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**TREASURER; MINISTER FOR COMMERCE;  
SCIENCE & INNOVATION; HOUSING & WORKS**

Our ref: 6867390

AFTS Secretariat  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Dear Sir/Madam

**WESTERN AUSTRALIA'S SUBMISSION TO THE REVIEW OF AUSTRALIA'S  
FUTURE TAX SYSTEM**

I am pleased to enclose the Western Australian Government's submission to the Review of Australia's Future Tax System.

The wide-ranging scope of this review provides the opportunity to consider visionary reform options that are only possible through inter-governmental cooperation, and is strongly supported by Western Australia.

A key thrust of Western Australia's submission is support for further examination of tax base sharing, which offers the opportunity to both improve States' fiscal autonomy and flexibility while also dramatically reducing tax administration and compliance costs nationally.

Our submission also highlights reforms to the Commonwealth tax system that would be conducive to investment and national economic activity, including in relation to the income tax zone rebate arrangements, depreciation allowances and a flow through shares scheme.

We also see the collection of the GST nationally and distribution of the proceeds between the States according to 'horizontal fiscal equalisation' rather than 'State of origin' principles as integral to any review of the national tax and transfer system, and a fertile area for productivity-enhancing reform.

At the same time we see States' retention of mining royalties as non-negotiable. Royalties are clearly distinct from taxes, and any transfer of this revenue base to the Commonwealth would significantly exacerbate the many problems caused by Australia's already excessive level of vertical fiscal imbalance.

I trust that you will find the submission useful and look forward to Western Australia's continuing participation in the review process.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Troy Buswell', written in a cursive style.

**TROY BUSWELL MLA  
TREASURER; MINISTER FOR COMMERCE;  
SCIENCE AND INNOVATION; HOUSING AND WORKS**

Enc.

03 JUN 2009



Western Australian  
Government  
Submission  
to the Review of

Australia's

**Future  
Tax System**

May 2009

Further information or enquiries related to this report may be obtained by emailing [TreasuryCommunications@dtf.wa.gov.au](mailto:TreasuryCommunications@dtf.wa.gov.au)

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# 1. Introduction

## 1.1. Western Australia's Contribution to the Federation

Western Australia's estimated population stands at nearly 2.2 million, or about 10.1 per cent of Australia's total population. Approximately 74 per cent of Western Australia's population lives in the Perth metropolitan region and about 3.5 per cent of its population is indigenous<sup>1</sup>.

The importance of the Western Australian economy to the national economy and Australia's international trade performance is highlighted by the fact that its merchandise exports of \$89.4 billion for the year to March 2009 represented 37.9 per cent of Australia's total merchandise exports for that period (more than double New South Wales' share of 16.5 per cent, more than four times Victoria's share of 9.0 per cent and higher than the combined share of Queensland and Victoria at 33.2 per cent)<sup>2</sup>. Western Australia's trade surplus for the same period was \$53.4 billion, compared to \$9.1 billion for Australia.

Similarly, total capital expenditure in Western Australia for 2006-07 and 2007-08 exceeded that of every other State and Territory (the States) and comprised 25.4 per cent and 26.8 per cent respectively of total capital expenditure in Australia for those years<sup>3</sup>.

Western Australia's gross state product (GSP) for 2007-08 was \$146.4 billion or 13.5 per cent of Australia's total gross domestic product (GDP) for that year. Its GSP per capita for 2007-08 was \$68,837, the highest of all States<sup>4</sup>.

The industries that contribute most to Western Australia's economy, measured as components of GSP for 2007-08, are mining (\$41,820 million or 28.6 per cent), property and business services (\$15,902 million or 10.9 per cent), manufacturing (\$11,901 million or 8.1 per cent) and construction (\$11,064 million or 7.6 per cent).

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<sup>1</sup> Australian Bureau of Statistics, Australian Demographic Statistics, September 2008, Cat. 3101.0

<sup>2</sup> Australian Bureau of Statistics, International Trade in Goods and Services, February 2009, Cat. 5368.0

<sup>3</sup> Australian Bureau of Statistics, Private New Capital Expenditure and Expected Expenditure Australia, December 2008, Cat. 5625.0

<sup>4</sup> Australian Bureau of Statistics, Australian National Accounts, State Accounts 2007-08, Cat. 5220.0

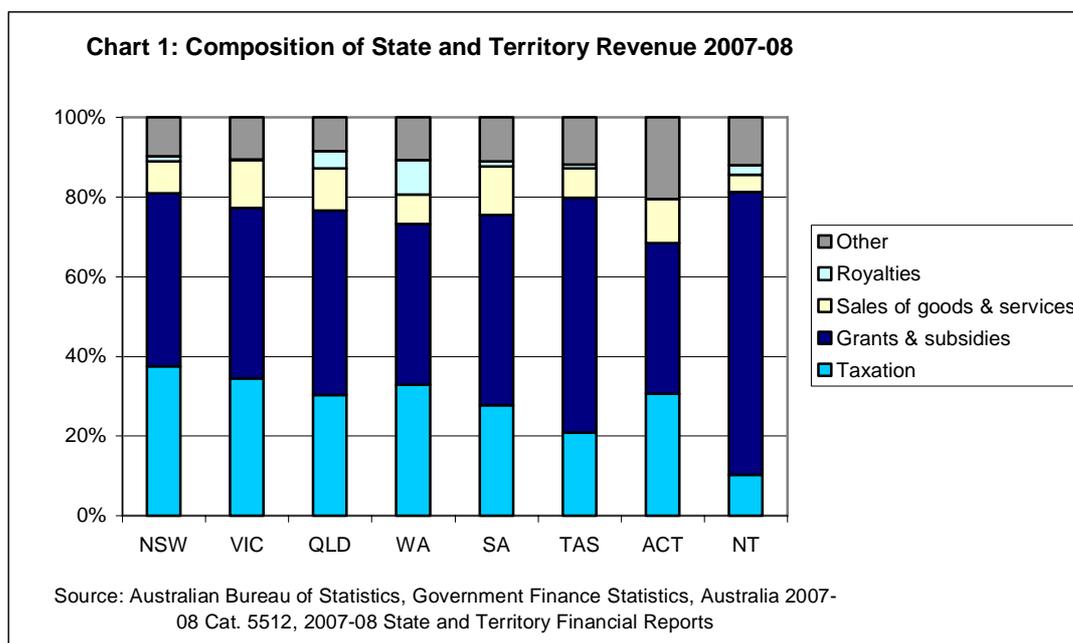
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The mining sector in Western Australia is clearly also a significant industry for Australia, comprising 50.6 per cent of mining output nationally and 3.8 per cent of Australia's total GDP<sup>4</sup>. Total mineral and petroleum exploration expenditure in Western Australia in 2007-08 was \$3,434.7 million, about 62.5 per cent of all mineral and petroleum exploration expenditure in Australia for that year<sup>5</sup>.

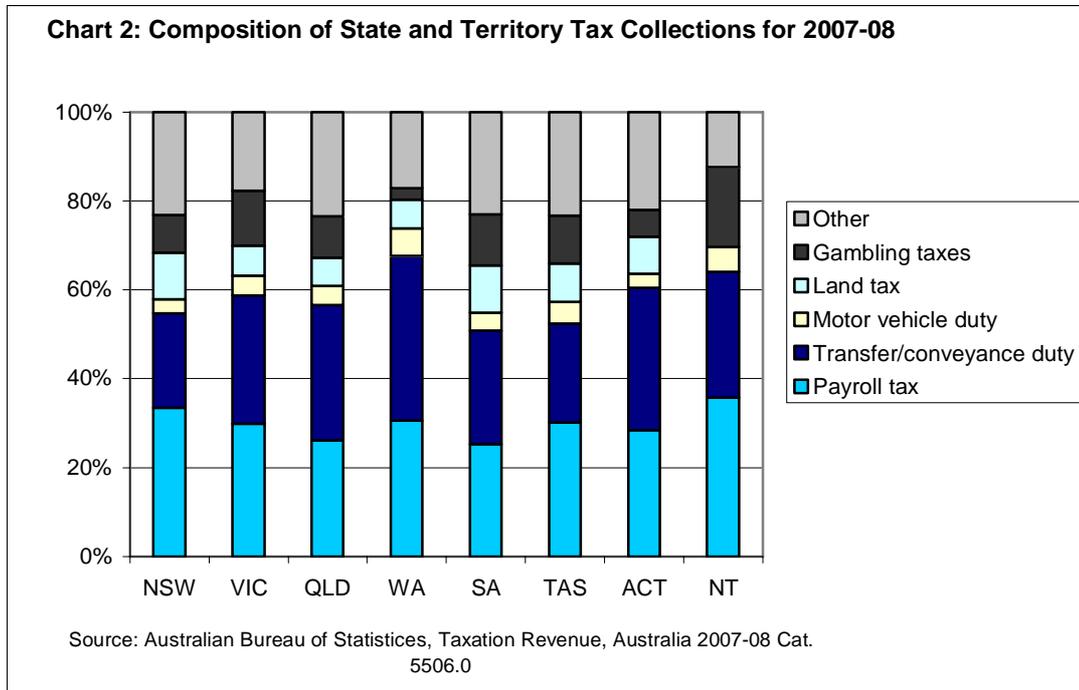
Western Australia is also very important to the overall fiscal health of the Australian economy and the individual States. For 2007-08, it is estimated that Western Australia contributed \$8.2 billion to the Federation in net terms. This is an estimate of the difference between revenue the Commonwealth derives from Western Australia (\$37.3 billion) and Commonwealth expenditure relating to the State (\$29.1 billion). Western Australia's contribution is much greater than New South Wales' and Victoria's, the only other States that are net contributors.

