



## **Beyond its use-by date:**

**Australia's System of fiscal equalisation, and how to reform it**

**Submission to the Federal GST Distribution Review**

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## 1.0 EXECUTIVE SUMMARY

- The horizontal fiscal equalisation (HFE) regime of distributing GST revenues amongst the states and territories is associated with a number of adverse consequences affecting state government operations and the effectiveness of competitive decentralised federalism.
- The application of the HFE methodology imposes efficiency costs upon the Australian economy, chiefly by inhibiting incentives for individuals to relocate to jurisdictions more consistent with their underlying taxation and expenditure preferences.
- The HFE model detracts from unilateral state government efforts to engage in economic reform, as the proceeds of ‘growth dividend’ revenues are equalised away by the redistribution of GST.
- The equity rationale for HFE is highly questionable, given that the system poorly targets the redistribution of benefits across individuals.
- The maintenance of the HFE system for redistributing GST revenue encourages strategic rent-seeking behaviour by state governments, at a cost to taxpayers.
- HFE undermines federalism by inhibiting competition between governments for mobile factors of production and succouring the commonwealth’s monopoly tax position.
- A number of reforms have been proposed to alter the basis of distribution of untied commonwealth government revenues to the states. However, most of these proposals fail to remedy the perverse symptoms associated with the existing HFE distribution methods.
  - If a choice were to be made amongst these ‘second-best’ models of reform, the best policy would be to abandon the existing HFE system in favour of a model of distributing GST grants to states on the basis of GST revenue raised within each jurisdiction.
  - Under this suggestion there is no basis to continue the Commonwealth Grants Commission.
- This paper proposes an alternative conception of Australian fiscal federalism, whereby the states provide grants to the commonwealth to fund basic commonwealth functions.
- This system of ‘reverse revenue sharing’ must be couched within a framework of radical decentralisation of revenue and expenditure functions to the states and territories.
- Some advantages of this system would include a promotion of interjurisdictional tax and expenditure competition, an encouragement of economic growth strategies, and a reduction in incentives for special interests to seek favours from governments.
- Dismantling the outmoded HFE grants distribution system and Commonwealth Grants Commission will be vital in revitalising an Australian federal system weakened by decades of centralism and lack of effective public sector competition.

## 2.0 INTRODUCTION

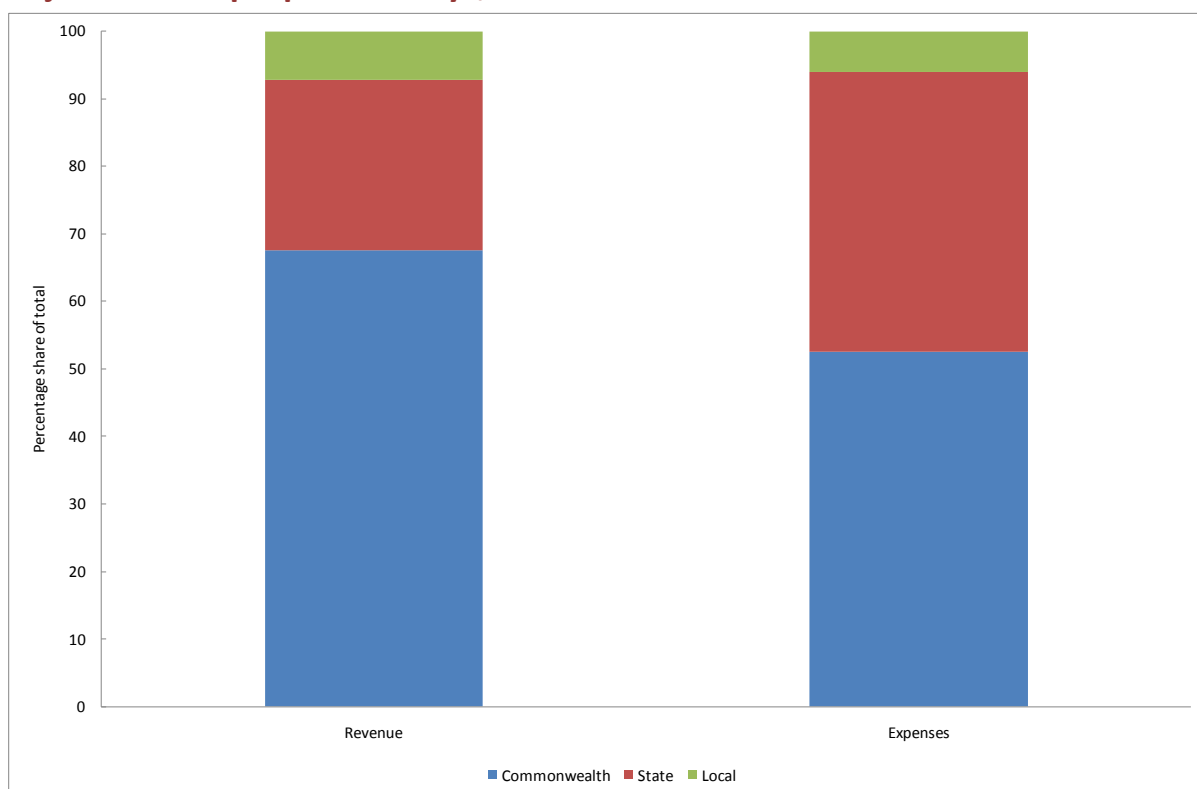
A persistent feature of Australia's intergovernmental financial relations is the separation between the revenue sources and expenditure responsibilities among the different tiers of government - a phenomenon known as 'vertical fiscal imbalance' (VFI).

In Australia this is derived from the relatively high degree of centralisation of taxing powers that has emerged over a century of Australian federalism, with the central (i.e., commonwealth) government enjoying exclusive powers over customs duty and excises, taxes on the consumption of goods and services and, due to historical and political reasons, income taxation.

On the other hand, expenditure responsibilities are relatively decentralised, albeit increasingly less so over time, with the states being responsible for major areas of services provision such as public order and safety, justice, health, education, welfare and community services, and transportation.

The true extent of VFI in Australia is evidenced by the fact that the level of own-source revenue exceeds own-purpose outlays at the commonwealth level, whereas the states' own-purpose outlays are greater than the amount of own-source revenue that they acquire (Figure 1).

**Figure 1: Composition of general government own-source revenue and adjusted own-purpose outlays, 2009-10**



Data for general government sector. Based on own-source revenue (excludes grants from other levels of government) and own-purpose expenses (excludes payments to other levels of government).

**Source:** Australian Bureau of Statistics, Government Finance Statistics, Australia, 2009-10, cat. no. 5512.0.

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Australia has attempted to address the problem of VFI through the creation of an elaborate system of grants from the commonwealth to the states, in turn enabling states to meet their spending commitments. It is estimated that in 2009-10 the commonwealth transferred approximately \$97 billion in grants to the states, with about \$45 billion (or 47 per cent of the total) comprising the transfer of GST revenues to the eight states and territories.<sup>1</sup>

The commonwealth distributes GST revenue between the states and territories on the basis of a principle known as horizontal fiscal equalisation (HFE). The annual distribution of GST is recommended by a commonwealth instrumentality - the Commonwealth Grants Commission (CGC) - with reference to the costs borne by states of providing public services and their capacity to raise revenues, and is influenced by conditions put in place by the Commonwealth Treasurer through terms of reference to the CGC.

The HFE method of distributing GST revenues amongst the states is not only complex by international standards, but remains a highly controversial issue in the broader context of Australia's federal landscape.

The purpose of this paper is to provide an overview of the HFE system, followed by a critique of the model on various grounds related to efficiency, equity and simplicity concerns, and to outline potential reform options to improve the integrity of Australian fiscal federalism through wholesale reforms to the current system of transferring unconditional grant payments to the states and territories.

It will be submitted that, ultimately, the first-best option would be to abolish the HFE model altogether and replace it with a system of 'reverse revenue sharing' from the states to the commonwealth, in tandem with broader reforms that return additional revenue raising responsibilities to the states.

