Summary of a Workshop on the GST Distribution held in Canberra 23 July 2012

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The workshop was organised by Henry Ergas and Jonathan Pincus, and was held under the Chatham House rule, using funding from the Ian Wilson Foundation at the University of Adelaide and with assistance from Deloitte Australia.

This submission offers a personal summary of the main arguments presented and discussed at the workshop. The focus in this summary is on arguments and points that may not have had much exposure elsewhere. Those who presented short papers were encouraged to convert them into submissions.

A: Hierarchy of Objectives

1. It is important to distinguish primary from secondary objectives.
2. The primary objectives of HFE should be equity and efficiency.
3. These primary objectives should drive the methodology used to achieve the mandated degree of fiscal equalisation.

B: Equity

1. The equity case for HFE should recognise the federal nature of the Australian constitution, and should be based on criteria that apply to federal systems (and which may not apply to unitary systems).
2. The case for full equalisation assumes that federal constitution implies that residents in a State should have no ‘property right’ in the fiscal differences that flow from their residing in one state rather than another. (The contrast may be made with the recognition of rights in other property or assets, voluntarily acquired or renounced.)
3. This assumption, of no ‘property rights’ in a jurisdiction’s fiscal outcomes, has to be squared with the fact that, in Australia, no explicit law or impost restricts interstate migration. As a result, individuals can ‘choose’ their State, and hence the differences in outcomes that gives rise to are at least partly voluntary (and hence not in themselves inequitable).
4. On the other side, a “Burkean” or ‘property rights’ view was used to argue that HFE has been ‘entrenched’ in Australia since the early 1980s, essentially as an agreement to achieve ‘substantially equal’ or ‘as near as exactly equal’ fiscal capacity; and so there needs to be a strong argument for its abandonment or substantial modification.
5. Subsequently, the response has been made that present system of HFE, which has been around for only a decade (since the introduction of the GST), may well have established an expectation of a continuation of redistribution via HFE; but arguably the current unexpected minerals boom has led to much larger redistributions than anyone reasonably envisaged; and that although fiscal redistribution is an ‘institutional feature’, its extent (and detail) should not be considered carved in stone.
6. A related point is that, while some form of HFE has been an enduring feature of the Australian federation, as has the CGC as an institution, the precise form HFE takes has adapted to major changes and to perceived shifts in the federation’s requirements. With rapid growth in Asia potentially reshaping Australia’s economic geography and

creating new opportunities, it would be unsurprising—and not inconsistent with the federation's history—for the extent and nature of HFE to change.

C: Equality

7. When the Grants Commission was first established, it was partly as a result of two factors no longer relevant:
    a. It was widely accepted in the 1920s that some States (including Tasmania and Western Australia), far from benefiting from federation, had been harmed by it and the resultant set of Commonwealth policies, especially those concerning import tariffs.
    Today, it is widely accepted that no State would benefit from secession—indeed, the net recipients from HFE would likely benefit least of all.
    b. It had been expected that federation and free internal trade would quickly cause a convergence in living standard across the States. However, significant differences remained in the 1920s in the standards of living of the various States. With little by way of Commonwealth redistributive spending, these differences detracted from a sense of common nationhood.
    Today, the interstate variation in average living standards is extremely small (but, however, there are significant differences in living standards of regions and ethnic groups, both across and within States).
8. HFE, considered as an element of redistribution at the level of the individual, is minor in comparison with the combined effects of the tax, expenditure and subsidy systems of the Commonwealth and the States.
9. The wide Constitutional scope for the Commonwealth to engage in vertical competition with the States, and its strong fiscal capacity so to engage, suggest that if some States fail to deliver services of a standard and scope reasonably comparable with those in other States, then, if the politics are right, the Commonwealth would step in with its own programs, or with tied grants (and maybe with grants quarantined from HFE, at least for a number of years). That is, HFE may be a substitute for either new or greater direct Commonwealth engagement in fields wholly or partially occupied by the States; or new or additional tied grants.
10. By their nature, and given the cost they would impose on the Commonwealth (consuming revenues that it might deploy elsewhere), such compensating interventions are likely to be relatively selective. Moreover, they would not reduce the GST funding available to the States, and so would not, in themselves, displace State autonomy. The claim that the absence of HFE (or a move to EPC) would lead to greater centralism therefore seems misplaced, though that is not to deny it might lead to a number of selective Commonwealth interventions.

D: Efficiency

1. There were strong opinions but no consensus that HFE brings a significant national benefit (or damage) by way of a gain (or loss) in economic efficiency.
2. Numerical modelling of the kind provided in the SA government submission finds that HFE has a positive efficiency effect in the long run, by discouraging excessive population in the States with large mining royalties (or other large fiscal advantages in revenue capacity, service demands or costs). That is, HFE prevents labour being attracted by a more generous fiscal dividend which would be financed from royalties, if royalties had not been subject to HFE. (Similarly, for other causes of differences on the revenue and expenditure sides.)

