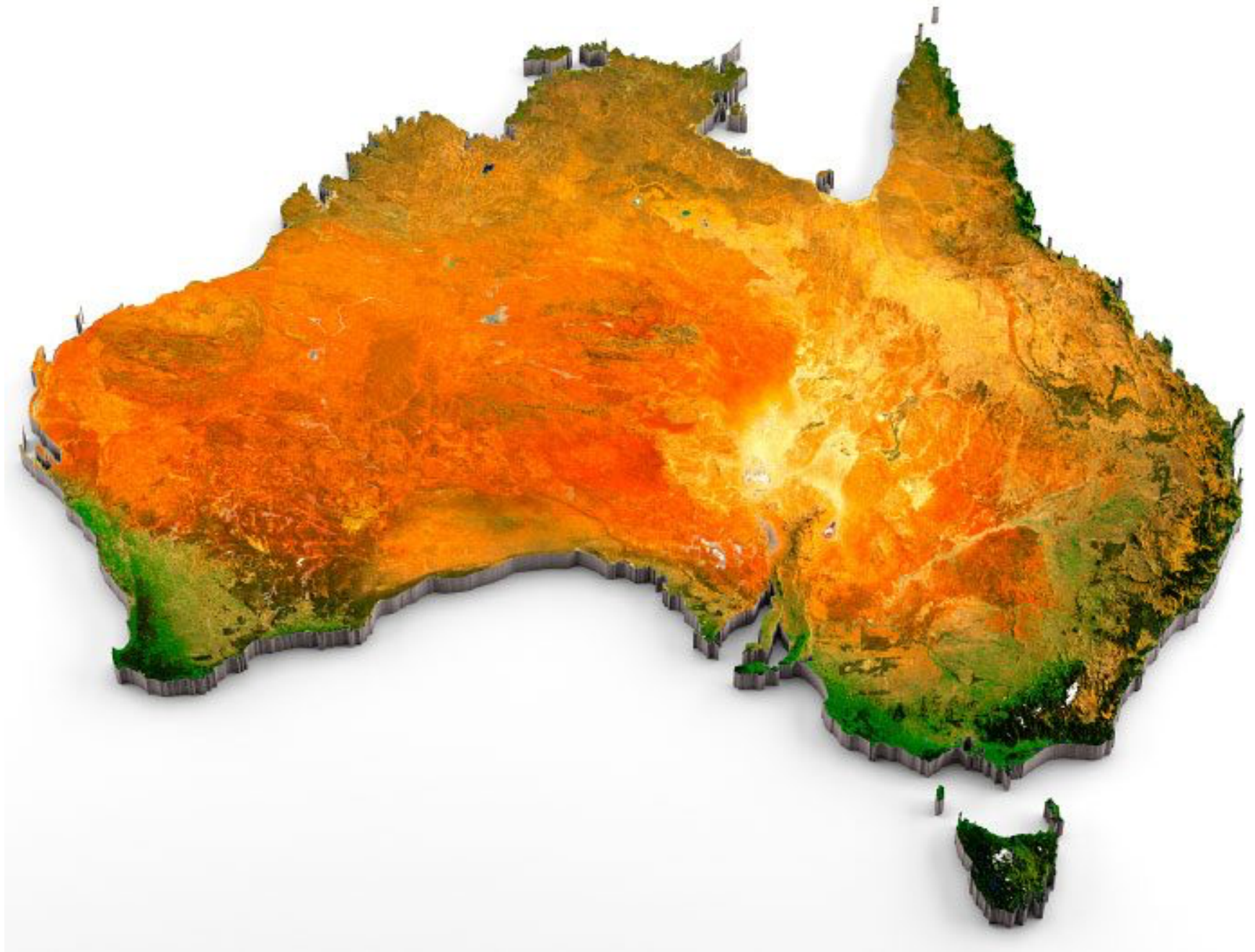


Federalism, Australian Style: Federal-state financial socialism

[Darren Brady Nelson](#) February 4, 2019



There has been a lot of public debate this year in Australia about the federal system of government, in general, and, in particular, the system of payments between the national level of government and the sub-national level. Australia has a federal system of government similar to countries like the USA and Canada. Like the U.S., there is a national government and sub-national governments called the states and territories. Like Canada, these sub-national governments are a relatively small in number and population compared to the U.S. and include territories. Australia has six states and

two territories compared to Canada's ten provinces and three territories remembering of course that the U.S. has fifty states plus sixteen territories. The Australian national government is called the "Commonwealth".