These arrangements would dramatically reinvigorate the Australian federalism ideal, which has been eroded by HFE in conjunction with varied commonwealth incursions into areas of state constitutional responsibility. This reform would have the beneficial side-effect of promoting competitive federalism pressures, which would in turn ensure greater accountability towards taxpayers and citizens regarding their preferred array of public goods provision and taxation, as well as the overall size of government.

### **3.0 THE AUSTRALIAN FISCAL EQUALISATION SYSTEM: AN OVERVIEW**

Under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA), signed by commonwealth and state Treasurers in 2000, the states receive all of the GST revenue collected by the commonwealth (less administration costs associated with revenue collection).

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<sup>1</sup> Commonwealth of Australia, 2011, *Federal Financial Relations*, Budget Paper No. 3, Government Printer, Canberra.

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The method by which this GST is distributed amongst the states is determined on a HFE basis as recommended by the CGC, an independent statutory body of the commonwealth government. The principle of HFE suggests that:

*'... [s]tate governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its sources and operated at the same level of efficiency.'*<sup>2</sup>

The HFE model for redistributing GST revenues can be stylised in the form of a simple arithmetical expression:<sup>3</sup>

$$g_i = (G/N) + (E/N) (\Upsilon_i - 1) + (T/N) (1 - \rho_i)$$

where  $g$  = per capita grant to state  $i$

$G$  = pool of GST grant funds available

$N$  = national population

$E$  = total expenditure of all states

$\Upsilon_i$  = cost disability for state  $i$

$T$  = own-source tax revenue of all states

$\rho_i$  = revenue disability for state  $i$ .

On the basis of this formula, state  $i$  receives an equal per capita share of the grant pool,  $(G/N)$ , which is then amenable to further adjustments.

The first of these is the 'expenditure need' of the state,  $(E/N) (\Upsilon_i - 1)$ . When  $\Upsilon_i > 1$  the expenditure need is positive and tends to raise the state's grant above the per capita allocation, while if  $\Upsilon_i < 1$  the state has a negative expenditure need which tends to reduce its grant below the equal per capita amount.

Similarly,  $(T/N) (1 - \rho_i)$  is the state's grant element representing 'revenue need.' If  $\rho_i > 1$  the state has a relatively high income and a negative revenue need, tending to reduce its grant below its per capita entitlement. If  $\rho_i < 1$  the state has relatively low income and a positive revenue need which serves to increase its grant.

In effect, the HFE formula adopted by the CGC seeks to provide a relatively higher share of grants to states that have below-average capacity to raise their own revenues and/or have to spend more to provide the same standard of public services as other states.

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<sup>2</sup> Commonwealth Grants Commission, 2011, *Report on GST Revenue Sharing Relativities - 2011 Update*, p. 31.

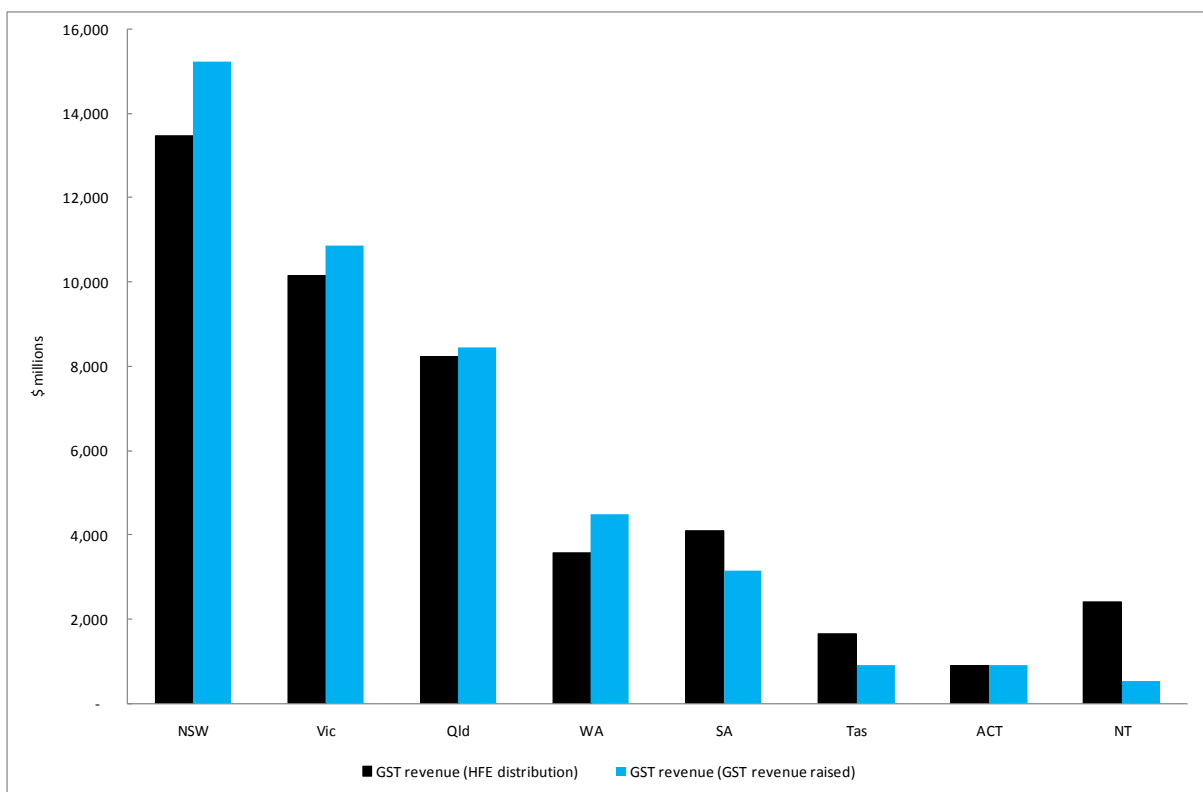
<sup>3</sup> Jeffrey Petchey and Sophia Levtchenkova, 2004, 'Fiscal Equalisation in Australia: Proposals for an Efficiency-Based System', *Economic Papers* 23 (2): 189-200. The formula excludes a term used by the CGC to account for the budgetary position of each jurisdiction, and those aspects of the HFE formula that take into account specific purpose payments, many of which are incorporated into the equalisation pool by the CGC.

To determine the values of  $\gamma$  and  $p$  for each jurisdiction, the CGC identifies and quantifies a number of so-called ‘disability’ factors, which are physical, economic, social and demographic characteristics outside the policy control of the states and territories that affect their expenditure requirements or their ability to raise revenues. The CGC states that this ensures that the HFE calculations are couched in ‘policy neutral’ terms.

The CGC, for example, may calculate a ‘dispersion’ factor on the expenditure side of state budgets which, for example, accounts for the fact that it may be more costly for decentralised states such as Queensland and Western Australia to provide roads at a standard provided in more geographically concentrated states such as Victoria. In terms of revenues, the CGC may apply weightings that take into account, say, the greater capacity for jurisdictions in northern Australia to raise revenues from the mining sector compared to those jurisdictions situated in Australia's south.

The HFE formula redistributed about \$45.2 billion of GST revenue in 2009-10, and the complex ‘needs’ adjustments calculated by the CGC resulted in significant state-specific variations compared with the level of GST actually raised in each jurisdiction (see Figure 1).

**Figure 1: GST revenue distribution, HFE basis and revenue raised basis, 2009-10**



Calculations of GST revenue raised based on total household final consumption expenditure, less expenditures on food, health care and education, in each state and territory.

**Source:** Commonwealth of Australia, 2010, *Australia's Federal Financial Relations 2010-11*, Budget Paper No. 3; Australian Bureau of Statistics, *Australian National Accounts: State Accounts, 2009-10*, cat. no. 5220.0.

