost 70 years thereafter, Western Australia got "more than 100 cents in the dollar" (as they would describe it today) from the distribution of 'untied' grants from the Commonwealth
  - but after the onset of the mining boom in the first decade of this century – which brought unprecedented prosperity to WA (relative to the rest of Australia) – WA's share of GST revenues began to fall sharply, to "less than 30 cents in the dollar" (as they described it)
- In response to this persistent whinging, and after a flawed Productivity Commission inquiry, in 2019 the Morrison Government (with the support of the then Labor Opposition) made 2 changes to the GST distribution system
  - first, the 'fiscal capacity' of the weaker states & territories will be raised to that of the stronger of NSW or Victoria, rather than to that of WA if WA is the fiscally strongest state (as it has been in most of the past 20 years)
  - WA is guaranteed that it will not get less than 70% (in 2023-24 and 2024-25) or 75% (in 2025-26 and beyond) of what it would have received under a notional 'equal per capita' distribution, irrespective of its 'fiscal capacity'
- This is a 'heads WA wins – tails, the Eastern States lose' outcome (exactly what WA wanted)
- In order to cajole the other states and territories into accepting something so obviously disadvantageous to them, the Morrison Government offered them a 'no worse off transitional guarantee' until 2026-27
  - which was initially estimated to cost the federal budget $8.2 bn over eight years
  - but has now blown out to $39.2 bn over 11 years, and could end up being as much as $50bn

‘Horizontal fiscal equalization’ explained

- ‘Horizontal fiscal equalization’ (HFE) seeks to ensure that each state and territory has the same capacity to provide public services to its citizens whilst imposing a similar burden of state taxes and charges on its citizens
- As the Commonwealth Grants Commission puts it,
  - “Australia is a federation of eight states and territories with diverse economic, social and geographic circumstances. This leads to differences in the cost of providing services to residents and different capacities to raise revenue from taxes”
  - “Yet all Australians, regardless of the state in which they live, should be able to receive comparable levels of health, education, justice, welfare, public housing and other services”
- Since federation in 1901, the primary tool for achieving ‘horizontal fiscal equalization’ has been the way in which the Commonwealth Government has distributed ‘untied’ grants (that is, grants which states are free to spend as they see fit, rather than in accordance with terms and conditions laid down by the Commonwealth) among the states and territories
- Australia takes horizontal fiscal equalization further than other similar federations (such as the United States, Canada and Germany)
  - which it can do because ‘vertical fiscal imbalance’ (that is, the difference between the expenditure responsibilities of state & territory governments, and their revenue-raising powers) is much greater in Australia than in other federations
  - which means that Australia’s states and territories are more dependent on transfers from the federal government than states or provinces in other federations
- That’s one reason why the differences in per capita incomes, and in access to public services, between Australia’s richest and poorest states are smaller than those in other federations
- If Australia had a unitary system of government like (eg) the UK or New Zealand, the national government would almost certainly distribute its spending (on services provided in Australia by state governments) in a manner consistent with the objectives of HFE

Horizontal fiscal equalization is one reason (though not the only reason) why 'spatial inequality' is smaller in Australia than in other federations

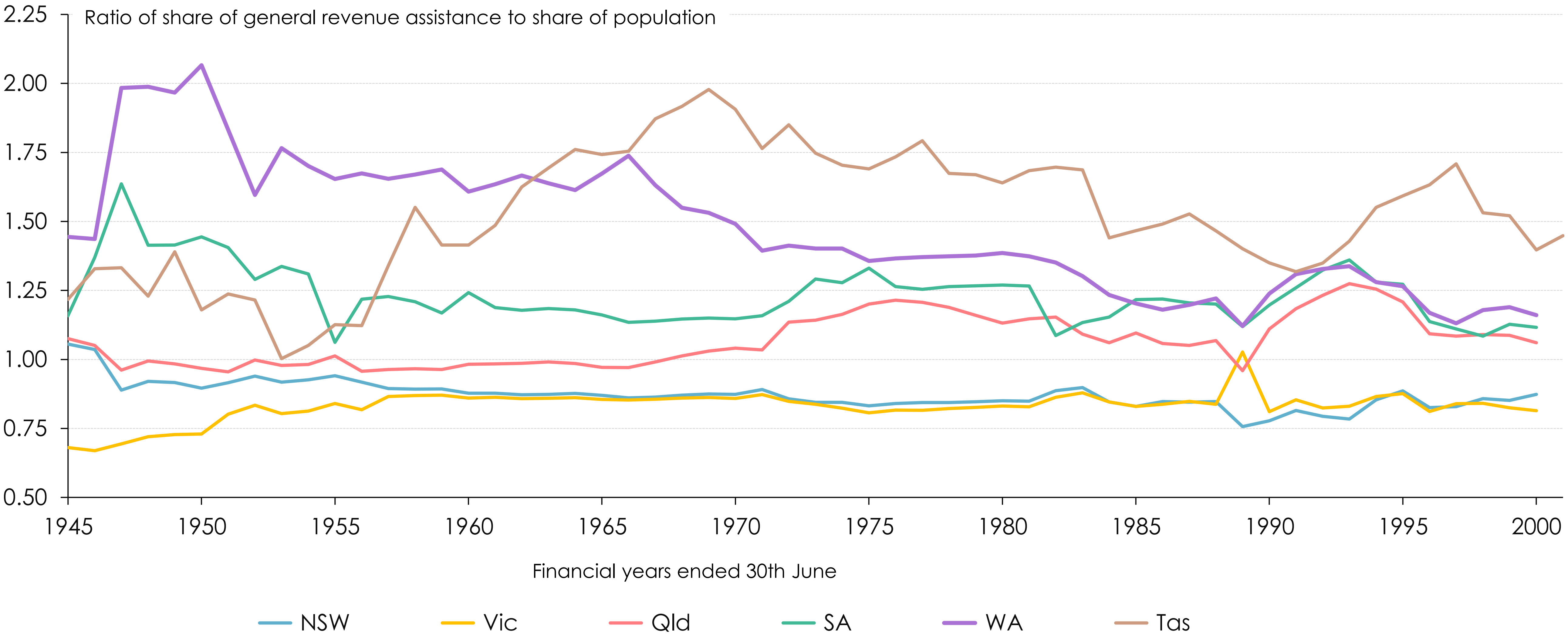
Per capita household or personal disposable income in the richest and poorest states or provinces, Australia and other federations, as a per cent of national averages



Sources: Australian Bureau of Statistics, *Australian National Accounts: State Accounts*, 2022-23; US Bureau of Economic Analysis, *Personal Income by State*, 3rd quarter 2023; Statistics Canada, *Distributions of household economic accounts, income, consumption and saving, Canada, provinces and territories*; Statisiches Bundesamt, *Regional accounts (redistribution accounts) - Disposable income of Länder*, 2021; Corinna.

The pre-2019 system of HFE was invented for WA in the mid-1930s – and for the best part of 70 years WA got more than "100 cents in the $" out of it

State 'relativities' for the distribution of Commonwealth general purpose grants, 1944-45 to 1999-2000



Note: 'General revenue assistance' includes tax reimbursement grants, financial assistance grants, tax sharing grants, GST revenues, health care grants (from 1981-82 to 1987-88), special grants, special revenue assistance, identified road grants (from 1991-92 to 1996-97), national competition payments (from 1997-98 to 1999-2000), grants in lieu of royalties and other general revenue assistance. Territories not shown.
Source: Commonwealth Grants Commission, *History of General Revenue Assistance to the States* (2016).

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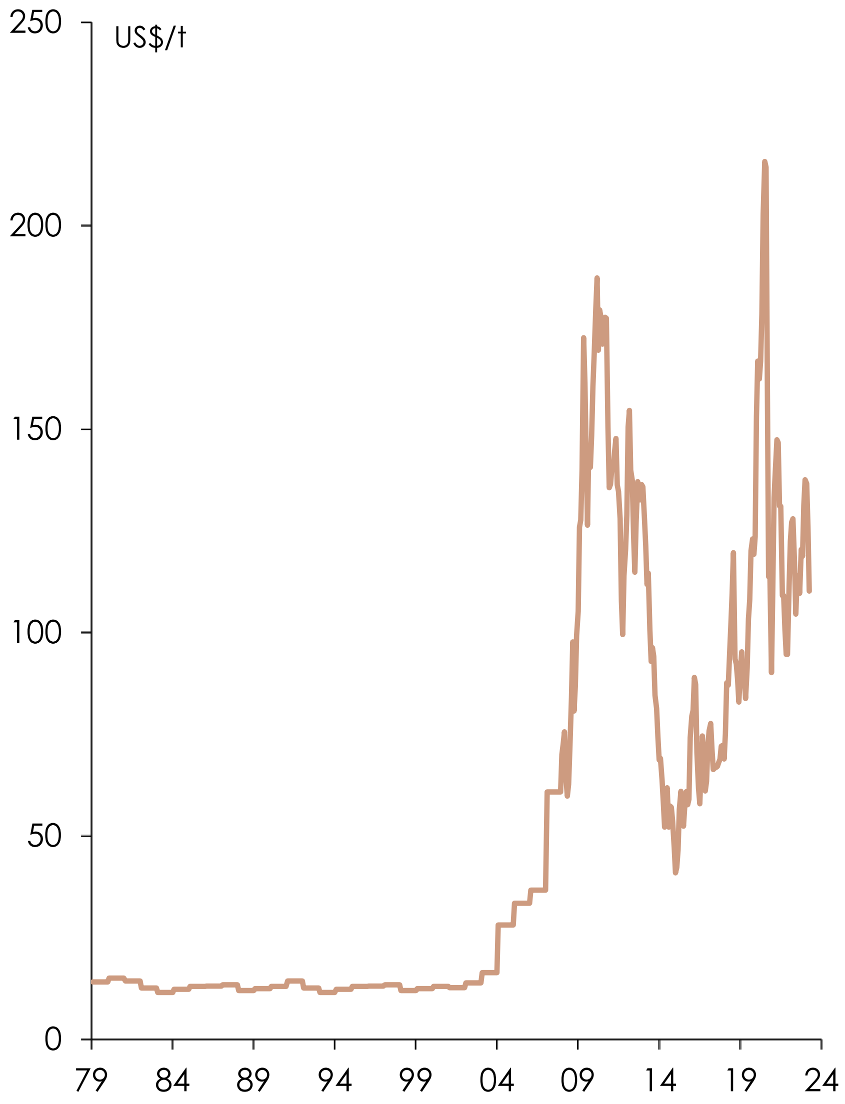
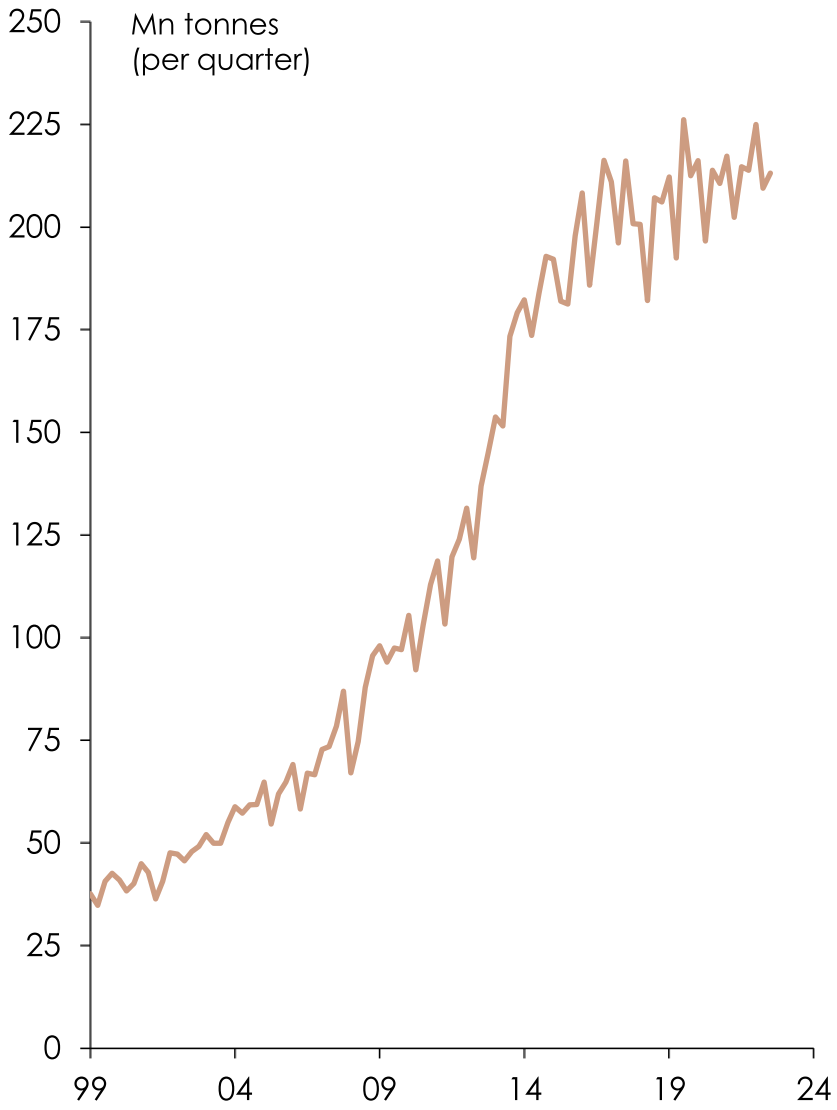
But then, in the early 2000s, WA got (as Paul Keating might say) kissed on the 'nether regions' by a (Chinese) rainbow