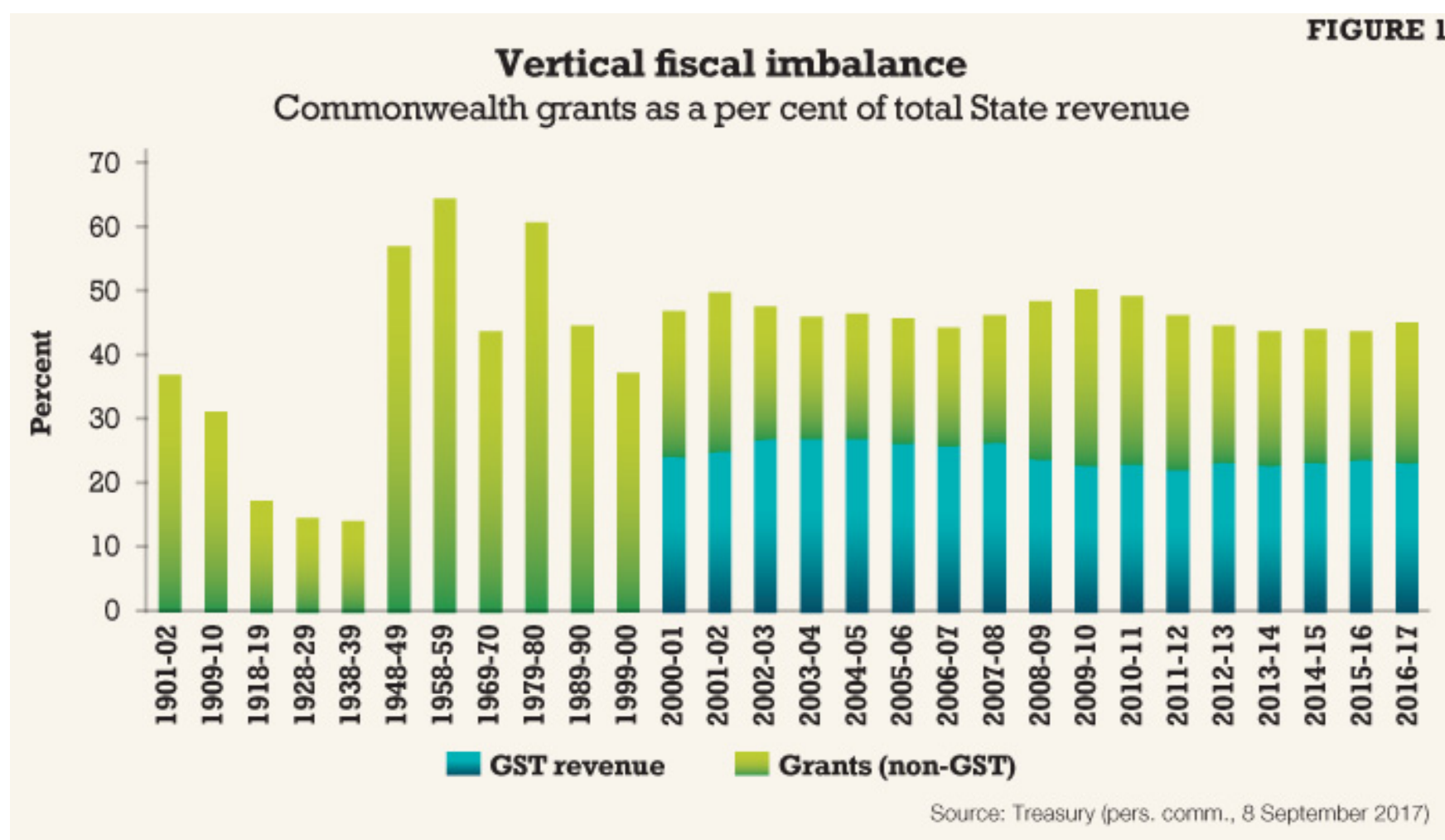
Three Aussie states are strongly complaining that it is largely unfair and unreasonable that they respectively and collectively do not get nearly enough revenue back from the Commonwealth for the Goods and Services Tax (GST) collected from their respective residents. Three other states and two territories are strongly of the opinion that it is mostly fair and reasonable that they get way more back in GST than they respectively and collectively pay. The complainants are New South Wales (NSW), Victoria and Western Australia (WA). The former two have been GST creditors for decades, whilst WA only became one in relatively recent years. The GST debtors are Queensland, South Australia (SA), Tasmania, the Australian Capital Territory (ACT) and the Northern Territory (NT). Of course, the creditors are really net tax-payers, the debtors are actually net tax-consumers, and the financial intermediary of the Commonwealth is in fact a tax-and-redistribute intermediary not a financial one.