Figure 1 illustrates that the two traditional ‘donor’ states - New South Wales and Victoria - and the two resources giants - Queensland and Western Australia - receive less than their share of GST

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revenues raised in their respective jurisdictions. On the other hand, ‘recipient’ states such as South Australia, Tasmania, the Australian Capital Territory and the Northern Territory all receive GST redistributions in excess of the levels originally raised within their jurisdictions. In other words, the HFE system effectively provides a ‘welfare cross-subsidy’ from high income/low cost states to low income/high cost states.

#### **4.0 PROBLEMS ASSOCIATED WITH FISCAL EQUALISATION**

The prevalent view amongst fiscal federalism experts is that Australia has erected the most complex system of intergovernmental fiscal transfers of all the federations in the developed world.

Consistent with this, there are a host of conceptual and practical problems associated with the operation of the HFE method of grants distribution. These should serve not only as caution for other countries considering such a model for determining financial transfers among levels of government, but as a good reason for Australian policymakers to fundamentally rethink the desirability of the HFE model in the context of a globalised and dynamic market-based economy.

The problems associated with the HFE model of grants distribution in Australia are outlined in the discussion that follows.

##### *Application of the HFE methodology invokes significant efficiency costs on the Australian economy*

The maintenance of the HFE system reduces the incentives for mobile factors of production, such as labour and capital, to relocate to higher, rather than lower, productivity locations. This in turn creates efficiency costs within the national economy, as opportunities to produce even more output than is currently available, are foregone.

The HFE system also encourages production factors to remain in areas where service provision is relatively costly, and in the long run raises the overall cost of providing public services. The system of HFE thus undermines efficiency by preventing the full operation of migration, which is one of the key factors in disciplining governments within a federal system, and therefore increasing the national product.

These effects have been known to exist for a significant period of time, as evidenced by a Victorian government submission to the 1990 CGC methodology review:

*‘... location-specific fiscal equalisation has adverse economic efficiency implications. Where they work i.e. to enable States to equalise the provision of services geographically, grants containing compensation for location-based factors create an inequality between marginal social benefit and marginal social cost of service provision. This gap produces a loss to economic efficiency. Efficiency will also be harmed by the inducement of resource flows from low-cost areas to high-cost ones.*

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*Efficiency losses will arise in other circumstances of State response such as using the additional funds to over-expand provision of services in particular areas (e.g. marginal electorates) or in allowing a relaxation of cost control over the provision of services.<sup>4</sup>*

To the extent that the HFE raises impediments to internal migration, it more generally compromises some of the inherent individual rights within a federal state - i.e., freedom of movement and association - and dilutes the responsiveness of state governments to cater for citizen preferences.

A number of empirical studies have been undertaken to quantify the resource misallocation costs associated with HFE.

The 2002 FitzGerald-Garnaut inquiry into commonwealth-state financial relations commissioned research which found that replacing the current HFE allocation model would increase economic output by up to \$280 million per annum,<sup>5</sup> while the Melbourne-based National Institute for Economic and Industrial Research estimated that the exclusion of location-specific disabilities from the CGC's assessment would result in an expansion of GDP by some \$500 million per annum.<sup>6</sup> Other studies over the past two decades that have assessed the inefficiencies generated by HFE in the Australian context include Dixon, Madden and Peter,<sup>7</sup> and Groenewold, Hagger and Madden.<sup>8</sup>

Notwithstanding these empirical results, which provide modest gains from reform to the HFE system, it is most likely that the full extent of efficiency gains from reforming HFE is significantly understated by the available studies. This is because the empirical studies rely upon static neoclassical economic assumptions, whereby resources are fixed, ignoring the efficiency costs of HFE in a more realistic setting characterised by ongoing resource mobilisation within a dynamic economy. For instance, economic gains may come from changes to incentive patterns, following reform of HFE, which affect the intensity of the search for more productive ways of using resources, or the intensity with which resources are applied to increasing output.

*The HFE distribution system detracts from state efforts to further promote long term economic development*

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<sup>4</sup> Robert Albon, 1990, 'The Efficiency Implications of Locational-based Factors in Commonwealth Grants Commission Determinations', in Government of Victoria, Inquiry into Grants Commission Methodology: Victoria's Response to the Discussion Papers of the Commonwealth Grants Commission, February.

<sup>5</sup> Vince FitzGerald and Ross Garnaut, 2002, *Commonwealth-State Relations for the 21st Century, Review of Commonwealth-State Funding*, Final Report.

<sup>6</sup> National Institute for Economic and Industrial Research, 1991, 'The Victorian Economy, Grants Commission Policy and the 1990 Decade'.

<sup>7</sup> P B Dixon, J R Madden and M W Peter, 1993, 'The Effects of Reallocating General Revenue Assistance among the Australian States', *Economic Record* 69: 367-381.

<sup>8</sup> N Groenewold, A J Hagger and J R Madden, 2002, 'The Efficiency of Federal Inter-Regional Transfers under a Regime of Politically-Maximizing Regional Governments', University of Western Australia, Department of Economics, Discussion Paper No. 02.03.



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The existing HFE approach to redistributing GST revenues reduces the incentives for state governments to promote microeconomic reform and further economic development more generally.

This effect is due to the fact that the HFE scheme disburses the ‘growth-dividend’ revenue benefits from economic development around Australia, without similarly sharing many of the costs of such development borne by the growing states.

In other words, the HFE system, with its systematic equalisation of the revenue costs and benefits of growth-enhancing economic policies, discourages efficiency-seeking political agents in the states who realise that state gains from efficiency will be taxed or equalised away from them, in an *ex-post* sense.

Economists have regularly outlined the desirability of states engaging in taxation reforms, including extending the base of current taxes and lowering tax rates (Gabbitas and Eldridge 1999; Potter 2005). However, as the former Victorian Department of Treasury and Finance Secretary, Ian Little, remarked, say if Victoria:

*‘... wanted to improve its payroll tax structure by broadening the base and lowering the rate to encourage employment and economic activity, as soon as this increased overall payrolls the CGC would assess that Victoria has a strong payroll tax capacity. So it would assess the state as having a lower need for GST revenue and redistribute GST to other states. Because the GST redistributes much of the fiscal gains from tax reform to other states, one of the major incentives of such reform for government, an enhanced revenue base to fund services to the community, can be significantly diluted.’<sup>9</sup>*

Furthermore, these perverse incentives attached to equalisation may penalise smaller states for seeking to develop their economy, leaving them complacent about the need for reform and encouraging them to settle for permanent fiscal reliance upon intergovernmental transfers.

By rewarding smaller jurisdictions for foregoing local revenue, instead making them reliant upon taxpayers in other regions of the country, HFE can generate ‘poverty traps’ by reducing incentives to introduce growth-promoting policies. There is no coincidence that smaller Australian states, which have consistently received the ‘welfare drip’ of disproportionate shares of GST revenue grants under the HFE process, have not engaged as heavily in the microeconomic reform process compared with the larger, HFE subsidy donor states.

Australia’s future prosperity will critically depend upon its capacity to promote policy reforms which promote long run economic growth and productivity. However the HFE process provides clear, yet perverse, incentives for states, especially beneficiary jurisdictions, to drag their feet on implementing much-needed pro-growth policies that may, as a side effect, generate additional own-source revenues.

*The equity rationale for HFE is highly questionable*

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<sup>9</sup> Ian Little, 2005, ‘Thought needed for progress to succeed’, The Australian Financial Review, 30 June.

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The CGC has long trumpeted the purpose of its HFE distribution model as promoting equity between states and territories in raising revenues with the same effort and providing public services at the same standards.

However, the equity foundations of HFE are questionable since state governments, as institutions comprised of state politicians and bureaucrats with the coercive powers to tax, regulate and expend taxpayers' funds, cannot possibly have 'equity' needs independently of the circumstances of individuals within the states. Indeed, the existing HFE model of ensuring 'intergovernmental equity' does not necessarily translate into improved equity between citizens of different states, nor within a given jurisdiction.

For instance it is conceivable that the imposition of GST on the consumption activities of poor residents in donor states (e.g., Victoria) could be effectively redistributed by the CGC to support a rich resident in a recipient state (e.g., South Australia), due either to the provision of public services in the rich person's locality or through lower state taxes.

