

# Submission to the Productivity Commission inquiry into Horizontal Fiscal Equalisation

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June 30, 2017

## Executive Summary

The Australian Chamber welcomes the opportunity to provide comment on the Productivity Commission's inquiry into Australia's system of horizontal fiscal equalisation (HFE). The Chamber notes that this review follows the Commonwealth Grants Commission Review of GST distribution in 2015, the GST Distribution Review of 2012 and the Commonwealth Grants Commission GST Review of 2010. The Commonwealth Grants Commission is due to conduct another review in 2020.

In regards to the Productivity Commission's terms of reference, the Chamber notes that while previous studies found no evidence that the current system of HFE was having a negative impact on productivity, economic or resource development or a state's reform agenda, there is considerable disquiet in some quarters, particularly Western Australia, about outcomes arising from the current system of HFE. The Chamber considers that the principle of HFE needs to be applied so as to ensure a GST system that is sensible and durable in the overall national interest.

The Chamber would note however, that HFE and the GST distribution in particular, cannot be looked at in isolation. That is, tax reform cannot be looked at in a piecemeal fashion and the Chamber suggests that if the Commission examines any alternatives to the current HFE system, that they do so in the context of broader taxation and welfare reform.

Specifically, the Australian Chamber urges the Productivity Commission to also examine options to address the sizeable vertical fiscal imbalance and ways in which broader taxation and welfare reform can lift national productivity.

The Chamber stresses however, that conducting broader taxation and welfare reform has its own merit, independent of HFE issues. If there is going to be a broader review, then the Australian Chamber would be pleased to be involved in further consultations.

## Background to the Productivity Commission's Inquiry

The background to this inquiry, as noted by the Productivity Commission, is that:

*"In recent years, some States and commentators have suggested Australia's approach to HFE does not sufficiently recognise the differences between States' individual circumstances nor States' efforts to manage those circumstances thereby creating disincentives for reform, including reforms to enhance revenue raising capacities or drive efficiencies in spending."*<sup>1</sup>

At the heart of these suggestions is the concern or dissatisfaction that some states have with their share of GST revenue, with some stating that it is no longer 'fair'.

The 2012 GST Review found that the notion of 'fairness' was quite subjective<sup>2</sup> however and that is a viewpoint with which the Australian Chamber would agree. What is regarded as 'fair' for one party may not necessarily be regarded as fair for another. Particularly as the process of distributing GST revenues is a zero sum game. The 2012 Review found that divisions on the notion of 'fairness' were found not only among the States, but also academics.

The view of some states is a significant change from 2008 and again in 2011, when the Commonwealth (alongside all the State Governments) signed The Intergovernmental Agreement on Federal Financial Relations. The objective of this framework is the improvement of the well-being of all Australians through:

- The equalisation of fiscal capacities between States and Territories.
- Stronger incentives to implement economic and social reforms.
- The on-going provision of Goods and Services Tax (GST) payments to the States and Territories equivalent to the revenue received from the GST.

### *Horizontal fiscal equalisation underpins the federation*

With that background in mind, the fundamental question is why Australia should even pursue a system of Horizontal Fiscal Equalisation?

The Commonwealth Grants Commission (CGC) approaches Horizontal Fiscal Equalisation (HFE) as follows:

*"State governments should receive funding from the pool of GST 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 own sources and operated at the same level of efficiency."*<sup>3</sup>

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<sup>1</sup> The Australian Government, GST Distribution Review Final Report 2012

<sup>2</sup> The Australian Government, GST Distribution Review Final Report 2012 pg. 43

<sup>3</sup> Department of the Parliamentary Library, Horizontal Fiscal Equalisation Research Note, No.1 2002-03

As to the reason for this approach, a persuasive case<sup>4</sup> was made for HFE on the basis that:

*“it is inequitable and inefficient for individuals within a single political and economic union to be treated differently solely because of State borders. ...individuals in like circumstances should receive the same fiscal deal, just as individuals in like circumstances should receive the same treatment before the law. ...arbitrarily different treatment is inefficient because individuals could be motivated to migrate between States on the basis of fiscal differences rather than locating where they are most productive and happy<sup>5</sup>.”*

The CGC further suggest that:

*“In a federation comprising a national government and a number of States, services can be delivered in two broad ways. Services can be provided by the national government on a uniform basis across the federation. For example, old age pensions are provided across Australia in the one way so that similar people receive the same benefit. States also deliver services, but because they have different fiscal capacities and make different choices, only similar residents in a State receive the same standard of services... ...The aim of fiscal equalisation in Australia is to create the capacity/opportunity for similar residents across the federation to receive similar State services as well as face the same tax burden.”<sup>6</sup>*

Once again, and put more simply, it is this notion of fairness that underpins Australia's current HFE system. This is perhaps why some form of equalisation started at Federation, when it was recognised that the respective colonies had unequal economic strength. On top of this, it is possible that colonies may have felt aggrieved by Commonwealth protection, wage and coastal shipping policies, and perceptions that these also contributed to a widening of inequalities among the states.

## Addressing the Productivity Commission's Terms of Reference

Against that backdrop, providing comment to the Productivity Commission on its terms of reference is inherently difficult – it's very difficult to reconcile two competing notions of fairness. In addressing the terms of reference the Chamber notes that many of the reference points are interrelated e.g. on issues as to whether:

- *The present adoption by the CGC of a HFE formula to equalise States' revenue raising and service delivery capacities is in the best interests of national productivity; or whether there may be preferable alternatives, and whether;*
- *the present HFE formula, may have the effect of producing a disincentive for a State to develop a potential industry or raise a royalty rate for an existing industry at an appropriate time, and whether;*
- *State laws and policies restrict the development of energy resources.*

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<sup>4</sup> Buchanan J, 'Federalism and fiscal equity', American Economic Review, vol 40, 1950. in The Australian Government, GST Distribution Review Final Report 2012 pg. 26

<sup>5</sup> The Australian Government, GST Distribution Review Final Report 2012 pg 26

<sup>6</sup> Commonwealth Grants Commission, Introduction to Fiscal Equalisation in Australia, 2017

## *Is there any evidence that the current system of HFE provides a disincentive to productivity, reform or to grow state industries?*

The Australian Chamber notes that there is no evidence that the current system of HFE is not in the best interests of national productivity. Nor does it produce a disincentive for a state to develop its resources or a potential industry.

The Commonwealth Treasury also found in 2012 that there wasn't any evidence, noting that:

*"It seems unlikely that there are a large number of unambiguously efficiency enhancing reforms available for which HFE is the marginal factor that is dissuading governments from pursuing reform...the HFE redistribution effects tend to be small compared to the total cost or benefit of the policy. In fact, the total benefits of pursuing growth enhancing policies are likely to be very diverse and outweigh any HFE effects, such as higher State GSP, and more and/or higher paying jobs being made available in that State. Furthermore, a large driver of the current redistribution is the difference in resource endowments, which is largely independent of State government policies."*<sup>7</sup>

This was a similar position adopted by the 2012 GST Review<sup>8</sup>, where the panel noted that there was no evidence that the GST had changed a State's decision on economic development or taxation - although they did acknowledge there was a theoretical potential for it to do so.

It stands to reason however, that if the current system of HFE does discourage a state from developing its economy or particular industries, then this would be clearly visible. This is especially in regards to Western Australia. If the current system of HFE discouraged a state to develop its economy or resources, the government of the day would have discouraged the development of the iron ore and gas industry. Similarly, NSW and Victoria would currently be taking steps to restrain the comparatively stronger rates of economic growth in their economies.

With that in mind it would appear highly unlikely that labour or capital mobility would in any way be affected by the current system of HFE. The experience during the investment boom in Western Australia showed labour and capital proved to be very mobile during and after that period. Indeed, labour mobility is affected by many other, arguably much more important factors (community networks, care for family) than the exact system of HFE.

It is difficult therefore, without any firm evidence or analyses of a reasonable counterfactual, to suggest that the current system of HFE is *not* in the best interests of national productivity growth or that it acts as a disincentive for state growth agendas. To assume this is speculative.

## *Is there any evidence that the GST distribution influences restrictions on the development of state energy resources?*

There has been speculation that some governments have introduced state-based laws banning certain mining activities on the basis of HFE rules. Our analysis suggests there is no evidence that decisions on resource exploitation are influenced by HFE distribution effects.