A recent Sydney Morning Herald¹ story nicely summarises the situation between the multiple warring parties: "[Commonwealth] Treasurer Josh Frydenberg has accused the states of playing politics with the GST, as NSW and Victoria call on the Morrison government to ensure 'no state will be worse off' under its \$7.2 billion package. Victorian Treasurer Tim Pallas [has] demand[ed] Prime Minister Scott Morrison legislate that no state will be worse off under the changes, which will see a floor of 75¢ per person per dollar of GST and a six-year formula transition period put into law. NSW Treasurer Dominic Perrottet has gone further [when he] said his government believes 'that it's not fair that NSW continues to subsidise inefficient states as well as states like Western Australia who do not plan for future downturns to their economies.'"

Vertical fiscal imbalance (VFI)

The introduction of the GST in 1999 may have somewhat improved the longstanding vertical fiscal imbalance (VFI) between the Commonwealth and the states and territories, but at the expense of a more permanent entrenchment of VFI. The Productivity Commission (PC)² defines VFI as: "The situation where the Commonwealth raises more revenue than it requires for its own direct expenditure responsibilities, whereas [states and territories] raise less revenue than they require for their expenditure responsibilities."

VFI started in 1901 upon federation with the states giving up tariffs to the Commonwealth. The next big step in VFI was when they gave up income taxes during World War II. The third was GST, which is levied by the Commonwealth for spending by the states and territories. The latter also raise their own revenues through payroll taxes, mining royalties, stamp duties and land taxes. The PC documented VFI early this year in the following graph, noting that Australia has higher VFI than say Austria, Canada, Germany and the US but lower VFI than for example Belgium and Mexico: See figure 1



Horizontal fiscal equalization (HFE)

Besides the mismatch between the raising and spending of GST revenue at the national and sub-national levels, known as VFI, there is a further mismatch of revenue and expenditures across sub-national levels, known as horizontal fiscal equalization (HFE). The Commonwealth Grants Commission (CGC)³ defines HFE as: "The transfer of fiscal resources between jurisdictions with the aim of offsetting differences in revenue raising capacity and the cost of delivering services. Its principle aim is to allow sub-national governments to provide similar standards of public services at a similar tax burden."

The key to HFE is relativities. Each year, the CGC assigns a relativity number less than 1.0 to creditor states or territories and greater than 1.0 to debtor ones, with the aim of being a zero sum game of sorts. As the PC has described it in a 2018 inquiry report into HFE: "Relativities reflect differences between state and territory fiscal capacities, both the revenue and expenditure sides, and this includes those factors outside state/territory control (known as disabilities) that increase its costs of delivering services relative to the average or that hinder its ability to raise revenue. Frequently, and erroneously, these relativities are referred to as the share of GST returned to a state or territory compared to the amount that was collected or generated by, or in, that jurisdiction."

If all of states and territories were to receive GST on an average or equal per capita (EPC) basis then that would be like them all getting a relativity of 1.0. As can be seen in Figure 1.1 below, NSW and Victoria (at less than 1.0) have been carrying the other states and territories (at greater than 1.0) for more than 20 years. WA has swapped from the latter to the former over the past 10 years. GST payments are the single biggest payment from the Commonwealth⁴ to the states and territories at \$63.4 million in 2017-18 or 52 percent out of a total of \$122.4 million in that fiscal year. Figure 1.2 below shows the cumulative gap in total Commonwealth payments to the poorer

and smaller states over the richer and bigger states of NSW and Victoria.
See figure 2 and 3