To take another example, while the Northern Territory may receive significant disability weightings in its assessed expenditure needs on account of its relatively high indigenous population, the NT government remains free to spend the majority of its GST revenue grants in the Darwin local area, where most Territorians live, and not in regional areas where most NT indigenous peoples reside.

The 2002 FitzGerald-Garnaut Review into commonwealth-state funding commissioned the National Centre for Social and Economic Modelling (NATSEM) to test the extent to which the HFE system promotes equity in the distribution of income between families. The study found that the HFE redistribution subsidies do precious little to reduce the inequity of income between rich and poor individuals and families; in the other words, the HFE model has a negligible, or in some instances an adverse, effect on income equity.

The current system falls well short of the ideal model of equalising fiscal outcomes for *individual citizens*, as outlined by the Nobel laureate in Economics, James Buchanan, in his famous 1950 paper on fiscal equity.<sup>10</sup> Indeed, the NATSEM study showed that the income tax system, combined with social security and welfare transfers, is far more effective in moderating the income distribution of individuals and households than the HFE system.

Notwithstanding that it is in the nature of untied intergovernmental transfers that the grantor jurisdiction (i.e., the commonwealth) cannot attach (explicit) conditions to GST revenue grants,<sup>11</sup> the

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<sup>10</sup> James M Buchanan, 1950, 'Federalism and Fiscal Equity', *American Economic Review* 40: 583-599.

<sup>11</sup> It cannot be discounted that the grantor may impose implicit conditions upon recipients. There appears to be some anecdotal evidence of this effect occurring in the Australian context, with the commonwealth government repeatedly expressing frustration with the apparent unwillingness of states and territories to devote GST revenues towards certain activities to the desired extent. These pressures led, under the Rudd prime ministership, to the commonwealth proposing to claw back 30 per cent of states' GST revenue to enable the commonwealth to assume majority funding status in the public hospital system. For further discussion of this phenomenon from a theoretical perspective, see G Brennan and J J Pincus, 1990, 'An Implicit Contracts Theory of intergovernmental Grants', *Publius: The Journal of Federalism* 20 (4): 129-144.

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contention by the CGC and other proponents of the HFE system that the current Australian model promotes equity is simply too far-fetched to hold true.

*Maintenance of HFE promotes strategic rent-seeking behaviour amongst grant recipients*

The CGC's HFE model creates a strong incentive for states and territories to expend scarce taxpayers' resources to maximise their grant share.

In this context, states do not treat their equalisation grant as being exogenous to their decisions; strategic 'grantsmanship' behaviour induced by fiscal equalisation is possible as a result of the potential to manipulate the terms (E/N) and (T/N) within the HFE formula expressed earlier.

These parts of the formula, which relate to state decisions on expenditure and own-source revenues, are potentially open to manipulation by the states in order to influence the degree of the grant share they receive. Resources are also expended by individual jurisdictions to persuade the CGC to determine values for  $Y$  and  $\rho$  to generate more favourable grant shares.

Apart from the presence of the CGC itself, the HFE system has facilitated the development of commonwealth and state bureaucracies whose sole role is to administer, monitor and influence developments in this area. The task of these officials, at the state level, is to seek to maximise CGC assessments of their own jurisdictions' disabilities, to minimise assessments of their revenue-raising abilities, and to critique the arguments presented to the CGC by other jurisdictions.

While differences in commonwealth and state departmental annual report presentations make it difficult to calculate the administrative costs of administering the HFE system, it is not unreasonable to suggest that these costs alone could be up to \$10 million per annum, and with 100 staff nationally engaged in this system.<sup>12</sup>

The strategic rivalry between states to optimise their grant share is a classic example of the 'rent-seeking' phenomenon referred to in an important paper by Gordon Tullock - when lower level governments can attain grant revenues from the central government, they have an incentive to expend more of their scarce resources in order to obtain additional grants, creating substantial welfare losses in the process.<sup>13</sup>

More broadly, in an important 2001 address to a Canadian conference on fiscal equalisation, the widely acknowledged 'father of equalisation,' James Buchanan, conceded that HFE programs can be captured and compromised by politics and bad design, with political interference with the operations of such programs outweighing the noble policy intentions behind them.<sup>14</sup> In particular,

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<sup>12</sup> This estimate is based on the assumption that the CGC engages approximately 50 staff members, the commonwealth treasury ten, and five for each state and territory.

<sup>13</sup> Gordon Tullock, 1975, 'Competing for Aid', *Public Choice* 21: 41-52.

<sup>14</sup> James M Buchanan, 2001, 'Fiscal Equalization Revisited', Presentation to conference co-sponsored by Atlantic Institute for Market Studies, Montreal Economic Institute and the Frontier Centre for Public Policy.

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Buchanan noted that once an equalisation instrument is set in place bureaucratic, rent-seeking momentum can affect the integrity of the system.

*The CGC's HFE calculations are prone to significant methodological and data problems*

The HFE methodology used to determine the distribution of GST revenue grants is extremely complex, and is rife with data limitations leading to the excessive use of subjective judgment by the CGC.

In terms of the methodology, the CGC claims that the HFE approach is neutral with respect to the policies chosen by the states. However it is practically difficult to assess states' needs independently of states' policies, as many of the assessed conceptions of needs are in fact influenced, at least in part, by policy decisions.

For example, the size of the overall tax base is used by the CGC to calculate revenue effort, yet these characteristics are directly influenced by state policy. According to a study by Dixon, Picton and Rimmer, payroll tax design not only affects the size distribution of firms in the states, but influences the CGC's assessment of a state's capacity to generate payroll tax revenue.<sup>15</sup> Similar findings have been canvassed in relation to state land revenues.<sup>16</sup>

These findings are contrary to the principle that the distribution of grants to states, determined by HFE as assessed by the CGC, is independent of the state's policies. A number of states have long highlighted the CGC's attempts to remove the influences of state policy control as being incomplete or inconsistently applied, casting further doubt on the integrity of the Australian HFE process from this perspective.

In addition, the CGC requires vast amounts of data to support its assessments which, in many cases, are not available or incomplete. To overcome this obstacle, the CGC frequently resorts to judgment - in other words, a best guess. This reliance on guesses rather than facts significantly undermines the credibility of the HFE redistribution system. The Australian academic, Jonathon Pincus, once stated that 'the CGC research does not ... reach the standards that would be expected of academic publications. It would not deserve a pass if it were submitted as a third-year undergraduate project in econometrics.'<sup>17</sup>

Even the CGC itself in the past has acknowledged the difficulties in the calculation of its relativities: '[i]t is not obvious that increasing detail is producing a better equalisation outcome. Our processes are stretching the available data to the limit. ... We remain uncertain that some of the data we are

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<sup>15</sup> Peter B Dixon, Mark R Picton and Maureen T Rimmer, 2004, 'Payroll Taxes: Thresholds, Firm Sizes, Dead-Weight Losses and Commonwealth Grants Commission Funding', *The Economic Record* 80 (250): 289-301.

<sup>16</sup> Bev Dahlby and Neil Warren, 2003, 'Fiscal Incentive Effects of the Australian Equalisation System', *The Economic Record* 79 (247): 434-445.

<sup>17</sup> 'Grants system 'sub-standard'', *The Australian*, 24 March 2005.

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using are as robust and reliable than we believe is necessary. ... If the data we are using are not consistently reflecting the circumstances of the States, the quality of our results is compromised.<sup>18</sup>

The data limitations result in an excessive reliance on judgment, while the weaknesses of the policy neutrality stance results in a lack of transparency and accountability. The GST reforms undertaken in 2000 have increased the importance of the CGC's recommended state relativities (since a number of state taxes have been abolished), as have the extension of HFE coverage to include capital costs, and these developments in turn have increased the impact of any defects in the CGC's calculations on state budgetary bottom lines.