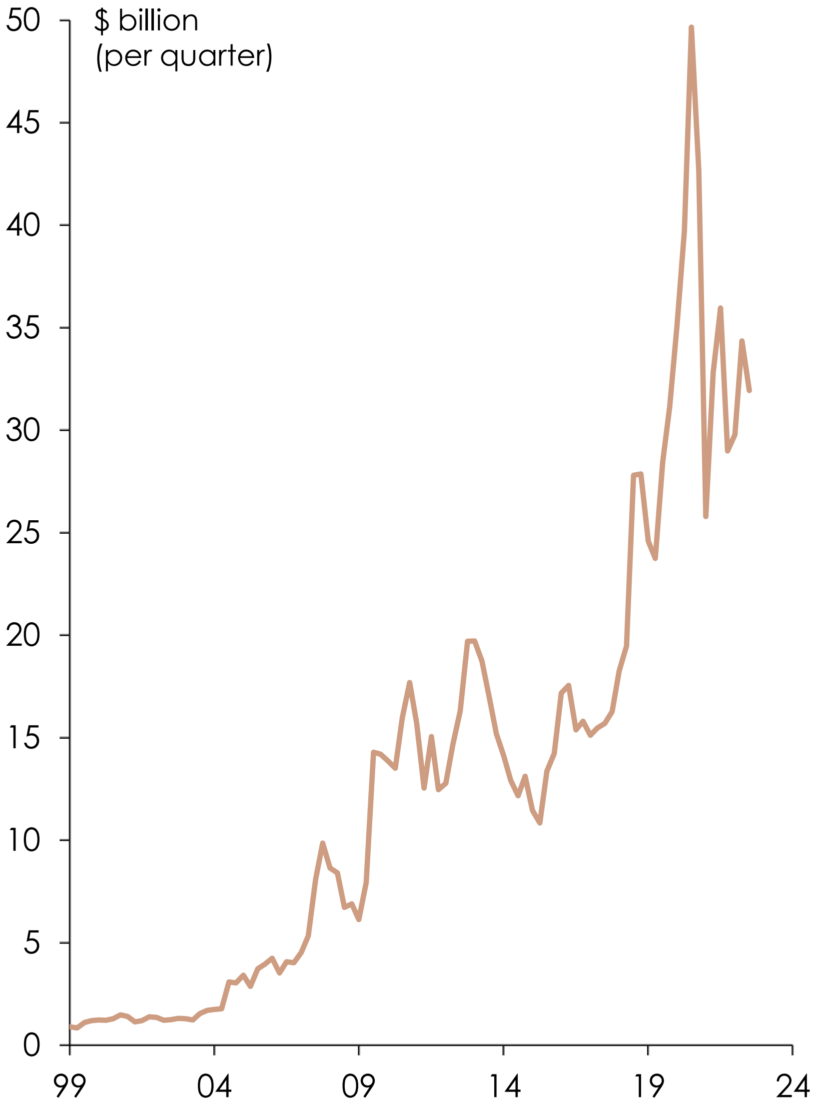
Iron ore prices



WA iron ore production volume



Value of WA iron ore production



Sources: International Monetary Fund, Primary Commodity Price System; Government of Western Australia, Department of Mines, Industry Regulation and Safety, Major Commodities Resource Data File, *2022-23.*

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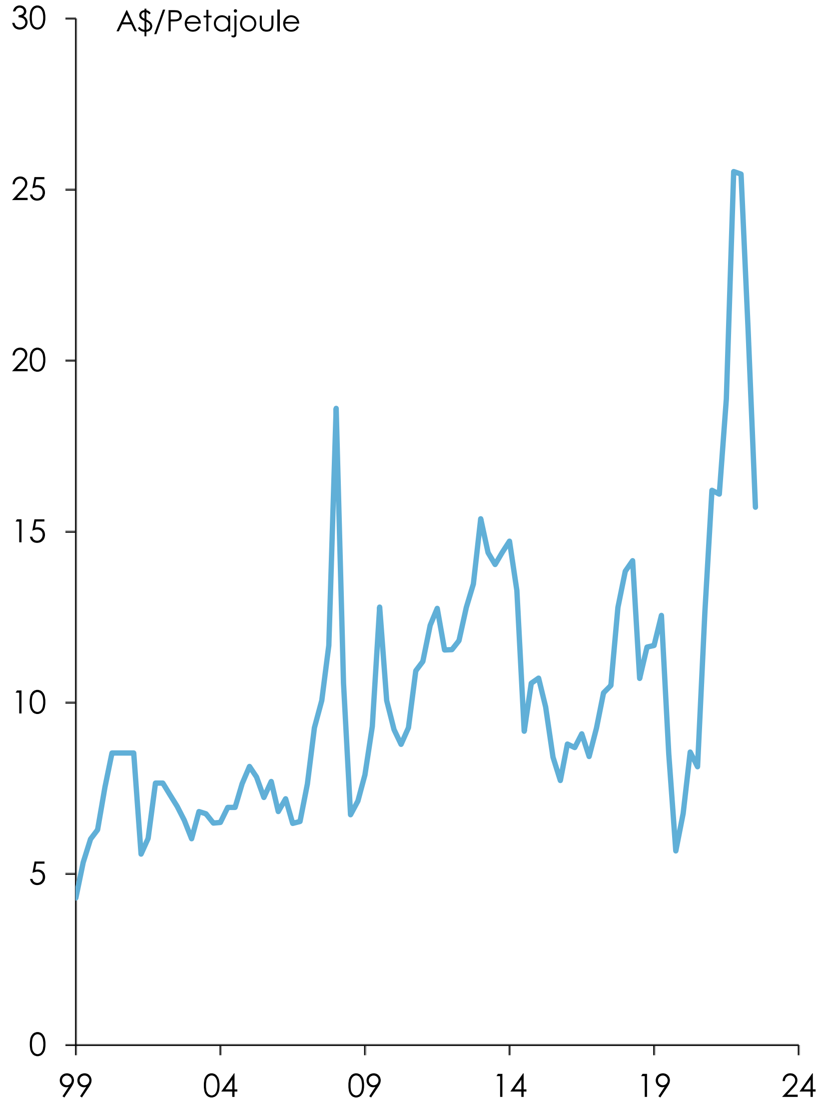
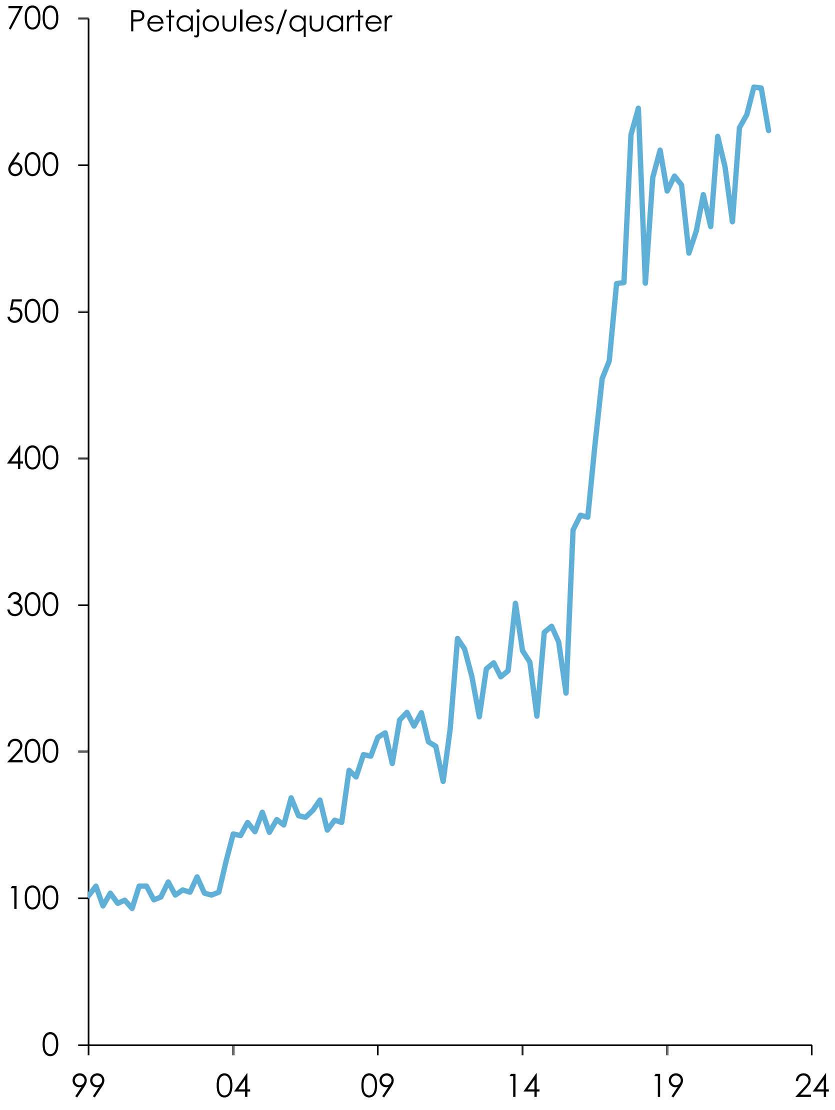
And it wasn't just about iron ore – it's about LNG …

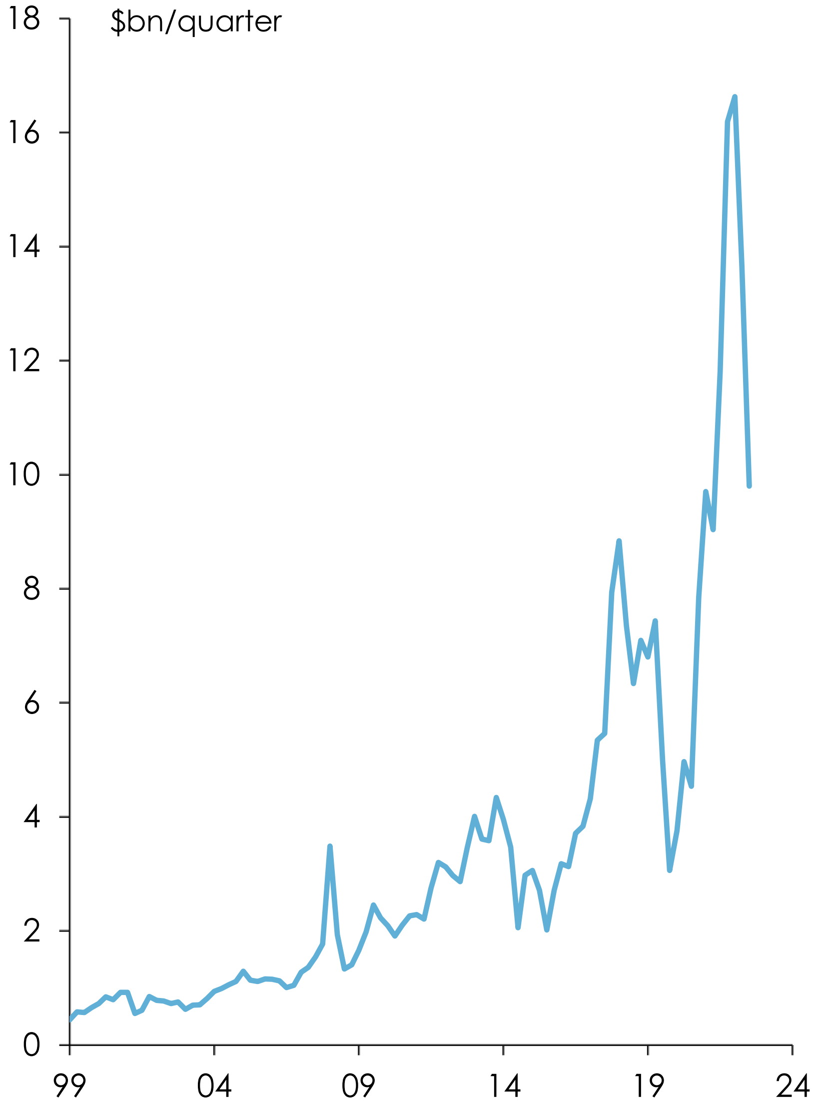
LNG prices



Volume of WA LNG production



Value of WA LNG production



Sources: Government of Western Australia, Department of Mines, Industry Regulation and Safety, Major Commodities Resource Data File, *2022-23.*