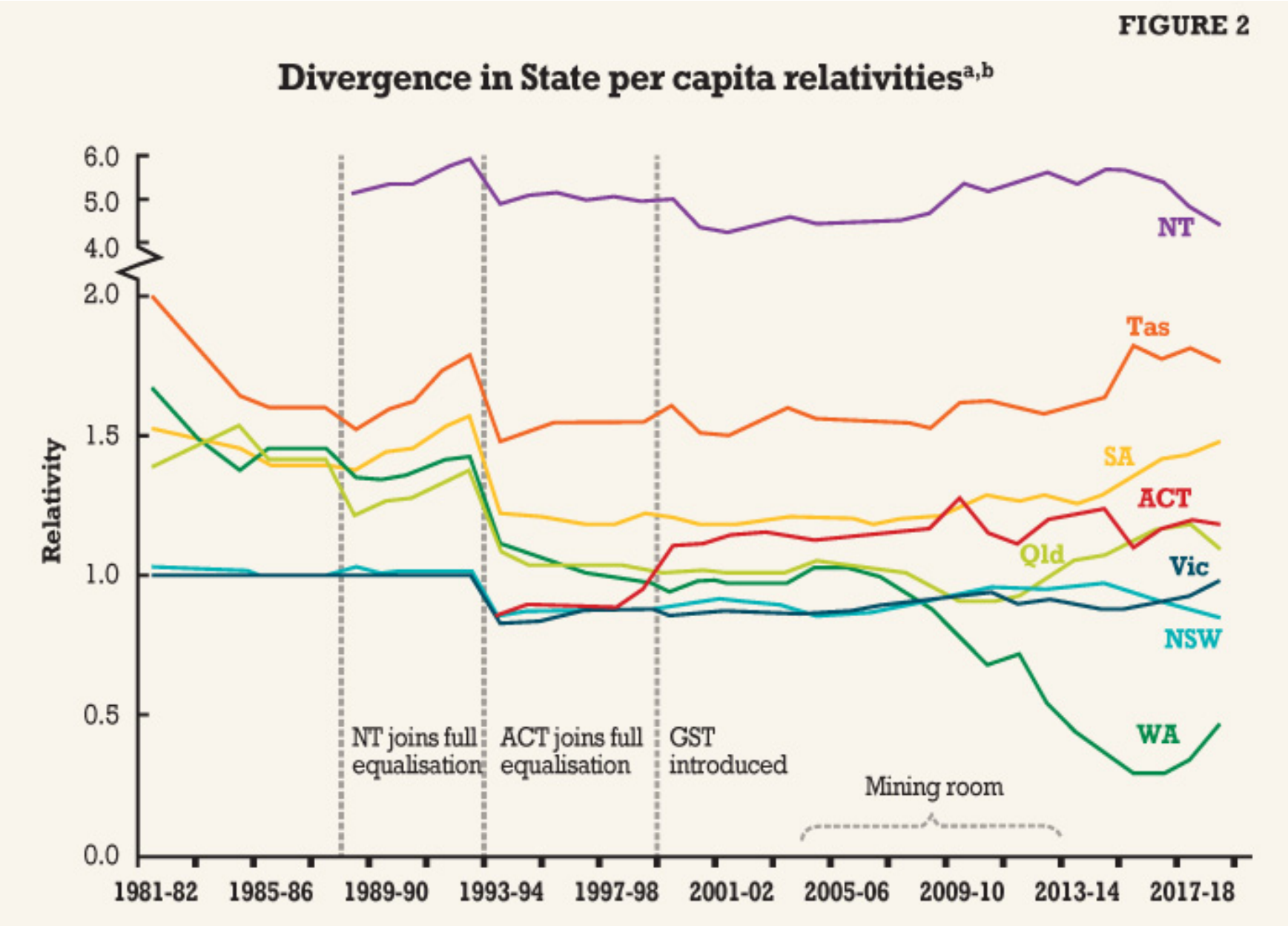
