

GST DISTRIBUTION REVIEW

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**HAS ANY GOOD CASE BEEN MADE FOR SUBSTANTIAL CHANGE TO CURRENT
HFE ARRANGEMENTS?**

Paradise, South Australia

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Those who have read the three Papers I have previously put to the Panel will not be surprised to learn that my answer to the question posed on the front cover of this Paper is “no”.

Numerous propositions have been put to the Panel which come to a different conclusion. For those of us who have been involved in or have followed the debate over past decades it is not all that difficult to determine where and how these propositions fall down. However, I can understand that those who have come to the debate more recently might find it more difficult to sort the wheat from the chaff especially when some of the chaff is somehow dressed up to look like wheat. In the first of my Papers I drew attention to the weaknesses in some of the propositions put to the Panel by those who do not favour current arrangements. It is not my role or purpose to identify and go through in detail all the propositions which have been put forward. However, I thought it might be of assistance to some readers if I set down in an extremely brief and convenient format what some of these propositions are about and where they fall down. In some cases I also identify written material which supports what I have to say. For current purposes I have identified 10 propositions and dealt with them for convenience on separate pages below. It is not suggested that this is comprehensive.

Before turning to the individual propositions I think it is relevant to note the question of **onus**. Australia has developed a highly sophisticated, systematic, well documented and successful system of fiscal equalisation between the States and Territories. I suggest that in these circumstances it is appropriate that if proposals are being put forward to make basic changes in current arrangements the onus should be on those advocating change to demonstrate that their proposals would indeed be an improvement in logic and in practical effect.

DISINCENTIVES FOR ECONOMIC DEVELOPMENT

SUMMARY OF PROPOSITION: the current arrangements result in a disincentive for the States to pursue economic development and efficiency objectives.

COMMENTS ON THE PROPOSITION:

- No factual evidence has been adduced to support the proposition that HFE produces a disincentive for States to encourage economic development.
- I can attest as a former senior State Treasury officer involved with many major projects such as Olympic Dam that the effects of or implications for HFE calculations are not regarded as relevant to decision-making.
- Acknowledged that States make mistakes on economic development issues but not due to HFE details and they are made by all States small and large.
- Aside from pro development motivations, State Governments understand that with HFE all States share in the expansion of revenue bases of any one State. National productivity improvement is an all States endeavour e.g. COAG reforms. Occasional backsliding e.g. re OHSW by Victoria is not attributable to HFE.
- As for Government efficiency I assume the Review is aware of the analysis contained in the Commission's 2012 Update Box 2-1.

PROPERTY RIGHTS

SUMMARY OF PROPOSITION: views on this have been put forward by Professor Cliff Walsh. As I understand it the view is that Australia is not a complete union, but State Government fiscal circumstances in some sense “belong” to the people in each individual State and that redistribution between States is therefore not appropriate.

COMMENTS ON THE PROPOSITION:

- This is a peculiar notion. It seems difficult to reconcile the notion of property rights in relation to State fiscal circumstances given the high degree of migration into Australia and between the States and Territories.
- Australia is becoming more and more economically unified through national “seamless” economic initiatives agreed at COAG level, uniform social security across the States and Territories and so on.
- This may seem an obvious point but no-one is questioning that individual State Governments “own” the revenues and expenditures generated by financial legislation of State Parliaments. The question is about how Commonwealth funds generated by its taxes and other revenues should be distributed between the States having regard to the differences in revenue raising capacity and expenditure needs of States.
- Is it really suggested that the Commonwealth Government should in 2012, **with its moneys**, no longer seek to advance the cause of Australian economic and social union and act instead to promote an incomplete union?

COMPARISONS WITH OTHER FEDERATIONS

SUMMARY OF PROPOSITION: other Federations commonly have a lower degree of fiscal equalisation than Australia, Canada being one example and this indicates that Australia should change its arrangements.

COMMENTS ON THE PROPOSITION:

- It should not be regarded as surprising that Australia has developed something different from other Federations in this respect as it has in others.
- Those putting forward this proposition seem to ignore the obvious possibility that Australia's arrangements are not only different but better in the sense that they are more systematic and comprehensive. As suggested in the first of my Papers submitted to the Panel it would be very useful for the Panel to produce some material comparing differences between States and Regions in Australia in terms of incomes and public services with other Federations such as the United States of America.
- I wonder why some of us find it difficult to accept the notion that in some areas of public policy Australia does well compared with elsewhere?

