TIME TO END GST REDISTRIBUTION

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Executive summary

Horizontal Fiscal Equalisation attempts to address differing economic financial circumstances of the state governments by redistributing GST revenue according to an elaborate relativity formula.

However, the equalisation mechanism is associated with a number of conceptual and practical problems. There is no justifiable rationale for jurisdictional equalisation, while in practice the process is riddled with uncertainty and complexity.

As a consequence of redistribution, this paper calculates that there is a significant misallocation of funding based on the principles of equal per capita distribution (where states receive GST revenue according to their share of the national population) and state of origin distribution (where GST revenue is distributed according to the amount that is attributable to each state).

For instance, in the 2015-16 financial year Western Australia was responsible for raising approximately 13 per cent of all GST revenue in Australia, but received only 3 per cent of the total revenue pool in return. In other words, Western Australia effectively lost approximately $4.3bn in GST revenue due to redistribution in 2015-16.

Additionally, equalisation negatively distorts incentives in several ways.

- It reduces the incentive for mobile factors of production (such as labour and capital) to move to higher productivity locations thereby imposing efficiency costs on the national economy; and
- It incentivises state governments to avoid important economic policy reforms and can encourage net-recipient states to develop a dependency on the Commonwealth.

Above all else, Horizontal Fiscal Equalisation fails to adequately address (and entrenches) the core issue afflicting federal-state relations in Australia – the disproportionate centralisation of taxation powers to the Commonwealth level that results in the high degree of vertical fiscal imbalance.

For these reasons, equalisation should be abandoned as a policy objective. In its place, the principles of decentralisation should be adopted. The states should be given the power to set the rate of GST that applies in their respective jurisdictions, with an associated entitlement to claim the proportion of the GST that is attributable to that particular state.

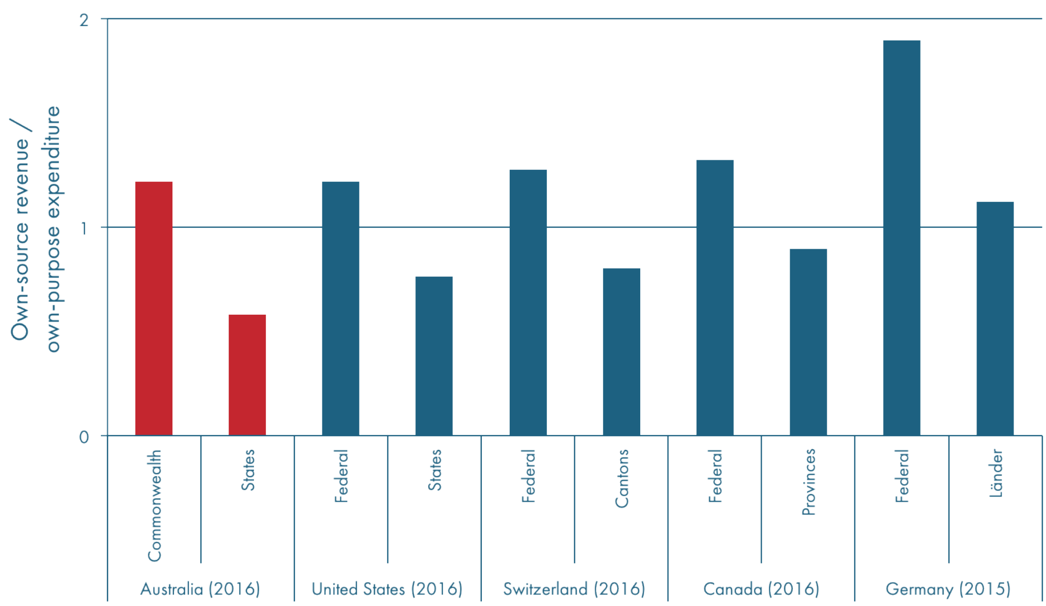
In the absence of fundamental reform, distributions should be based either on state of origin principles or on an equal per capita basis.

1. Introduction

Horizontal Fiscal Equalisation is a mechanism used to address fiscal imbalances between the states by redistributing GST revenue according to an elaborate relativity formula. Underlying the debate surrounding the GST is a much more serious problem afflicting Australian federal relations: Australia's high degree of vertical fiscal imbalance.