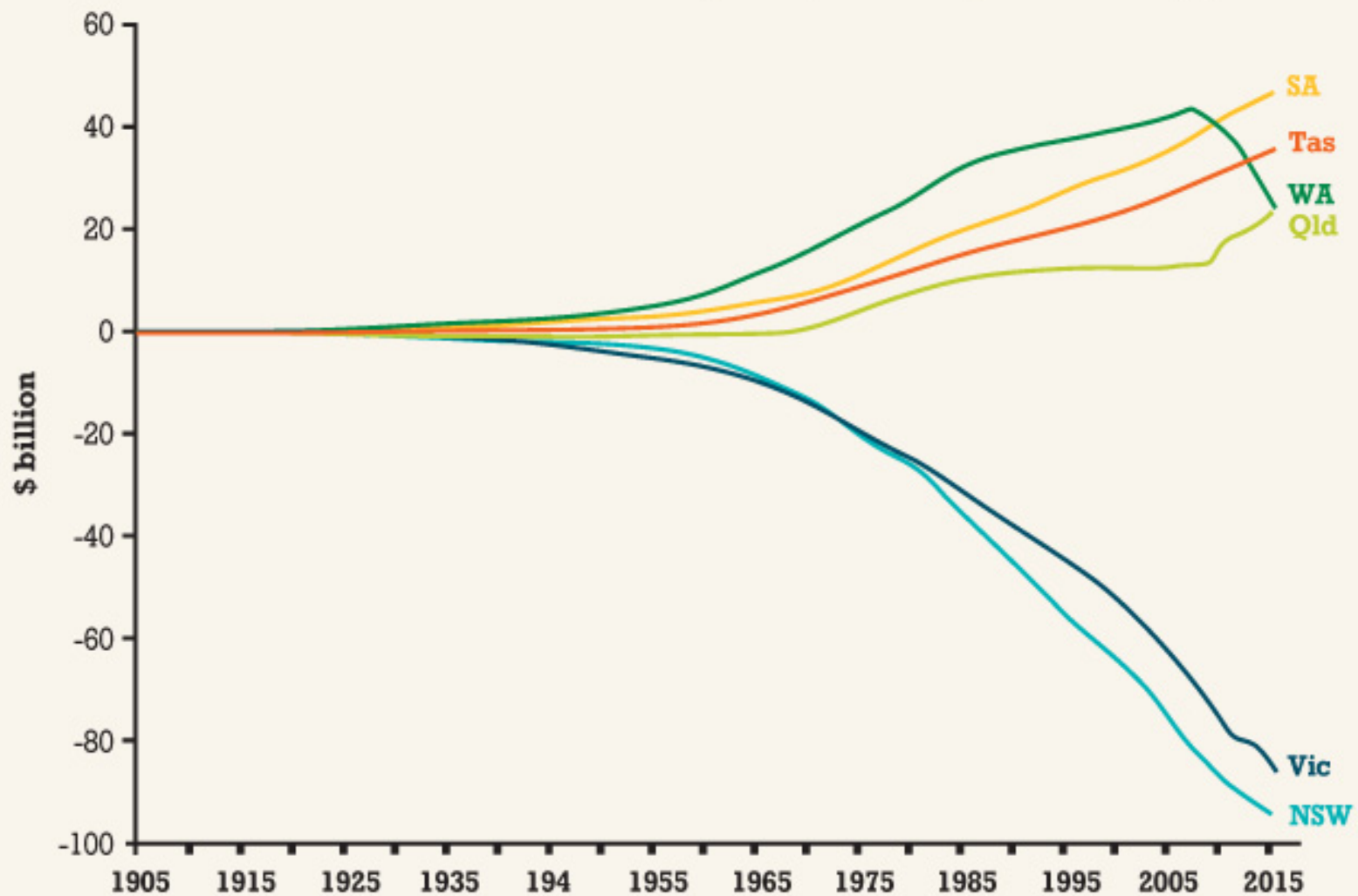