LINKING WITH THE CONCEPT OF A SOVEREIGN WEALTH FUND

SUMMARY OF PROPOSITION: that some rather complex arrangements should be made linking fiscal equalisation with the creation of a sovereign wealth fund.

COMMENTS ON THE PROPOSITION:

- This idea, put forward by Professor Pincus, borders on the bizarre.
- Whatever the merits of a sovereign wealth fund (and personally I think they are considerable) there is no connection in logic or practice with horizontal fiscal equalisation.

CHANGING FROM FULL TO PARTIAL EQUALISATION

SUMMARY OF PROPOSITION: this notion has been put forward in several different ways but the basic idea is that a move should be made away from the current objective to enable (but not required) all the States and Territories to provide the same standard of services without imposing higher taxes or other charges to an approach which “waters down” the objective by replacing “same” with something less. This can be put in terms of replacing equalisation with partial equalisation.

COMMENTS ON THE PROPOSITION:

- We can, I think, start by noting no-one seriously involved in the debate is advocating zero equalisation (i.e. equal per capita grants). On the other hand we currently have a system of full equalisation. The selection of anything else would obviously be arbitrary.
- In any event it would first have to be established that there was something significantly wrong about current arrangements which has not yet been done.
- It is relevant to note, I believe, that the GST Agreement between the Commonwealth and the States (which is a fundamental document in Australia’s public finance system) uses the term “equalisation” in stating how GST revenue is to be distributed between the States. It does not say “partial equalisation” or anything of that kind.
- I suggest that the collective minds engaged in this Review should be directed to **improving** fiscal equalisation rather than trying to come up with a contrived arrangement which results in something **less than** equalisation.

DEVOLVING RESPONSIBILITY FOR DISTRIBUTION OF STATE GRANTS TO OTHER COMMONWEALTH AGENCIES

SUMMARY OF PROPOSITION: that the current system through the Commonwealth Grants Commission should be replaced by one under which distributional issues on the expenditure side were dealt with by Commonwealth agencies responsible for specific functional areas – e.g. education, health, transport etc. This proposition has been put forward by Adjunct Professor Vince Fitzgerald.

COMMENTS ON THE PROPOSITION:

- It is very difficult indeed to see the merits of this idea. Australia now has the benefit of a comprehensive, systematic and internally consistent set of principles and methodologies followed by the Commonwealth Grants Commission, which takes into account both Commonwealth and State sources of funds. The proposed alternative would result in a hotch potch of inconsistency and even more disputation than we have now. The expertise and talents of the Grants Commission and its staff would be wasted (unless as seems difficult and unnecessary that expertise could be incorporated into distributions managed by Commonwealth line agencies).

SIMPLICITY AND CLARITY

SUMMARY OF PROPOSITION: that the current methodologies and workings of the Commonwealth Grants Commission are opaque and too complex.

COMMENTS ON THE PROPOSITION:

- I would recommend to readers some excellent comments on this matter made in a Paper submitted by my former South Australian colleague, Mr John Hill. They are very much to the point.
- If there are two ways of doing something which end up with the same result and one is simpler than the other then the former is obviously to be preferred. But that is not the case here. To implement the Commission's principles and methods and to get to a reasonably accurate answer some reasonable degree of detail and complexity is simply necessary. In my experience it is not in any event especially difficult for anyone with a genuine interest to understand the principles and methodologies although it may take some patience to work through the particulars of calculations in some areas. This is surely not an unusual situation – compare, for example, someone who wanted to understand Australia's income tax – in fact a more difficult task indeed. Many other comparisons could be made.
- I note here in my view the Commission has already gone too far in the "simplicity" direction by eliminating calculations in some more minor areas. This has resulted in a lower degree of accuracy for no real benefit.
- It is stating the obvious to say that we don't expect politicians to personally work through the detail of methodology and calculations. They have decided to delegate this to an independent body which experience proves can be trusted to do this job well.

GST PAYMENTS AND GRANTS TO THE STATES

SUMMARY OF PROPOSITION: that it is wrong that there should be large differences between the aggregate of GST paid by persons or corporations resident in a particular State and that State's receipts from the Commonwealth out of GST revenue. This view has been particularly advanced by the Western Australian Government.