While most federal systems of government in the world contain some degree of mismatch between the central government's revenue raising capacity and expenditure responsibilities compared to those of the states or provinces, the problem is particularly pronounced in Australia. Using data from the International Monetary Fund's Government Finance Statistics for 2016 it is calculated that the Australian states are at a particular vulnerability when compared to other major Western federal countries (Figure 1):

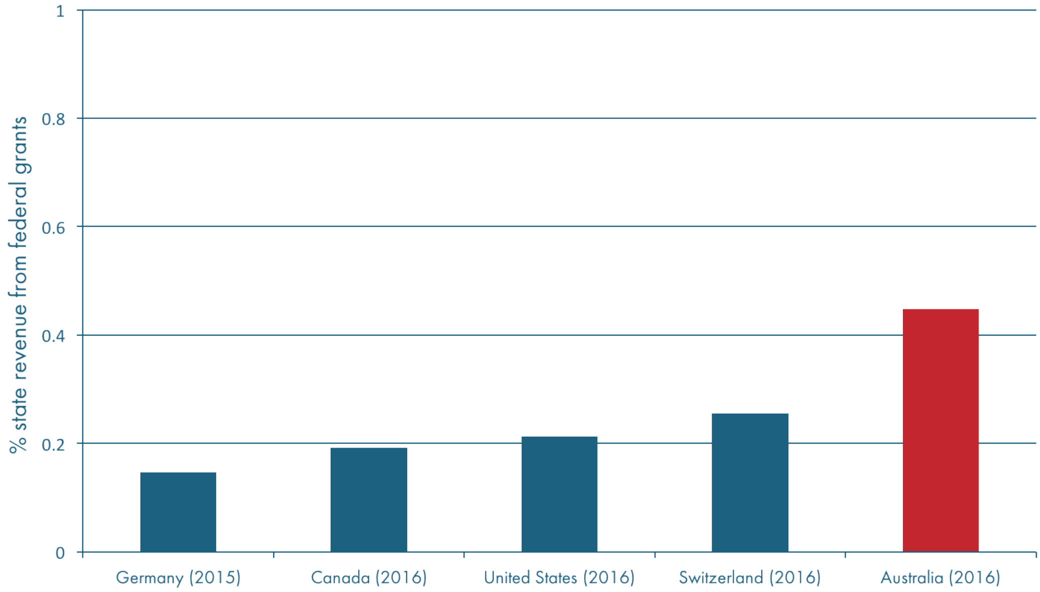
Figure 1: Vertical fiscal imbalance in Australia and other comparable federal countries as measured by a jurisdictions own-source revenue relative to its own-purpose expenditure.



Source: IMF Government Finance Statistics

According to the data, the States' own source revenue (total state revenue less grants) is only 58 per cent of their own purpose expenditure (total expenditure less grant payments). The equivalent figure in the state-level governments of the United States, Switzerland, Canada and Germany were 76 per cent, 80 per cent, 90 per cent and 112 per cent respectively. Due to the high level of imbalance, the Commonwealth manages an elaborate system of grants to make up the revenue shortfall of the states. The data on the proportion of state level revenue from federal grants again reveals the extent of the fiscal problem in Australia (Figure 2):

Figure 2: Vertical fiscal imbalance in Australia and other comparable federal countries as measured by the proportion of state level revenue accounted for by federal grants.



Source: IMF Government Finance Statistics

Australia's pronounced fiscal imbalance is primarily a function of the states' reduced power to levy taxes relative to the Commonwealth.[1] Consequently, the Commonwealth's excessive revenue capabilities are distributed to the states via grants to enable the states to meet their spending responsibilities.

There are primarily two categories of grants: specific purpose payments (SPPs, or tied grants), and general revenue assistance which is comprised primarily of the GST revenue. The GST revenue is distributed to the states and territories on the basis of Horizontal Fiscal Equalisation principles on the recommendation of the Commonwealth Grants Commission. In effect, funds are transferred from fiscally successful states to less successful states based on obscure calculations which rest on principles that are fundamentally flawed.

