

# Submission to the Productivity Commission review of the GST distribution reforms

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**This submission is compiled and endorsed by David Vanderwolf**

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## Introduction

I write as a community independent candidate seeking to represent the Croydon electorate in the upcoming Victorian election. I see a role for me as an independent to speak up for the best interests of the local community, as the risk presented by the 2018 arrangements and the potential removal of the 'no worse off guarantee' would have serious implications for the Victorian Government's ability to do what it needs to do.

I aim to be constructive and move away from the usual argument of 'states getting their fair share' at the expense of others, as that has seen us land where we are today. My focus is on the current system, its shortcomings and the need for a system where all three levels of government within our federation are working cohesively.

In making this submission, the views expressed are my own. Whilst they draw on my experience working in Federal Financial Relations in both the ACT and Victorian governments, the views put forward in this submission do not in any way reflect the views of my current employer, the Victorian Department of Treasury and Finance, or the Victorian Government, its departments or agencies.

## Recommendations

1. That GST revenue be distributed amongst the states<sup>1</sup> solely on the Commonwealth Grants Commission's assessment of states' relative fiscal capacities, without the 2018 legislation making adjustment.
2. That Federal Government commences a process towards federation reform that considers:
  - 2.1. The best way to achieve and preserve the principle of horizontal fiscal equalisation (HFE).
  - 2.2. Efficient mechanisms for managing vertical fiscal imbalance.
  - 2.3. How to ensure the Federal Government provides the states with the recurrent funding they require to ensure they can provide for their citizens.
  - 2.4. Reforming the Federal Financial Relations framework to better align incentives, rewards and responsibilities across the Federal and state governments.
  - 2.5. Mechanisms to ensure states receive a fair return on state-led reform.
  - 2.6. How best to educate, inform and engage the community in shaping the future of our federation.

## Submission

I support the principle of horizontal fiscal equalisation (HFE), as it underpins the principle of the Aussie fair go. HFE ensures no matter where you live in this country, your state government will have the means to provide for you.

In my support of HFE, I wish to address the argument that the pre-2018 GST methodology punishes well performing jurisdictions, while rewarding states for poor performance and poor decisions. This argument conveniently ignores the Grants Commission's almost excessive efforts to ensure policy neutrality in its

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<sup>1</sup> 'states' is used to refer to the states and territories.

assessment of need. Every attempt is made to ensure it is state circumstance and characteristics that determine the flow of funding, not policy and performance.

It also ignores the origins of HFE in this country, which ironically arise from a time when the Western Australian economy was on the brink of collapse, leading to it holding a referendum to leave the federation. In response, the Commonwealth Grants Commission was established in 1933, tasked with advising the Federal Government on allocating funding to the states on the basis of HFE.

This raises the question of where Western Australia would be today, if the Federal Government had turned around to it in 1933 and said, 'we won't reward you for poor performance'? Would it have been in the position to capitalise on the minerals' resources boom in the way that it has been doing this century?

It's a real question for consideration, not just while we review the 2018 GST arrangements, but when we contemplate the nation we want for our future. If this is the moment we move away from HFE as a governing principle for federal grants funding to the states, it's not just walking away from being the land of the fair go – we also need to consider what future prosperity, wealth and opportunity we are turning our backs on.

This isn't a question that should be dealt with in a rushed political deal to secure marginal seats. It needs to include a national conversation about our federation and what we want from it.

An appropriate process should be established and our communities should be supported to take part in a properly informed discussion on our future. We need to consider as part of this conversation, the model of federalism we wish to follow.

Competitive federalism is often spoken about in glowing terms for promoting efficient and productive policies that encourage the states to stand on their own two feet. However, there are significant risks and downsides in placing too heavy an emphasis on competitive federalism.

States only have a small set of levers at their disposal to compete with one another. The most common lever pulled is tax, leading to states eroding their own tax base in the name of competition.

At a time when we need to consider how to better tax asset wealth to address inequality, no government in Australia currently collects an inheritance tax. In Victoria, this tax once accounted for 6-7% of total revenue. However, this revenue is no longer available to the state government, due to the states abolishing this tax while competing for the residency of wealthy retirees.

This erosion of state revenue bases creates greater dependency on the Federal Government. The Federal Government uses this dependency to dictate policy to the states, placing greater conditions and controls on the funding it provides.

This point is often poorly understood or ignored – the role competitive federalism can play in both broadening the degree of vertical fiscal imbalance (VFI) in Australia and diminishing subsidiarity of decision making.