Western Australia's contribution is also reflected in the distribution of the Goods and Services Tax (GST) revenue by the Commonwealth. The horizontal fiscal equalisation (HFE) process applied by the Commonwealth Grants Commission will leave Western Australia with only 8 per cent of GST revenue in 2009-10, even though its population comprises over 10 per cent of Australia's total population. Western Australia's share of GST revenue is forecast to decline further to about 6 per cent in 2011-12.

The composition of Western Australia's revenue base compared to other States in part reflects its resourced-based economy and low share of Commonwealth grants.



<sup>5</sup> Australian Bureau of Statistics, Mineral and Petroleum Exploration, Australia, December 2008, Cat. 8412.0



Like other States, Western Australia's tax base is now largely limited to payroll tax; stamp duties on property transfers, insurance and motor vehicles; and land tax. Other States also collect significant tax revenues from gambling, whereas Western Australia continues to prohibit electronic gaming machines in hotels and clubs.

## 1.2. Our stake in Australia's Future Tax System

Western Australia strongly supports the inclusion of State taxes in the Australia's Future Tax System review (the Henry Review). A number of previous State reviews<sup>6</sup> have found that genuine reform of State taxes cannot be considered independently of Australia's federal financial relations arrangements and effectively requires national leadership and/or co-ordinated inter-governmental action.

Along with the Commonwealth of Australia and all other State and Territory governments, Western Australia recently formally recognised further reform of Commonwealth, State and Territory taxes as an integral part of improving federal financial relations, and the importance of improving the effectiveness and efficiency of the national tax system<sup>7</sup>.

Constitutional constraints (e.g. the exclusive Commonwealth power to impose 'excises', which are interpreted very broadly by the High Court) and the Commonwealth's effective monopoly on income tax have forced the States to rely on relatively inefficient and/or contentious taxes (as listed above) to fund essential State services/infrastructure in core areas such as health, education and law and order.

<sup>6</sup> Including Western Australia's May 2007 State Tax Review and the October 2008 Review of State Taxation by the New South Wales Independent Pricing and Regulatory Tribunal.

<sup>7</sup> Clause B9, Intergovernmental Agreement on Federal Financial Relations, which came into effect on 1 January 2009.

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Furthermore, the Commonwealth's current domination of taxation nationally drives high levels of vertical fiscal imbalance (VFI) between the Commonwealth and the States. While some of the issues associated with VFI are well articulated in the Henry Review papers published so far, Western Australia is concerned at the tendency to downplay the more serious VFI concerns, including:

- reduced incentives for States to initiate policies supporting growth and economic efficiency, as benefits in the form of increased tax revenue are received primarily by the Commonwealth, with only some of this revenue subsequently flowing back to the States (and even then it is distributed on the basis of equalisation principles rather than where the revenue originated); and
- the power it gives the Commonwealth to excessively influence areas of State responsibility, undermining core benefits of a federal system such as the tailoring of policies and priorities to local circumstances. This is of particular concern in Western Australia due to the State's unique economic, demographic and geographic features, and its physical remoteness from the federal capital.

This submission should be read in the context of the following.

- Our understanding that the Henry Review's focus is on long term direction setting and producing mainly high level recommendations that will potentially guide a number of reforms over time, rather than necessarily one major reform package.
- Our keen interest, before reaching firm positions, in seeing the outcome of the research commissioned by the Henry Review in core areas such as roads and transport, natural resources, environmental taxation and Australian-State government taxation.
- No modelling having been undertaken at this stage of the potential revenue or redistributive impacts of the reform options canvassed in this submission.

The focus of this submission is equally on reforms of Commonwealth taxes and concessions that are of particular importance to Western Australia but also considered to be in the national interest and in keeping with sound tax principles.

Appendix 1 includes a summary of feedback collected from a host of Western Australian government agencies in relation to the Henry Review, which it is hoped will provide a useful supplement to the public consultation already completed.

### 1.3. Summary of Recommendations

#### *Recommendation 1*

The Henry Review should examine the efficacy of the current zone rebate scheme, recognising the importance of the regions to Australia's economic wellbeing and that the attraction and retention of skilled and professional staff to these communities is critical for their future viability. Areas of focus should include:

- Options for restoring the value of the zone rebate, including:
  - reinstating the value of the zone rebate to reflect the original amount adjusted for wage increases; and

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- developing a formula for indexing the fixed amount going forward to reflect cost of living pressures (and allow for low access to services).
- Potential alternatives to the zone rebate for compensating people for living in regional areas (e.g. direct grants), consistent with an objective of the Henry Review to reduce the complexity of the tax/transfer system and make it more transparent.

***Recommendation 2***

Consistent with the Australian Government's recent attempts to promote greater capital investment in Australia by introducing temporary capital allowances, and to ensure that Australia's taxation regime remains competitive with other nations, the Henry Review (informed by research that it has commissioned in the area of capital income and business taxation) should examine:

- (i) reintroducing accelerated depreciation in some form; or
- (ii) entrenching capital allowances in Australia's taxation system.

***Recommendation 3***

The Commonwealth Government should implement its election commitment to introduce a flow-through shares scheme for smaller explorers, potentially as part of a broader flow-through taxation approach for small businesses who may be particularly disadvantaged in raising finance from traditional sources in the current environment.

***Recommendation 4***

Responsibility for mineral royalties should continue to rest with the States, to avoid exacerbating VFI and the associated disincentives for States to support optimal resource development in the national interest.

***Recommendation 5***

The Commonwealth should share Petroleum Resource Rent Tax (PRRT) revenues with the adjacent jurisdiction, as a means of reducing VFI and the associated disincentives for States to support optimal resource development.

***Recommendation 6***

The Commonwealth should implement its election commitment to allocate a share of certain future PRRT revenues to a State infrastructure fund (via a National Partnership agreement).

***Recommendation 7***

Tax base sharing should be further examined as the potentially preferred model for reforming existing State taxes. In this regard, the research commissioned by the Henry Review should include a report on the merits of the Canadian provincial tax system compared to Australia's State tax system.

***Recommendation 8***

In the absence of tax base sharing reforms, motor vehicle duty should be flagged for future replacement by a State road user charge that takes into account 'externalities' such as congestion and environmental costs, as permitted by emerging technology and supported by appropriate social concessions.

***Recommendation 9***

The Commonwealth Government should lead major reform of the current GST sharing arrangements in Australia, with the objective of improving incentives for economic development, growing the size of the GST pool and reducing the current administrative overheads and lack of transparency.

***Recommendation 10***

Western Australia supports the commissioning of further research into tax-transfer issues concerning fuel, roads, transport and the environment more generally.

## **2. Principles to Support Outcomes from the Review from a State's Perspective**

Western Australia will apply the following inter-related principles as part of its assessment of recommendations arising from the Henry Review.

### **2.1. Maintain or increase the State's budget capacity**

It is important that any recommendations not have a detrimental affect on the Budget capacity of the State in terms of both quantum and flexibility of funding.

Given the expectations of citizens for States to provide more and better public goods and services, Henry Review recommendations should provide for the States having adequate and robust revenue streams.

### **2.2. Reduce the States' reliance on the Commonwealth for revenue**

Henry Review recommendations that result in a reduction in the States' reliance on the Commonwealth for funding and improve the States' financial autonomy and flexibility (i.e. reduce the level of VFI) would be welcome. Section 5 of this submission discusses wide-ranging taxation reform options that could reduce the level of VFI in Australia.

### **2.3. Promote economic growth and productivity by increasing the efficiency, equity and simplicity of the taxation system**

Review recommendations should result in a more efficient, equitable and simple taxation system in Australia that would contribute to economic growth and productivity increases in the Australian economy. Recommendations should also promote sustainable economic growth, for better environmental outcomes.

## 3. Reforms to Commonwealth Taxes to Encourage Investment and Promote Efficient Resource Allocation

### 3.1. Income tax zone rebates

An income tax rebate was introduced in 1945 to support people living in specified regional areas of Australia to encourage settlement in those areas. The rebate was primarily provided “in recognition of the disadvantages to which they are subject because of the uncongenial climatic conditions, isolation and high cost of living in comparison with parts of Australia not included in the zone rebate areas”<sup>8</sup>.

However, it was also acknowledged that allowances paid by employers to compensate employees for living in remote areas would be diluted by the application of the progressive income tax scale, and the rebate would partially offset that impact.

The zone rebate has two components – a fixed component that is currently \$338 for the Zone A rebate, \$57 for the Zone B rebate and \$1,173 for the Special Zone rebate; and a variable component that is based on a person’s entitlement to other existing or notional rebates (e.g. the variable component of the Zone A rebate could be up to \$1,220 for a dependent spouse and up to \$188 for each dependent child).

While the zone rebate is still available, its value has been severely eroded over time, with the fixed component last being increased in January 1993. When it was originally introduced the fixed Zone A rebate equated to 4.6 weeks average earnings and the Zone B rebate equated to 2.3 weeks average earnings<sup>9</sup>. Today, the Zone A rebate equates to only 0.27 weeks average earnings and the Zone B rebate equates to only 0.04 weeks average earnings<sup>10</sup>.

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<sup>8</sup> Section 79A of the Income Tax Assessment Act 1936

<sup>9</sup> KMPG, Review of the Zonal Tax Rebate Scheme, February 2002

<sup>10</sup> This has been calculated using Australian Bureau of Statistics data on total male full time ordinary weekly earnings for November 2008 (Average Weekly Earnings, Australia Cat. 6302.0) to maintain consistency with the basis of the calculation for 1945, as the Australian Bureau of Statistics only collected statistics for male earnings at that time.