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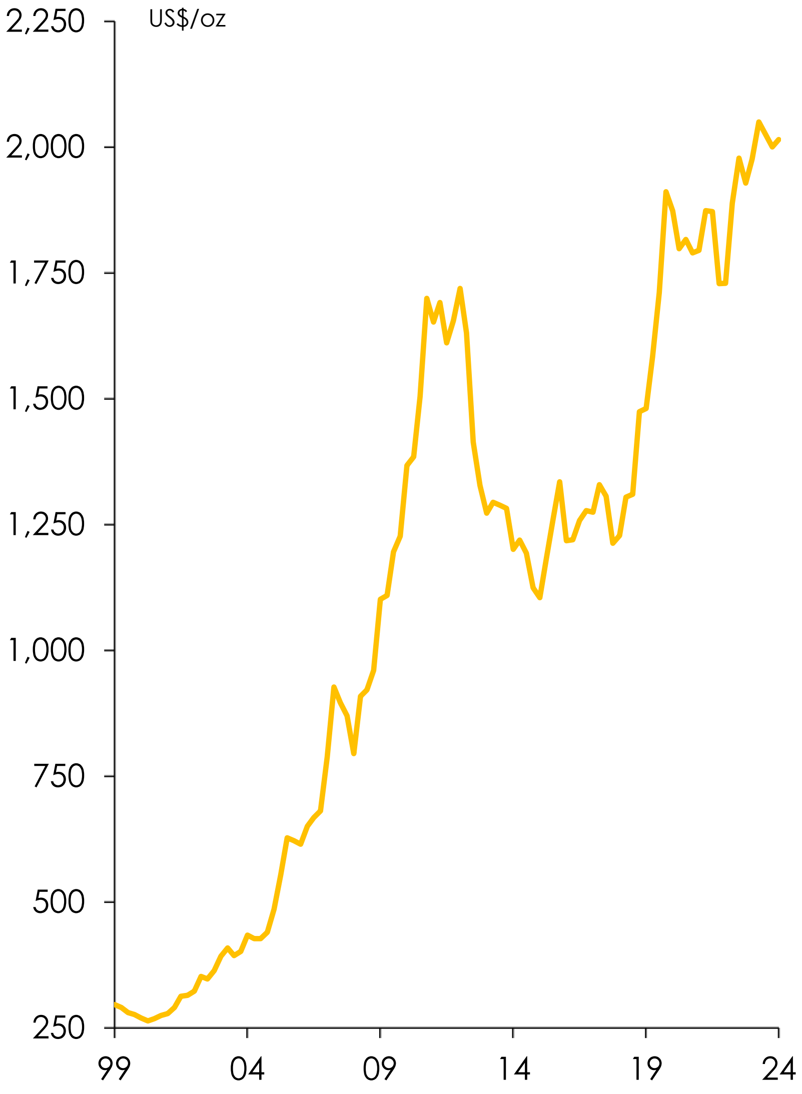
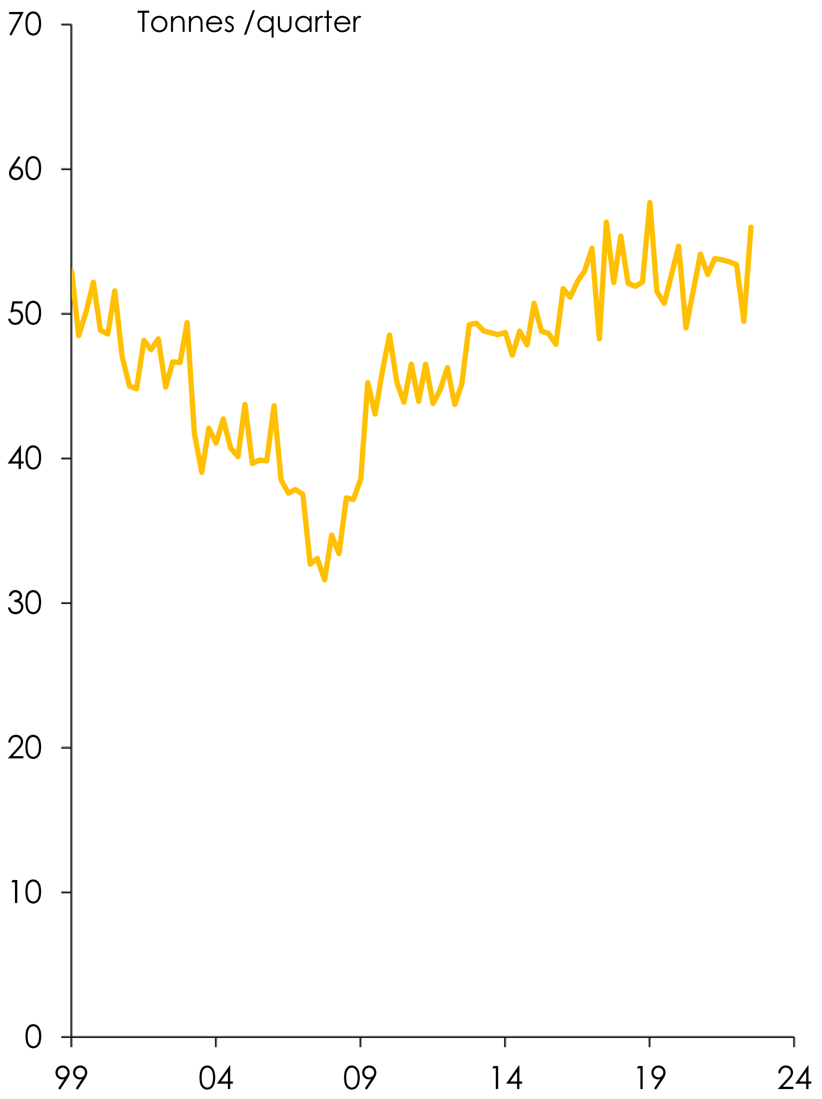
… and it's about gold …

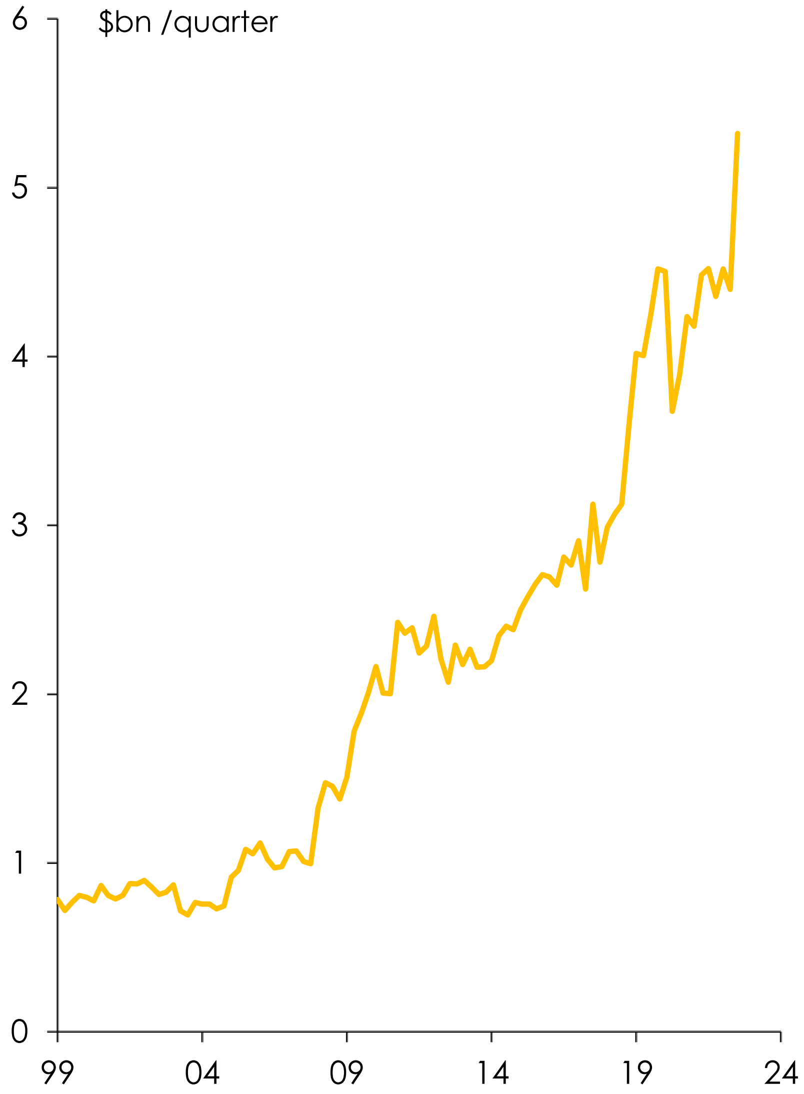
Gold prices



Volume of WA gold production



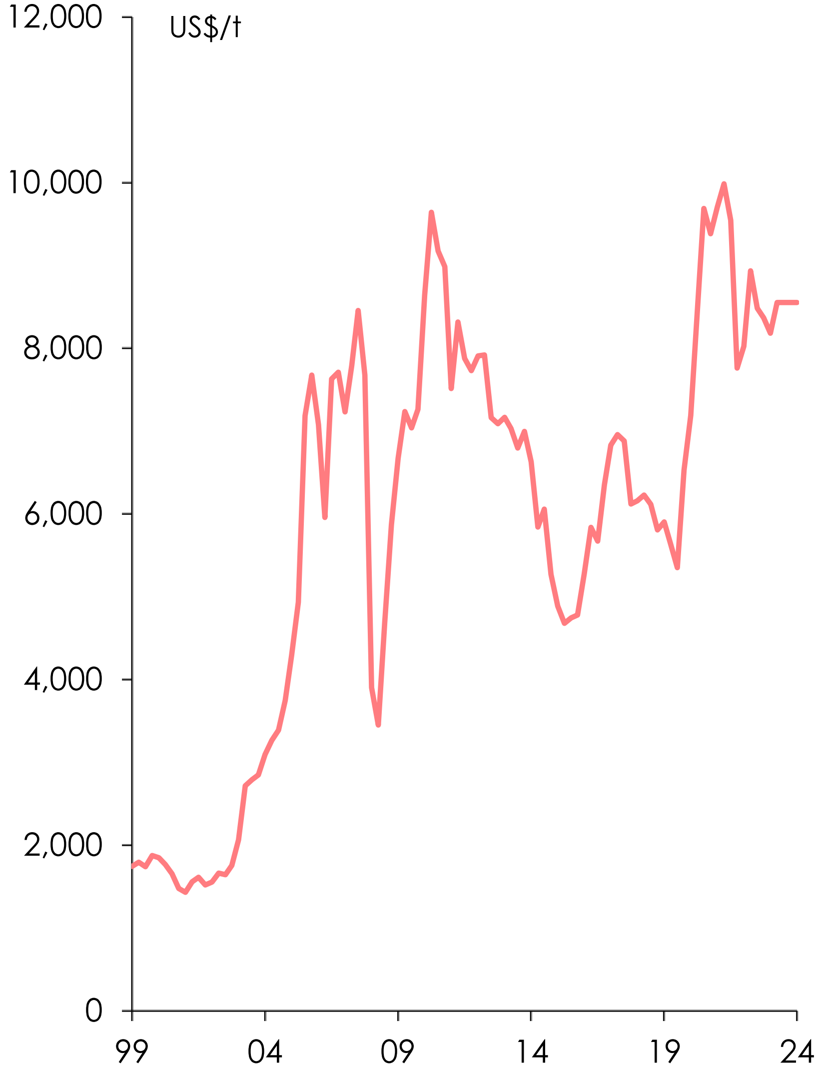
Value of WA gold production



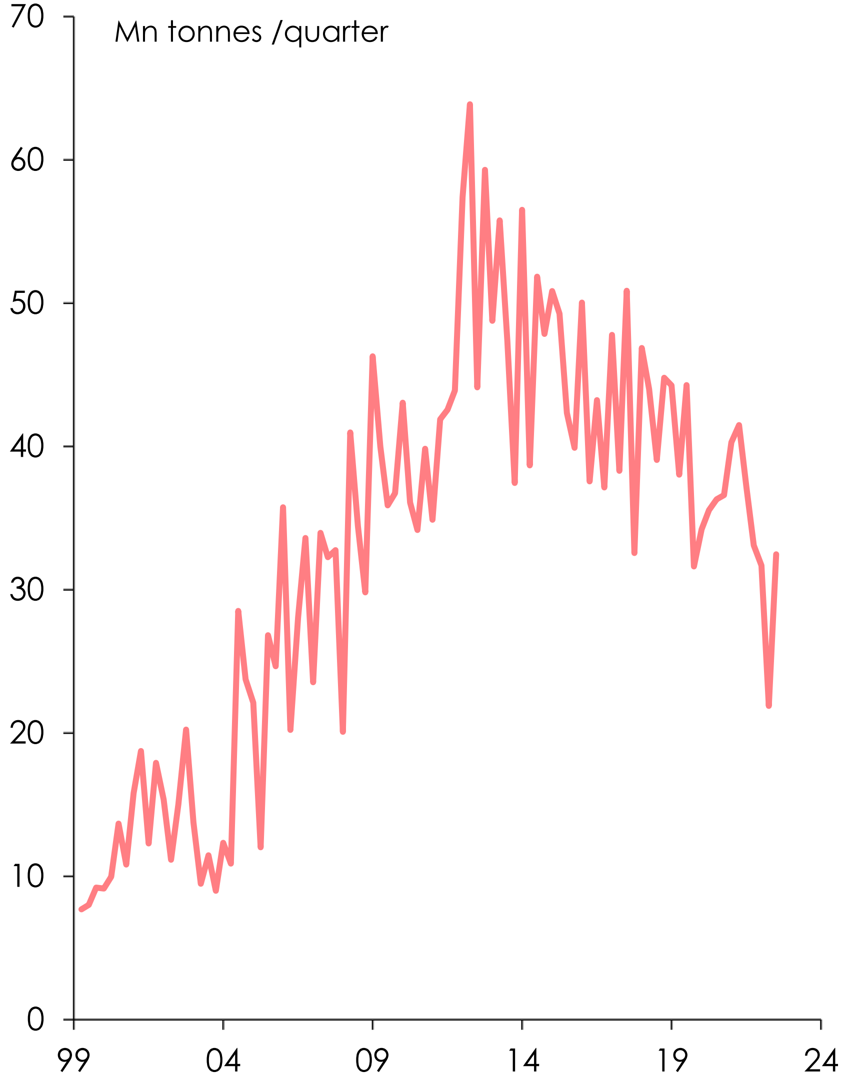
Sources: International Monetary Fund, Primary Commodity Price System; Government of Western Australia, Department of Mines, Industry Regulation and Safety, Major Commodities Resource Data File, *2022-23.*