This paper will argue that in both principle and practice Horizontal Fiscal Equalisation is fundamentally flawed. Moreover, this paper will argue that Horizontal Fiscal Equalisation is an ineffective mechanism to address Australia's vertical fiscal imbalance, as it fails to deliver to the states the fiscal autonomy necessary to implement their own policies and raise their own revenue. As the problem affecting state finances in Australia is the fiscal imbalance between the Commonwealth and the States, rather than between the states, more fundamental reform of the national taxation system is required. Finally, this paper will assess various proposals for reform, and submit that the equalisation principles should be abandoned. In its place taxation reform should follow the principles of decentralisation as much as possible to revive the benefits of competitive federalism.

1 See for instance the High Court of Australia's decision in the Uniform Tax Cases of 1942 and 1957 that permitted the Commonwealth to takeover income taxing powers from the states, and the Court's broad interpretation of 'excise' in cases such as *Ha v NSW* (1997) that invalidated several other state taxes

2. Horizontal Fiscal Equalisation in Australia

2.1 Background to Horizontal Fiscal Equalisation in Australia

Horizontal fiscal equalisation is the process whereby the Commonwealth government operates a mechanism to effectively transfer funds between states and territories to offset differences in revenue-raising capacities or the costs of providing services and infrastructure. The Commonwealth Grants Commission (the CGC) currently defines HFE as follows:

> State governments should receive funding from the pool of [Goods and Services Tax] 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.[2]

Equalisation has a long history in the Australian Federation. In the earlier decades, revenue sharing schemes with the states were formed on an ad hoc basis, before the threat of Western Australian secession prompted the federal government to establish the CGC to make recommendations on 'special grants' made to the states. The CGC determined that grants should be based on financial need, such that claimant states were to be able "with reasonable effort, to put their finances in about as good a position as that of the other states."[3]

In 1976, increasingly ad hoc financial assistance grants were replaced with income tax sharing arrangements. The initial per capita 'relativities' used to distribute revenue under this framework were derived by dividing the per capita financial assistance grant received by each state in 1975/76 by the per capita grant received by Victoria (which received the smallest grant). In 1979, the Commonwealth Grants Commission (which had been granted the responsibility to administering this arrangement in 1978) conducted a review of relativities based on new equalisation principles that provided payments to enable states to provide services at "standards not appreciably different from the standards of government services provided by the other States". There have been further revisions to the principle, which now refers to states being able to function at the "same standard", but essentially the CGC has been recommending relativities based on full equalisation since 1981.[4]

The introduction of the Goods and Services Tax (GST) in 2000 replaced various state taxes and financial assistance grants, with the resulting revenue pool to be redistributed to the states based on HFE principles.

2.2 How does Horizontal Fiscal Equalisation work?

In order to achieve equalisation, the Commonwealth Grants Commission assesses the fiscal capacity of each state and territory to raise revenue and the costs incurred by each state and territory in providing services and infrastructure. Needs are assessed for each state based on the average policies of all the states.

2 Commonwealth Grants Commission, *2020 Review: The Principle of HFE and its implementation* (Position Paper, 2017) 1.

3 Productivity Commission, *Horizontal Fiscal Equalisation* (Draft Report, Canberra, October 2017) 64-67.

4 Productivity Commission, *Horizontal Fiscal Equalisation* (Draft Report, Canberra, October 2017) 70-72.

The CGC makes the following three assessments based on the three most recent years for which reliable data is available:

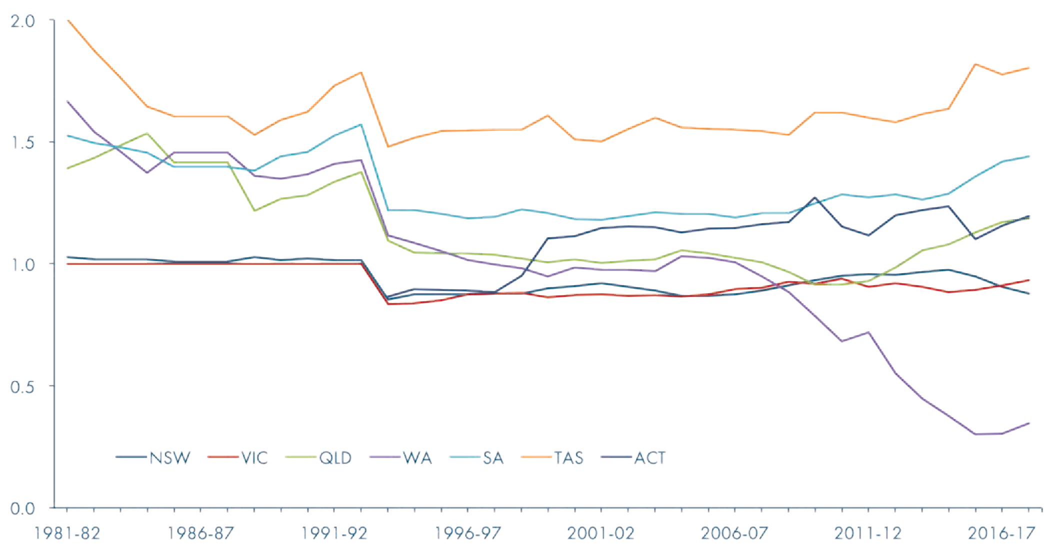
- How much the state needs to spend to provide the Australian average level of services and infrastructure;
- How much revenue the state could raise itself under Australian average tax regimes;
- How much each state receives from the Commonwealth in tied funding is taken into account in determining GST needs (so that needs are not met twice)

