

Submission to the Productivity Commission Inquiry into the GST Distribution Reforms

Prior to the 2018 changes to the arrangements governing the distribution of untied Federal Government grants to the States, Australia's system of fiscal equalisation was based on the principle that untied Australian government grants would be distributed to:

"... enable each State to provide, without imposing taxes and charges at levels appreciably different from the levels of the taxes and charges imposed by the other States, government services at standards not appreciably different from the standards of the government services provided by the other States; taking account of differences in the capacities of the States to raise revenues; and differences in the amounts required to be expended by the States in providing comparable government services."

In other words, it created a capacity for each State and Territory Government to provide a bundle of services/taxes and charges to their residents that are not appreciably different to those enjoyed by residents of other States and Territories. Post 2018 the principle underpinning the distribution of untied grants has changed, to one which effectively says that residents of Western Australia are entitled to a better bundle of State services than residents of other States and Territories. They are entitled to better hospital services, school services, roads and/or lower State taxes. There has never been any direct justification espoused for this outcome of the post 2018 arrangements.

The entitlement that residents of Western Australians now enjoy does not however apply to non-State government services - eg they are not entitled to higher pensions, higher pharmaceutical subsidies or lower income taxes than residents of other States and Territories. If responsibility for a publically funded service (such as disability services) were to shift from the States to the Federal Government, Western Australians would lose some of their new found entitlement, and vice versa. If the taxation of mining activity in Australia had been a wholly Federal Government responsibility, the post 2018 gifting of better State services to Western Australian residents would have never come about.

None of this makes any sense when compared to the principled objective which existed pre 2018. The notion of a "reasonable" level of equalisation has no analytical basis or credibility. The pre 2018 objective was principled and reasonable. The post 2018 arrangements are unreasonable - and are also welfare detracting. Fiscal equalisation of source-based revenues, such as mineral royalties, is recognised as efficiency enhancing, ensuring that labour is allocated according to its marginal productivity rather than migrating to locations in response to fiscal benefits. By dulling the equalisation of mineral royalty revenues, the 2018 changes to fiscal equalisation will have had adverse impacts on national productivity and living standards. In the performance of its functions, the Commission must have regard, inter alia, to the need *"to improve the overall economic performance of the economy through higher*

productivity in the public and private sectors in order to achieve higher living standards for all members of the Australian community". A return to the pre 2018 arrangements would enhance the welfare of Australians, which has been sacrificed for narrow interests.

Equalised capacity for all States and Territories has a sound basis in horizontal equity. There is a legitimate question which can be posed as to whether the pursuit of this objective imposes unintended costs.

The framework which should apply to analysing this question is 1) is there *evidence* of efficiency loss, 2) are the impacts sufficiently adverse to the welfare and living standards of all Australians *to require remedial action*, and 3) is the source of the efficiency loss capable of *direct remedy* (without collateral damage). No evidence has ever been forthcoming in relation to the first two points. The Productivity Commission in its previous review skirted around these evidentiary hurdles and recommended significant changes to equalisation on the basis that "*absence of evidence isn't equivalent to evidence of absence*". As a result, a "solution" has been implemented, one which is completely arbitrary from a policy (but not political) perspective, and which lacks any link to an identified and evidenced problem. The fundamental importance of Australia's system of horizontal fiscal equalisation system to the working of the Federation and the welfare of Australians deserves far better.

Aside from efficiency there have been other criticisms of equalisation, but they are issues that even if proved to be significant could be remedied within the equalised capacity objective rather than through modifying it.

One example is the contention that the practical application of equalisation involves a high degree of complexity - which makes it difficult to understand. This has led to simplification proposals such as the use of "broad indicators" of revenue raising capacity. It is not clear what exactly the problem is here. Treasury Departments employ highly capable people who deal with many complex issues on a daily basis and are more than capable of understanding the work of the CGC and engaging in the assessment process. In any case, many public policy instruments involve a degree of considerable complexity (for example aspects of taxation legislation and electricity market design). Like any aspect of public policy, the assessments underpinning equalisation should be no more complex than is required to achieve the objective of equalising capacity. Many of the proposals to introduce significantly simpler assessments would however be at the expense of achieving that goal. The objective of equalising capacity should not be made subordinate to reduced complexity.

Volatility has also been highlighted as a potential concern. Governments face many uncertainties in planning budgets and adhering to desired fiscal trajectories, and the future trends in the relativities which underpin untied grant revenues are just one of many sources of uncertainty. The time lags in the determination of relativities mean that the impact of the emerging revenue capacity of each jurisdiction on relativities should be fairly predictable. A potential degree of uncertainty does arise from the five yearly reviews, particularly when new or revised assessment methodologies or new data are introduced. The CGC does employ some techniques such as discounting to address the impact of data quality, but it is worth considering whether more could be

done by the CGC to assist State and Territories to anticipate future changes, particularly those associated with the five yearly review process where the cumulative effects of methodology and/or data changes might be significant for an individual jurisdiction. It should be noted however that equalisation does inherently have a (relative) smoothing effect on State and Territory total revenues, as movements in untied grants counter movements in relative own source revenue raising capacity (albeit with a lag).

The current equalisation arrangements are unsustainable. This is quite apparent in the emerging fiscal position of Western Australia relative to other States and Territories. All States and Territories are facing significant financial pressures to deliver more and better infrastructure and to meet growing health service delivery pressures, due to a rapidly growing and ageing population, but one jurisdiction has been granted a significantly greater capacity to meet these needs than the other States and Territories. What is the rationale for that? It is also apparent that the arrangements have imposed a significant cost on Australian taxpayers arising from the no worse off guarantee, the abolition of which would simply shift rather than solve the problem.

But more than this, the current arrangements represent a poor public policy outcome, favouring narrow interests over the broader welfare of the Australian population.

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