… and it's about copper …

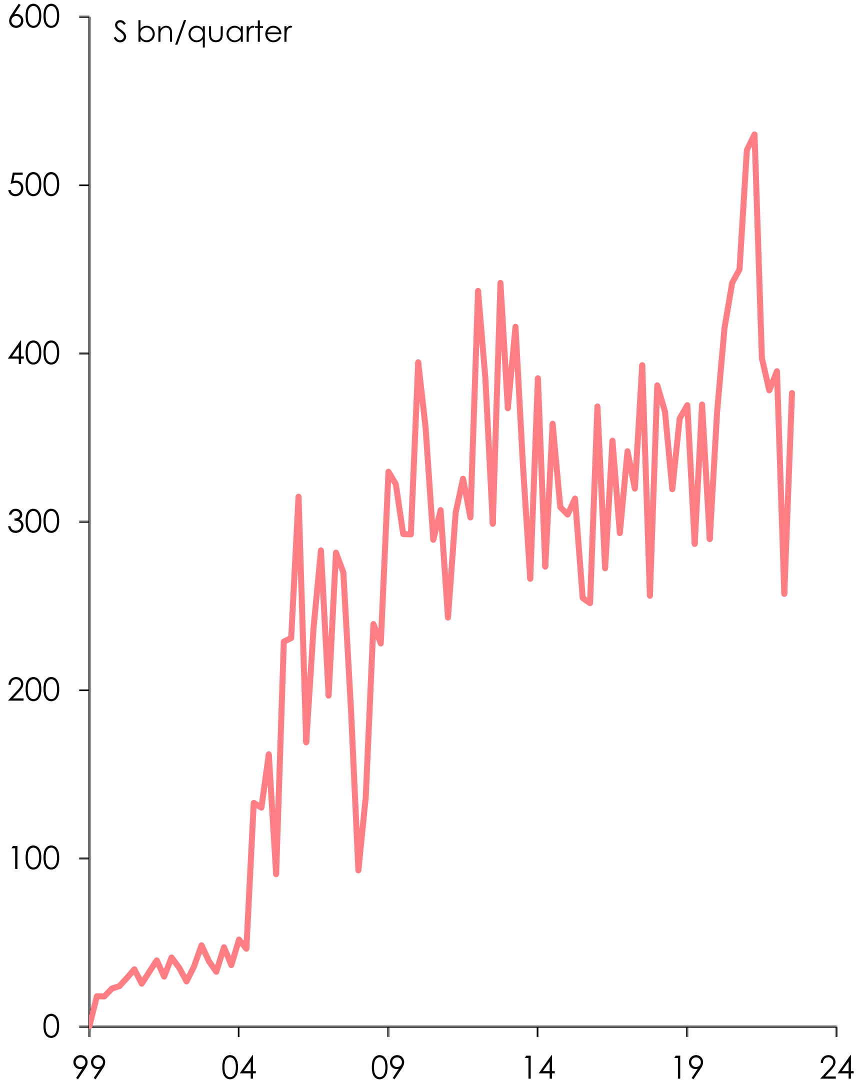
Copper prices



Volume of WA copper production



Value of WA copper production



Sources: International Monetary Fund, Primary Commodity Price System; Government of Western Australia, Department of Mines, Industry Regulation and Safety, Major Commodities Resource Data File, *2022-23.*

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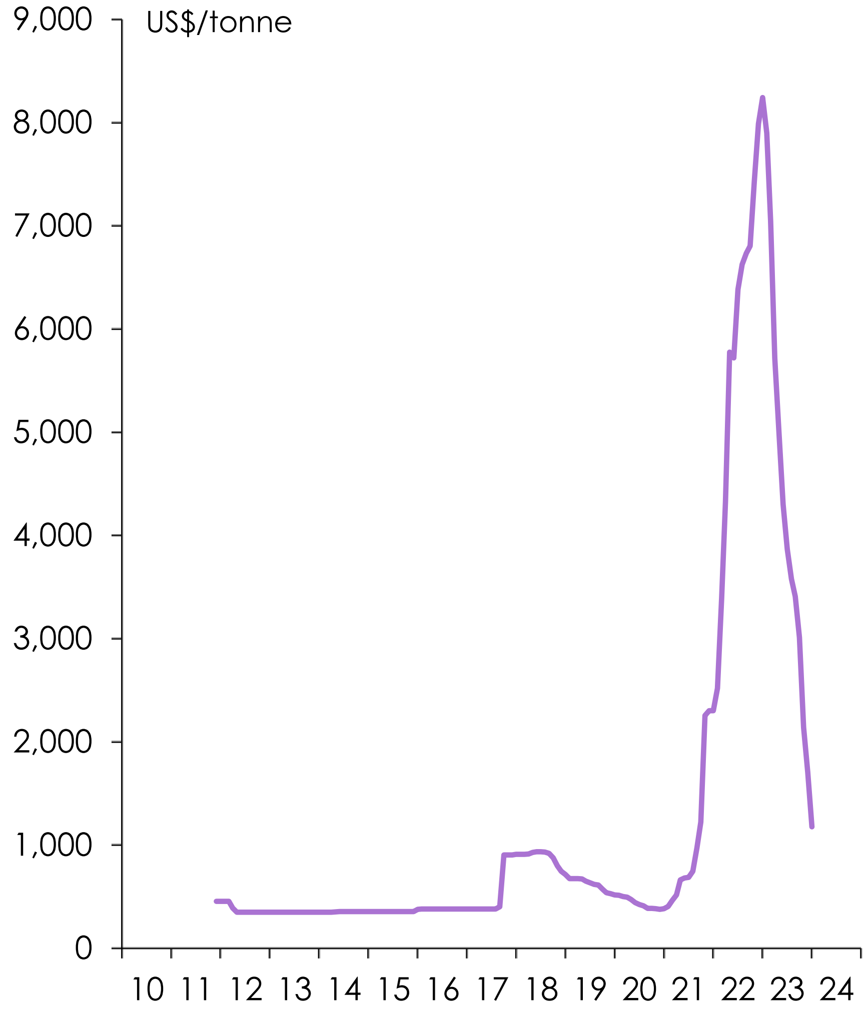
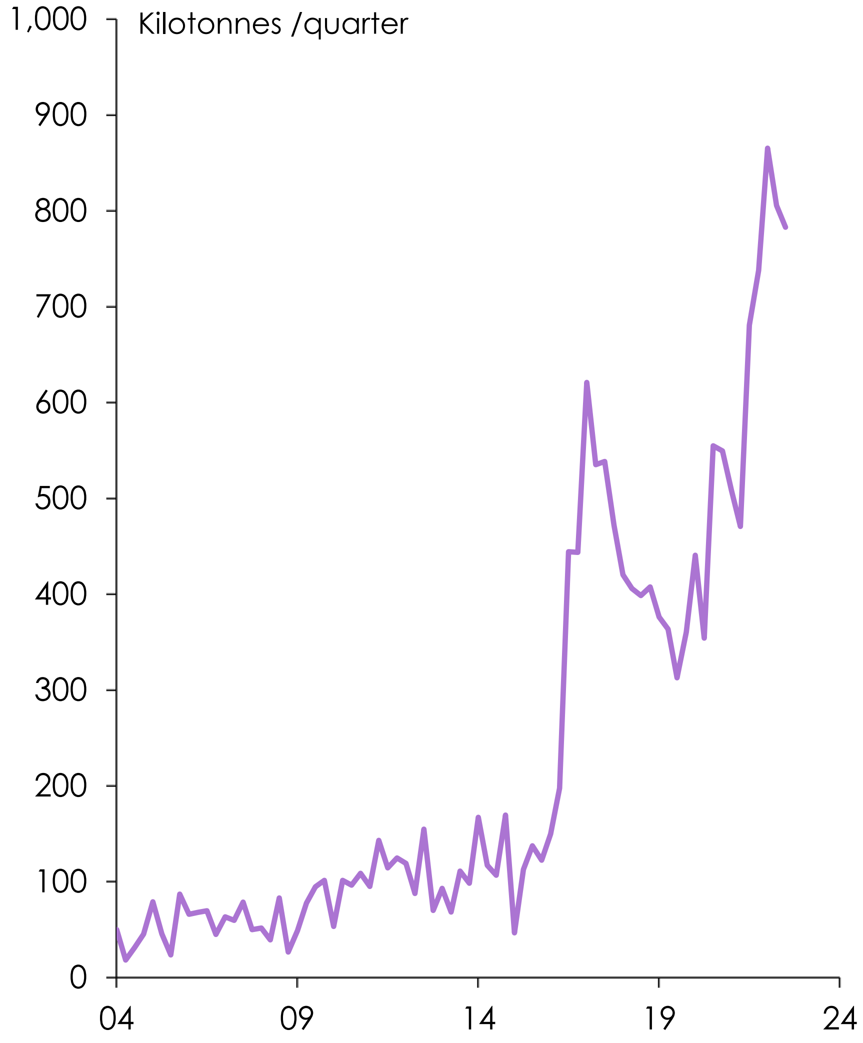
… and more recently it's been about spodumene (lithium ores)

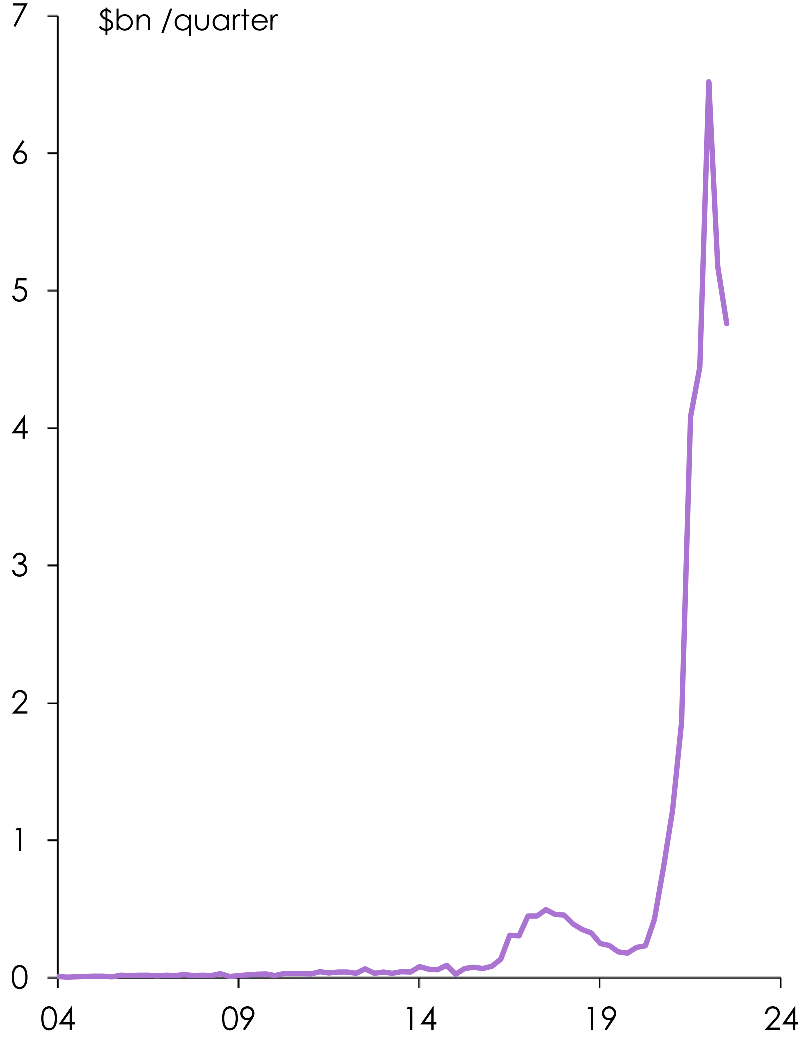
Spodumene prices



Volume of WA spodumene concentrate production



Value of WA spodumene concentrate production



Sources: Refinitiv Datastream; Government of Western Australia, Department of Mines, Industry Regulation and Safety, [Major Commodities Resource Data File](), *2022-23.*