*Above all else, the HFE system undermines federalism by diluting the extent of competition between jurisdictions*

One of the central benefits of federal systems of government is that they can facilitate the emergence of a policy environment in which governments compete against each other to provide residents with their preferred configurations of public goods and taxation levels, as well as reducing the prospect of market interference by governments to an extent contrary to citizen preferences.

Brennan and Buchanan, in their famous book *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, outlined a conception of competitive federalism as a means of constraining the revenue-maximising appetites of 'leviathan' government. The essence of the Brennan-Buchanan framework is explained as follows:

*'... [i]ntergovernmental competition for fiscal resources and interjurisdictional mobility of persons in pursuit of 'fiscal gains' can offer partial or possibly complete substitutes for explicit fiscal constraints on the taxing power. ... Total government intrusion into the economy should be smaller, ceteris paribus, the greater the extent to which taxes and expenditures are decentralized, the more homogeneous are the separate units, the smaller the jurisdictions, and the lower the net locational rents.'*<sup>19</sup>

They also pointed out that sharing tax revenues between jurisdictions, in top-down fashion, should be opposed on the grounds that they implicitly establish a taxation cartel among governments to undermine the benefits of decentralised taxation assignment:

*'... the central government would act as an enforcer of the agreement between governments, doling out financial penalties to those jurisdictions which attempt to breach the agreement. ... If some state/province levied a low rate of tax in relation to some instrument over which it retained jurisdiction, other states would need to be able to penalize it by means of its grant appropriation.'*<sup>20</sup>

As noted above, lowering tax rates in order to cultivate a revenue base tends to be penalised under the HFE formula, by reducing the relative share of GST revenue entitlement of the tax-reforming

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<sup>18</sup> Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities - 2004 Review*, Commonwealth of Australia, Canberra, p. 86.

<sup>19</sup> Geoffrey Brennan and James M Buchanan, (1980) 2000, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, Liberty Fund Edition, Indianapolis, p. 215-216.

<sup>20</sup> *Ibid*, p. 212-213.

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jurisdiction and raising shares for the other, non-reforming jurisdictions. This effectively acts as a key enforcement mechanism to maintain the tax cartel, diluting the discipline of competitive federalism that would otherwise prevent the fiscal exploitation of citizens.

The HFE system dramatically weakens the incentives for the dynamic efficiency gains of competitive federalism to emerge, as the commonwealth and states have joined together, more or less willingly, to exploit the monopoly power of the commonwealth with regards to GST revenue collection.

By retaining the tax cartel, the states are able to enjoy the revenues of a centralised revenue base, the proceeds of which would be greater than under a more competitive system in which tax powers are decentralised so that states engage in vigorous tax competition with their own autonomous tax instruments. As discussed by Marlow, top-down '[r]evenue-sharing and intergovernmental grants are ... devices which restrict abilities of taxpayers to thwart the goals of policymakers. Both programs have the central government collecting taxes in excess of its spending and sharing the residual with noncentral governments.'<sup>21</sup>

## **5.0 AN EXPLORATION OF SECOND-BEST REFORM OPTIONS, AND ASSESSMENT**

The HFE methodology for distributing GST revenue grants amongst the states and territories has come under increased scrutiny in recent years. In essence, critics have suggested that HFE exhibits precious little equity advantage that could justify the allocative and dynamic efficiency costs generated by the model, the extensive rent-seeking activities undertaken by the states to attain additional grants, or the problems and complexity of the HFE methodology and data which undermines the accountability of the system.

The following provides a summary and general assessment of some of the major reform options advocated by various policy and academic interests over the past decade.

### Option 1: Simplification of methodology

One proposal has been to undertake a comprehensive program of simplification of the CGC's HFE methodology, which could improve the rigour and reliability of the process, ensure that the performance of the model is more effectively assessed by external parties, and enhance community understanding of the HFE concept.

The simplification of methodology has emerged as a high priority for the commonwealth and states in recent years.

At the 2004 Ministerial Council for Commonwealth-State Financial Relations Conference, a majority of states, supported by the commonwealth, agreed to a review of the way the CGC applied HFE principles.

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<sup>21</sup> Michael L Marlow, 1992, 'Intergovernmental Competition, Voice and Exit Options, and the Design of Fiscal Structure', *Constitutional Political Economy* 3 (1): 73-88.

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The report from this Heads of Treasuries review was presented at the 2005 Conference, which confirmed that changes in methodology have added to complexity, that the CGC had increased its reliance on poor quality data, and there were perverse incentives operating between jurisdictions and the CGC that led to greater complexity and more data-intensive requirements. Of the large number of assessments used in the HFE system at the time, approximately half distributed less than \$5 million with these tending to benefit certain states in seemingly arbitrary ways.

The report recommended various options for simplification, including aggregating assessment categories, applying 'materiality' thresholds, adopting indicators of revenue capacity and expenditure need, and eliminating unreliable category assessments.

All of the state, territory and commonwealth Treasurers accepted the recommendations of the review at the 2005 Ministerial Council meeting, to be implemented in the context of the CGC's 2010 methodology review.

The CGC 2010 review recommended the reduction in the numbers of assessment categories that capture 'the full range of State expenses and revenue in our assessments, but ... do so in fewer, broader aggregates and using broad indicators of differences among the States.'<sup>22</sup> The outcomes of this simplification process are outlined in Table 1.

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<sup>22</sup> Commonwealth Grants Commission, 2010, *Report on GST Revenue Sharing Relativities - 2010 Review*, p. 8.

**Table 1: Comparisons of level of detail in assessments**

	2004 Review	2010 Review
Revenue assessments	13 categories of taxes and other revenues and 8 categories of user charges, some of which were sub-divided and each sub-division had a revenue base measure.  In total there were 29 sub-categories.	7 categories of taxes and other revenues, some of which are sub-divided and each sub-division has a revenue base measure, plus commonwealth payments (8 categories in total).  In total there were 13 sub-categories. <sup>a</sup>
Expenditure assessments	39 expense categories, most of which were divided into components and multiple disabilities were assessed for each component.  In total, there were 171 components and 344 disabilities.	12 expense categories, which are divided into components and multiple disabilities are assessed for each component, plus an 'investment' category and a 'net lending' category (14 categories in total).  In total, there are 43 components and 93 disabilities.

<sup>a</sup> There are no categories for user charges as they are mostly included in the 'other revenue' category.

**Source:** Commonwealth Grants Commission, 2010, *Report on GST Revenue Sharing Relativities - 2010 Review*, p. 85.

While the CGC has stated that it considers 'the focus on simplification ... should be maintained in any future reviews and that in any future updates, methodology changes be restricted to those essential to capture major changes in average State policy, federal relations or data,<sup>23</sup> the clear risk is that a reliance on simplification alone to improve the integrity of the Australian HFE process contains the seeds of its own defeat.

In essence, there appear to be no durable safeguards against future growth in the complexity of the CGC assessments of equalisation, which in turn would aggravate the adverse economic and equity effects of HFE.

It is well known that the CGC has long promoted, and continues to promote, an objective towards 'full equalisation,' which has directly contributed to the complexities observed in recent years.

A good example of this at work has been the gradual inclusion, encouraged by the Commission, of cost disability assessments associated with capital expenditures, which have long been abstracted away from consideration within the Australian HFE model. These developments have been associated with an increase in the intensity of rent-seeking behaviour by individual states and

<sup>23</sup> Ibid, p. 9.



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territories to acquire additional grant shares for themselves at the expense of the others, which facilitate the observed complexity developed over time.

Even terms of reference established by the commonwealth government, including clauses which commit the CGC to maintain a focus upon simplification, may be subject to changes in interpretation over time.

Option 2: Revenue equalisation process only

Another proposal is for the CGC to discontinue its expenditure disability assessment regime, and focus on the equalisation of states' revenue capacity only.

Under this system, jurisdictions with relatively greater revenue capacities - typically the larger states - would receive lower shares of GST revenue funding relative to smaller states and territories which typically have a lower capacity to raise their own-state revenues.

It could be argued that a focus on revenue equalisation only would represent an improvement upon existing processes in that the expenditure assessments, which are arguably more complex and thus more prone to arbitrary judgments by the CGC, would be eliminated.