If the value of the fixed rebate was to be restored to its original real value, the Zone A rebate would now be about \$5,720 (compared to its actual value of \$338) and the Zone B rebate would be about \$2,860 (compared to its actual value of a meagre \$57). As a result of the value of the fixed component of the rebate being substantially eroded over time, it is highly unlikely that the original policy intent of the rebate is still being met.

The variable component of the rebate has been adjusted over time in accordance with changes in the relevant rebate, or notional rebate, amounts.

Notably, the overall cost of living in the Pilbara is estimated to be 20 per cent higher than the cost of living in Perth. The overall cost of living in the Kimberley is about 17 per cent higher. A key contributor to this disadvantage is the relative cost of housing, which is estimated to be 49 per cent and 27 per cent higher in the Pilbara and Kimberley respectively than in Perth<sup>11</sup>.

### ***Recommendation 1***

***The Review should examine the efficacy of the current zone rebate scheme, recognising the importance of the regions to Australia's economic wellbeing and that the attraction and retention of skilled and professional staff to these communities is critical for their future viability. Areas of focus should include:***

- ***Options for restoring the value of the zone rebate, including:***
  - ***reinstating the value of the zone rebate to reflect the original amount adjusted for wage increases (as quantified above); and***
  - ***developing a formula for indexing the fixed amount going forward to reflect cost of living pressures (and allow for low access to services).***
- ***Potential alternatives to the zone rebate for compensating people for living in regional areas (e.g. direct grants), consistent with an objective of the Review to reduce the complexity of the tax/transfer system and make it more transparent.***

## **3.2. Accelerated depreciation**

As part of the last major review of Australia's business taxation system, the 1998-99 Ralph Review of Business Taxation (RBT)<sup>12</sup>, accelerated depreciation was removed (to fund a reduction in the company tax rate) and replaced with a uniform capital allowance regime that aligned depreciation rates to an asset's effective life. The Western Australian Government's submission to the RBT, while supporting a reduction in the company tax rate, did not support this being funded by removing accelerated depreciation.

Western Australia's fundamental objection to the removal of accelerated depreciation was that it would be detrimental to capital investment in Australia, with the reduction in the company tax rate not offsetting the negative tax effect on businesses with long-lived assets of removing accelerated depreciation. The net outcome would favour States with a large services sector at the expense of those States with a large mining and manufacturing base.

<sup>11</sup> Sourced from Regional Prices Index November 2007, Department of Local Government and Regional Development.

<sup>12</sup> The RBT was chaired by Mr John Ralph and formed part of the Government's *A New Tax System*. The RBT looked at the fundamental design of the business income taxation system with the aims of improving the competitiveness and efficiency of Australian business, providing a secure source of revenue, enhancing the stability of taxation arrangements, improving simplicity and transparency and reducing the costs of compliance.

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Since the RBT changes, it is acknowledged that depreciation rates under the diminishing value method were increased in the Commonwealth's 2006-07 Budget. Apart from better aligning taxation depreciation rates with the actual decline in asset values, the stated objective was to encourage Australian businesses to invest in new plant and equipment to keep pace with technological change and remain competitive.

Reference was made to the report *International Comparison of Australia's Taxes*, showing that Australia's depreciation rates for taxation purposes were low compared to 10 OECD comparator countries studied.

Furthermore, in response to the recent slowing of economic activity in Australia, the Australian Government has introduced a number of measures to stimulate the economy. These include the introduction of temporary capital allowances that provide an immediate tax deduction of 30 per cent or 10 per cent of the cost of an asset, depending on the date the asset is purchased and ready for use.

Going forward, Australia must ensure that its depreciation regime is competitive with other countries, as an uncompetitive depreciation regime combined with the additional risk taken on by businesses that invest in assets with longer lives (it is unclear if capital markets fully compensate investors for these risks) could influence business investment decisions that are detrimental to Australia's future growth.

### ***Recommendation 2***

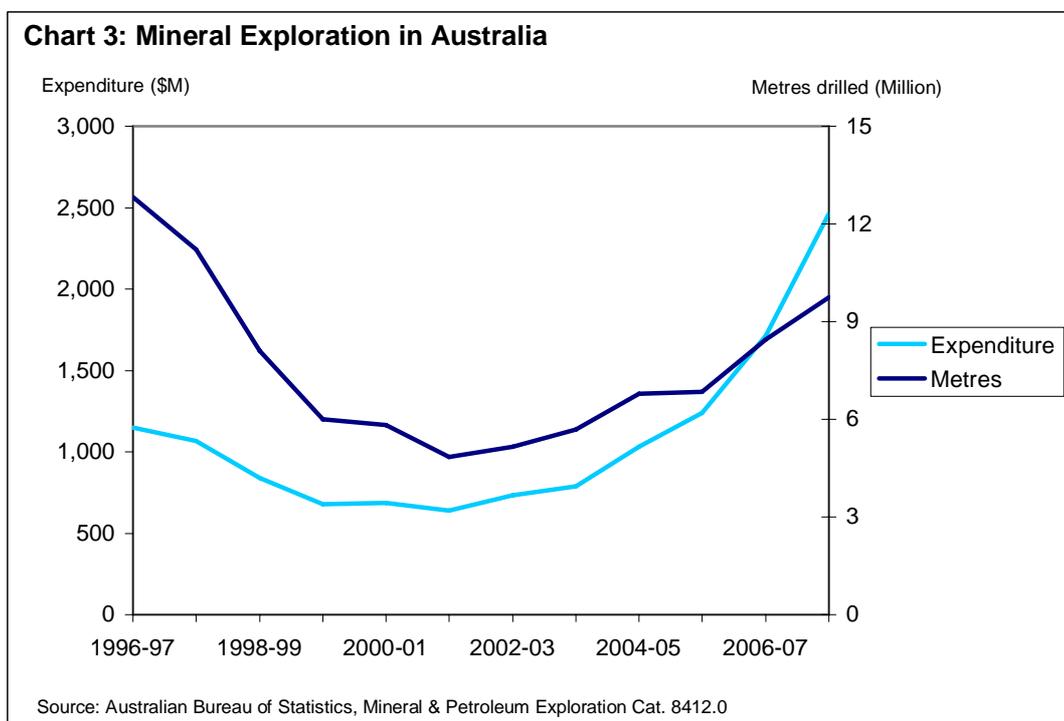
***Consistent with the Australian Government's recent attempts to promote greater capital investment in Australia by introducing temporary capital allowances, and to ensure that Australia's taxation regime remains competitive with other nations, the Review (informed by research that it has commissioned in the area of capital income and business taxation) should examine:***

- (i) reintroducing accelerated depreciation in some form; or***
- (ii) entrenching capital allowances in Australia's taxation system.***

### **3.3. Flow-through share schemes for smaller explorers**

Mineral and petroleum exploration activity fluctuates over time in response to a number of factors, such as commodity prices.

To illustrate, total mineral exploration expenditure in Australia declined from \$1,148.6 million in 1996-97 to \$640.6 million in 2001-02, before increasing to \$2,461.4 million in 2007-08. During the same period, the total number of metres drilled for mineral exploration declined from 12.8 million in 1996-97 to 4.8 million in 2001-02, before increasing to 9.8 million in 2007-08.



The recent increase in exploration activity corresponded to the “minerals boom” experienced in Australia and globally. Nonetheless, while total exploration expenditure in 2007-08 was over twice that in 1996-97 (evidently reflecting cost-escalation), the total number of metres drilled in 2007-08 was only 76 per cent of the metres drilled in 1996-97.

The reasons for the declining trend in mineral exploration activity are not certain. However it would be in Australia’s economic interests to remove unnecessary impediments to efforts to locate new mineral and petroleum deposits.

In this regard, Australia’s existing tax settings favour larger mining companies that undertake exploration (and are also producers). This is because these miners are much more likely to be able to fund exploration activity from internal sources or borrowings, and are able to recoup part of their exploration costs through the taxation system by offsetting these expenses against other income.

In contrast, smaller explorers typically raise capital from equity markets to fund their exploration activity. These explorers usually do not generate sufficient cash-flows from their activities to fund exploration or against which to offset exploration costs. As a result, they face a higher cost of capital than larger miners, and often find it difficult to borrow because of the risks associated with exploration.

A flow-through shares scheme may address some of the biases in the taxation system by allowing exploration costs to be utilised for tax purposes by investors (shareholders) in smaller explorers. This may have the affect of encouraging increased exploration in Australia. It is noted that increasing levels of exploration activity in Canada have been attributed to its flow-through shares scheme.

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Such a scheme could also be usefully extended to other forms of exploration for natural resources, such as exploration for underground water supplies.

Prior to the 2007 Federal election, the Labor Party announced its policy in relation to the resource sector – *Labor's Plan for a Stronger Resources Sector*. Part of that policy was aimed at promoting exploration activity in the oil, gas and minerals industries and included a commitment to introduce a flow-through shares scheme for small operators. Past Parliamentary committees, at both the State and Commonwealth level, have made similar recommendations.

It is understood that the Commonwealth Government has requested the Henry Review to consider an optional flow-through taxation system for small businesses. Furthermore, the *Australia's Future Tax System Consultation Paper* (the Consultation Paper) discusses how a flow-through taxation system for small businesses could overcome distortions introduced by the taxation treatment of different sources of finance generally.

A flow-through shares scheme for small exploration companies would complement *inter alia* Western Australia's recently announced \$80 million boost to mineral and petroleum exploration from its 'Royalties for Regions' program. The Exploration Incentives Scheme will include a series of surveys to gather more (public) information on Western Australia's geology, improvements in the online exploration application process and promotion of strategic industry research.