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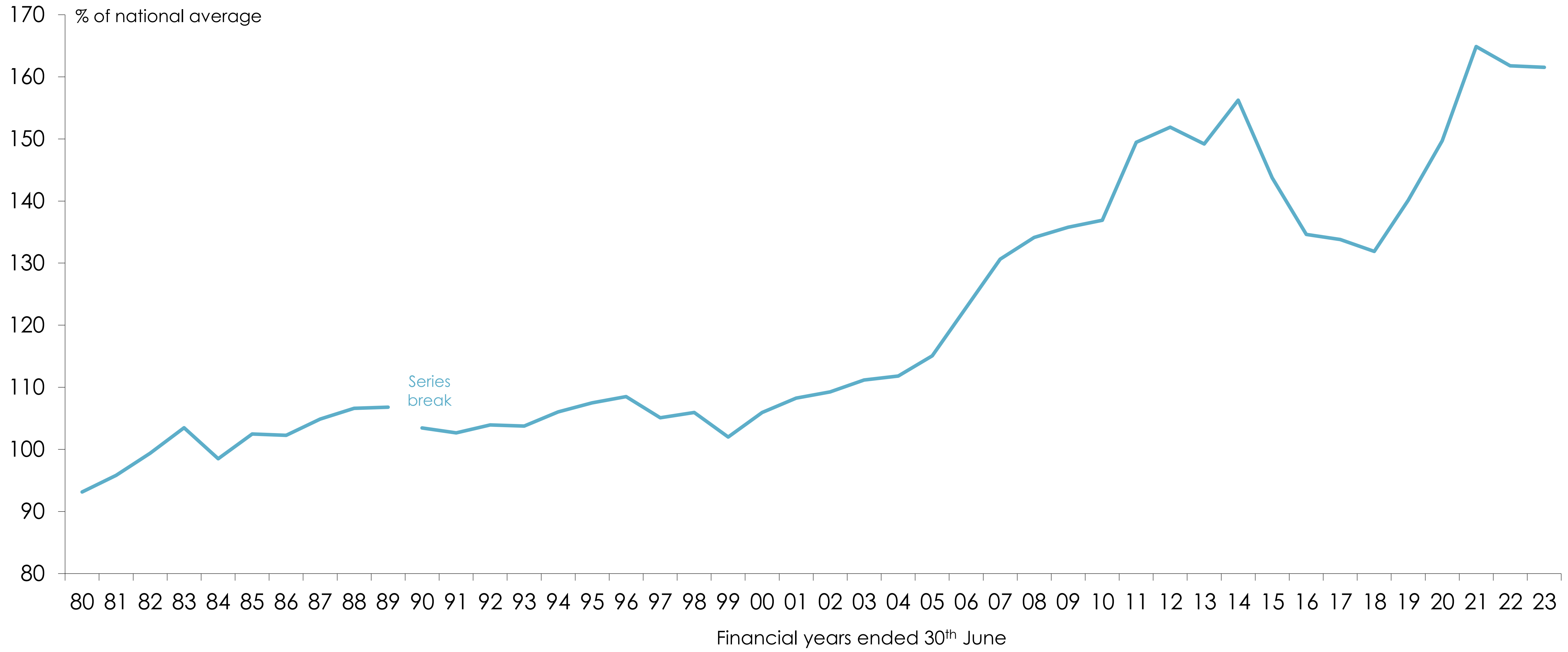
Western Australia has become the richest state in Australia, by a much bigger margin than any other state or territory has ever been

Western Australia's per capita gross product as a percentage of the national average



Source: ABS, *Australian National Accounts: State Accounts*, 2022-23 financial year, 21st November 2023.

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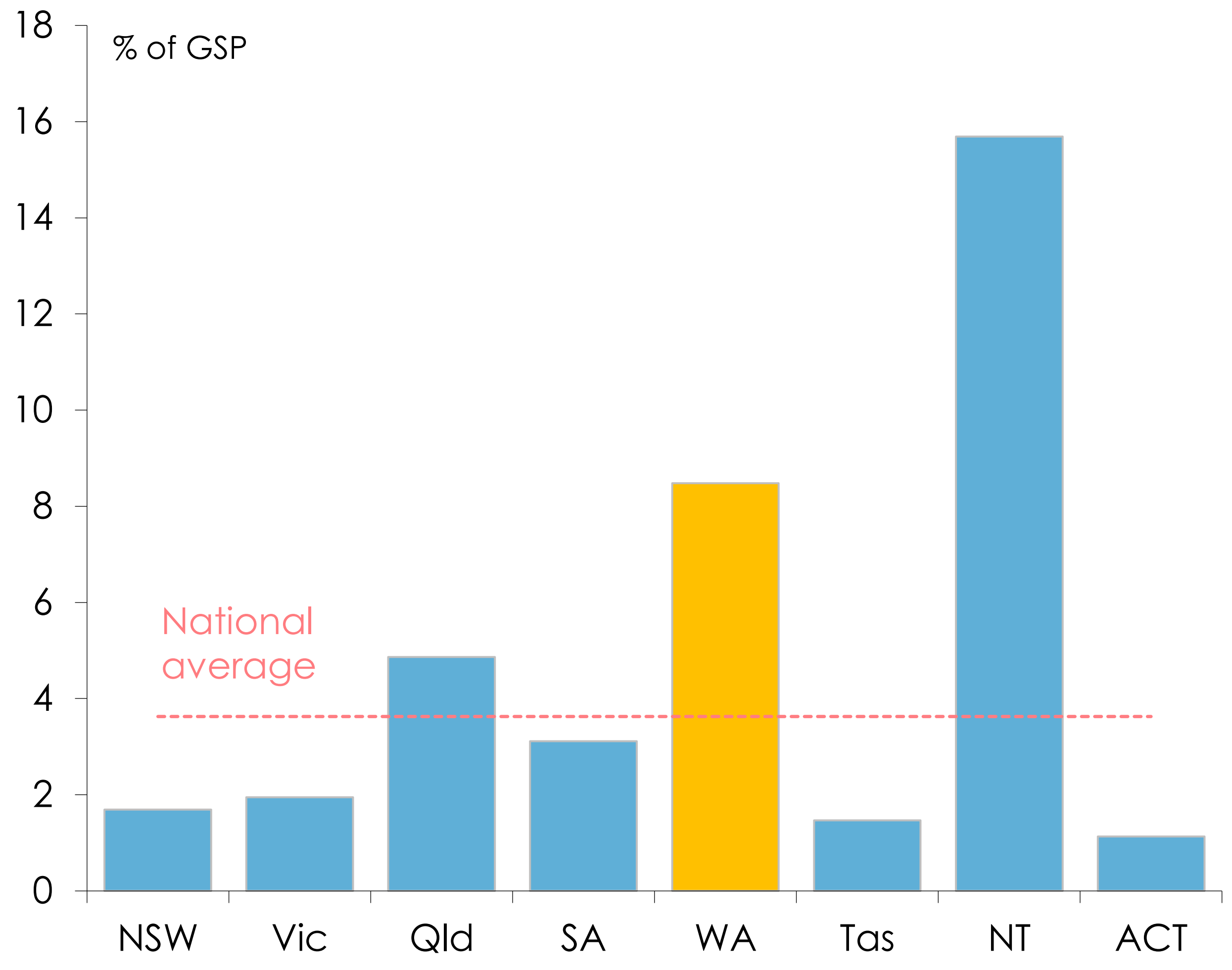
This extraordinary increase in WA's per capita GSP relative to the rest of Australia wasn't, primarily, the result of any WA policy initiatives

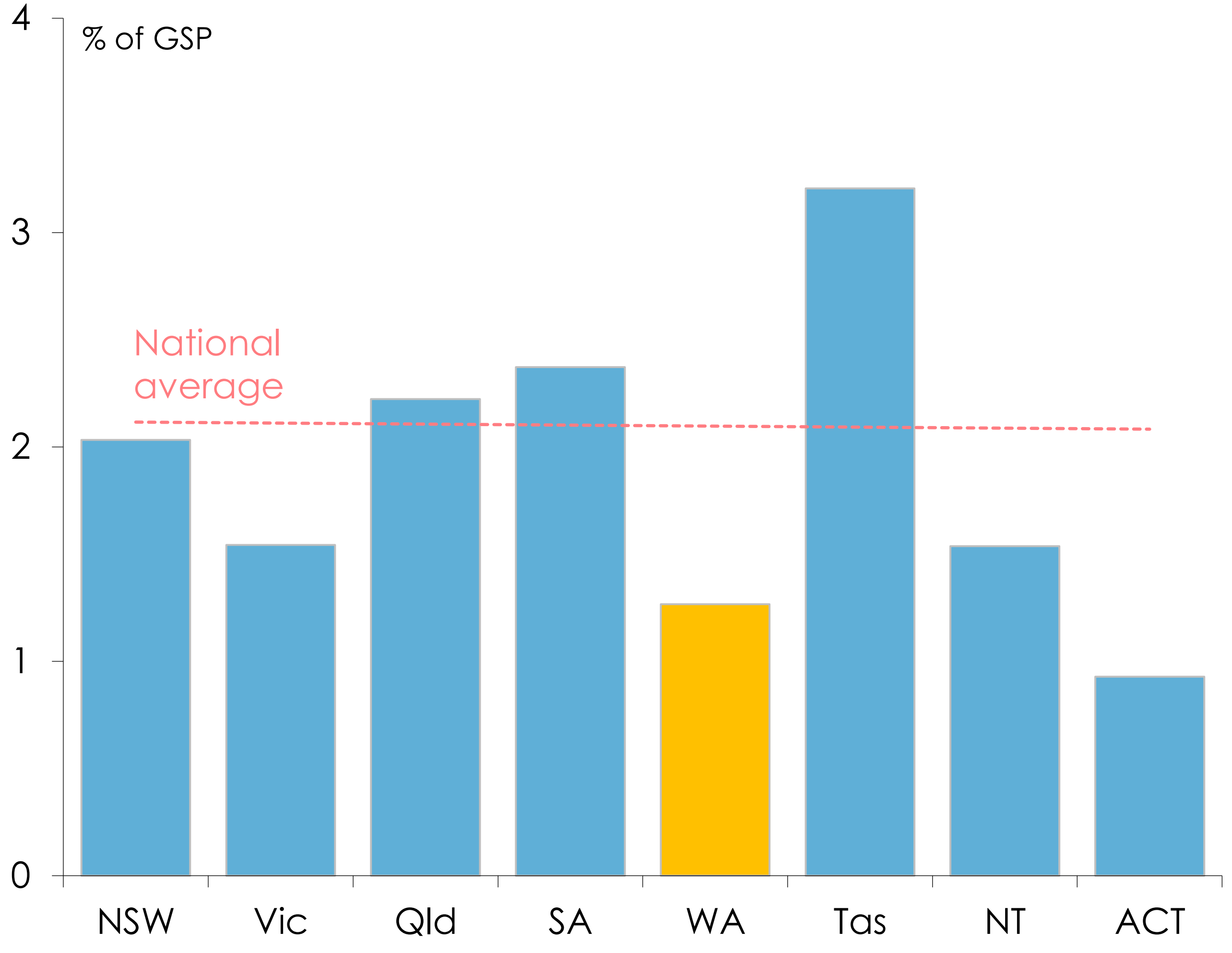
- To be sure, successive Western Australian state governments have assiduously courted investment in the state's resource sector
- But neither Western Australian Governments nor Western Australian entrepreneurs put the minerals in the ground under Western Australia, or the oil and gas under the seas off the north-west coast of Western Australia …
- … and they didn't drive the price of those resources up to the stratospheric levels they've reached (and in most cases held) over the past dozen or so years
- While some individual Western Australians put up a lot of capital to develop or expand mineral resources, the vast majority of the capital required to expand WA's minerals and energy production capacity came from shareholders in the 'Eastern States' or overseas
- And a good deal of the additional labour came from outside of Western Australia – either as a result of people moving to WA from the 'Eastern States' (as 786,000 people have done so far this century) and from overseas (as 550,000 people have done since 2000), or on a 'fly-in, fly-out' basis
- Additionally, in Western Australia mining companies are largely responsible for the provision of transport infrastructure such as railways and ports – in contrast to New South Wales and Queensland where those facilities are largely provided by State governments
  - large mining companies in Western Australia are also expected to contribute financially to the provision of education and health services in the areas in which they operate
- A surprising number of Western Australians seem to think that if only other state governments weren't "so hostile" to mining investment, they would enjoy the same prosperity as Western Australians are

It's nonsense to suggest that WA needs a bigger share of GST revenue in order to 'build the infrastructure required to support resources development'

Value of engineering construction work done for the private sector, 2013-14 to 2022-23



Value of engineering construction work done for the public sector, 2013-14 to 2022-23



Sources: ABS, *Engineering Construction Activity, Australia*, September 2023; *Australian National Accounts: State Accounts*, 2022-23 financial year.