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<sup>7</sup> The Australian Government Treasury, 2012 GST review submission, pg. 36

<sup>8</sup> The Australian Government, GST Distribution Review Final Report 2012 pg. 138

For example, the ban on onshore gas exploration and development in Victoria came on the back of environmental concerns in relation to fracking and coal seam gas. The ban was well received by community groups and residents of regional Victoria, who campaigned very hard to see this ban put in place. Reasons cited for this, include concerns that this type of mining activity could harm groundwater and agricultural land, or cause other environmental damage. The decision also marked the extension of the temporary ban on conventional offshore gas exploration and development until the end of June 2020.

There is also no evidence that the decision to pursue energy reserves in Victoria would have any substantial effect on the GST revenue received. The Geological Survey of Victoria found that there is approximately 100 petajoules of conventional gas that could be accessible (subject to a comprehensive geoscientific investigation) which represents only about 6 months' supply. Furthermore, if GST was a key concern in resource development, then the NSW government would not have designated Santos Narrabri project as a strategic energy project to speed up the approvals process. The project is expected to provide 50% of gas needs for NSW and has the support of business and government.

There is also the broader question as to why the impact of GST distribution, assuming there was one, would only affect decisions on resources and not all industries. Taken to its logical conclusion, questions could also be raised on whether HFE distribution prevents a state utilising its land mass for other revenue raising purposes.

Similarly, in calculating GST relativities, the Commonwealth Grants Commission has observed<sup>9</sup> that coal seam gas (or the potential resourcing of it) is a 'non-material' resource and so doesn't fall under consideration when calculating the GST distribution. The Commission did note however, that it will continue to monitor developments in state mining policies to ensure that any mineral by mineral assessment is not influencing State behaviour and to:

*"check whether other minerals, such as coal seam gas, become material, requiring a change to the minerals separately assessed."*<sup>10</sup>

### *Is the present formula capturing real state revenue raising abilities?*

The Productivity Commission has also been tasked to determine whether the present use by the CGC in its HFE formula of rolling three year averages provides the most appropriate estimate of real state revenue raising abilities, particularly for those states heavily reliant on large and volatile revenue streams. Particular emphasis was given to whether the lagged fiscal impacts that result from averaging and non-contemporary data leads to GST relativities which accentuate rather than moderate peaks and troughs in State economic cycles.

The Commonwealth Grants Commission uses rolling three year averages in its HFE formula to capture as contemporaneously as reliable data will allow, the conditions in the States in the year the GST is distributed<sup>11</sup>.

The Commission states that their priority is to achieve HFE, with contemporaneity being a supporting principle.

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<sup>9</sup> Australian Government Commonwealth Grants Commission, Report on GST revenue sharing relativities 2015 review Vol. 1 pg. 12

<sup>10</sup> Australian Government Commonwealth Grants Commission, 2020 Review State Mining Policies Research Paper 2017 pg. 3

<sup>11</sup> Australian Government Commonwealth Grants Commission, History of Contemporaneity, 2016 pg. 3

Some states, such as Western Australia, hold concerns about using three year averages (noting a fall in iron ore royalties) and suggest that using average royalties for 2011-12 to 2013-14 as the basis for the 2015-16 GST distribution was inappropriate. It was suggested instead that a distribution based on prospective base year conditions should be used.

The Commission subsequently considered<sup>12</sup> whether a different method to its three-year average approach may be more appropriate in some situations. The Commission noted at the time, that the aim of any change would be to better reflect States' fiscal capacities in the application year - that is, to be more contemporaneous and possibly achieve an improved equalisation outcome.

In replying to this review, many of the other States noted that that any improvement in contemporaneity would come at the expense of one or more of the following:

- *Reliability and practicality — as data are not available for the application year, including it in the Commission's assessment would entail having to use projections or forecasts of State circumstances - and that these would be unreliable.*
- *Simplicity — there would be grant design issues associated with using unaudited State provided data, and that the use of forecasts and estimates would necessitate subsequent adjustments for actual outcomes to ensure that HFE is achieved.*
- *Predictability of GST revenue — more contemporaneous assessments would lead to States having less certainty about their GST entitlements, increasing the volatility of GST revenue for all States and making budget management more difficult.*<sup>13</sup>

Other States noted that they did not consider the fall in iron ore prices to be an exceptional circumstance warranting a departure from the current three year average approach. In adopting as the basis for all assessments the data for three historical years, the Commission has accepted that fiscal equalisation is achieved over a run of years with a lag.