### ***Recommendation 3***

***The Commonwealth Government should implement its election commitment to introduce a flow-through shares scheme for smaller explorers, potentially as part of a broader flow-through taxation approach for small businesses who may be particularly disadvantaged in raising finance from traditional sources in the current environment.***

## 4. Tax and Royalties in the Non-Renewable Resources Sector

This section focuses on *Section 14.1 Non-renewable resources* of the Consultation Paper and two of the related consultation questions.

- *Consultation question 14.1: When considering the appropriate return to the Australian community for the use of its non-renewable resources, what relative weight should be given to the determinants of that return?*
- *Consultation question 14.2: What is the most appropriate method of charging for Australia's non-renewable resources, given they are immobile but that Australia needs to compete globally for mining investment?*

Since the publication of the Consultation Paper, the Henry Review has also explicitly posed the question about which level (or levels) of government should design, administer and receive the revenue from resource charging.

### 4.1. Current royalty arrangements in Western Australia

The State Government owns, on behalf of the community, all (onshore) resources in Western Australia existing in their natural form, including mineral and petroleum resources. Compensation in the form of a royalty is paid to the State for the extraction and sale of these resources.

Most mineral and petroleum royalties in Western Australia are designed to return to the community about 10 per cent of the wellhead or minehead value of the resource – this is the purchase price paid by the producer to the community for the resource (producers are also subject to all the usual State and Commonwealth taxes). More specifically:

- an ad valorem royalty applies to petroleum (both oil and gas) produced onshore and in offshore areas within the State's jurisdiction, together with the North West Shelf Project, based on the value of petroleum at the wellhead; and
- an ad valorem royalty applies to most minerals produced in Western Australia, designed broadly to apply to the value of the mineral at the minehead (although a set rate royalty per tonne is applied to low-value, bulk commodities).

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Accordingly, certain deductions from the sales value of minerals and petroleum are permitted under Western Australia's ad valorem royalty schemes. For petroleum, these include the cost of processing, storing and transporting the petroleum, where these costs are incurred post-wellhead by the producer.

For minerals, deductions are limited to certain transport costs. However, the royalty rates for minerals attempt to recognise the varying levels of processing costs incurred post-minehead - a rate of 7.5 per cent applies to bulk material, 5 per cent for mineral concentrates and 2.5 per cent for minerals in metallic form.

In addition a resource rent royalty applies to petroleum produced on Barrow Island, while (until recently) a profits-based royalty applied to the Argyle diamond mine (albeit with an ad valorem 'floor'). A petroleum resource rent tax (PRRT) applies to petroleum produced in waters within the Commonwealth's jurisdiction.

Like the Commonwealth's petroleum resource rent tax, the Barrow Island resource rent royalty applies only to the economic profit or rent of the project<sup>13</sup>. Such schemes allow the resource developer to fully recover their investment (including a 'normal' rate of return) before the royalty or tax applies.

The profits-based component of the 'hybrid' royalty that applied to the Argyle diamond mine (i.e. prior to underground mining) was based on accounting profits rather than economic profits or rent (in particular it excluded any deductions relating to the return on equity capital). As a result, it would be considered less economically efficient than a scheme based on economic profits.

Ad valorem royalties are one form of production-based royalties, which are generally considered to be less economically efficient than profit-based royalties, but are simpler than profit-based royalties and provide more stable revenue streams (over the full life of a project).

## 4.2. Relative merits of alternative resource charging regimes

In evaluating a royalty regime, emphasis is often given to maximising its economic efficiency. However, other important design principles include fairness, simplicity and whether the revenue streams are relatively stable and predictable (from a State government financial management perspective).<sup>14</sup>

In determining an appropriate return for the community, it is also important to ensure that resource companies receive a fair return for their investment and risk. A fair return to the community and resource companies would be that amount that can be sustained on economic, social and political grounds.

In addition, it is important that the needs of current generations are balanced against those of future generations. In this regard, a royalty can be used to deter the present generation from over-consumption at the expense of future generations.

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<sup>13</sup> Details on the way in which the petroleum resource rent tax operates are provided in Section 14 of the Consultation Paper.

<sup>14</sup> The relative merits of a profits-based versus a production-based (eg. ad valorem) royalty regime are outlined in Section 14 of the Consultation Paper.

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Overall, Western Australia's royalty regime is considered to strike a sound compromise between these often competing objectives. For example:

- Allowing deductions under an ad valorem royalty may increase the economic efficiency of the regime and its recognition of 'capacity to pay', but lessens its simplicity.
- Also, while it is acknowledged that an ad valorem royalty may be more likely to lead to undercharging for the extraction of non-renewable resources over the long-term (compared to a profit-based regime)<sup>15</sup>, the revenue stream is more predictable.

As the Commonwealth is aware, in 2004 the Ministerial Council for Mineral and Petroleum Resources investigated the fiscal environment in which Australia's mineral and petroleum industries operate. The Ministerial Council found that "No single type of resource tax is likely to be ideal for all circumstances and a range of resource tax regimes is probably unavoidable".

Furthermore, while an internationally competitive royalty regime is an important consideration, it is unlikely to rate highly (in terms of influencing investment decisions) relative to other factors such as Australia's resource endowment and prospectivity, political and social stability, corporate tax system, infrastructure, skilled labour market and regulatory framework.

Practical issues in transitioning to any new resource charging regime would also need to be considered, especially for existing projects where the investment decision has been made on the basis of an existing regime. In addition, in Western Australia some royalty arrangements are currently enshrined in State Agreement Acts.

### 4.3. Allocation of resource revenues between levels of government

While the Consultation Paper does not explicitly invite comment on which level of government should keep resource charge revenues, it is an issue canvassed in the Consultation Paper and one that more recent public comment from the Henry Review chair suggests the Henry Review will consider.

In this regard, the Consultation Paper notes that the immobility of natural resources would appear to make them ideally suited to resource charging by the States. More significantly, the place of location of natural resources would usually determine which government has jurisdiction over royalties for the exploitation of those resources.

As also noted in the Consultation Paper, any concerns about the physical location of resources favouring some States over others are effectively addressed through the fiscal equalisation process in Australia. Indeed, Western Australia is concerned that this process operates too voraciously, including *inter alia* by failing to recognise all of the costs incurred by the State to support resource development.

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<sup>15</sup> Undercharging is likely to occur because States will tend to trade-off lower royalty rates/revenues for reduced inherent inefficiencies of ad valorem schemes compared to schemes that charge (for example) only super-normal profits, and because ad valorem schemes do not capitalise on any super-normal profits derived by miners.

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VFI would clearly be exacerbated if the Commonwealth were to take responsibility for mining royalties from the States. Further to the observation made in the introduction to this submission, the incentive for States to encourage and support the development of resource projects would be diminished, with the costs incurred by the States potentially being less than the fiscal returns to the States.

In this regard, in addition to the significant costs incurred in regulating mining activity and assisting with land access issues, the States are also responsible for providing (and maintaining):

- infrastructure used by the mining industry, including road and rail, port facilities and other multi-user facilities (which can be under-provided or restrict access to third parties if left to the private sector, and do not entail full-cost recovery). To illustrate the level of infrastructure spending by Western Australia, Western Australia is expected to have the second highest per capita spending on public infrastructure investment in 2008-09 of all States and the Commonwealth (This is only exceeded by Queensland, which is addressing a substantial capital works backlog); and
- social infrastructure and services, including in relation to education, health and law and order, to towns in mining areas.

Accordingly, Western Australia strongly asserts that the responsibility for mining royalties properly sits with the States. Indeed, we consider that the Commonwealth should belatedly deliver on a promise it gave in the early 1980s to share offshore PRRT with the States, as a means of reducing VFI and improving incentives for optimal resource development.

In this regard, we also consider that the Commonwealth Government needs to act quickly to implement its election commitment to allocate up to \$100 million per annum from future Pluto and/or Gorgon LNG project PRRT revenues to a Western Australian infrastructure fund. This could be achieved through a national partnership agreement, ideally backed by Commonwealth legislation.

It is noted that research commissioned by the Henry Review in the areas of natural resources, Australian-State government taxation and capital and business taxation is relevant to this aspect of the Henry Review. Western Australia will be keenly interested in the findings when they are available.

#### ***Recommendation 4***

***Responsibility for mineral royalties must remain with the States, to avoid exacerbating VFI and the associated disincentives for States to support optimal resource development in the national interest.***

#### ***Recommendation 5***

***The Commonwealth should share PRRT revenues with the adjacent jurisdiction, as a means of reducing VFI and the associated disincentives for States to support optimal resource development.***

***Recommendation 6***

***The Commonwealth should implement its election commitment to allocate a share of certain future PRRT revenues to a State infrastructure fund (via a National Partnership agreement).***

## 5. Reforms Requiring National Leadership or Coordination

This section focuses on *Section 9 State and local taxes and transfers* and addresses Consultation Questions 9.1, 9.2, 9.3 and 9.4, in the Consultation Paper.

*Consultation Question 9.1: Noting the overall structure of Australia's federal financial arrangements, what changes, if any, should be made to the assignment of revenue raising powers and intergovernmental transfers in Australia?*

*Consultation Question 9.2: Given the widely held view in submissions that the current state tax arrangements need to be reformed, what changes should be made to state and local government own source revenue instruments? What scope is there for greater use of user charging to bring social, environmental or economic benefits?*

*Consultation Question 9.3: What is the appropriate allocation of the roles of the Australian and state governments in income redistribution?*

*Consultation Question 9.4: What opportunities could be pursued to deliver more seamless administrative arrangements of the tax-transfer system across the federation?*

### 5.1. Recent reform of State taxes in a federal financial relations context

In recent years, the States have embarked on significant reforms to their revenue base through the now superseded *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* and State tax reviews, culminating in the abolition of a number of inefficient transaction-based taxes.