COMMENTS ON THE PROPOSITION:

- The basic point is that there is not **meant** to be any particular relationship between these aggregates.
- One way of looking at this is to consider what the situation would be if a GST hadn't been implemented or if the Commonwealth payments to the States were determined by a formula which had nothing to do with tax collections (as indeed they used to be for many years). In these circumstances this kind of argument would have no relevance.
- This line of thought has no more relevance than if someone did some calculations showing the amount of income tax paid by the residents of a particular suburb somewhere in Australia and the aggregate value of pensions paid in that suburb and compared the two. If the former happened to exceed the latter would anyone seriously argue that the rate of pensions in that suburb should be reduced?
- It would be appropriate for the Panel to be particularly blunt in its final Report in rejecting this whole line of thought.

CONFLICT BETWEEN EQUALISATION AND ECONOMIC EFFICIENCY

SUMMARY OF PROPOSITION: that is an inherent conflict between equalisation and economic efficiency. This view has been put forward by a number of participants in the debate.

COMMENTS ON THE PROPOSITION:

- This proposition is in the category of a hoary old chestnut. It has been gone over and over in discussions between Commonwealth and State Treasury officers and before the Grants Commission for about 30 years or so.
- This proposition is the reverse of the truth. Equalisation is not only consistent with but promotes economic efficiency. Someone advancing this proposition, if they were to be consistent, would have to accept that it would promote economic efficiency if tax rates were higher in the less populous States and Territories – surely a very unlikely view.
- Does anyone seriously argue that tax rates should be higher in the less populous States and Territories on the grounds of economic efficiency? As I have observed elsewhere there is a very useful parallel between the explicit equalisation achieved through the Grants Commission and the implicit equalisation achieved by the Commonwealth through its common tax rates and expenditure policies across the country.
- Amongst the writings which are helpful on these matters I would recommend my own Paper of 1989 entitled "The Commonwealth Grants Commission, Fiscal Equalisation and Economic Efficiency" included in the publication "Fiscal Equalisation Allocative Efficiency and State Business Undertakings C. Walsh ed." and a Paper co-authored by Petchey, Smith and Walsh.
- It is very pleasing to note that just recently there has become available an excellent Paper by Independent Economics which goes into analytical and quantitative detail to show how the current system promotes economic efficiency. This is arguably the most important piece to come forward in this whole area in recent years and certainly deserves prominence in the Panel's Final Report.
- Again it would be a good step forward if the Panel could come out strongly on this point to help perhaps the debate to move on to potentially more productive lines.

ASTRONOMICAL ANALOGIES

SUMMARY OF PROPOSITION: that thinking in this area needs a revolution of the kind which occurred when astronomers came to accept that the earth and other planets moved around the sun. According to an article in the Financial Review this is a view put forward recently by Professor Ross Garnaut in relation to HFE and other aspects of public finance.

COMMENT ON PROPOSITION:

- Analogies can be useful but this one, at least as it relates to HFE, isn't. It is stunningly off the mark.
- When it comes to fiscal equalisation we had our major revolution in the early 1930's. Prior to that time there was a mess. The less populous States were constantly running into financial problems. There were frequent enquiries, disputes and ad hoceries. The formation of the Grants Commission and its early work was a revolution. It established a clear principle and devised a systematic method to determine grants to the less populous States in implementation of these principles. Its work was accepted by Governments and Parliaments. Order replaced chaos.
- Two lesser but extremely important revolutions took place in the 1970's. One was the introduction of what was referred to at the time as direct assessments of relative revenue raising capacities and expenditure needs to replace the previous system of budget result equalisation after what were referred to as adjustments and modifications to the relevant State's budgets. The second was the replacement of the special grants/claimant States system with the assessment of relative needs between all of the States. Both of these ideas were initiated by the Commonwealth Treasury.
- The Grants Commission has always accepted that its methods can be changed as new circumstances arise, as data are improved and as better methodological ideas come forward. This is a desirable process of continuous improvement – we do not need a counter revolution.
- The fact is that acceptance of some of the ideas put to the Panel would result in less than full equalisation, the less financially advantaged States and Territories would face severe financial problems and the country would return to the kind of circumstances which existed prior to the revolution which so fortunately took place in the early 1930's. If equalisation is unreliable or inadequate e.g. in respect of the exponential health cost

burden of the very aged, ad hoc bailouts of the kind recently seen with respect to the Tasmanian Health system would become endemic.

- If the conclusion that a counter revolution is neither necessary nor desirable is correct then we can avoid attending to the particulars of Professor Garnaut's proposals. I knew that if I kept at it long enough I would find some good news!