FIGURE 3**Cumulative distribution of all Commonwealth grants to States^{a,b}**

Difference from EPC distribution of grants, excluding Territories; \$2015



The annual CGC process of HFE has been likened by many to a “black box” of overly onerous input data and overly complex calculations. The process has the following broad stages of assessing: 1) initial fiscal capacity; 2) average fiscal capacity; and 3) strongest fiscal capacity; plus redistributing: 4) most of the GST based on 1, 2 and 3; and 5) remainder of the GST based on EPC. Fiscal capacity is a somewhat fictitious and static concept of average and uncontrollable revenue raising and budget spending by each state and territory.

Prospects for reform

The PC publicly released the final report on HFE in July 2018, upon a year of inquiry and after providing the Commonwealth with this report in May along with recommendations for reform. The key recommendations included: “The objective of the HFE system should be refocused to provide the States

with the fiscal capacity to provide services and associated infrastructure of a reasonable (rather than the same) standard. The CGC should immediately and systematically make the data provided by the [states and territories] publicly available on its website, along with the CGC's calculations on these data. Reforming HFE in isolation will only go a small way to improving federal financial relations [and thus] there is a need to revisit the broader [federalism] environment in which HFE takes place, and to renew efforts to reform [this]."

The Commonwealth⁵ officially and publicly provided an interim response to the PC in July, when the current Prime Minister of Scott Morrison (nickname ScoMo) worked for former PM Malcolm Turnbull as the Treasurer. Turnbull was replaced as PM by Morrison⁶ in late August. It is not yet clear if the following Commonwealth response and three-step reform plan will change: "The Government's plan involves transitioning to a new HFE system over eight years from 2019-20 to 2026-27. The Government proposes to accept the PC's recommendation to move to an updated reasonable equalisation standard. Instead of the PC's proposed model of equalising [states and territories] to the average of all, the Government's preferred model involves moving to a benchmark that would ensure the fiscal capacity of all is at least the equal of NSW or Victoria (whichever is higher). [In step 1] the Commonwealth would provide short-term funding over the three years from 2019-20 to 2021-22 to ensure that no [state or territory] receives less than 70 cents per person per dollar of GST. [In step 2] a within-system GST floor would be introduced in 2022-23 to ensure no [state or territory] can receive any less than 70 cents per person per dollar of GST [and] this floor would be raised to 75 cents in 2024-25. [In step 3] the Commonwealth Government would continue to boost the GST pool to ensure that all states and territories would be better off [and the] 0.75 within-system relativity floor would [become] a permanent feature of the HFE system."

This response did not properly address some of the major economic findings by the PC such as:

“Despite the CGC’s aspiration and endeavour, Australia’s HFE system is not policy neutral. State [and territory] policy decisions can and do influence the share of GST revenue flowing to each. On the revenue side, changes in one [state or territory’s] tax rates [can] have a [substantial] impact on GST shares in some circumstances such as large tax reforms where one departs from what other ones do on average or where one policy has a significant influence on the size of a tax base (such as mining activity). On the expenditure side, changes in [state or territory] policy can affect GST shares though the potential to do so is much lower than on the revenue side [noting that] a greater driver is accountability which is lacking due to [VFI] and blurred funding responsibilities. The modelling results available suggest that the size of HFE’s impact on interstate migration of labour is small. [However] model outcomes are largely driven by assumptions of whether HFE is good or bad for efficiency, rather than having this determined by the model itself. [One school of thought] is that HFE dulls economic signals for labour and capital to move to where they are most productive.”

International federalism lessons

Wikipedia⁷ defines federalism as a “mixed or compound mode of government combining a general government (ie the central or federal government) with regional governments (eg provincial, state or other sub-unit governments) in a single political system” or as a “form of government in which there is a division of powers between two levels of government of equal status”. Wikipedia also displays a world map showing two-dozen “federations” and the rest as “unitary states” as well as a map of Europe showing seven “federations” and the rest as “unitary states” plus “devolved states”. The U.K. is an example of a devolved state into lesser regional governments of Scotland, Wales, Northern Ireland and London (but not England itself).

Other OECD countries were also assessed this year by the PC in terms of the HFE inquiry. The PC found that: “OECD countries exhibit considerable

variation in the extent to which their equalisation schemes seek to [fully or partially] reduce fiscal disparities among sub-central governments. Although full equalisation [as pursued in Australia] largely eliminates fiscal disparities between sub-central governments, partial equalisation (as pursued in most OECD countries) allows for greater emphasis to be placed on other criteria such as efficiency, transparency, accountability, simplicity and predictability. While [EPC] fiscal capacity of sub-central governments is often used as the benchmark to guide equalisation, the methods of equalisation and the outcomes achieved under the alternative systems differ considerably."

The PC, in particular, examined the HFE situation in Canada, Germany and Switzerland. The PC concluded regarding these three OECD countries that:"Canada seeks reasonably comparable levels of public services at reasonably comparable levels of taxation across provinces. Provincial governments with below-average fiscal capacity are equalised up to the Canadian-average fiscal capacity, but provinces with above-average fiscal capacity neither receive payments nor are required to contribute. Germany aims to equalize the differences in financial (revenue raising) capacity of states or Länder. Länder with below-average fiscal capacity are levelled up towards the German average, while Länder with above-average fiscal capacity are levelled down. Switzerland looks to provide minimum acceptable levels of certain public services without much heavier tax burdens in some states or Cantons than others. Equalization payments aim to provide each Canton with a minimum per capita financial resource level of 85 percent of the Swiss average."