However the remaining concerns about the integrity of the HFE process would remain under a revenue equalisation process, including issues surrounding the potential growth in revenue assessment complexity and state rent-seeking behaviour, and the effective fiscal punishment of those jurisdictions that pursue economic reforms yielding the fiscal reward of growth-dividend revenue streams.

Option 3: GST on an equal per capita basis

The GST revenue grants pool may be distributed amongst the states and territories based on their respective share of the national population. Under this per capita redistribution, NSW and Victoria would receive a relatively greater share of GST revenue funding, with other jurisdictions receiving relatively lower shares of GST.

The CGC could be abolished under this model of untied grants distribution, with presumably the Australian Bureau of Statistics playing the leading role in providing estimates of resident population on an annual basis.

This method of GST revenue distribution appears to be that which has long been favoured by the larger states, including on the basis of the radical reduction in the level of complexity that an equal per capita distribution of GST would present.

An equal per capita distribution is also likely to prove beneficial for larger states that face greater costs, at least in absolute terms, associated with the provision of public services for residents. To the extent that larger states devote their greater GST entitlement, under an equal per capita sharing

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model, towards redressing such issues as congestion costs then economic efficiency gains are likely to transpire from such a reform.

However, as with any other method of redistributing untied grants from other levels of government, there is no guarantee that politicians in larger states would expend their GST entitlements in an economically desirable manner.

#### Option 4: GST on a modified equal per capita basis (Carr option)

In a proposal outlined by former NSW Premier Bob Carr, the smaller states (South Australia, Tasmania, Northern Territory) would continue to receive HFE subsidies over a smaller range of assessment categories, which relate to core functions such as education and health, for a fixed term.<sup>24</sup>

The larger states (New South Wales, Victoria, Queensland, Western Australia, Australian Capital Territory) would receive GST revenue funding on a per capita basis.

This reform would represent something of a variation to the previous 'claimant' method of distributing untied grants to the states, with the smaller jurisdictions able to claim greater shares of revenues accorded to them under their special status.

Whilst the potential loss to national economic efficiency is likely to be lowered somewhat under this proposal, the risk is that the smaller states would tend to maintain inefficiently larger and costly public sectors to perpetuate a sense of 'disadvantage' in order to be assessed favourably by the CGC under a HFE-maintained funding formula for small states.

#### Option 5: Minimum cost of government grants (FitzGerald-Garnaut option)

The 2002 FitzGerald-Garnaut Commonwealth-State Funding Review, commissioned by NSW, Victoria and Western Australia, found that Australia needs a simpler and more efficient system of intergovernmental financial relations, which allows governments to meet the basic costs of administering a state and providing core services to their citizens, whilst maintaining incentives for economic growth.

Under the model advocated by FitzGerald and Garnaut, the current HFE system would be abolished, to be replaced by a funding model where each state would receive a flat amount calculated to cover the minimum overhead costs of government (\$98 million per state at the time of the publication of the Review's final report). The remainder of GST revenues would be distributed amongst the jurisdictions on an equal per capita basis.

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<sup>24</sup> Government of New South Wales, 2005, 'GST: The Way Ahead - A New South Wales Government Proposal', [http://www.treasury.nsw.gov.au/\\_\\_data/assets/pdf\\_file/0017/1268/gst-way-ahead.pdf](http://www.treasury.nsw.gov.au/__data/assets/pdf_file/0017/1268/gst-way-ahead.pdf).

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In addition, FitzGerald and Garnaut recommended that the functions of the CGC should revert to a role similar to that which it played about the time of its establishment - i.e., the CGC would provide advice on the need for assistance where a state is experiencing severe financial difficulties, and also to assist in calculating the minimum cost of government.

While this reform, again, could well represent an improvement upon the current HFE methodology, it would not come without its problems.

Apart from the likelihood of disputes amongst levels of government concerning what constitutes the 'core functions' of state government, using actual costs as the basis for establishing the minimum overheads for such functions is unlikely to generate incentives to reduce such costs in the long run. This is because, other things being equal, a state could potentially increase its GST grant share by inflating public sector costs more greatly than other jurisdictions.

#### Option 6: GST on a state-of-origin basis

The GST revenues could be returned to the states and territories on an origin basis - in other words, the funds would be returned on the basis of GST revenue generated within each jurisdiction.

Under this proposal, NSW, Victoria, Queensland and Western Australia would receive greater funding entitlements compared with the current system, while all other jurisdictions would receive lower funding shares. The CGC would be abolished under this proposal.

This proposed reform is arguably the 'least bad buy' from a second-best perspective.<sup>25</sup> It would encourage the states to facilitate economic growth, through value adding private production subsequently spilling over into buoyant household consumption.

The complexity of assessing implied grant shares would be greatly reduced in comparison with the current system, and rent-seeking behaviours by states would also be practically eliminated.<sup>26</sup>

#### Option 7: GST on a modified state-of-origin basis (Petchey-Levtchenkova option)

In a paper published in 2004, Jeffrey Petchey and Sophia Levtchenkova developed an alternative GST distribution model, where the origin basis for GST revenue distribution would be augmented by payments that capture the fiscal effect of the movement of mobile factors of production across state borders.<sup>27</sup>

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<sup>25</sup> The author of this submission has previously argued in favour of this alternative method of GST revenue distribution. For example, see Julie Novak, 2011, 'Three wise men must end GST's 'groundhog day'', The Canberra Times, 5 April.

<sup>26</sup> This is in part due to the legislative design of the GST, insisting that changes to the tax rate and base can only proceed if agreed to unanimously by all states and territories.

<sup>27</sup> Jeffrey Petchey and Sophia Levtchenkova, op. cit.

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The existing 'equity based' equalisation system would be abolished, and the CGC would calculate new disability factors for interjurisdictional differences in fiscal externalities, economic rents, and any other factors that affect the distribution of mobile factors of production across regions.

Petchey and Levtchenkova also argue that the HFE formula should also be amended by making expenditure and revenue standards used within the formulas exogenous, so as to avoid inducements by states for strategic behaviour to increase their relative grant share.

While also presenting a potentially significant improvement upon the existing HFE methodology underpinning GST revenue distribution, the design of this alternative would be bedevilled by great difficulties surrounding the quantification of the extent of fiscal externalities, economic rents and other factors that affect mobile resource distribution across the states and territories.

#### Option 8: Performance-based grants (Norman-Brogden option)

Another alternative is to ensure that at least some element of the methodology governing untied intergovernmental transfers appropriately takes account of performance, to avoid the possible drain on economic development associated with the current system.

In 1995, economist Neville Norman proposed that the CGC methodology be altered such that grants distribution favours jurisdictions on the basis of their progress in implementing microeconomic reforms.<sup>28</sup>

During his stint as leader of the NSW Opposition, John Brogden noted that the 'existing Grants Commission formula actually encourages states not to improve services - the worse they are, the greater the disadvantage, the greater the funding. Funding should recognise the best performing jurisdictions. The efficiencies and savings will be significant, as will the improvement in the delivery of public services.'<sup>29</sup>

In light of these observations, Brogden advocated that 'the Grants Commission formula ... be reformed to reflect not only need, but also performance. Fifty per cent Grants Commission funding should be allocated on need. ... The remaining 50 per cent of funding should be allocated on performance. States must have an incentive to excel. They must be rewarded for improvement rather than funded for mediocrity.'<sup>30</sup>

In a related point made more recently, Neil Warren has raised concerns about how 'general purpose grants are allocated in such a way as to conflict with the objectives assigned to specific purpose grants.'<sup>31</sup>

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<sup>28</sup> Neville R Norman, 1995, *Refocusing fiscal reform: An analysis of the fiscal crisis in Australian states - How we can avoid it, learn from it and restore Australia's international standing*, Business Council of Australia, Melbourne.

<sup>29</sup> John Brogden, 2005, 'Government club overdue for reform', *The Australian*, 24 June.