A state's GST requirement is the difference between its assessed expenditure needs and the sum of its assessed own-source revenue capacity and actual tied Commonwealth funding. In other words, the GST requirement fills the gap between assessed revenue and expenditure.

The CGC's recommendations for GST revenue distribution take form of a per person 'relativity' for each state. If each state had identical needs with regards to expenses for services and infrastructure, own-source tax revenue, and tied Commonwealth grants, then each state would receive the same amount of GST revenue per capita. In that situation, the relativity would be equal to 1.

Differing circumstances of the states are represented by a either a higher relativity (above 1, meaning the state enjoys revenue advantage or lower service cost requirements) or a lower relativity (below 1, meaning the state suffers a revenue disadvantage or higher service cost requirements). The relativities since 1981 are displayed in Figure 3:[5]

Figure 3: State relativities since 1981-82.



Source: Commonwealth Grants Commission (2017)

5 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities: 2017 Update Supporting Documentation (Relativities Over Times)* (Canberra, 2017) <https://cgc.gov.au/index.php?option=com_content&view=article&id=263&Itemid=542>.

3. The problems with Horizontal Fiscal Equalisation

This paper follows many of the criticisms identified in an earlier report by the Institute of Public Affairs' Dr Mikayla Novak in 2011.[6] Both reports argue that equalisation is a fundamentally flawed mechanism. In principle, it is unclear that it is a desirable or valid objective in a federal system of government. In practice, Horizontal fiscal equalisation in Australia is complex, affected by the use of old data (the time lag) and arguably cannot be calculated with certainty. Additionally, horizontal transfers distort incentives for fiscal reform at a state level.

Fundamentally, horizontal fiscal equalisation partially attempts to address the critical problem of vertical fiscal imbalance. Because of this vertical imbalance, states lack the means to raise revenue to fund their expenditure requirements, necessitating the use of Commonwealth grants and horizontal transfers to fill the funding shortfall of several states. vertical fiscal imbalance is the key issue affecting federal fiscal relations, and horizontal transfers are an insufficient solution: more fundamental reform of the national taxation system is required.

3.1 Equity is a questionable policy rationale

The primary purpose of equalisation is to address differing financial circumstances of the states, and the underlying rationale for such a system is the attainment of jurisdictional equity. Indeed, as Henry Ergas and Jonathan Pincus argue, the attainment of equity is promoted far above other considerations:

> All redistributions have efficiency consequences, some positive and some negative. In the absence of an overriding ethical principle that supports the goal of exact fiscal equality, democratic nations generally accept a trade-off between efficiency and equity, for constitutional and political reasons. As a result, equity is not pursued beyond a point defined by taking account of its efficiency cost. In contrast, HFE does not explicitly account for that trade-off, and hence pushes equalisation beyond the point with any realistic view of social preferences.[7]

Dr Novak explained a key flaw in the promotion of jurisdictional equity in 2011:

> [The] equity foundations of HFE are questionable since state governments, as institutions comprised of state politicians and bureaucrats with the coercive powers to tax, regulate and expend taxpayers' funds, cannot possibly have 'equity' needs independently of the circumstances of individuals within the states. Indeed, the existing HFE model of ensuring 'intergovernmental equality' does not necessarily translate into improved equity between citizens of different states, nor within a given jurisdiction.[8]

A 2002 review into Commonwealth-state funding found that equalisation methods do not improve vertical equity and may actually worsen it slightly – mainly by transferring income from Australians in larger states to people with higher incomes in the two Territories.[9] Recent data show that the Australian Capital Territory is still a beneficiary of the equalisation mechanism (its relativity has

6 Mikayla Novak, *Beyond its use-by date: Australia's system of fiscal equalisation, and how to reform it* (Submission, Institute of Public Affairs, 2011) 7-14.