Buy, sell or hold

Australia's system of HFE is a "sell", even if new PM Morrison undertakes reforms more closely in line with those suggested by the PC rather than those flagged by former PM Turnbull. As the Institute of Public Affairs (IPA) has pointed out regarding Aussie HFE: "The equalization process creates

damaging incentives for state governments to avoid undertaking necessary pro-growth reforms, and compounds the central problem affecting state government finances – namely the near complete loss of state fiscal autonomy. The solution to Australia’s GST problem is to restore fiscal autonomy to the states. This would unlock the benefits of competitive federalism, as exists in countries like the United States and Canada.”

HFE incentivises high taxation and even higher spending at the expense of economic growth, for not just the poor performing states and territories, but ultimately for all, including making VFI worse. As the great Chicago School economist Milton Friedman⁹ has shown – incentives matter:

You are the spender		
WHOSE MONEY	ON WHOM SPENT	
	You	Someone Else
YOURS	I	II
SOMEONE ELSE’S	III	IV

“A simple classification of spending shows why [government redistribution] leads to undesirable results. When you spend, you may spend your own money or someone else’s; and you may spend for the benefit of yourself or someone else. Combining these two pairs of alternatives gives four possibilities summarized in the following simple table [below]. Category I in the table refers to your spending your own money on yourself. You clearly have a strong incentive both to economize and to get as much value as you can for each dollar you do spend. Category II refers to your spending your own money on someone else. You have the same incentive to economize as in Category I but not the same incentive to get full value for your money, at least as judged by the tastes of the recipient. Category III refers to your spending someone else’s money on yourself. You have no strong incentive to keep down the cost, but you do have a strong incentive to get your money’s worth. Category IV refers to your spending someone else’s money on still another person. You have little incentive either to economize or to try to get value most highly. All welfare programs [like HFE] fall into either

Category III or Category IV."

The "E" in HFE stands for "equalization". Such a goal is, intentionally or unintentionally, based on the socialist ethic of equality. To paraphrase the great Austrian School economist Murray Rothbard¹⁰ –equality destroys: "Compulsory equality will demonstrably stifle incentive, eliminate the adjustment processes of the market economy, destroy all efficiency in satisfying consumer wants, greatly lower capital formation, and cause capital consumption—all effects signifying a drastic fall in general standards of living. Furthermore, only a free society is casteless, and therefore only freedom will permit mobility of income according to productivity. [Socialism], on the other hand, is likely to freeze the economy into a mold of (non-productive) inequality."

Professor Rothbard goes even further by pointing out that such a goal, is not only inefficient and ineffective, but is also unethical and fake – or, in other words, systems like HFE are really Horizontal Fiscal Ersatzism¹¹: "In all discussions of equality, it is considered self-evident that equality is a very worthy goal. But this is by no means self-evident. For the very goal of equality itself is open to serious challenge. If [humanity] is diverse and individuated, then how can anyone propose equality as an ideal? If each individual [and aggregation thereof like a state or territory] is unique, how else can he/she [or they] be made "equal" to others than by destroying most of what is human in him/her [or them] and reducing human society to the mindless uniformity of the ant heap? The fact must be faced that equality cannot be achieved because it is a conceptually impossible goal for [humanity], by virtue of his/her necessary dispersion in location and diversity among individuals. If a goal is pointless, then any attempt to attain it is similarly pointless."

ENDNOTES

1 <https://www.smh.com.au/politics/federal/put-it-into-law-states-seek-gst-guarantee-from-scott-morrison-20181001-p5074i.html>

- 2 <https://www.pc.gov.au/inquiries/completed/horizontal-fiscal-equalisation/report>
- 3 <https://www.cgc.gov.au>
- 4 <https://www.budget.gov.au>
- 5 <https://treasury.gov.au/publication/p2018-308096/>
- 6 <https://www.news.com.au/national/politics/the-race-is-on-bishop-to-run-turnbull-out-as-showdown-nears/news-story/5b48d2f4fa017cc30c93a301746f469d>
- 7 <https://en.wikipedia.org/wiki/Federalism>
- 8 <https://ipa.org.au/publications-ipa/research-papers/four-problems-with-gst-redistribution-and-how-to-fix-them>
- 9 <https://www.amazon.com/Free-Choose-Statement-Milton-Friedman-ebook/dp/B004MYFLBS>
- 10 <https://mises.org/library/power-and-market-government-and-economy>
- 11 <https://www.dictionary.com/browse/ersatz>