The cost of appeasing Western Australia's greed

Two years ago, following a Productivity Commission inquiry, the Morrison Government made two important changes to the long-standing system of 'horizontal fiscal equalization' under which the revenue from the GST is distributed among the states and territories on the recommendations of the Commonwealth Grants Commission:

- whereas, since 1981, the Grants Commission had been required to recommend a distribution (prior to 2000, of Commonwealth 'general revenue grants' to states and territories, and since 2000, of revenue from the GST) which would allow each state and territory government to provide public services at the same standard as those of the 'fiscally strongest' state, over a five year period beginning in 2021-22 the Grants Commission's objective would change to that of allowing each state and territory government to provide public services at the same standard as the 'fiscally stronger' of New South Wales and Victoria; and

- irrespective of the outcome of those recommendations, from 2022-23 no state or territory would receive less than 70% (and from 2024-25 75%) of what it would receive under a notional 'equal per capita' distribution of the revenue from the GST.

The Morrison Government describes these changes as being required in order to provide "a fairer and more sustainable way to distribute the GST among the states [sic]".

In fact, they were a response to the persistent complaints from Western Australia about the decline in its share of GST revenue as a result of the enormous improvement in its 'fiscal capacity', relative to the other states and territories, flowing from the 'mining boom' – which saw WA's mineral royalty revenue increase from less than $700mn in 2000-01 to over $6bn in 2013-14, then decline to $4.1bn in 2015-16, before roaring back to a forecast $10.7bn in the 2020-21 fiscal year. Because a state's capacity to raise revenue from its own sources is one of the principal things which the Grants Commission takes into account (along with the demand for state public services and the unit cost of providing them) in determining how the revenue from the GST should be carved up, WA's share of GST revenue fell from a peak of $4.0bn in 2007-08 to $1.9bn in 2015-16 (a drop which was more than offset by the increase in WA's royalty revenues over this period) – although it since climbed back to $3.5bn in 2019-20 (even though WA's mineral royalty revenue has also nearly doubled over this period).

However, because Western Australia is so important to the Coalition at a Federal level – it has held at least two-third's of WA's seats in the House of Representatives at every federal election since 2004 – and because WA had five Cabinet Ministers (out of 22) at the time – following the Liberal Party's loss at the WA State election in March 2018, the Federal Government overturned the principles which had governed the distribution of 'untied' grants from Canberra to the states since 1936 (and territories since the 1980s) – principles which had worked to WA's financial advantage for more than 70 years, until the 'resources boom' turned Western Australia into the richest state in the Commonwealth.

It's important to remember that – all else being equal – the distribution of GST revenues is a 'zero sum game': anything which makes one state or territory better off inevitably and unavoidably makes other states and territories worse off. So it is with acceding to Western Australia's demands that the system be changed to give it a larger share of the GST revenue than it would have been entitled to under the long-standing 'rules of the game'.

However, in a concession to the other states and territories, the Morrison Government undertook that for a six-year 'transitional period', from 2021-22 to 2026-27 inclusive, the Federal Government would 'guarantee' that no state or territory would receive less under the 'new system' than they would have received under the 'old' one. At the time, it was assumed that this 'guarantee' would in practice not be called on, because the iron ore price was assumed to remain at the level of US$55/t to which it had fallen.

Instead, however, the iron ore price has returned to, and surpassed, its previous peaks. As a result, the cost of the 'transitional guarantee' is now estimated to be $7½bn over the four years 2021-22 to 2024-25, according to a table up the back of Budget Paper No. 3 accompanying last month's Federal Budget (reproduced below: note that in making this projection, Treasury uses different – though unstated – assumptions about the iron ore price from the one stated explicitly in Budget Paper No. 1, ie that it will fall to US$55/t by March next year).

Table 3.8: Other general revenue assistance

$million	2020-21	2021-22	2022-23	2023-24	2024-25
ACT municipal services	41.2	41.7	42.3	42.9	43.4
Compensation for reduced royalties	19.5	24.2	24.3	22.6	17.9
Royalty payments	362.0	352.7	337.3	329.0	271.7
Transitional GST top-up payments(a)	1,546.6	2,115.2	-	-	-
HFE transition payments(a)	-	124.5	2,312.2	2,422.1	2,748.0
Total other general revenue assistance	**1,969.3**	**2,658.3**	**2,716.1**	**2,816.7**	**3,081.0**

(a) Estimates of the HFE transition payments for 2022-23 and later years are based on a technical assumption of current GST relativities, and adjusted to take into account the transition to the new HFE system.

This is a sum which the Federal Government will be, in effect, adding to its own budget deficit in order to boost the surpluses being run by Western Australia – the only government in Australia, and almost certainly one of very few anywhere in the world, which is running and forecasting budget surpluses – by an equivalent amount. Otherwise, that $7½bn would have been stripped from the GST shares of the other states and territories.

All of this leaves open the question as to what will happen in 2027-28 when the 'transitional guarantee' expires. It could be – and the Federal Government would not doubt be hoping – that the iron ore price will have fallen to a sufficiently low level that WA's share of the GST will rise to more than 75% of what it would get under a notional equal-per-capita distribution, without the 'floor' being activated. My understanding is that the 'threshold' iron ore price for this outcome is – all else (including in particular coal prices, which are important for Queensland's share of the GST) being equal – US$70-75/t.