7 Henry Ergas and Jonathan Pincus, 'Reflections on fiscal equalisation in Australia' Submission to the GST Distribution Review (Issues Paper) (2011) 15-16.

8 Novak (2011) 10-11.

9 Ross Garnaut and Vince FitzGerald, *Review of Commonwealth-State Funding* (Final report, 2002).

moved between 1.10012 and 1.27051 over the life of the GST) while its residents have the highest weekly median income in the country according to the most recent national census ($998 for individuals, compared to the national median weekly income of $662). Likewise, the Northern Territory has the country's second highest median weekly income ($871 for individuals) but its relativity has never been below 4.[10]

In any case, it is not clear that the attainment is a desirable policy goal, or that differing fiscal circumstances between states needs to be addressed directly. It not obviously a problem that some states have higher revenue capacities or expenditure requirements compared to other states: in a functioning federal system the states would have the autonomy to implement policies to address fiscal deficiencies themselves. Australia's dysfunctional federal system cannot be resolved by Horizontal Fiscal Equalisation because it does not deliver fiscal autonomy to the states.

3.2 Equalisation calculations are prone to significant methodological and data problems

The calculations made by the Commonwealth Grants Commission that form the basis of the relativities figure is complex and lacks transparency. Dr Novak explained in 2011 that the

> CGC requires vast amounts of data to support its assessments which, in many cases, are not available or incomplete. To overcome this obstacle, the CGC frequently resorts to judgment – in other words, a best guess. This reliance on guesses rather than facts significantly undermines the credibility of the HFE redistribution system.[11]

Australian academic Jonathan Pincus noted in 2005 that "the CGC research does not... reach the standards that would be expected of academic publications. It would not deserve a pass if it were submitted as a third-year undergraduate project in econometrics."[12]

The only portion of the relativities equation that can be accurately assessed with any certainty is the size of tied grants from the Commonwealth to the states: calculations of states' revenue raising capacity or expenditure requirements are riddled with uncertainty. As Peter Abelson argues, the revenue raising capacity of the Australian Capital Territory and Victoria is underestimated, while the per capita financial capacity of Queensland and Western Australia is greatly overestimated:

> [The] CGC determines capacity as a function principally of the estimated values of the tax bases. This... is a fundamentally flawed approach and produces flawed conclusions. This is supported by a common sense test. Whereas average disposable household income in the ACT is far higher than in any other state and territory and over 60% higher than the Australian average, the CGC concludes that the ACT has only 89% of the average Australian capacity to raise revenue. This extraordinary conclusion suggests that something is seriously amiss with the CGC's calculation method.[13]

Using a calculation of revenue raising capacity based on household incomes, Professor Abelson estimates significantly different per capita relativities when compared to the CGC, amounting

10 Data based on supporting documentation to the Commonwealth Grants Commission 2017 update on relativities and Census data from 2016: See Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities: 2017 Update Supporting Documentation (Relativities Over Times)* (Canberra, 2017); Australian Bureau of Statistics, 'Australian Capital Territory records the nation's largest population growth' (Media release, 070/2017, 27 June 2017); and Australian Bureau of Statistics, '2016 Census reveals the changing face of Northern Territory' (Media release, 071/2017, 27 June 2017).

11 Novak (2011) 12.

12 Jonathan Pincus, 'Grants system 'sub-standard'', *The Australian*, 24 March 2005.

13 Peter Abelson, 'Estimating the revenue-raising capacities of the states and territories and the implications for the equitable distribution of GST revenue' (2011) 30(4) *Economic Papers; A Journal of Applied Economics and Policy* 443-454.

to billion dollar differentials.[14] There is no reason to conclude that calculations of expenditure requirements would be any more certain.

Adding to the complexity is the current practice of using old data (three most recent years for which reliable data is available). This means that changing economic circumstances do not impact the GST distribution determinations until years after the change. This can exacerbate revenue volatility, as economic cycles are often out of phase with the GST distribution process. The complex mix of future and past influences used to formulate forward estimates in budget papers erodes procedural transparency.