<sup>30</sup> *Ibid.*

<sup>31</sup> Neil Warren, 2011, 'Designing Intergovernmental Grants to Facilitate Policy Reform', [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1903623](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1903623).

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The determination of GST revenue grants to jurisdictions on a HFE basis might create inconsistencies in a funding environment where Specific Purpose Payments (SPPs) (and National Partnership Payments) are established on the basis of commonwealth-state negotiations regarding performance aspirations for various areas of state expenditure.

In effect, by including SPPs in the ‘pool’ of total assessable funding for GST redistribution on HFE principles, the CGC undoes the intended effect of SPP distributions arising from intergovernmental negotiations to the extent that SPPs are not quarantined from the total assessable funding pool.<sup>32</sup>

Warren recommends that the grant pool be broken into separate and smaller grant pools, with a more judicious application of quarantining to ensure that the performance-based objectives of tied grants are not compromised by their inclusion into an otherwise total assessable funding pool distributed on the basis of HFE.

There is much to be said in favour of Warren’s proposal that intergovernmental financial transfers tied to explicit (bilateral or multilateral) agreements between the commonwealth and the states be quarantined, at least to a far greater degree than presently, from HFE assessments.

However, proposals to determine the distribution of currently untied GST revenue grants on the basis of reform progress, however defined, would further undermine the integrity of Australian federalism.

As noted above, there is some evidence to suggest that the commonwealth is gradually imposing implicit conditions or expectations upon the states and territories regarding how they should expend GST revenue grants. To go a further step and make the receipt of GST revenue by the states explicitly contingent upon the achievement of reform, as adjudged by federal politicians or agencies, would only formalise the subversion of constitutionally sovereign states to become administrative sub-units of the commonwealth government.

## **6.0 REVERSE REVENUE SHARING: AN ALTERNATIVE PROPOSAL TO REVIVE COMPETITIVE FEDERALISM, WITHOUT THE NEED FOR FISCAL EQUALISATION**

Given the obvious problems in the design, implementation and effects of the Australian HFE system, it is clear that reform is required. Even so, it could be argued that, in fact, the best route for reform is not pursued through tinkering with an inherently flawed status quo.

Many, but not all, of the second-best options noted above might serve to patch up, at least temporarily, some of the most obvious shortcomings in assessing the distribution of untied, general revenue grants from the commonwealth to the states.

However these quick fixes would tend to leave behind an institutional edifice that continues to weaken incentives for the dynamic efficiency gains of competitive federalism to emerge. As Brennan

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<sup>32</sup> Ibid, p. 14.

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and Buchanan noted, '[r]evenue sharing ... [from central to lower levels of government] ... is undesirable, because it subverts the primary purpose of federalism which is to create competition between jurisdictions.'<sup>33</sup>

An alternative to intergovernmental grants from central to lower levels of government that would be compatible with the fundamental spirit of competitive federalism would be a regime of 'reverse revenue sharing,' or the assignment of intergovernmental financial transfers *from lower levels of government to the central government*.

This proposal was originally devised by the American public choice theorist, Dwight Lee, in the mid-1980s,<sup>34</sup> and has been the subject of subsequent, albeit limited, discussion in US,<sup>35</sup> European<sup>36</sup> and Australian<sup>37</sup> contexts.

At the centre of a reverse revenue sharing regime is the obligation that the states and territories must provide, on an annual basis, a proportion of the revenues (including taxes, receipts from sales of goods and services, fees and fines, etc.) they raise to the commonwealth, with this proportion being uniform across all states/territories.<sup>38</sup> The commonwealth would then expend its grants revenue receipts on the core functions of government, such as defence, foreign affairs and its other core powers enumerated in Section 51 of the Australian Constitution.

This arrangement would need to be coupled with a reassignment of taxing powers back to the states. In the extreme case the commonwealth government would be deprived of any power to impose taxation and raise other forms of revenue. However under a more realistic alternative scenario it would retain its existing constitutional responsibility to exclusively impose customs duties and excises.<sup>39</sup>

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<sup>33</sup> Brennan and Buchanan, op. cit, p. 214.

<sup>34</sup> Dwight R Lee, 1985, 'Reverse Revenue Sharing: A Modest Proposal', *Public Choice* 45 (3): 279-289. Also see: Dwight R Lee, 1994, 'Reverse Revenue Sharing: A Return to Fiscal Federalism', *Cato Journal* 14 (1): 75-85; and Dwight R Lee, 2001, 'Taxes, Grants, and Porkbarrel Politics: The Case for Decentralizing the Power to Tax', in Donald P Ratcheter and Richard E Wagner, eds., *Federalist Government in Principle and Practice*, Kluwer Academic Publishers, Dordrecht.

<sup>35</sup> Peter Boettke and Scott Beaulier, 2011, 'Deficits, Debt, and Debasement', *Cato Institute Policy Report*, July/August.

<sup>36</sup> James M Buchanan and Dwight R Lee, 1994, 'On a Fiscal Constitution for the European Union', *Journal des Economistes et des Etudes Humaines* 5 (2/3): 219-232.

<sup>37</sup> Robert Albon, 1996, 'Commonwealth Financial Dominance, Fiscal Balance or Reverse Revenue Sharing?', *Agenda* 3 (3): 287-296. Albon noted that a scheme to provide states with exclusive powers over direct taxation, and payment of per capita grants to the commonwealth, was proposed by a minority commissioner during the 1920-1923 Kerr Royal Commission on Taxation.

<sup>38</sup> As explained by Buchanan and Lee, a uniform fixed percentage of revenues to be distributed from the states to the commonwealth government would greatly reduce rent-seeking attempts by individual states to free ride on the contributions of others. Consistent with this, changes to the uniform revenue sharing proportion should only be made by the unanimous consent of all states and territories.

<sup>39</sup> It is widely understood that a broad, yet economically questionable, interpretation of the commonwealth's power to levy excises by the High Court is in force, which includes commonwealth jurisdiction over indirect

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A realignment of taxing powers, including a return of personal income taxes, would enable the states and territories to adequately fund their expenditure functions (including exogenous cost conditions impacting on the ability to provide state public services), and those of the commonwealth, without any recourse to the 'welfare tap' of financial transfers from other levels of government.

The literature has cited a number of benefits that would ensue from a comprehensive system of reverse revenue sharing. In no necessary order these include:

- By radically decentralising the power to tax to lower levels of government, individuals and businesses are accorded far greater freedoms to choose a more tailored suite of taxes consistent with their preferences over public goods supply. Individuals and businesses that do not approve of high taxing and spending solutions in one jurisdiction can relocate to another with lower taxes and expenditure, which tends to restrain the appetite of any given jurisdiction to impose punitive taxation burdens or to spend wastefully.
- To the extent that it retains economic management functions, the commonwealth would have a greater incentive to pursue policies conducive to economic growth and productivity. This would increase the amount of 'growth dividend' revenues available to the states, in turn providing for absolutely greater amounts of grants from states to the commonwealth.
- The commonwealth would be deterred from recycling its grant receipts back to the states and territories, especially when it comes to financing public services with localised benefits. Likewise, the ability of the commonwealth to financially punish states will be reduced as it is deprived of lucrative sources of monopoly taxation powers.
- Reverse revenue sharing would also hamper the ability of special interests to extract rents through the political system. The commonwealth's access to independent sources of revenue to expend in favour of interest groups would become heavily circumscribed. State taxpayers would, for their part, have a greater motivation to resist higher taxes for the particular benefit of special interests and can punish, through their mobility, inappropriate policies that serve specific rather than general economic interests.
- In addition to the political accountabilities accorded by periodic general elections at the commonwealth level, a system of reverse revenue sharing would magnify the extent to which the commonwealth is accountable to local communities, in effect reversing the current situation in which '[a] large share of State and local tasks is financed with grants from higher up, that is, without any direct critical check by local taxpayers and local legislatures.'<sup>40</sup>

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taxation on the sales of goods and services including the GST. Some Australian economists have suggested that a test case be pursued to clarify the extent of commonwealth jurisdiction over indirect tax bases. Failing this, or if a test case confirms commonwealth exclusive jurisdiction over indirect taxes on sales, the GST would remain as a commonwealth tax. It would be preferable in these circumstances to maintain GST revenue grants to the states (albeit under new distribution arrangements, preferably allocations on a state-of-origin basis, that replaces the HFE model). Alternatively should it be agreed by commonwealth and state governments that the commonwealth exclusively retain GST revenues under a reverse revenue sharing regime, then the current legislative restrictions on the setting of the tax rate and base should be retained to limit the commonwealth's ability to extend its GST revenue takings.