3. This modelling is 'comparative static', not dynamic, and so does not necessarily reflect recent experience, which indicates that Western Australia attracted six overseas migrants for every interstate migrant (on ABS data). This experience suggests that, if large differences in wages are not sufficient incentive to move, then small differences in 'net fiscal dividends' are unlikely to trigger significant additional internal migration. Therefore, the efficiency gains of the size suggested in the model may not eventuate for many years.
4. Moreover, if there are distortions affecting the labour market that impede or prevent migration, as most participants accepted, then it is unclear there would be the excess movement assumed in the South Australian modelling. Moreover, in those circumstances, it would potentially increase efficiency for 'booming' States to be able to subsidise movement from 'lagging' States.
5. The modelling done for the SA Government shows that there is a national efficiency loss from adjusting the GST distribution for differences in unit costs of service delivery. However, in that modelling, the (negative) efficiency effect is smaller than the (positive) efficiency effect on the inter-jurisdictional allocation of mobile workers and other factors of production.
6. To the extent that there is a good correlation between a State being a net beneficiary of HFE and having higher unit costs of services, then a static efficiency gain may be offset by a dynamic efficiency loss, if HFE encourages larger populations in high cost areas and States. (See also E16 below.)
7. This would be reinforced if HFE has the dynamic effect of limiting the benefits of economies of agglomeration, which are absent from the modelling (which does, however, have a disutility from crowding due to additional population).
8. The point was made that if HFE does improve economic efficiency, then in theory HFE makes it possible to improve the welfare of every State.

E: Effects on State government decisions?

9. The SA government-commissioned modelling assumes that HFE does not influence the decisions of State governments at all (apart from the spending effect of larger or smaller budgets), but recognises that it is a possibility.
10. In particular, the modelling assumes that State government decisions are not influenced by losing all of its royalties except its population share; and are not influenced by any other aspect of HFE. For example, WA loses about 88% of its additional royalties to other States.
11. In contrast, the modelling assumes relatively small changes in fiscal attractiveness have substantial effects on individual decisions about where to locate. To that extent, while individuals' decisions are modelled as highly sensitive to long run differences in economic conditions, there is an implied assumption that those same individuals, when they take collective decisions, are not responsive to incentives.
12. A counter-example was cited—a government that encouraged mining companies to contribute to the welfare of the jurisdiction in ways that substitute for higher royalties.
13. However, it was pointed out the Grants Commission can and does take account of such contributions.
14. Nonetheless, the choice between royalties and other 'payments' from miners may be distorted by the high visibility and political salience of the redistribution of royalties through the Grants Commission. (State governments tend to boast about the flow of royalty payments that will follow an indenture agreement or mining-related approval.)
15. Moreover, it may be that HFE alters the relative attractiveness of royalties versus other forms of resource taxation, for instance, if a somewhat smoother (i.e. less cyclical)

profile to royalties reduced the long run extent of redistribution. (Modelling would be required to assess this issue.)

16. There must equally be a question whether at the margin, States that have withheld the development of their natural resources (as it was suggested Tasmania has done), would have done so to the same extent had they faced the full consequences of those decisions.
17. It is easier to observe things that are done, and resources that are developed, than to observe those that could have been done (and from the perspective of the nation as a whole, should have been done) but were not. As a result, a practical system of HFE, one that also aims at being comprehensive, risks taxing the doers without penalising those who chose the potentially softer option of not pursuing otherwise worthwhile development.
18. A broader point was made, namely, that political transparency and accountability are blurred by VFI (and the resultant mixing of State and Commonwealth funds) and by HFE: States do not face the full consequences of their spending, taxing and regulatory decision (including on the margin).
19. An analogy was offered, and disputed, between dependence on federal grants and foreign aid, with the claim that both encourage rent seeking and poor public decision making and, in the long run, both are damaging to economic development.
20. Ultimately, it was suggested, the question must be this: To the extent to which WA and Queensland should grow relative to the other States, over the next decade or more, does the HFE system retard or facilitate this major economic realignment?