3.3 Horizontal Fiscal Equalisation negatively distorts incentives

The Equalisation process has a perverse impact by reducing naturally occurring economic incentives, and creates incentives for state governments to raise taxes and rely on the Commonwealth for revenue, rather than undertake pro-growth economic reform.

3.3.1 Interstate migration

A key economic rationale for Horizontal Fiscal Equalisation is that it reduces the naturally occurring incentives that arise in a federation for interstate migration. As explanation puts it:

> [The] equalisation system removes the incentive for fiscally induced migration between states. For examples, without equalisation, a state with a high endowment of mineral resources will have a fiscal advantage, allowing it to offer lower taxes and higher government services. Similarly, a state in which many citizens have a low socio-economic status will have a fiscal disadvantage, so taxes are likely to be higher and services low. This leads to fiscally induced migration from states with lower fiscal capacity to states with higher fiscal capacity.[15]

However, the reduction of incentives for mobile factors of production (such as labour and capital) to move to higher productivity locations creates efficiency costs for the national economy. This is because opportunities to produce even more output than is currently available are foregone, while factors of production are encouraged to remain in areas where service provision is relatively costly that raises the overall cost of providing public services in the long run.[16] Labour market mobility is an important but overlooked source of productivity gain. As the then-Chairman of the Productivity Commission Gary Banks explained in 2011:

> The potential benefits of geographic mobility of labour during a mining boom were explored in recent modelling conducted by the Commission. Unsurprisingly, GDP and average real wages were projected to be higher when labour was fully mobile across jurisdictions, reflecting the gains from resources moving to higher valued uses. A less obvious, though equally important result, was the role of labour mobility in distributing the benefits of the resource boom across Australia. The ability of workers to move to work in another state or territory moderated the growth in wages in booming jurisdictions, and increased it elsewhere.[17]

The Western Australian state government echoed this argument in 2017, noting that while most of the population is concentrated in New South Wales and Victoria, there are “many unexploited economic opportunities outside these States and in principle no reason why much more economic

14 Ibid.

15 Independent Economics, ‘Horizontal Fiscal Equalisation: Modelling update and scenarios’ (Report, 2015) 1.

16 Novak (2011) 7.

17 Gary Banks, ‘Australia’s mining boom: What’s the problem?’ (Speech to the Economic and Social Outlook Conference, Melbourne, 30 June 2011).

activity (and investment) should not ultimately occur outside these States and attract a higher population."[18]

3.3.2 State government fiscal reform

Horizontal Fiscal Equalisation reduces the incentives for state governments to pursue microeconomic reform or other pro-growth policies. This is because states bear the political costs of promoting contentious reforms, but do not necessarily fully receive the fiscal benefits of such a change.

Certain policy changes will affect the formula that is used by the Commonwealth Grants Commission, thereby affecting a state's relativity. This phenomenon can be explained in several ways:

- The average-rate effect of a change in a tax rate, where an amended tax rate increases or decreases the national weighted-average rate, which will have a different impact on GST payments depending whether a state has a relatively large or small share of the tax base;
- The elasticity effect of a change in a tax rate, where an amended tax rate leads to a reduction in the state's own tax base, due to changes in demand or the movement of resource into or out of that state. The GST payment to a state will change as it is assessed as having an altered revenue raising capacity;
- Some other policy change that alters the size of a state's tax base. For example, due to additional land being made available for development, or state approval of resource extraction. Any change in the size of the base affects a state's capacity or needs compared to the other states, with the equalisation formula acting to level out the changes across all states. This means that a state that expands its tax base will see all but its population share of the additional revenue (calculated at the average rate, which may rise or fall due to the tax-base change) redistributed to other states, and vice versa.