While imperfect, this approach recognises that State fiscal capacity in any one year must take account of the operation of the system over a run of years. In past circumstances, the system has been highly favourable to Western Australia and will remain so under continual application of the current methodology<sup>14</sup>.

The Commission recognised that there was a trade-off between contemporaneity and data reliability. However, they did not consider that State, or independent, forecasts of revenues (in the application year) were sufficiently reliable to be used as the basis of the GST distribution.

*“As a result, the averaging approach may underestimate actual revenue outcomes in the application year and thereby provide more GST than a fully contemporaneous assessment would. However, as each year moves through, there will be compensating overestimates of actual revenue outcomes in the application year, thereby reclaiming previous overprovision of GST revenue.”*<sup>15</sup>

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<sup>12</sup> Australian Government Commonwealth Grants Commission, Report on GST revenue sharing relativities 2015 review Vol. 1 pg. 68

<sup>13</sup> Australian Government Commonwealth Grants Commission, Report on GST revenue sharing relativities 2015 review Vol. 2 – Assessment of State fiscal capacity

<sup>14</sup> Australian Government Commonwealth Grants Commission, Report on GST revenue sharing relativities 2015 review Vol. 2 – Assessment of State fiscal capacity

<sup>15</sup> Australian Government Commonwealth Grants Commission, Report on GST revenue sharing relativities 2015 review Vol. 1 pg. 73



## Commonwealth-State Financial Relations and the Vertical Fiscal Imbalance

In analysing the current system, the Australian Chamber urges the Productivity Commission not to look at HFE in isolation, nor at the issue of GST distribution specifically, as the GST does not reflect total Commonwealth payments to the states.

A key reason for this, is because the horizontal fiscal imbalance is only one feature of the Commonwealth's financial relations with the states. Indeed, any discussion on horizontal fiscal equalisation must, by necessity, start at the heart of Commonwealth - State Financial relations - which are the vertical fiscal imbalance (VFI). This imbalance is the difference between the taxing powers and spending obligations of the Commonwealth and State governments.

By international standards, Australia exhibits a high degree of VFI. On some measures, Australian States experience considerably higher levels of VFI than sub-national Governments in Canada and Germany. State Government own-source revenues are around 54 per cent of State Government expenditure in Australia compared to over 70 per cent in both Canada and Germany.<sup>16</sup>

Current demographic trends, including the ageing population and rapidly rising healthcare expenditure, are likely to see growing pressure on state budgets and increased tension over the vertical fiscal imbalance over coming decades. This has already led to calls for the States to have greater revenue raising powers in order to deal more efficiently with the vertical fiscal imbalance and budgetary pressures.

*"In the longer term, a more preferable outcome may be if States are able to match their expenditure more closely with their own revenues and become less dependent on the Commonwealth, while the Commonwealth matches its revenues more closely to its own needs... Since federation, developments have changed the relative revenue raising powers between the two arms of government in favour of the Commonwealth<sup>17</sup>."*

As the vertical fiscal imbalance is addressed by commonwealth payments to the states, of which the GST is only one component, the Australian Chamber suggests that many of the concerns some states hold over HFE, and in particular the GST share, could be alleviated through broader tax and welfare reform. Specifically, the Australian Chamber would urge the Productivity Commission to also examine options to address the sizeable vertical fiscal imbalance.

The Chamber stresses however, that conducting broader taxation and welfare reform has its own merit, independent of HFE issues. If there is going to be a broader review, then the Australian Chamber would be pleased to be involved in further consultations.

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<sup>16</sup> Warren, Neil, Benchmarking Australia's intergovernmental fiscal arrangements, final report to the New South Wales Government, 2006, page 56.

<sup>17</sup> GST Distribution Review, Second Interim Report, June 2012, Chapter 1, Section 1.2.



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## **About the Australian Chamber**

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