In all, Western Australia has abolished 10 taxes (previously accounting for about 20 per cent of total State tax revenue), including financial institutions duty, debits tax, mortgage duty and an array of smaller stamp duties, in return for GST grants and increased reliance on the remaining State taxes.

While GST grants (in place of abolished State taxes) have been a more efficient and stable source of revenue for the States, they have also reduced the States' autonomy.

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Western Australia's State Tax Review released in 2007 and New South Wales' Review of State Taxation by the Independent Pricing and Regulatory Tribunal provide a sound analysis of issues and relative priorities for further State tax reforms. However, each finds that national leadership and/or coordinated action across governments would be needed to achieve fundamental reforms, including because:

- constitutional constraints limit States' ability to replace the remaining still relatively inefficient or contentious taxes with broader-based taxes; and
- the difficulty of one State 'leading' on base broadening due to pressures of inter-state competition that can adversely impact on investment decisions in that State.

While duties on motor vehicles, insurance contracts and property transfers are generally accepted to be the least efficient of the remaining State taxes, they account for around 35 per cent of total State taxation, with property transfer duty comprising 70 per cent of duties.

Any proposals to remove these inefficient duties would need to be in the context of replacement revenue sources that enable the States to continue funding the services and infrastructure they are responsible for, and would need to be evaluated against the principles outlined in Section 2 of this submission.

As noted in the introduction to this submission, the paucity of discretionary revenues available to the States and their associated heavy reliance on Commonwealth grants potentially undermines the benefits of Australia's federal system, with Western Australia being especially exposed to adverse community outcomes as a result of its unique features and physical remoteness from Commonwealth decision makers.

While the benefits of 'centralisation' may be more visible (including the simplicity and cost-effectiveness of uniform taxes and regulations and the capacity for policies to reflect the national interest), the benefits of federalism are just as real (including customisation of policies to local needs, continuous improvement through competition and testing of innovations, and limits on the abuse of power).

Nonetheless, in the context of the national tax and transfer system, it is considered that there are reform options that could help deliver the best of both worlds.

## 5.2. Tax base sharing

Tax base sharing between the different levels of government could see existing taxes with the least desirable design features absorbed as separately identified components of similar taxes on an identically defined base, potentially slashing administration and compliance costs nationally while still preserving State fiscal autonomy. The following options are listed in order of diminishing intuitive appeal.

- Payroll tax could be amalgamated with the Commonwealth's Pay as You Go (PAYG) income tax system (administered nationally by the Australian Taxation Office), reflecting that both taxes apply to 'wages' and are collected 'at source' by the employer. As has been noted by other commentators, this would be a natural extension of the current payroll tax harmonisation process.

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This option is considered worthy of serious consideration, but only on the proviso that States' budget flexibility is preserved by enabling each State to specify the rate of State PAYG tax that applies to wages paid for services provided within the State, with the revenue returned on a State-of-origin basis.

Notably, the preservation of State autonomy on tax rates under the interstate payroll tax harmonisation process has been sacrosanct. Under this option payroll tax bases would be harmonised with the PAYG base, and payroll tax then effectively replaced by a State PAYG surcharge.

- A PAYG base sharing option on the above basis would be a narrower version of a more comprehensive potential personal income tax base sharing model, as applies in various guises in other federations such as Canada (which would also enable payroll tax and/or other existing State taxes to be replaced by a surcharge on the Commonwealth personal income base)<sup>16</sup>.

It is understood that the commissioned research for the Henry Review on the Australian-State government division of taxing responsibilities is being conducted by a Canadian academic. To the extent it is not already occurring, Western Australia supports this research including a comparison of the efficacy of the Canadian provisional tax system with the State tax system in Australia.

- An alternative option in relation to payroll tax would be to remodel it as a profits-based tax and make it a separately identified State component of the Commonwealth's company tax (again preserving State autonomy over the rate). A robust, contemporaneous 'factor' for defining each State's share of a company's total profits for company tax purposes would need to be agreed. States' exposure to more revenue volatility would be one disadvantage.
- Land tax could be converted from an unimproved value basis to gross rental value basis and amalgamated with local government rates. In so doing, the land tax base could be broadened to align with the rating base (facilitating reduced tax rates), and progressive land tax scales replaced by proportional rates (albeit potentially differentiated by property type according to local government practice).

This could substantially improve the equity, efficiency and simplicity of land tax. Savings in administration costs may also be possible as a result of unimproved values no longer being needed, and State Revenue Offices working with local governments on collection mechanisms.

However, detailed investigation of the redistributive consequences and associated capacity to pay issues (potentially overlapping with the proposal for the Commonwealth to assume responsibility for State social concessions) would be required to inform decision making on any such reform<sup>17</sup>.

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<sup>16</sup> This need not see a net increase in personal income tax rates, if combined with a rationalisation of Commonwealth income tax 'expenditures'. Notably, stamp duties, rather than payroll tax (or land tax), are generally considered to be the most damaging of the State taxes, and the highest priority for replacement.

<sup>17</sup> Clearly consultation would also be needed with the local government sector on both general design and administrative arrangements.

A variation of this option would be for land tax to effectively be handed over to the local government sector for absorption into the rates base as local authorities see fit, with the sector foregoing a corresponding amount of Commonwealth grants. The States would be compensated for the loss of land tax by a share of a Commonwealth tax base, rather than by redirection of the grants.

- Both motor vehicle stamp duty and insurance stamp duty could be absorbed into a higher GST rate, reflecting that both motor vehicle transactions (excluding private sales) and insurance premiums are already subject to the GST. However, this would further reduce States' autonomy, and changes to the GST rate and base have been ruled 'out of scope'.

Absorption of these duties into a higher State PAYG or personal income tax surcharge could be an alternative. Again, however, while this could be achieved at no net additional cost to taxpayers in aggregate, modelling of the redistributive impacts would be needed.

- In principle, State property transfer duties could be converted from a property value to capital gains basis (albeit requiring much higher rates) and amalgamated with the Commonwealth's existing capital gains tax (reflecting that both taxes are triggered by the sale of property), again subject to State-specific tax rates being preserved and State revenues being returned on a State of origin basis.

However, transfer duty represents a much larger proportion of States' existing revenue base than capital gains tax does of the Commonwealth revenue base, and such a proposal is likely to introduce an unacceptable level of revenue volatility and uncertainty for the States.

### **5.3. Replacing motor vehicle duty**

In the absence of tax base sharing reforms, it is considered that motor vehicle duty should be flagged for replacement by a new State charge that takes into account road use, congestion and emissions, as emerging technology may permit (see also Section 6). The new charge could also absorb motor vehicle registration fees (other than for administrative cost recovery), which in Western Australia is already structured as a quasi road-user charge.

Again, redistributive impacts and the need for changes to social concessions would need to be modelled. However, such a reform option holds considerable appeal, with the potential to end the distortionary impact of the current up-front duty and speculation from time to time over its constitutional validity, and to send improved signals and incentives for reduced emissions.

### **5.4. Broadening relatively efficient State taxes**

Again putting tax base sharing reform options to one side, economists generally agree that reforming State taxes such as payroll tax and land tax to apply to the broadest possible base (by reducing the number of exemptions or concessions) could improve their overall efficiency, fairness and simplicity.

It may also allow for a significant reduction in tax rates, while still raising sufficient revenue to enable the States to meet their expenditure requirements.

In principle, the removal of agreed tax 'expenditures' could be undertaken as a furtherance of the harmonisation of State taxes, involving full consultation and agreement on best practice approaches. This could reduce the chances of future destructive tax competition.

Efficiencies and economies of scale could also arise from the central administration of harmonised business taxes, such as payroll tax. However, this does not necessarily require the involvement of a Commonwealth agency, such as the Australian Taxation Office.

Streamlined administration could also be achieved through the use of single interfaces for businesses interacting with multiple State Revenue Offices and/or consolidation of operations across States Revenue Offices. Steps are currently being examined in this regard to identify and exploit opportunities of this nature.

## 5.5. User charging arrangements

User charging is supported in principle as a means of sending more appropriate price signals to consumers of public services and reducing the pressure on potentially less efficient State taxes to fund them. However, in practice several factors have limited the scope to apply cost-reflective prices even in cases where 'public good' or 'externality' considerations are not a major issue. These include:

- equity and regional development considerations, where cost-reflective user charges may penalise a particular group of people or restrict access to core goods and services.

The economic, social and environmental development of regional communities is dependent on equitable access to quality services and infrastructure. This has resulted in the use of 'uniform tariff' policies and community service obligation payments to ensure that the availability and cost of energy and water enhances regional Western Australia's economic competitiveness;

- the push for commercialisation of Government Business Enterprises (including their pricing) has seen the emergence of a number of social concessions over recent years in order to replace special tariff rates for concession card holders which failed to transparently display the cost of service provision to the user and subsidising taxpayer.

A number of social concessions are generally recognised as having a sound social purpose in assisting those on low fixed incomes. However, it is acknowledged that the way in which they are delivered may not be sending the right signals for social, environmental and economic outcomes.

A single untied cash payment could deliver greater increases in individual welfare than subsidies of specific goods or services of the same cost and possibly reduce price signal distortions relative to specific subsidies.

This approach would need to include appropriate safeguards to ensure that payments are achieving the intended outcomes.

- commitments entered into between the Commonwealth and States in key service areas covered by Specific Purpose Payments (SPP) including health, education, housing and disability services.

For example, the National Health Care Agreement requires the States to provide health and emergency services free of charge through the public hospital system, with some Commonwealth funding assistance.

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More generally, to the extent that a number of services are 'subsidised' through SPPs, it would be contrary to the spirit of the agreements to collect user charges.