I am concerned by the exceedingly narrow debate this country has on VFI and how it can be addressed. VFI tends to be viewed as an inefficiency in and of itself. However, in a federation subsidiarity and tax uniformity move in opposite directions making VFI a reality of the federated model to some degree. Moreover, we can view it as an opportunity – VFI itself need not be an inefficiency, it is the system that manages it that introduces inefficiency or otherwise.

This cannot be the case, however, while our governments pull in opposite directions. Our system wrongly views the money raised by the Federal Government as federal money, and state and local raised revenue as state and local money. This is contradictory to the view of the High Court which finds that there is only public money that belongs to the Australian people. It is therefore the responsibility of our three levels of government not to play politics with that money, but to work together to expend it in the most effective and efficient manner to meet our communities' needs and expectations. Our governments are falling well short in this regard.

As an example of the impact this misalignment of incentives has, consider the position of the Federal Government when contemplating the proposed offshore gas tax, something most Australians strongly support. The tax would deliver significant and much needed public revenue. The proposition for the Federal Government is to fight powerful interests, only to hand over most of the revenue raised to the states to spend.

We fail to recognise the Federal Government is often tasked with the unpopular job of taxing to raise the revenue, while states do the popular job of providing the public service. The mismatch in political credit for how the money is spent creates a disincentive for the Federal Government to pursue tax reform opportunities that expand the public revenue base. Our current system cannot reconcile the misalignment of incentives across levels of government while revenue is seen as belonging to a particular government, and governments compete with one another for political credit.

Exacerbating this problem is the poor functioning of the federal financial relations system. The introduction of the Intergovernmental Agreement on Federal Financial Relations (IGA FFR) in 2008 was a rare moment in Australian history, representing a genuine improvement in federal financial relations. The IGA FFR delivered:

- secure, indexed funding to the states tied to key sectors
- short-term, program-based funding
- the opportunity to pursue reform through targeted agreements offering facilitation and/or reward funding to the states.

However, almost as soon as it was introduced, it began to be dismantled.

Under the IGA FFR, National Agreements were underpinned by Specific Purpose Payments, providing recurrent funding to the states to use as needed within the relevant sector. These National Agreements were criticised for not achieving progress towards the national reform agenda, leading to all of the Specific Purpose Payments being replaced by National Agreements that include reform funding.

This was a fundamental failure to understand the original framework. It was not the role of Specific Purpose Payments under the National Agreements to achieve reforms. This was the role of reform-based National Partnership Agreements. The structure of National Agreements and how the states spent Specific Purpose Payments were blamed for what was more a failing of the Federal Government to use the framework to its full effect.

The transition away from the original National Agreements to the now reform-based national agreements has narrowed the scope of what states can spend this funding on and shifted funding away from state priorities towards federal ones. This crowding out of state decision-making and lack of co-operation between governments is counter to the efficient functioning of a federation.

It is for these reasons that my recommendations go beyond the scope of the GST distribution changes introduced in 2018.

On the topic of the GST, my recommendation is that revenue be distributed to the states solely on the Commonwealth Grants Commission's assessment of states' relative fiscal capacities and that the 2018 arrangements be discontinued.

I would like to see the additional money being put into the system for the sake of the 'no worse off guarantee' to remain in the system and be distributed on the basis HFE. States have been calling for more untied funding for years, only to be told there wasn't any. However, when Western Australia made it a political necessity, more funding was made available. To remove it from the system now would be a backwards step.

I understand the political reality that neither federal party will agree to this and that the likely outcome is that the 2018 arrangements will remain in place, with the 'no worse off guarantee' continued on a rolling basis. However, this would be another missed opportunity for Australia, as the issue of the GST distribution only points to the broader challenges within federal financial relations.

With this in mind, I recommend the Productivity Commission recommends to the Federal Government that it takes this opportunity to engage in a genuine, open and informed public discussion on federation reform. This process should consider:

- The best way to achieve and preserve the principle of HFE.
- How Australia can benefit from the efficient management of VFI.
- How to ensure the Federal Government provides the states with the recurrent funding they require to provide services for their citizens.
- Reforming the Federal Financial Relations framework, maturing it to recognise and align the political realities, incentives, rewards and responsibilities faced by Federal and State governments.

- This must be done in an open and transparent manner – state governments recognise the need for reform but are fearful the end result will be worse than the current situation.
- Enduring mechanisms for encouraging state reform.
  - Many of the direct fiscal benefits from economic and productivity reform undertaken at the state level come in the form of higher federal revenue (income and company tax) and lower federal welfare payments, creating a potential barrier to reform.
  - An enduring mechanism that ensures states receive a fair return on their investment would help remove a barrier to ongoing reform.