F: Broader indicators; global indicators

1. The use of broader indicators is consistent with the pursuit of full equalisation; and consistent with the principle of basing HFE assessments on 'what States do', rather than on what States could or should do.
2. However, the use of global indicators is probably not consistent with the pursuit of full equalisation.
3. The use of broader indicators may lead to the elimination of some factors, on grounds of immateriality.
4. Also, the use of broader indicators may reduce the number of instances in which unilateral changes in a state's taxation system are discouraged by HFE (e.g., switching land taxation from taxes on transactions or sales, to taxes on the value of the stock of land could, under the current system of calculation, lead to a loss of GST; clearly, if the value of the stock of land was one of the broader indicators used to estimate a State's capacity to tax—as seems reasonable—then there would be no such effect).
5. The broadest indicator would be a measure of the inherent differences in the capacity of the various States to generate economic welfare—perhaps a version of 'natural capital' as estimated by the UN Development Program could be used to calculate the "Hicksian" income capacity of each State (as the amount that could be consumed without impairing wealth). This would be in keeping with Giblin's original conception of the task of the Grants Commission: to compensate States for the fiscal effects of inherent differences, that is, those not able to be influenced by State policy.
6. However, this could mislead the Grants Commission into making wholesale redistributions of balance sheets, rather than redistributions of "Hicksian" income.
7. The risk is increased by the fact that some aspects of inherent differences are easier to capture in such broad indicators than others—for instance, mineral endowments may be more readily measured than economies of agglomeration and other forms of 'social capital'.

8. On the expenditure side, it would be possible for the Grants Commission to present the results of its calculations in terms of a 'formula' in which assessment depends on the various 'drivers' of expenses—essentially, numbers or proportions of the State population in assessed categories—multiplied by the standard costs of serving each category. Such a presentation could make the overall assessment of expenses easier to understand. It could also lead to a reduction in the number of categories that meet the 'materiality' test (using something like a principal component analysis?). Treasury used a simple formula of this kind during 1948-58, for the dispersal of most Commonwealth funds to the States.

G: Incentives for tax and other reforms

1. Australian governments as a whole and individually face the prospect that their citizens' expectations of government spending and transfers will exceed the willingness of taxpayers to fund those expenditures. Ageing of the population, higher expectations, and progress in medical technology will be the main drivers of public spending.
2. If a reform improves economic efficiency, then an overall fiscal dividend is likely to be generated.
3. The extent of vertical and horizontal fiscal leakage, following a unilateral reform by a State, can be as high as 88% for a State as large as NSW.
4. Vertical leakage of the fiscal benefits of reform far exceeds the horizontal leakages through HFE.
5. Nonetheless, the horizontal leakage via HFE is a disincentive, even if only a relatively minor one. The rhetorical (but by no means inappropriate) question was asked: Why should a State government suffer the political costs of implementing a change in the tax system, when the fiscal dividend is largely lost to the Commonwealth and to other jurisdictions?
6. Both forms of leakage can erode goodwill between jurisdictions.
7. All this points to the need for a grand bargain between the States collectively and individually, and the Commonwealth. If coordinated State tax reforms are undertaken, then there is a good argument for some vertical sharing of the fiscal benefits (as under National Competition Policy).
8. An example of disincentive was offered: if one State funded all schooling using vouchers, then this could reduce its GST distribution appreciably, if it led to a fall in the share of pupils attending state schools. Similarly, it has been argued that a State would lose GST funds if it shifted from higher-cost public provision of some service, to lower-cost private provision.
9. This is a case where the use of 'what States on average do' as the indicator, tends to lock in the historical pattern, increasing the costs to any individual jurisdiction of taking the lead on reform.

H: Royalties and MMRT

1. Under the current legislation and HFE, any State can vary its royalty arrangements and capture some revenue that otherwise would have accrued to the Commonwealth, especially via the MRRT (and, to a less extent, under the company tax).
2. This incentive would be removed if royalties were eliminated. This would worsen VFI appreciably, in a country already with a remarkably high degree of VFI.
3. The incentive would also be removed if the MRRT were a State tax or if the revenues of the MRRT were, like those of the GST, hypothecated to the States.

4. Jonathan Pincus argued his publicly stated case that royalties represent a conversion of one State asset into another, namely, cash; and so royalties should be treated differently to ordinary flows of State government revenues.
5. It was argued that if that distinction between capital and income were made in this case, should it not be made more broadly? The obvious answer is yes, but the practical difficulties that might involve (and those difficulties would need to be established) should not prevent its implementation in this instance, all the more so as royalties (which reflect the fact that the States own sub-soil resources) are likely to be the largest single area of relevance.
6. There was concern that the pool of funds not distributed by the Grants Commission, under the Pincus proposal, would come under the joint control of the States—which was considered an unstable and undesirable situation. Pincus responded that the undistributed royalties would remain with the State that earned them—until they came to be disbursed later by the Grants Commission, under the annuity scheme.
7. Royalties do not reduce the post-tax incomes of companies with MRRT liabilities and so should have no effects on their decisions or on economic efficiency.
8. Quantitative economic modelling provided to the Henry tax review concluded that royalties were very inefficient—causing a loss in national economic wellbeing of 50 cents for every dollar of royalties received and 70 cents for every extra dollar of revenue from a rate rise. The explanations given are that, although by themselves royalties would be relatively efficient, they are superimposed on existing taxes—company tax and payroll tax, especially—so that the cumulative rate is high and, therefore, the excess burden of the 'additional' levy is high; also, royalties acted like an excise and thus distorted miners' decisions. Other modelling was cited, using higher mineral prices, which arrived at half the number for the average excess burden of royalties (that is, around 25% rather than 50%).