The suggestion in the Consultation Paper for the Commonwealth to take over States' social expenditures as part of its wider redistributive role is considered worthy of further consideration. However, while this would free up some budget capacity for the States, including for further tax reform, there are legitimate reasons for the States to maintain some redistributive activities to address the specific circumstances of their communities.

Nonetheless, Western Australian supports further reforms to user charging, backed by appropriate changes to social concessions. In particular, to achieve environmental, social and economic benefits, reforms to road user pricing (including through motor vehicle charges) should be examined with the aim of ensuring more efficient transport networks are developed and maintained, to signal appropriate vehicle use, and to reduce congestion.

Furthermore, it is only after appropriate price signals for road use are established that more effective user charging for public transport can be applied, reflecting the substitutability between the two services.

In this regard, Western Australian welcomes the research commissioned by the Henry Review on options to improve fuel, roads and transport policy, including any suggestions on how to use taxes and various pricing systems to make transport networks more efficient and reduce the social costs of motor vehicle use.

## 5.6. GST sharing between the States

Along with the GST rate and base, the Commonwealth has ruled the HFE process (administered by the Commonwealth Grants Commission) out of scope of the Henry Review. The Western Australian Government considers this to be short-sighted, and that reform of HFE should be seen by the Commonwealth as unfinished economic reform business.

The conceptual case for reforming HFE is powerful, and inextricably linked to the national tax and transfer system.

- The Commonwealth's dominance of the national tax and transfer system means that, even without applying HFE to GST revenue grants, a great deal of equalisation in the Australian Federation is already achieved 'automatically' through the Commonwealth Budget at the household/community level.

States with higher incomes and business profits contribute more to Commonwealth taxes, while those with higher employment and younger, healthier populations draw less on social security and health benefits (and vice versa).

- The current egalitarian concept of HFE reduces incentives for States to grow their economies/revenue bases and address their service delivery/expenditure 'disabilities' (i.e. by substantially redistributing the benefits to other jurisdictions).

By fully compensating jurisdictions for their lower revenue raising capacity or higher cost of service delivery, 'welfare dependency' is encouraged and the productivity and wealth of the nation is compromised.

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- The current HFE framework may distort policy choices by governments, such as by dissuading States from focussing their own revenue raising efforts in areas where they are assessed by the Commonwealth Grants Commission to have a substantially higher underlying capacity than other States.
- The Commonwealth Grants Commission's methods are highly detailed and complex, effectively restricting meaningful debate to only a small group of practitioners around Australia (among which there is much disagreement about the merits of the methods).

(This also produces large administrative overheads, including the need for State and Territory Treasuries to maintain specialist units/resources to support the HFE process.)

- The current HFE principle does not consider differences in unmet needs across the States, such as raising the low standard of services for remote indigenous communities.

There is no shortage of potential reform options that need not disadvantage the smaller jurisdictions who currently depend on redistributions through the HFE process, as Western Australia also once did. Indeed, all governments and the community would benefit from reform that grows the size of the GST pool through enhanced economic activity, and reduces the administrative burden of HFE.

- A return to the 'special grant' arrangements which applied in the period between the establishment of the Grants Commission in 1933 and 1978 could be considered – when a similar HFE principle applied but assessments of 'claimant' States needs were simpler and funded by the Commonwealth rather than directly cross-subsidised by the other States.
- An intermediate reform would be to overlay floors and caps (or bands) on shares any one jurisdiction receives – such as +/-25 per cent of a State's equal per capita entitlement (with special arrangements for the Northern Territory). This would help address the economic disincentives created by the current system, although not the complexity and associated lack of transparency and administrative costs.
- The possibility of a Canadian style model of partial equalisation (including equalisation of only 50 per cent of resource revenues) could also be explored.

**Recommendation 7**

***Tax base sharing should be further examined as the potentially preferred model for reforming existing States taxes. In this regard, the research commissioned by the Henry Review should include a report on the merits of the Canadian provincial tax system compared to Australia's State tax system.***

**Recommendation 8**

***In the absence of tax base sharing reforms, motor vehicle duty should be flagged for future replacement by a State road user charge that takes into account 'externalities' such as congestion and environmental costs, as permitted by emerging technology and supported by appropriate social concessions.***

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**Recommendation 9**

***The Commonwealth Government should lead major reform of the current GST sharing arrangements in Australia, with the objective of improving incentives for economic development, growing the size of the GST pool and reducing the current administrative overheads and lack of transparency.***

## 6. Responses to other Consultation Questions

This section examines issues raised in *Section 12 Fuel, roads and transport* and *Section 13 Tax-transfer impacts on the environment* of the Consultation Paper, and the associated Consultation Questions.

### 6.1. Fuel, roads and transport

*Consultation Question 13.1: How can motor vehicle related taxes and road funding arrangements be designed to improve the efficiency of transport of people and goods in Australia?*

*Consultation Question 13.2: What should be the role, if any, of fuel taxes? What does this mean for how fuels and their uses are taxed and the rates of tax applied?*

*Consultation Question 13.3: Do the existing tax arrangements lead people to make economically inefficient transport choices, and if so, how might they be improved?*

There appear to be a number of market failures in the general transport system that result in current transport patterns and activity imposing significant social and environmental costs on society (such as urban congestion and air pollution).

These costs can be reduced in various ways, including cutting travel demands, switching from private transportation to public transportation, substituting polluting fuels with clean fuels and encouraging the public to use high-fuel economy vehicles.

This can be encouraged through non-financial means such as regulation. As an example, stricter vehicle standards have substantially reduced the level of air pollutants from vehicles, leading to improved air quality and public health outcomes.

Another way to address these impacts is to recover the costs more directly from transport users. This could be achieved by imposing charges on transport users that more accurately reflect the costs and could be accompanied by a reduction in the level of general taxation on transport. Principles in relation to user charging are also discussed in Section 5 of this submission (not limited to transport usage).

It is noted that a number of studies are currently underway or being considered under the direction of the Council of Australian Governments and/or the Australian Transport Council to improve transparency of road use cost recovery, road spending and investment in road freight. These studies may assist in redesigning current taxes and road funding arrangements.

The inclusion of transport in the coverage of the proposed Carbon Pollution Reduction Scheme (CPRS) is also intended to address the social costs associated with transport by encouraging transport users to switch to less carbon intensive forms of transport. However, it is noted that in the initial years of the CPRS, distortions resulting from the existing fuel tax arrangements will remain as a result of:

- the availability of fuel tax offsets (or fuel excise reductions), based on the carbon content of diesel; and
- the availability of fuel tax credits for liquefied petroleum gas, compressed natural gas and liquefied natural gas.

Western Australia is interested in the outcomes of research instigated by the Henry Review in the area of roads and transport, including complementary measures that can achieve the desired levels of abatement and improved environmental outcomes. However, caution must be exercised to ensure that the research also addresses any socio-economic disadvantages.

## 6.2. Tax-transfer impacts on the environment

*Consultation Question 13.1: Bearing in mind that tax is one of several possible instruments that can address environmental externalities, what opportunities exist to use specific environmental taxes to address Australia's environmental challenges?*

*Consultation Question 13.2: Noting that many submissions raise concerns over unintended environmental consequences of taxes and transfers, such as the fringe benefits tax concession for cars, are there features of the tax-transfer system which encourage poor environmental outcomes and how might such outcomes be addressed?*

The Commonwealth Government plays an important role in addressing environmental problems that cross State boundaries, such as water flows in the Murray-Darling water system or where national standards are required as a measure of equity to reduce spill-overs into other jurisdictions, such as the administration of the CPRS.

However, State and local governments are ideally placed to address environmental problems that are localised within jurisdictional boundaries, with no spill-overs. Examples of environmental problems best addressed by lower levels of government include noise pollution, air pollution from road congestion and household waste management.

Moreover, there are also aspects of the current taxation system that encourage activity that has negative social and environmental outcomes. A good example of this is the application of the Fringe Benefits Tax (FBT) to employer provided motor vehicles. As has already been raised in a number of other submissions and acknowledged in the Consultation Paper, the current concessionary FBT arrangements:

- provide a financial incentive for users of employer provided motor vehicles to maximise the amount of work-related travel they undertake to minimise the FBT in relation to those vehicles; and

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- are not available for other less-damaging forms of transport (such as public transport or bicycles) and actually promote the use of motor vehicles over those other forms of transport.

Another example of inefficiencies introduced by the current taxation system that influence behaviour is the differences in import tariffs that benefit four-wheel drive vehicles (five per cent tariff) over more fuel-efficient and hybrid vehicles (ten per cent tariff). This could be viewed as being contrary to Government policy to reduce carbon pollution. However, it is understood that import tariffs on passenger vehicles will be reduced to five per cent in 2010 to align with the rate that currently applies to four-wheel drive vehicles.

The Henry Review could consider a form of motor vehicle taxation in Australia to reflect the energy efficiency of vehicles based on the Green Vehicle Guide, which provides a rating on vehicles based on the results of testing conducted in accordance with the Australian Design Rules for emissions and fuel consumption labelling.

Using the Green Vehicle Guide, a higher level of tax would be applied to less fuel-efficient motor vehicles, with a lesser level of tax applying to more fuel-efficient vehicles. This approach recognises that all vehicles impose some costs on the community through their emissions, so even the most fuel-efficient vehicles should be taxed to some degree, but also that inefficient vehicles impose greater external costs on the environment (so these should incur the greatest burden of tax).

However, this alone would not necessarily result in a reduction of emissions from transport, as it would have no bearing on the distance driven by fuel-efficient vehicles and hence the amount of fuel they consume.