<sup>40</sup> Wolfgang Kasper, 1995, *Competitive Federalism: Promoting Freedom and Prosperity*, States' Policy Unit, Federalism Project Issues Paper No. 3, p.40.

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To be sure, there are several important obstacles in the way towards the realisation of a revenue sharing system amongst the two main levels of Australian government.<sup>41</sup>

While it would be highly desirable to completely extinguish the commonwealth's unilateral power to impose taxation, this may not be entirely feasible to do so (absent a complete constitutional revision) as the commonwealth, as noted above, has already been accorded responsibilities to levy customs duties, excises and, arguably, the GST.<sup>42</sup>

However, for as long as the commonwealth is reliant upon the states for the majority of its revenues, and states can potentially exercise their right to secede from the federation,<sup>43</sup> the reverse revenue sharing system should be able to retain its desired effects.

Further, and as testified by experience both in Australia and around the world, governments have tended to substitute taxes, in an increasingly competitive global economic environment, with hidden regulatory impositions, as well as the ability to borrow funds from financial markets and the printing of fiat money.

Accordingly it will be necessary to constitutionally restrict the ability of the commonwealth to regulate and raise alternative or indirect forms of revenue in order to maintain the effectiveness of the reverse revenue sharing system.

Under this system of intergovernmental financial relations, the need for fiscal equalisation would be superfluous, as the states would be equipped with sufficient revenues to discharge their expenditure responsibilities and defray the costs of public services (putting aside whether or not these costs differ across jurisdictions due to natural, demographic or other attributes, as part of the diversity inherent within federal systems of government).

Further, as noted by Qian and Weingast, interjurisdictional competition prompted by the decentralisation of governmental functions can reduce interregional inequities without the need for centrally-mandated redistribution.<sup>44</sup> For instance, jurisdictions with relatively low levels of income,

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<sup>41</sup> Australian local governments are not considered in this section since they are, technically speaking, administrative sub-units of the state governments, with no constitutional powers of their own and with expenditure functions and very limited revenue-raising powers delegated to them by state parliaments.

<sup>42</sup> There might be a heightened risk that the commonwealth might increase protective tariff rates in response to a reverse revenue sharing system that deprives it of numerous exclusive sources of revenue. However such a policy would be self-defeating as the Australian economy would be lumbered with inefficient industries generating insufficient value added, with flow on consequences by way of constrained revenue raising potential by state governments. This would have a significant impact on the ability of the states to furnish the commonwealth with sufficiently growing levels of grant payments over time.

<sup>43</sup> See Buchanan and Faith for a discussion of how secession might exert limits on the taxing appetites of governments. James M Buchanan and Roger L Faith, 'Secession and the Limits of Taxation: Toward a Theory of Internal Exit', *The American Economic Review* 77: 1023-1031.

<sup>44</sup> Yingyi Qian and Barry R Weingast, 1997, 'Federalism as a Commitment to Preserving Market Incentives', *Journal of Economic Perspectives* 11 (4): 83-92.



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such as Tasmania, could promote wealth creation and reduce its income gap compared with the larger, mainland states, through a unilateral policy regime of lower taxes and fewer regulations.

However the benefits of reverse revenue sharing extend far beyond the abolition of the existing HFE model of GST revenue distribution.

By restraining the centralist tendencies of the commonwealth, and facilitating the decentralisation of governmental functions, reverse revenue sharing can promote individual liberties by providing effective checks on the size and growth of governments in the federal system.

This general sentiment was endorsed in an important, but seemingly largely forgotten, paper by Frederic Bland in 1946: '[a] federal system enables government to be so organised as to reduce it to terms that can be understood by the individual. It keeps administration close to the citizen rather than remote from him. By promoting at one and the same time unity and diversity, it prevents the Leviathan State from smothering the individual and from ruthlessly imposing its will upon him in the name of egalitarianism and uniformity.'<sup>45</sup>

## 7.0 CONCLUSION

The regime of horizontal fiscal equalisation in Australia has been glorified by its various defenders as the indispensable 'linchpin' or 'glue' of federalism, without which the Australian Federation would fragment and eventually disintegrate beyond repair.

However it should be recognised that the Australian Federation functioned effectively, albeit with the usual political tensions between levels of government, prior to the advent of the CGC and the movement towards full equalisation of state fiscal capacities.

The CGC and the fiscal equalisation process is in reality a *political* solution to a perceived historical problem in state public finance, established in an attempt to discourage Western Australia seceding from the Federation during the early 1930s.

Since then, the methodology used by the CGC to recommend grant distribution has changed markedly, as Garnaut and FitzGerald explained in 2002:

*'... [i]n truth, the actions of the CGC have changed much more over time than the words used to describe them. Payments allowing a State to function as a member of the Commonwealth in times of fiscal stress were transformed by the end of the 20th century into payments to provide capacity for the provision of equal services of all kinds, whatever the costs of delivery. ... The operative definition of HFE retained its limited character from 1936 until the 1990s, when full equalisation was adopted in terms of reference in 1999.'*<sup>46</sup>

The exposure of the States to the current complex model of HFE redistribution, and the costs that such an exposure entails, has increased markedly in recent years. This is because the CGC's

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<sup>45</sup> F A Bland, 1946, 'Federalism in Australia', *Australian Journal of Public Administration* 6 (3): 152-161, p. 155.

<sup>46</sup> Vince FitzGerald and Ross Garnaut, op cit, p. 36.

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processes now apply to a GST revenue pool (\$45 billion in 2009-10), which is much larger than the earlier financial assistance grants pool (\$17 billion in 1999-2000).

One of the most staunch defenders of Australian HFE, the late Russell Mathews, once stated that '[t]he threat to horizontal fiscal equalisation in Australia arises not from any defects in the system, but from the pressures placed upon it by the continuing failure to restore vertical fiscal balance. It is the Commonwealth tax monopoly that needs to be dismantled and not the system of fiscal capacity equalisation.'<sup>47</sup>

On the basis of information contained in this submission it is difficult, then as it is now, to sustain the notion that the Australian HFE model is costless, in terms of its effects on the economy and political conduct, or is perfectly designed as if by benevolently despotic political agents.

However the proposition that the commonwealth tax monopoly should be eliminated, or substantially dismantled, is strongly supported from the perspective of reviving a system of Australian federalism substantially weakened by decades of centralisation, with this weakness aggravated by a HFE system penalising states that unilaterally seek to compete against others in fostering an economic environment conducive to private sector development.

This submission argues that reform of the HFE system of distributing GST revenue amongst the states and territories cannot be divorced ultimately from the central problem of Australian federalism, viz. the unwarranted dominance of the commonwealth government in fiscal affairs.

To resolve both problems satisfactorily will require policy attention towards the opportunities and challenges of enshrining a genuine decentralisation of government functions, with residual commonwealth responsibilities financed primarily by a regime of reverse revenue sharing from the states.

Such a model would more satisfactorily reconcile the Australian federal political values of unity (via a limited commonwealth government focussed upon maintaining a customs and monetary union, and providing defence and foreign affairs) and diversity (via the radical decentralisation of all remaining tax and expenditure functions to the states) that does the costly and outmoded model of horizontal fiscal equalisation.

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<sup>47</sup> Russell Mathews, 1994, 'Fiscal Equalisation - Political, Social and Economic Linchpin of Federation', Australian National University, Federalism Research Centre, p. 18.