Given that the Grants Commission's determinations are derived from three-year rolling averages of the myriad assessments that it undertakes of different dimensions of each state's and territory's 'fiscal capacity', what matters is not only where the iron ore price ends up, but also *how long* it takes to get there.

Even if the iron ore price does end up being below US$70/t by mid-2027, the more slowly it falls towards that or a lower level, the more likely it is that the guaranteed 'floor' under WA's relatively will be 'binding', and hence that the other states and territories will end up paying for it, after the 'transitional guarantee' expires.

And of course if the iron ore price is still north of US$70/t by then, the other states and territories will be losing even more.

As reported by the Melbourne *Age* and *Sydney Morning Herald*'s Senior Economics Correspondent Shane Wright on Friday (see here), Victoria's Treasury has done some modelling of the possible consequences for the eastern states and territories when the 'transitional guarantee' expires. They show the impact on each state's and territory's GST shares in 2027-28 under each of six different scenarios, as summarized in the table below:

Table 1 – Difference in GST distribution based on former and new system, 2027-28 ($m)

Scenario	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
1: NSW and Vic stamp duty growth slows	-250	-196	-124	1,636	-17	2	-7	29
2: A decrease in WA's mining revenue	-105	-67	-6	1,185	18	14	1	35
3: Replicate mining boom scenario	-1,365	-1,178	-846	4,856	-258	-70	-70	6
4: Replicate 2011-12 relativities	-208	-193	-142	1,611	-21	1	-8	35
5: Replicate 2010-11 relativities	-332	-287	-224	1,955	-46	-7	-14	29
6: Relativities return to 10-year average	-1,198	-1,009	-744	4,360	-220	-58	-60	2

Source: Victorian Department of Treasury and Finance

The numbers in the above table don't refer to absolute levels of GST revenue shares, but rather to estimated differences between what Victoria's Treasury estimates the states and territories will receive in six years' time when the 'new rules' are fully in force and the 'transitional guarantee' expires, and what they would have received had the rules *not* been changed. They show that NSW, Victoria and Queensland are worse off, and in some cases significantly, under all six scenarios: and that the smaller states and the ACT are also worse off, by amounts which are in most cases significant for them, under most scenarios. (The Northern Territory appears to do OK under all of them – but the NT has much bigger problems of its own).

What Victoria's estimates *don't* encompass is the losses which all the eastern states and territories will experience as a result of the shift in the 'benchmark' to which states' and territories' fiscal capacities will be raised from the 'fiscally strongest' state – which at the moment, and for as long as iron ore prices remain at elevated levels is likely to be Western Australia – to 'the fiscally stronger of NSW and Victoria', which for the foreseeable future given Victoria's woes is almost certainly going to be NSW.

What this means in practice is that WA will get to 'keep' a much larger share of the windfall gains it is reaping – not from any particular 'hard work' by its own citizens, or by any extraordinary 'risk-taking' by them (with the exceptions, perhaps, of Andrew Forrest and Gina Reinhart – most of the capital to develop the iron ore mines has been committed by the foreign- or eastern states domiciled shareholders in BHP and Rio Tinto, or indeed even by its own government (since unlike Queensland or NSW, most of the rail and port infrastructure used by mining companies in WA is provided by the mining companies themselves, not by the state government) – than would have been the case if the iron ore had been located at, say, Broken Hill, rather than in the Pilbara.

This is what the Queensland Government had to say about this in its Budget Papers released last week:

> Queensland, like several other states, is concerned that these changes will ultimately lead to a fundamental reshaping of states' fiscal capacities.
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> Under the Australian Government's changes, Western Australia will benefit from heightened mining royalties without losing GST revenue. This will allow it to deliver more services, accrue less debt and implement lower taxes.
>
> The Australian Government's payments under the 'no worse off' guarantee are estimated to total $7.6 billion over the forward estimates. When the guarantee expires at the end of 2026–27, this cost will be borne by states unless the Australian Government responds appropriately.
>
> In attempting to fix a perceived problem, the Australian Government's unilateral changes could result in a substantial distortion of HFE and create a funding issue that states will need to grapple with in the future.

Presumably the New South Wales Government will also have something to say about this in its Budget Papers to be presented this coming Tuesday.

Unfortunately the Morrison Government – presumably out of a fear of losing any of the 11 seats it currently holds in Western Australia – appears wedded to the 'deal' which it imposed on the rest of the country three years ago. Speaking to the WA Chamber of Commerce and Industry on 14th April, the Prime Minister said "You have nothing to concern yourself with, when it comes to WA's GST deal. Nothing whatsoever … When it comes to this GST deal. It is in our marrow, it is in our bones, it is very much … within the heart and soul of our Government".

So this corruption of a system which has served Australia well for over 80 years – and in so doing helped to ensure that the degree of 'spatial inequality' in this country (the difference in living standards between, say, Tasmania and Western Australia) is much less than in other federations (between, say, Mississippi and Massachusetts, or between Newfoundland and Alberta, or even between Mecklenberg-Pomerania and Bavaria) – in order to appease the residents of Australia's richest state, seems set to continue.