Overall, a better outcome could be achieved through the application of more comprehensive road user charging, in combination with the CPRS. This will send price signals to motor vehicle users based on the types of fuels used and the quantum of fuel used.

In relation to energy production, about 94 per cent of Australia's energy is derived from the combustion of fossil fuels<sup>18</sup> (i.e. coal, oil and natural gas). This partly reflects the abundance of fossil fuels and the associated relatively cheap cost of energy.

The proposed CPRS should result in the cost of energy generated by fossil fuel better reflecting the total costs of that fuel source, including the cost of carbon pollution. This should assist in redressing some of the cost advantages that fossil fuels currently enjoy over renewable energy and promote the development of alternative clean energy sources.

For land management, there are potentially a number of ways to address the environmental issues faced in these areas.

Internalising the costs of farming activities may act as an incentive to reduce environmentally harmful externalities such as nutrient run-off, chemical overspray and siltation from erosion.

Alternatively, financial support could be provided to landholders to encourage management practices that reduce externalities. This could include tax incentives or direct payments.

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<sup>18</sup> Public subsidies and incentives to fossil fuel production and consumption in Australia – draft discussion paper – Chris Reidy, Institute for Sustainable Futures - [http://www.isf.uts.edu.au/publications/CR\\_2001.pdf](http://www.isf.uts.edu.au/publications/CR_2001.pdf)

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An example of where the taxation laws may be distorting investment decisions in relation to land management practices is the existing landcare taxation provisions. These provisions provide an incentive for farming and other business conducted on rural land to undertake capital works to combat land degradation. However, these incentives do not appear to extend to expenditure on conservation of biodiversity.

As highlighted in Section 6.1 for transportation, any cost increases that result from reform of the taxation system as it applies to environmental areas would need to consider compensation for the socially disadvantaged.

Western Australia notes the research commissioned by the Henry Review in the area of environmental taxation and would be interested in reviewing the outcomes of that research.

***Recommendation 10***

***Western Australia supports the commissioning of further research into tax-transfer issues concerning fuel, roads, transport and the environment more generally.***

## **Appendix 1: Summary of topics raised by Western Australian Government agencies in relation to Australia's future tax system**

In compiling this submission, the views of all Western Australian Government agencies were canvassed. A number of agencies expressed an interest in contributing to Western Australia's submission. Those agencies and a summary of the issues they identified are listed below.

Information provided by a number of agencies has been incorporated into the main body of Western Australia's submission. However, issues that were specific to a particular area and were not raised in other submissions have not been included in the main body of the submission.

Nonetheless, all of the issues raised by agencies have been listed to assist the Henry Review gather as much input from the wider community as possible. The technical accuracy of the issues identified has not been independently checked.

### **Department of State Development**

- A resource rent tax should be evaluated as an option for charging royalties in Western Australia. If such a scheme were to be adopted, compensation may be required from the Commonwealth because of the variable royalty stream that a resource rent tax would produce.
- Consideration should be given to the reintroduction of accelerated depreciation, including capping the maximum depreciation period at 20 years, to assist high cost, long life projects (such as LNG projects) and improve Australia's taxation competitiveness and ability to attract investment in these types of projects.
- The introduction of a flow-through shares scheme for resource exploration should be considered to benefit investment in exploration.
- The income tax zone rebate appears to be an ineffective way of retaining workers or encouraging them to relocate to specified regional zones of the State and provides little financial incentive to workers in the resources sector. As such, an alternative means for compensating eligible residents for the hardship of residing in remote areas should be considered.

### **Department of the Premier and Cabinet**

- Taxes should reflect externalities and environmental costs and can be used to address market failures in relation to activities that directly give rise to environmental problems.
- There is a general over-consumption of travel because the costs associated with transport are not sufficiently reflected in the transport charges in the current system.
- The concessionary FBT treatment of employer-provided motor vehicles and vehicle import tax regimes that favour four wheel drives over more fuel-efficient vehicles should be addressed to promote better environmental outcomes.
- Consideration should be given to ways to address the current unequal tax treatment and subsidies provided for the extraction of fossil fuels as opposed to renewable and energy efficiency alternatives.
- Energy supply and greenhouse abatement objectives can be better met in the short term by allocating further tax concessions to renewable energy and energy efficiency.
- Accelerated depreciation allowances could be considered for building investments that install specific energy efficient fittings, fixtures or raise the overall energy performance of a building to a predetermined standard.
- Natural resource management reforms are required to internalise the costs to land owners of harmful environmental externalities, or financial incentives, including taxation incentives, could be used as an alternative way to address these externalities.
- Land conservation activities should receive consistent tax treatment, irrespective of whether a business is conducted on land. An example of where this does not occur is the existing landcare taxation provisions that provide an incentive for farming and other business conducted on rural land to undertake capital works to combat land degradation, but does not include expenditure for conservation or biodiversity.

### **Building and Construction Industry Training Fund**

- Taxation incentives should be available to encourage employers to employ and train workers, regardless of the economic circumstances at the time. Similarly, impediments to employment that may arise from the taxation system should be removed.
- Grants provided to employers by training funds, such as the Building and Construction Industry Training Fund, for training employees should not be subject to taxation to increase the effectiveness of training subsidies.
- The tax deductibility of business expenses relating to employment and training could be given a weighting to increase the value of these deductions (in a similar way to the weighting given to research and development expenditure).

### **Commissioner for Children and Young People**

The following issues were included in a joint submission to the Henry Review by the States' Children's Commissioners, *The Tax Review: Improving outcomes for children and young people*.

- The redesign of the tax and transfer payments system should be informed by research findings on child, adolescent and youth development.
- The basis and operation of means testing for social support payments should be reviewed to remove perverse incentives for female and youth employment and poverty traps.
- Support should be given to families to meet the costs of raising children on an equitable basis, with priority given to low income families;
- The choices families make in respect of work and caring for family members should be respected.
- Barriers, such as high effective marginal tax rates, for female participation in the workforce should be removed.
- Incentives for young people's pathways onto higher education, training, and secure employment should be improved.
- Measures to reduce unemployment, especially youth unemployment and long-term unemployment, should be considered.
- The earnings of low-income families and young people should be increased.
- Access for families and young people to the various types of support available to them should be simplified.
- The income thresholds at which the marginal income tax rates change should be indexed to changes in Average Weekly Earnings to reflect rising incomes and cost of living increases.
- Tax incentives should be provided for businesses that employ at-risk and chronically unemployed young people, or participate in youth mentoring programs.
- Tax incentives should be increased for employers hiring apprentices and trainees.
- 12 months paid parental leave should be made available to employees that are new parents.
- Incentives should be provided to encourage greater use of parental leave by fathers.
- The income threshold for the withdrawal of Family Tax Benefits Part A should be increased.
- The income threshold of the second earner for reducing the Family Tax Benefits Part B should be increased.
- Families should be given the choice to receive Family Tax Benefits regularly during the year rather than wait for a single payment at the end of each year.
- The Family Tax Benefit payments should be reviewed to reflect the higher costs associated with raising adolescents.

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- The parenting payment requirements applying to short term foster carers should be reviewed.
- The benefits available for childcare should be integrated and simplified into a single benefit applicable to all forms of early education and care.
- The Higher Education Contribution Scheme should be redesigned to remove disincentives for low-income young people to undertake tertiary studies and to avoid young people starting their working life with a substantial debt.
- The parental income test for Youth Allowance should be redesigned to increase the levels of payment for young people and achieve greater parity with the Newstart Allowance rates.
- The Transition to Independent Living Allowance should be significantly increased to enable young people to cover the costs of moving, setting up a home, connecting to utilities, purchasing a uniform or tools for their first job, etc.
- Carer payments and allowances should recognise the special circumstances and needs of young carers and allow them to pursue further education, training and skills development.
- State Government tax expenditures should be regularly reviewed and on a comparable basis with other government expenditures to ensure that they continue to reflect the Government's policy priorities.
- The Horizontal Fiscal Equalisation (HFE) methodology should be simplified and an efficient and transparent process should be adopted.
- The Henry Review should consider Commonwealth-State Financial relations issues in making its recommendations.

### **Small Business Development Corporation**

- The GST reporting threshold of \$75,000 should be regularly reviewed, possibly every two years, to ensure it remains comparable to wage levels and economic conditions, and to avoid any inflationary creep.
- Consideration should be given to allowing small businesses (with, for example, five or less employees) to report superannuation obligations bi-annually rather than quarterly, to reduce compliance cost associated with superannuation reporting.
- An entity flow-through taxation regime would contribute to a reduction in compliance costs for small business conducted through companies and trusts.
- Fringe Benefits Tax (FBT)

Taxing fringe benefits in the hands of employees rather than employers simply moves the compliance burden onto someone else, but does not address the complexity inherent in the FBT regime.

Simplification of the present system of valuing, assessing and reporting fringe benefits is required, along with a rationalisation of the many different categories of fringe benefits to simplify the FBT regime.

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Providing consistency between the end of the taxation year and the FBT year would greatly reduce complexity and compliance costs for small business.

- Capital Gains Tax (CGT)

Tiered taxation rates for the CGT is not supported, as it would create more complexity for small businesses. If tiered taxation rates are introduced for CGT, small businesses should be able to opt-out of that regime.

A review of the tests for concessions available for small businesses under the CGT regime should be undertaken with a view to rationalising these. Removing the controlling individual test under a CGT concession would greatly simplify this aspect of the regime.

### **Department of Agriculture and Food**

- The Wine Equalisation Tax

The basis on which the Wine Equalisation Tax is calculated should be changed from ad valorem to volumetric, to ensure that producers of low value wine are not treated more favourably than producers of high value wine.

- Research and development policy in the agricultural sector

Greater and longer term funding is needed in areas of potential high return to build and maintain research capabilities in the sector.