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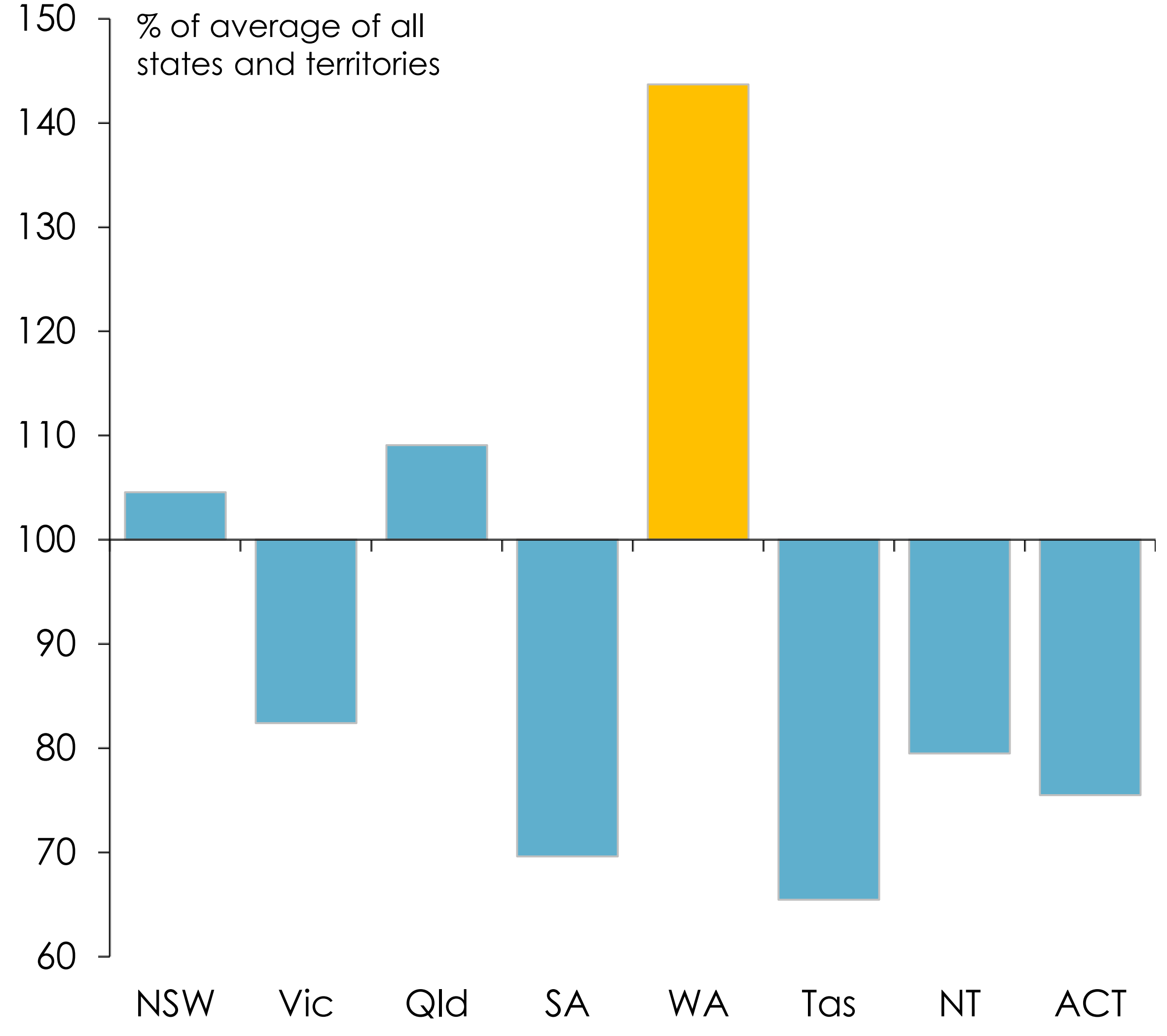
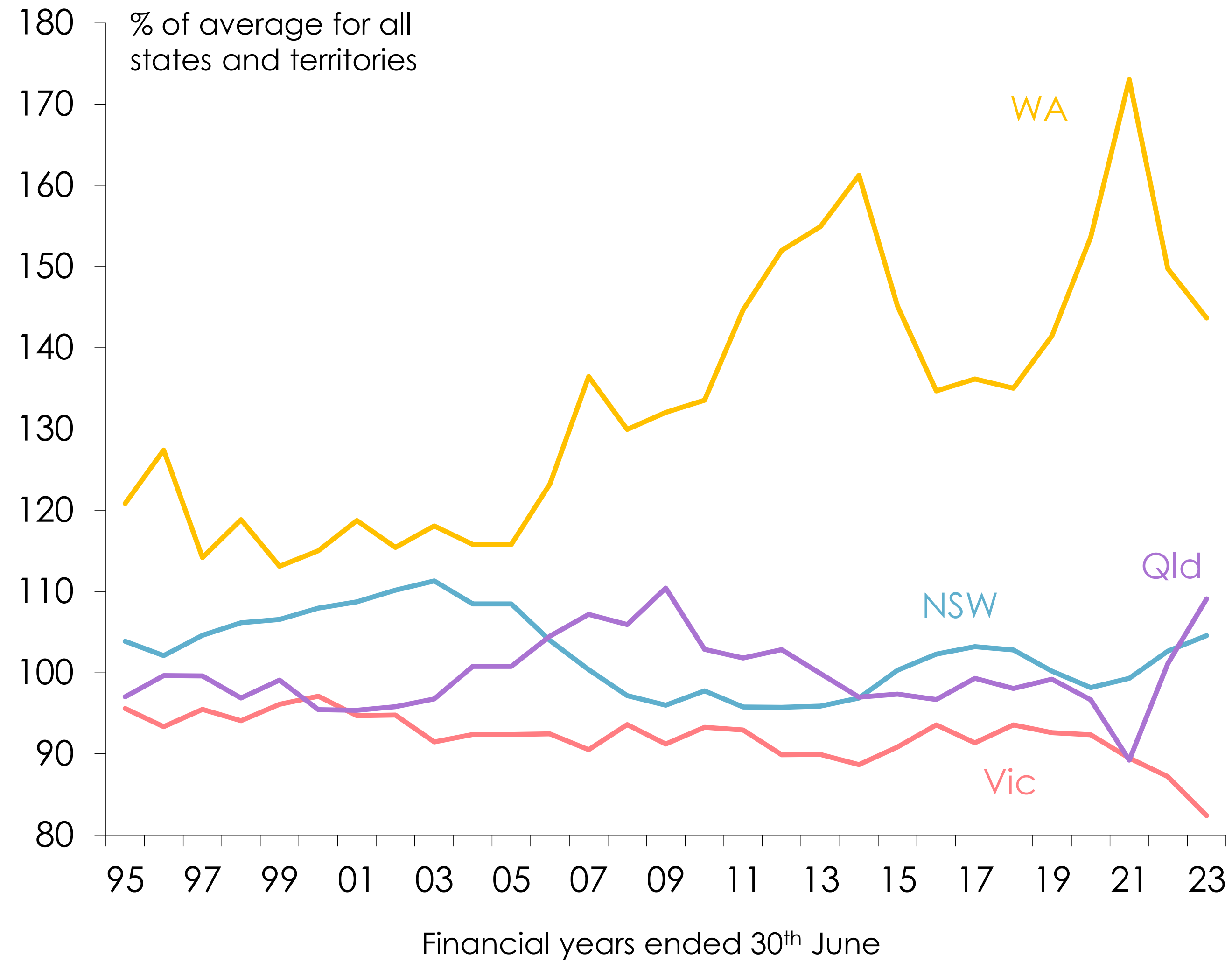
Never before has any one state's revenue-raising capacity exceeded that of the others by as much as Western Australia's has in the past 15 years

Grants Commission's assessment of states' & territories' revenue-raising capacities, 2022-23



Grants Commission's assessment of largest states' revenue-raising capacities, 1994-95 to 2022-23



Source: Commonwealth Grants Commission, [2024 Update - Tables, charts and supporting data], 12th March 2024. Note that there are discontinuities in the data on revenue-raising capacities at five-yearly intervals due to changes in methodology.

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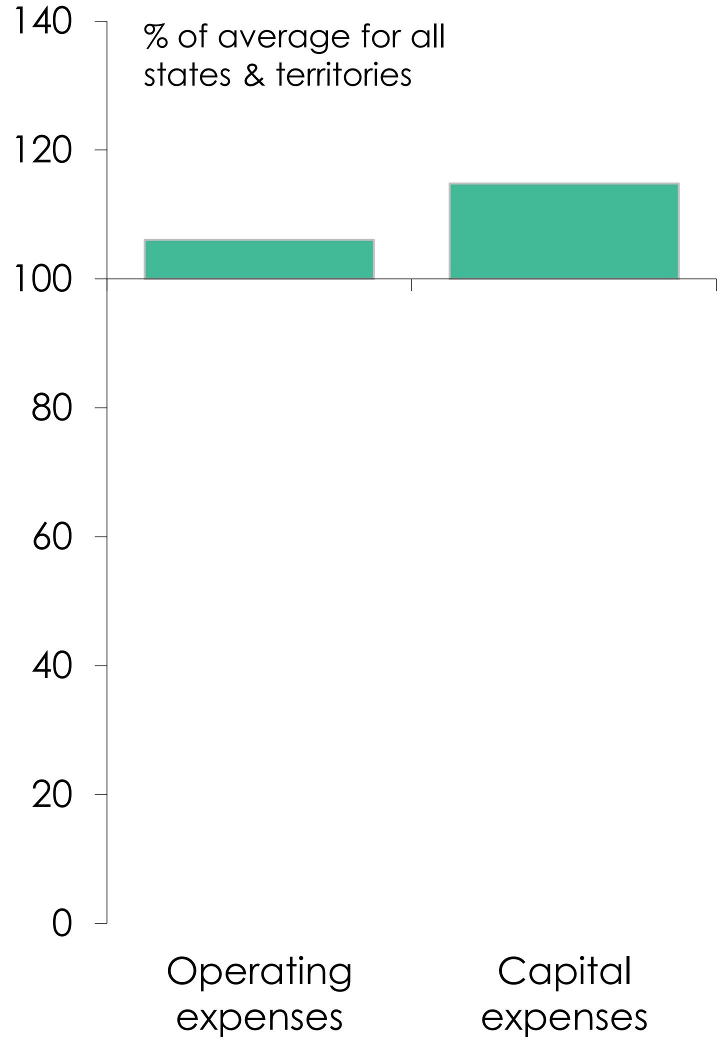
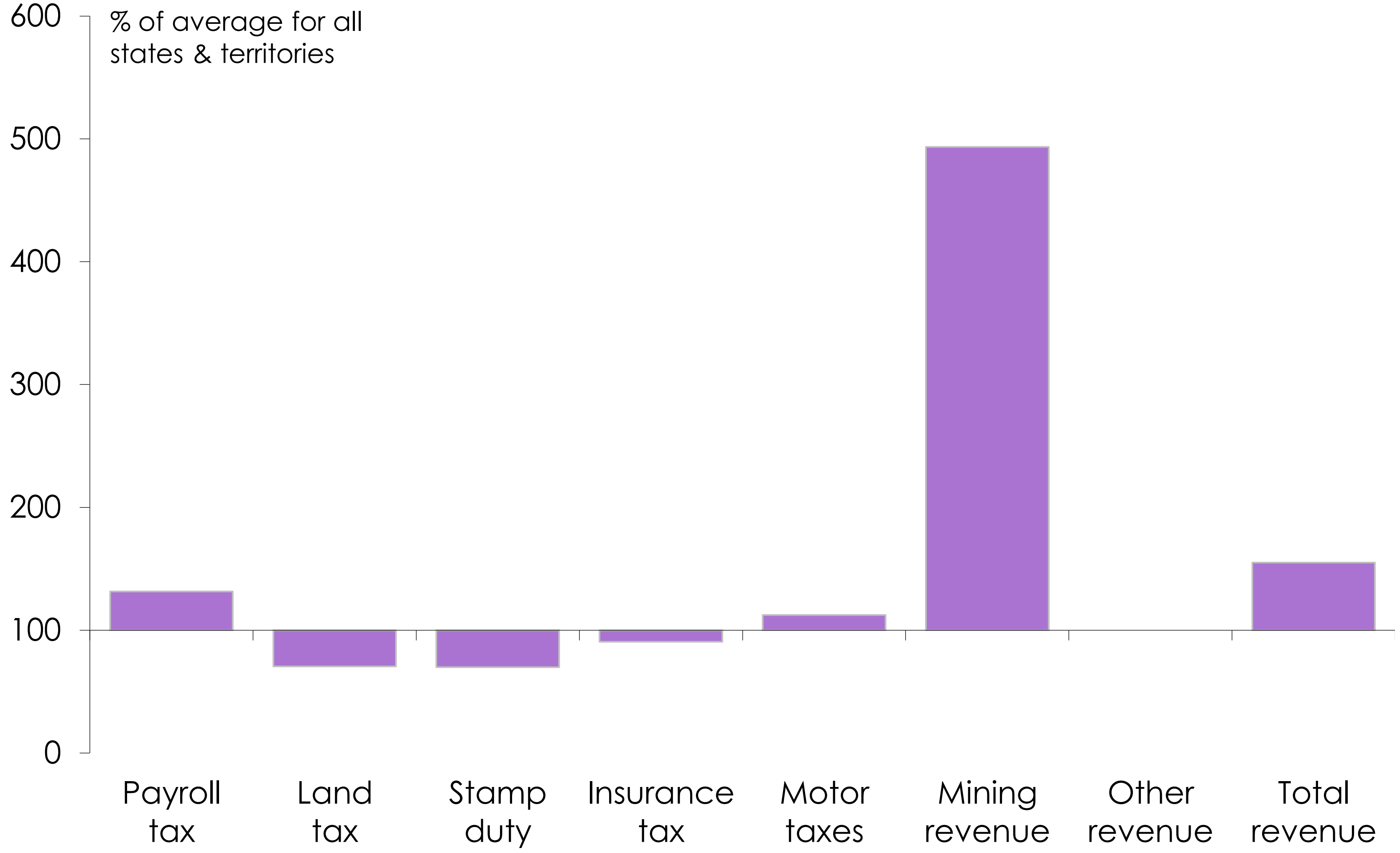
The Grants Commission recognizes WA's need for above-average per capita spending: WA thinks it should ignore WA's revenue-raising capacity

CGC's assessment of WA's spending needs, 2019-20 to 2022-23



Commonwealth Grants Commission's assessment of WA's revenue-raising capacity, 2019-20 to 2022-23



Source: Commonwealth Grants Commission, *2024 Update - Tables, charts and supporting data*, 12th March 2024.