I: HFE and analogies to a unitary state

This discussion was stimulated by a reference to the analogy in Appendix B to the March 2012 Interim Report of the GST Distribution Review, that HFE "provides a similar outcome to what would happen if Australia were a unitary system" (page 147). There have also been published comments of Ken Henry and Saul Eslake, suggesting that the crisis on the Eurozone would have been less if it had had a system of HFE like the Australian. The discussion mainly focussed on claims about the facts (a) and around a counterfactual (b):

a) What is the degree of equality or otherwise, in the regional or geographic distribution of public spending in unitary states, absolutely or in comparison with federal countries;
b) Would the current crisis in the Euro zone have been significantly avoided or mitigated if there had been an Australian-style HFE system in place?

1. In many non-federal countries, local governments have a degree of autonomy, and there exist no or very few examples of purely unitary countries.
2. France may be the closest to the ideal type. A study was cited (discussed in Le Monde http://abonnes.lemonde.fr/ecole-primaire-et-secondaire/article/2012/04/12/ecole-les-moyens-attribues-renforcent-les-inegalites_1684433_1473688.html) suggesting that the geographical distribution of educational expenditure was more unequal in France than in Germany. The Barnett formula used to allocate public spending across the UK mandated a convergence to EPC. Julian Le Grand's work suggested that UK public spending on education and health disproportionately benefits high-income users, who are concentrated in southeast England. This evidence concords with that showing that

the 'urban bias' is greater in unitary countries, than in federations, even when the endogeneity (of system) is accounted for.

3. Therefore, there seems to be little factual basis for the comment made in Appendix B. It was suggested, however, that that comment was not intended as a comparison to what actually happened in unitary states but as a comparison to the outcome were Australia a single State. However, it is not clear why that is relevant, as Australia is not a single State; moreover, the only way of inferring what would happen, were it such a single State, is by examining what does actually happen in unitary countries—and that comparison does not support the claim.
4. Turning to developments in Europe, it is difficult to think that any transfer union could have averted the problems facing the Euro: in fact, there must be a plausible argument that any form of HFE would have accentuated them, at least to the extent that it accentuated moral hazard issues in the member countries that were losing competitiveness. Indeed, the substantial transfers made by the EU under its structural funds to Greece, Ireland and Portugal are often criticized for having entrenched patronage politics and slowed economic adjustment.
5. There are large differences in living standards across the EU (up to 7 to 1), and thus full HFE would impose far larger and continuing fiscal burdens on the richer countries, than they are currently being asked to pay to avert defaults of countries or banks.
6. The usual trade-off between equality and efficiency would argue against complete geographic fiscal equalisation, when some of the differences are due to cost differentials (see comment D5 above).

J: The Grants Commission

An interesting presentation on the origins of the Grants Commission stimulated a lively discussion, of which what follows is a partial summary.

1. The Grants Commission is a Commonwealth agency, over which the States have no influence or control. Yet, the Grants Commission is an important element of Australia's federal arrangements.
2. The Commonwealth can restrict or direct the Grants Commission through its Terms of Reference (which the Commonwealth decides unilaterally and without having consulted the States).
3. However, the Commonwealth does not bind itself to follow the recommendations.
4. This is despite that there are no direct financial implications for the Commonwealth, arising from the recommendations.
5. All this raises a question about the appropriate governance arrangements, which the Review has raised but apparently shied away from pursuing. To whom should the Commission report, if not to the Commonwealth Treasurer? To COAG (which meets only when the Commonwealth decrees, and which decides by majority vote except on some matters relating to federal fiscal arrangements)? How would the members of a Commission be chosen, under a different governance arrangement?
6. HFE is more the province of economists rather than of lawyers. Despite the (welcome) publication of the Grant Commission's reports, there is very little public understanding of HFE (and maybe relatively little in some jurisdictions' bureaucracies).
7. The existence of the Commission reduces but does not eliminate the degree of political controversy over the distribution of the pool or GST and other funds.
8. Does the existence of the Commission reflect the Australian genius for the creation of bureaucracies, and of special agencies of an advisory or determinative kind?

9. The Grants Commission has scope for exercising judgment, which is appropriate for an autonomous (Statutory) body with significant public service support.