Research activity should be rationalised and focused to promote the efficient use of limited resources.

- Managed investment schemes.

The level of tax incentives available for managed investment schemes should be revised to better match returns available for direct investments in agriculture.

Promote better land use by managed investment schemes.

- Natural resource management policy

The taxation system should be framed to encourage the management of natural resources, in addition to promoting greater agricultural productivity.

- Farm management deposits

Review, on an annual basis, the limits on deposits and allowable off-farm income that apply to the farm management deposit scheme.

Relate the movements in the above limits to an index relevant to the purpose to which funds are directed, such as movements in the costs of farm inputs.

Exclude from the non-primary production income test any income that is derived from off-farm employment to encourage income diversification.

Exclude the interest earned on farm management deposit holdings from the non-primary production income test.

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Tax farm management deposit holdings at no higher rate than their deferred tax rate.

Assess the merits of taxing farm management deposits at a reduced or concessionary tax rate at the time funds are deposited rather than taxing funds at the time of their withdrawal.

Tax farm management deposits in the estate of a deceased producer in a similar manner to the other assets.

Extend the provisions of the farm management deposit scheme to include those supplying services to agriculture, such as contractors, whose income is directly related to the seasonal fortunes of producers.

- Taxation of cooperatives

The favourable taxation treatment of co-operatives only applies if certain criteria are met, including that the co-operative has as its primary objective the acquisition of commodities or animals from its shareholders for disposal or distribution. Investigate the possibility of allowing multiple objectives for co-operatives.

- Carbon trading and CPRS

Alternative mechanisms to encourage reduction of carbon emissions from the agricultural sector should be investigated.

If the CPRS were to apply to the agricultural sector, some form of compensation for that sector should be investigated to ensure its on-going viability.

### **Department of the Culture and the Arts**

- Consideration should be given to providing benefits of the Producer Offset for film and television production more evenly throughout the production process, rather than as a lump-sum at the completion of production. This should increase the effectiveness of the Offset.
- Incentives should be provided for investment in the arts, and government support and welfare benefits should be aligned to provide assistance to artists.
- Resale Royalties received by artists for their work should be made income tax free.
- Taxation incentives for research and development and venture capital for the arts industry should be considered. These could be similar to the Screen Production Incentive for film and television.
- Schemes allowing tax deductions for gifts and donations to the arts should be aligned and simplified and the eligibility criteria for these schemes should be clarified.
- The FBT treatment of salary packaging benefits available to charities and public benevolent institutions should be extended to the arts sector.

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- Western Australian Planning Commission
- The level of government responsible for particular expenditure should have access to greater revenue raising sources to fund that expenditure. This would better align revenue needs and expenditure requirements to allow for better planning for the delivery of public services.
- The Metropolitan Region Improvement Tax should be retained.
- The taxation system should encourage investment in infrastructure in Australia.
- Environmentally sustainable practices should be encouraged through the taxation system. It is noted that the FBT encourages the use of motor vehicles through salary packaging arrangements, but similar concessions do not exist for public transport use.

### **Office of Native Title**

The basis of this submission was the Western Australian Government submission in response to the Commonwealth's Discussion Paper on Optimising Benefits from Native Title Agreements.

- Benefits received by Aboriginal communities are commonly paid into charitable and discretionary trusts. These entities have a number of shortcomings, including that they do not permit funds to be retained in the relevant entity for the benefit of future generations without incurring significant taxation liabilities.
- Taxation changes are required to provide for a more equitable flow of funds from lump-sum payments received under native title agreements.
- Concessionary tax should be imposed on non-charitable income received by Aboriginal entities to encourage economic and social development. Subjecting these payments to some tax will strengthen governance arrangements and encourage these entities to operate on a commercial basis.
- Whether structuring arrangements for native title agreements provide opportunities to avoid tax should be investigated.

### **Department for Planning and Infrastructure**

- Any new distance based charging methods introduced for heavy vehicles (which is currently being investigated) could flow through to light vehicles but the practicality and cost effectiveness of this needs to be determined.
- Greater private sector participation in the provision of roads should be encouraged by reducing taxation and regulatory barriers to private sector investment in infrastructure.
- The purchase of more fuel efficient, lower emissions vehicles should be encouraged by aligning stamp duty and vehicle registration charges according to environmental performance criteria and/or direct financial subsidies or penalties for the purchase of high/low efficiency vehicles.
- The FBT rules that encourage the use of cars rather than alternative modes of transport and provide financial incentives to maximise the amount of travel to reduce the rate of tax should be addressed.

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- The regional aviation sector should be supported because of its importance in servicing regional and remote communities.
- Incentives such as accelerated depreciation should be considered to encourage the aviation industry to replace aircraft engines with engines that support alternative aviation fuels.
- There are a number of market failures in the transport system that result in current transport activity imposing significant social and environmental costs on society. Some of these impacts can be addressed through non-financial means such as regulation.
- Measures that are complementary to the CPRS will be required to achieve desired levels of abatement and improved environmental outcomes.

### **Western Australian Police Service**

- The application of GST and FBT to State government agencies unnecessarily increases compliance costs for the agencies.
- Compliance costs for the GST could be reduced by removing its application to transactions between government agencies.
- FBT
  - Housing and expense payment benefits, such as for air conditioning, electricity and telephone subsidies, are paid to compensate employees for living in remote locations.
  - Home security is provided to protect the safety of senior police officers and their families.
  - The private use of unmarked police vehicles with sirens, warning lights and radios is minimal.

The application of FBT to minor benefits such as those outlined adds significant compliance costs. Consideration could be given to removing the FBT from minor benefits or at least simplifying the process.

### **Department of Mines and Petroleum**

- Tax arrangements that promote the responsible management of economic activities and the protection of the environment should be pursued.
- The tax and transfer payment system in Australia needs to be improved. The current HFE process does not support the work that the State does to promote and encourage resource development, with most of Western Australia's mining royalties being distributed to other States.
- Western Australia should receive a share of the PRRT received from projects in offshore areas of the State. This would recognise the support the State provides these projects without receiving any return from revenues obtained from those projects.
- A flow-through shares scheme should be introduced to encourage resource exploration, especially greenfields exploration.

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- There are clear principles in Western Australian that guide the development of mineral and petroleum royalty systems.
- There is no one royalty scheme for resource charging that is more appropriate than any other. The least preferred to most preferred royalty regime taking into account revenue stability, transparency, producer equity, community equity, simplicity, economic efficiency and intergenerational equity are:
  - Petroleum ad valorem royalty – based on a percentage of well-head value
  - Mineral ad valorem royalty - based on a percentage of ex-mine value
  - Mineral ad valorem royalty - based on a percentage of sale value
  - Resource Rent Royalty
  - PRRT
  - Rate Per Tonne – a specific rate royalty that applies to bulk, low value minerals
- Further consideration could be given to changes to corporate tax arrangements to recognise the peculiar nature of investment in resource projects.

**Western Australian Tourism Commission**

- The threshold for immediate tax write-off for items of plant and equipment of \$300 or less under the uniform capital allowance regime should be adjusted annually to allow for inflation.
- The limit on depreciating luxury cars, \$57,128 for 2008-09, should not apply to luxury cars that are used exclusively for generating assessable income.
- The Luxury Car Tax should be refundable for all vehicles that are used exclusively for generating assessable income.
- Landscaping and outdoor recreation facilities integral to the tourism experience should be eligible for depreciation.
- FBT should be removed from benefits provided for health and safety reasons that are compulsory conditions of employment under an award or enterprise agreement and cannot be cashed-out.
- The Energy Grants Credits Scheme should be expanded to include eco-friendly businesses.
- The effective life for depreciation purposes of furniture, fittings and equipment used in tourist facilities should be five years rather than seven.
- The Passenger Movement Charge, visa charges, aircraft noise levies and other government charges should be examined to ensure transparency, and that the current charges are based on genuine cost recovery rather than revenue generation.
- While the GST is not within the scope of this review, the application of that tax on strata-titled tourist accommodation that is entirely for short-stay purposes and cannot be converted to other use(s) should be examined to ensure that it is not anti-competitive.

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- Taxation incentives should be provided to encourage businesses to invest in workforce participation, particularly Aboriginal tourism enterprises.
- An education and training tax incentive for approved training should be considered to encourage businesses to provide staff training.
- Tax averaging should be introduced for rural and remote tourism operators.

### **Fire and Emergency Services**

- A tax concession or other incentive should be considered for individuals volunteering for emergency services.

### **Water Corporation**

- The income tax laws should be consolidated into one Act.
- The taxation laws should be simplified and the compliance costs for large businesses reduced.
- The concession for research and development should be increased from 125 per cent to 175 per cent.

### **Department of Water**

- Allow tax deductions for individuals and accelerated depreciation for corporations for the installation, maintenance and replacement of water meters.
- Allow tax rebates for individuals and accelerated depreciation for corporations for using water saving and recycling technology.
- Apply concessionary tax rates to the inputs of desalination plants and accelerated depreciation for corporations building new plants.
- Provide taxation incentives for expenditure incurred by businesses in exploring for new groundwater sources.

### **Department of Environment and Conservation**

- Clarity is sought on the application of the GST to grants. Consideration could be given to making grants between government agencies GST-free.
- FBT compliance costs for meal entertainment are high and the rules for this FBT item should be made consistent between the public and private sector.
- The FBT compliance costs for home garaging of work vehicles is high when in many cases the benefits provided are minor. The rules should be simplified to reduce compliance costs.
- Consideration should be given to exempting employer subsidies of rent and home loan interest payments for remote area housing from FBT. It is noted that the provision of remote area housing is exempt from FBT.