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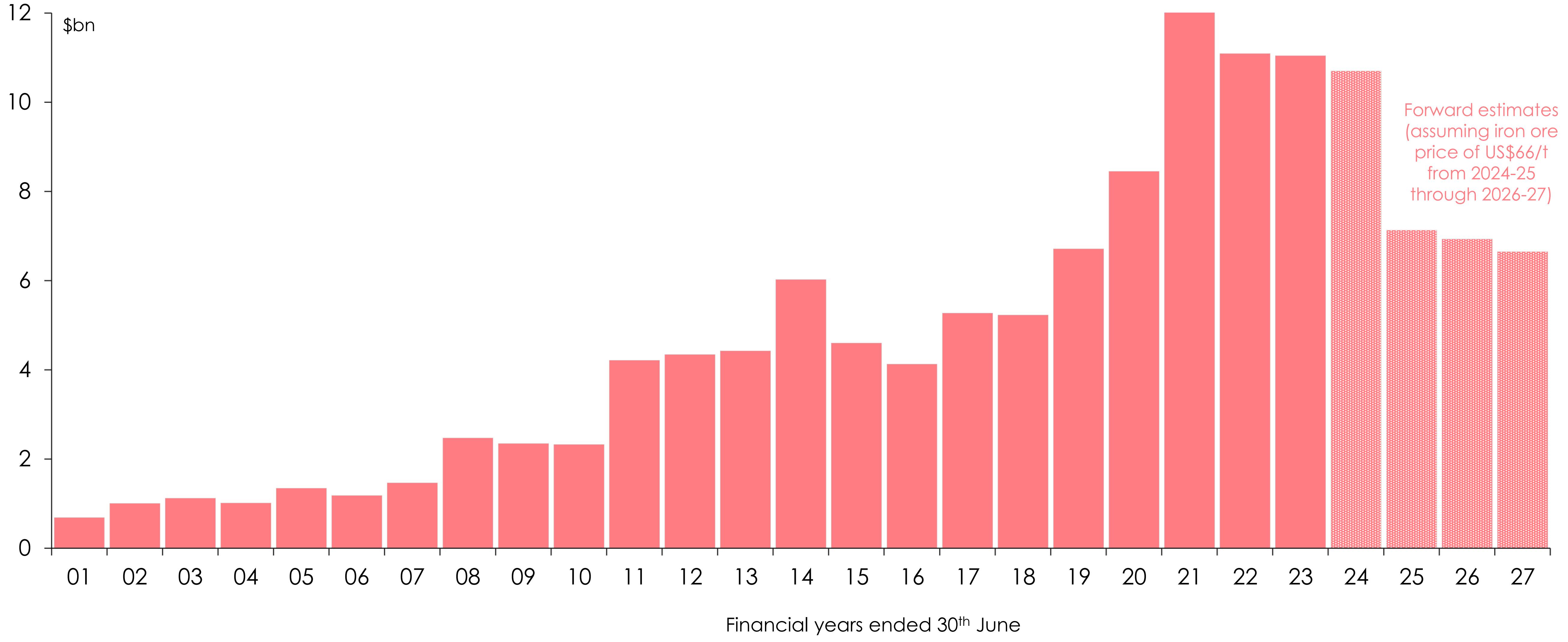
Western Australia is now raking in over $10bn a year in mineral royalties, compared with about $1bn a year 20 years ago

Western Australia's mineral royalty revenues



Source: Government of Western Australia, Annual Report on State Finances 2022-23 and previous issues; Government Mid-year Financial Projections Statement 2023-24.

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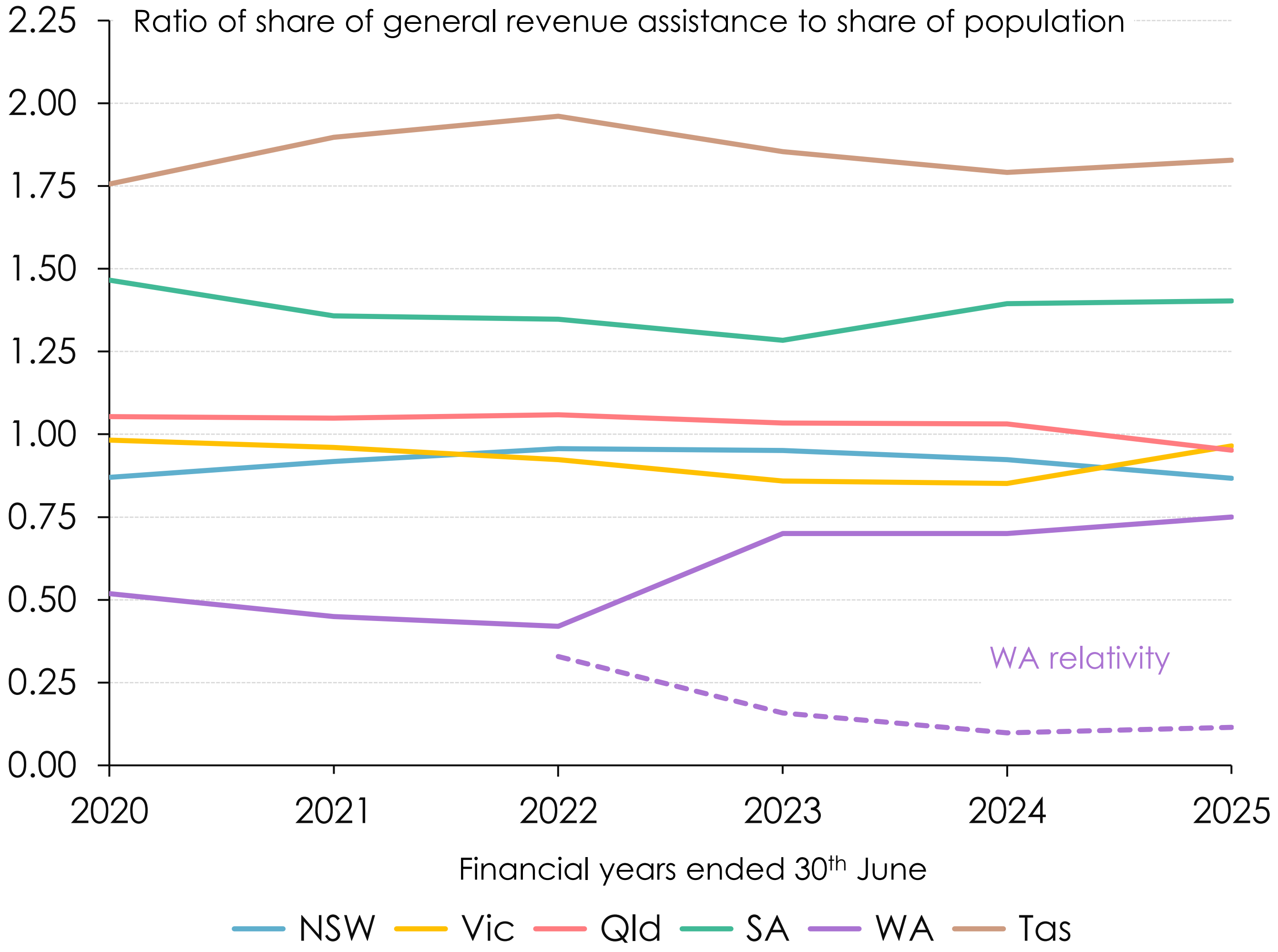
Western Australia repeatedly complained that this was ‘unprecedented’ and ‘unfair’ that it ‘only got 30c in the dollar’ of ‘its GST’

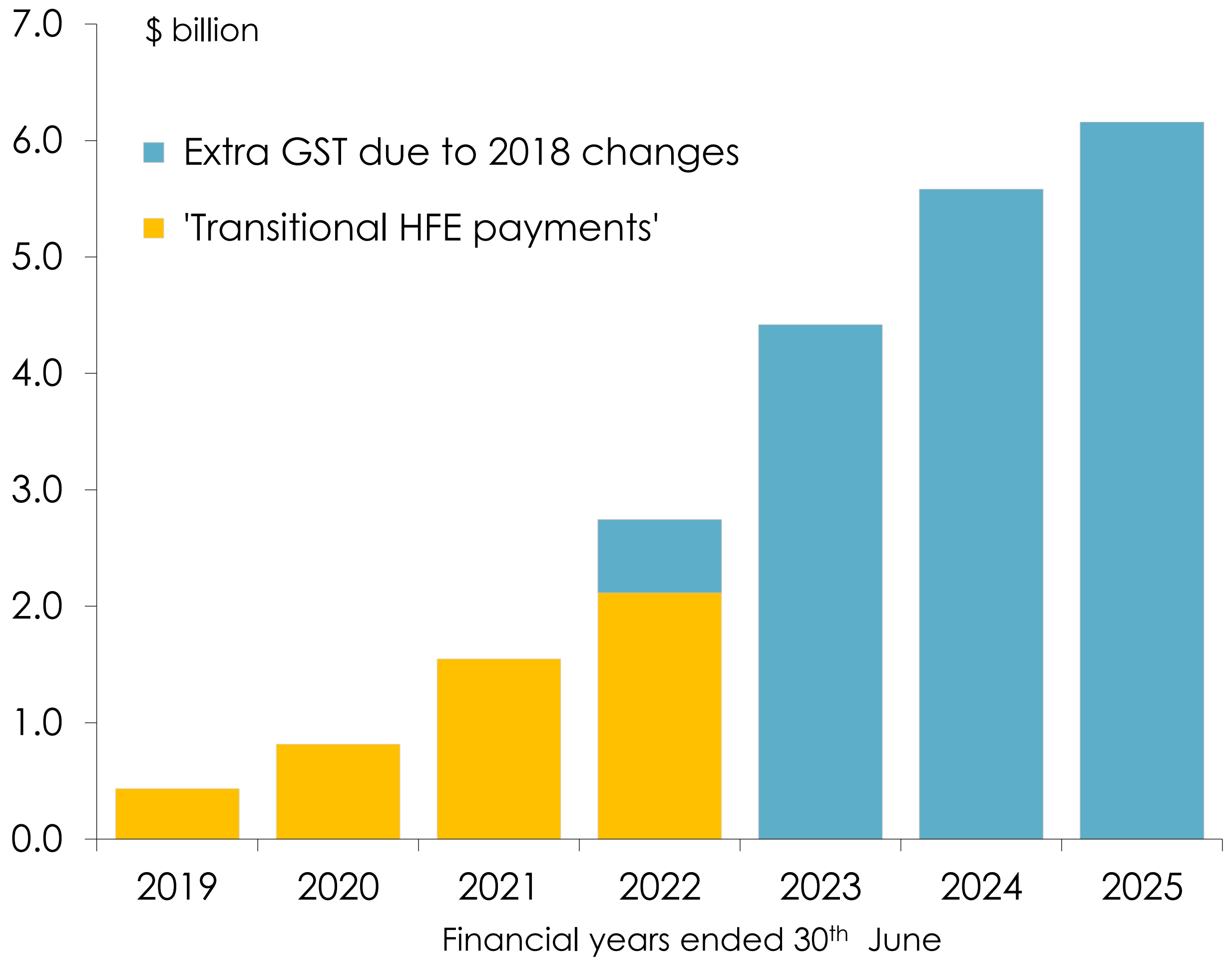
- **Successive Western Australian governments repeatedly claimed that there was something ‘unprecedented’ and ‘unfair’ about the decline in its share of GST revenues, to (as they put it) ‘less than 30 cents in the dollar’ of ‘their GST’**
  - previous Western Australian governments had never seen anything wrong with WA getting more than “150 cents in the dollar” – as it did between 1947 and 1970
- **No-one (including the ATO) actually knows how much GST is collected in each state and territory, or paid by the residents of each state and territory**
  - not least because residents of each state frequently purchase goods or services supplied by a business in a different state or territory from the one in which they live
  - it’s not “WA’s GST” (or any other state’s or territory’s) – it’s collected by the ATO, a Federal Government agency, and distributed to the states and territories under legislation enacted by the Federal Parliament
- **The decline in Western Australia’s share of GST revenues, relative to what it would have obtained under a notional equal-per-capita distribution, was ‘unprecedented’ only because the increase in WA’s ‘fiscal capacity’ was also unprecedented**
  - contrary to WA’s repeated assertions, it was not evidence that the system was ‘broken’
  - the Northern Territory has been receiving an otherwise unprecedently large share of GST revenues, and prior to 2000, financial assistance grants, since it joined the ‘system’ in 1987
- **It’s true that the volatility in WA’s mineral royalty revenues led to volatility in its (and other states’ and territories’) GST revenue shares**
  - but the option was always open to WA to ‘save’ any ‘excess’ GST revenue received in years when mineral royalty revenue was unexpectedly weak, to cushion the impact on GST revenues when mineral royalty revenue was unexpectedly strong
  - they just chose not to

By 2024-25, WA will have received $21.7bn more from ‘transitional’ payments and GST distribution than it ‘should have’ under pre-2018 rules

State ‘relativities’ for the distribution of GST revenues, 2000-01 to 2020-21



Additional GST revenue paid to Western Australia compared with entitlements under ‘old rules’



Note: Territories not shown. *Sources:* Commonwealth Grants Commission, 2024 Update: Relativities over time; 2024 Update and previous reports; Australian Government, Final Budget Outcome - Part 3: Australia's Federal Financial Relations, 2021-22, 2020-21, 2019-20 and 2018-19.

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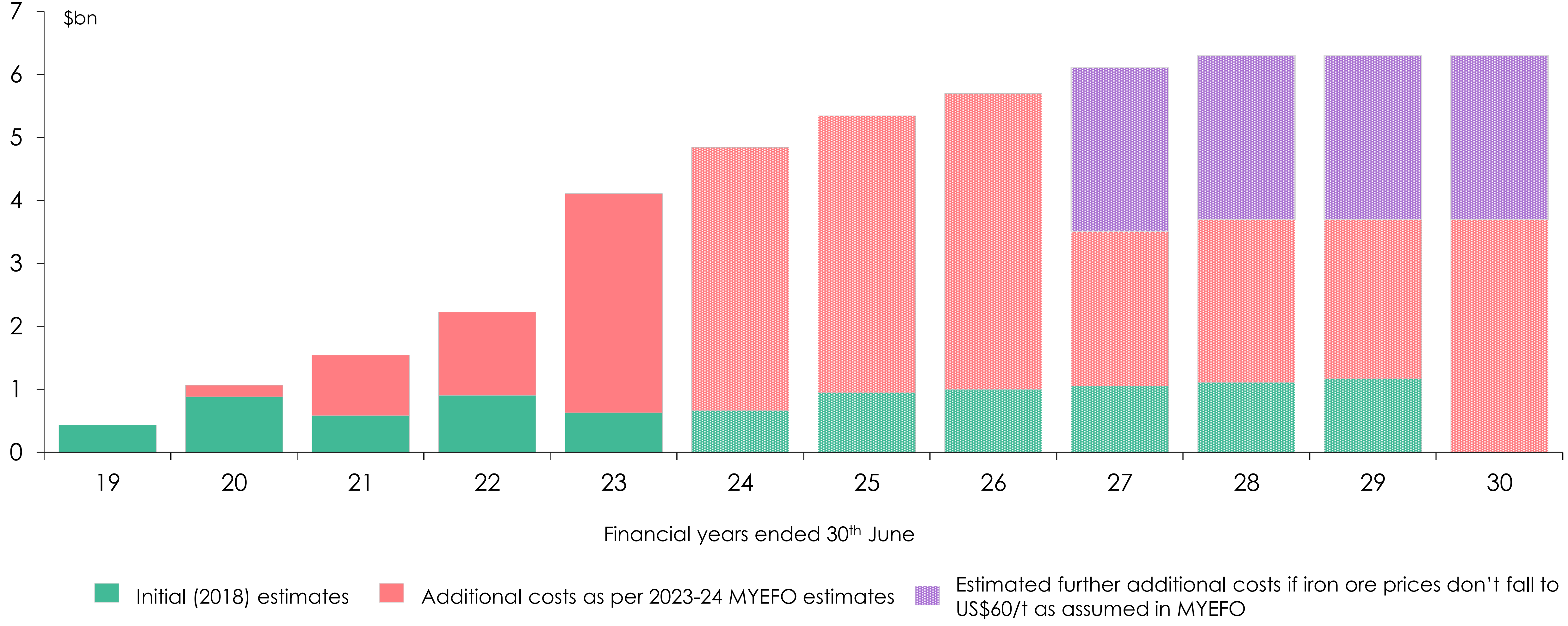
The Productivity Commission's inquiry into HFE had loaded terms of reference, and was conducted hastily, in a most un-PC like manner

- **The Productivity Commission's inquiry into horizontal fiscal equalization was given loaded terms of reference by Scott Morrison as Treasurer in May 2017**
  - they read as if they had been drafted, in the first instance, by the Western Australian Treasury, so replete were they with the grievances previously expressed by successive WA State Governments about the operation of the HFE system
- **The PC inquiry was conducted with unusual haste**
  - the Draft Report was published just five months after the Terms of Reference were issued, and the Final Report handed to the Government in just under 12 months after the ToRs were issued
  - by way of contrast the PC's recent inquiry into carer leave – a less complex subject than horizontal fiscal equalization – took just over 12 months to issue a 'position paper' and more than 15 months to deliver the Final Report to the Government
- **It was conducted with scant regard to much of the evidence presented to it**
  - in particular, having been tasked (by the ToRs) to consider whether HFE discouraged states from 'developing potential industries' or created 'disincentives for reform' (recurring WA gripes), the PC (like other inquiries before it) couldn't find any evidence to support these assertions
  - but it then asserted that 'absence of evidence wasn't evidence of absence' (the same logic as used by Bush, Blair & Howard to justify the 2004 invasion of Iraq despite UN weapons inspectors' inability to find evidence that Saddam Hussein possessed WMDs), and repeated that assertion in its Final Report
  - unlike the inquiry conducted in 2012 by Nick Greiner & John Brumby – who had the intellectual integrity to acknowledge that there was no evidence to support the arguments they'd used when they were Premiers of their respective states
- **There was apparently considerable unease among some of the staff who worked on that inquiry with the way it was conducted**
  - and one PC staff member subsequently resigned for that reason

The changes were originally estimated to cost the Federal Budget $8.2bn over 8 years – now it's $39.8bn over 11, and could be as high as $50bn

Estimates of the cost to the Federal Budget of the 'no-worse-off transitional guarantee' and other payments to WA



Source: Australian Government, *Government interim response to Productivity Commission inquiry into horizontal fiscal equalization*, 5th July 2018; and *2023-24 Mid-Year Economic and Fiscal Outlook*, 13th December 2023; Corinna estimates.

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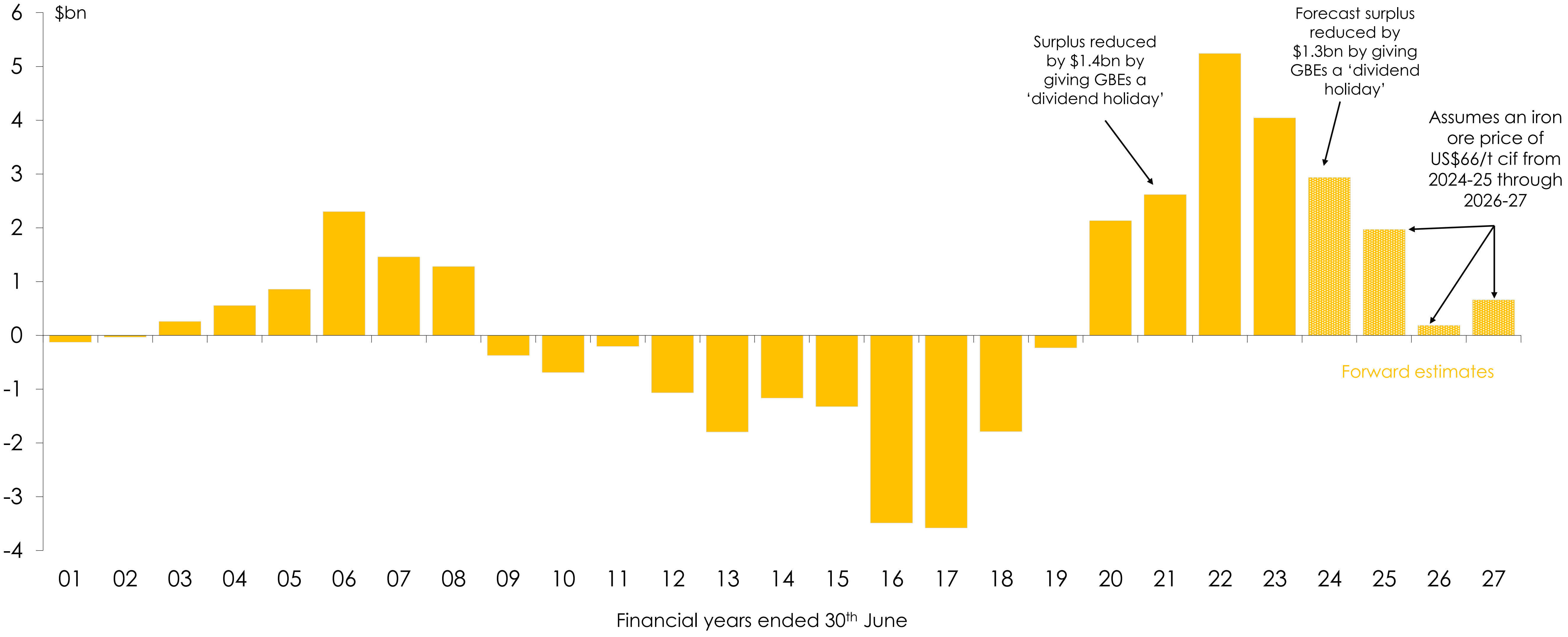
Western Australia expects to run surpluses totalling $20bn over the 8 years to 2026-27, cf. the Eastern states & territories deficits totalling $301bn

Western Australia's 'general government' cash balance



Source: Government of Western Australia, *Annual Report on State Finances 2022-23* and previous issues; Government Mid-year Financial Projections Statement 2023-24.

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Why ….

- **Why should the Federal Budget, which (according to MYEFO) is in structural deficit (notwithstanding the surplus recorded in 2022-23, and probably in 2023-24), be transferring \$40bn (or maybe as much as \$50bn) to the only budget in Australia – and one of very few in the world – which is in structural surplus?**
  - the *volume* of WA's mineral production has risen so much over the past two decades that WA may still record budget surpluses even if commodity prices fall back to the levels assumed in federal or WA Budget Papers

- **Why should the Federal Government in effect 'gift' \$40bn – or maybe as much as \$50bn – to the government of the richest state in Australia, a state which is richer than the rest of Australia by a bigger margin than any other state has ever been?**
  - so that its citizens can ultimately enjoy better public services and lower state taxes than citizens of other states and territories?
  - especially when those riches are largely the result of luck, rather than effort or 'good policy?

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It's all about House of Representatives seats from Western Australia

- Going into the 2019 and 2022 elections, the Coalition held 12 of Western Australia's 15 seats in the House of Reps
  - it knew that it couldn't afford to lose any of those seats if it were to have any chance of retaining government at either of those elections
  - which it didn't in 2019, but did (it lost 4, three of them to Labor) in 2022
- Conversely Labor knew it had to win some of those seats if it were to have any chance of winning the 2019 or 2022 elections
  - which it didn't in 2019, but (aided by the 'McGowan factor') it did in 2022
- Now the electoral arithmetic is reversed
- Labor knows that – unless it can improve on its dismal 2022 performance in Queensland, it can't afford to lose any of the WA seats it won in 2019
  - and it won't have the 'McGowan factor' to help it in 2025
- Conversely the Coalition knows it has to win back some of the WA seats it lost in 2022 (along with a lot of seats in other states) if it is to have any chance of returning to government in 2025

What should happen now

- The Orwellian-sounding *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* stipulates that the Productivity Commission report by 31st December 2026 on whether the changes to the GST sharing arrangements imposed by that Act are working 'efficiently and effectively'
- But there's nothing to stop the Government giving the Productivity Commission broader terms of reference than that
- The Government should ask the Productivity Commission also to review
  - whether the changes made in 2019 represent a prudent or sensible use of at least $40bn, maybe $50bn
  - and whether the changes have resulted (or will result) in 'equitable' outcomes
- The Productivity Commission could also be asked to make recommendations as to how to achieve the broad aims of horizontal fiscal equalization in a simpler, more transparent and more comprehensible manner
  - eg by using proxies such as gross state product per capita; proportions of populations aged 65+, 5-168, living with disability, Indigenous or of low SES background, living in remote or very remote areas, etc
  - one of the reasons
- The Productivity Commission would need more time to complete these tasks
  - which is why the PC inquiry should start sooner rather than later
- Encouragingly, PC Chair Danielle Wood is already on the record (in her previous role as CEO of the Grattan Institute) as saying that the 2019 changes should be scrapped

Important information

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