Professor Neil Warren argues that these effects and related incentives are a function of the Commonwealth Grants Commission's approach that effectively pools specific purpose grants and general purpose grants and allocates this pool on Horizontal Fiscal Equalisation principles:[19]

> A direct consequence of this approach is that, through the interaction of these different grants, the original objective of the specific purpose and VFE grants is undermined. So too is any attempt to encourage policy reform through these grants. By treating specific purpose and VFE grants as just another funding source when allocating general grants on HFE principles, any outcomes sought from these grants will be overridden through the allocation of general purpose grants. Complicating this result is the fact that most of the benefit from state policy reform will flow through to both other states (through its impact in HFE grants) and to the Commonwealth through increased revenue (Warren 2010a).[20]

This disincentive to increase the tax base is a standard feature of Horizontal Fiscal Equalisation. OECD economists Hansjörg Blöchliger and Claire Charbit observed in 2008 that "the amount of equalisation grants a state loses if it increases its own tax revenue varies considerably across countries; however on average sub-national jurisdictions have to dedicate more than 70% of

18 Government of Western Australia, Submission No 15 to Productivity Commission, *Inquiry into Horizontal Fiscal Equalisation*, June 2017, 20.

19 Tied grants are added directly to the calculation of a state's fiscal capacity when determining the allocation of general grants distributed on HFE principles.

20 Neil Warren, 'Fiscal equalisation and state incentive for policy reform' (2012) 10(1) *eJournal of Tax Research* 165, 171.

additional tax revenue to equalisation."[21]

Likewise, equalisation reduces the incentive to undertake necessary fiscal reform, by encouraging net-recipient states to adopt an attitude of dependency:

> Grant interactions may also result in a development trap or poor regions. Policy reforms designed to grow their economy with any downside-risk would be unattractive since any gains would confront a 100% marginal equalisation tax rate until they pass the floor or some minimum entitlement.[22]

By effectively rewarding smaller jurisdictions to forego own-source revenue, equalisation perversely creates poverty traps that make those states reliant on other jurisdictions. It is likely no coincidence that it is the smaller states (namely Tasmania and South Australia) that have consistently been the recipients of horizontal equalisation.[23]

3.4 Horizontal Fiscal Equalisation does not address but contributes to the underlying structural problem

Horizontal fiscal equalisation is an inappropriate mechanism for addressing vertical fiscal imbalance as it entrenches the role of the Commonwealth in the collection and distribution of taxation revenue. In this situation, a significant portion of state revenue is collected, administered and distributed by the Commonwealth, which erodes state fiscal autonomy. This erosion of fiscal autonomy has rendered the states heavily dependent on the Commonwealth for their fiscal needs, which leads to several problems, including:

- State governments have very little control over a major source of their revenue;
- Centralisation of power dilutes the extent of jurisdictional competition, whereby states compete with each other to meet residents' optimal point between public goods and taxation levels;
- It reduces the accountability of governments to their electorates, as it is less clear which level of government is ultimately responsible for service delivery compared to a system which is fiscally balanced;
- It facilitates the attachment of conditions by the Commonwealth to a significant proportion of domestic policy, and can lead to inefficient one-size-fits-all policies developed in Canberra;
- It potentially reduces the incentive for state governments to pursue pro-growth policies, if their revenue is primarily the function of decisions made by other jurisdictions.

21 Hansjörg Blöchliger and Claire Charbit, 'Fiscal equalisation' (2008) 44 OECD *Economic Studies* 1, 9.

22 Neil Warren (2012) 172. See also Bernd Huber, Christian Baretti, and Karl Lichtblau, 'A tax on tax revenue' (2000) *CESifo Working Paper No. 333*; Ross Garnaut and Vince FitzGerald, 'Issues in Commonwealth-State Funding' (2002) 35(3) *The Australian Economic Review* 290-300.

23 Novak (2011) 9. Novak also raises [at 11] the potential for recipient states to engage in rent-seeking behaviour to maximise their grant share.

Geoffrey Brennan and James M. Buchanan highlighted the problems of fiscal equalisation in their 1980 book *The Power to Tax*. Buchanan and Brennan believed that top-down revenue sharing between jurisdictions should be avoided as it would effectively establish a fiscal cartel where decentralised tax arrangements were undermined:

> ... the central government would act as an enforcer of the agreement between governments, dolling out financial penalties to those jurisdictions which attempt to breach the agreement. ... if some state/province levied a low rate of tax in relation to some instrument over which it retained jurisdiction, other states would need to be able to penalise it by means of its grant appropriation.[24]

As this paper argued in part 3.4, the equalisation formula used in Australia does contain incentives for states to avoid microeconomic reform, reflecting Brennan and Buchanan's concerns identified in 1980.

While horizontal fiscal equalisation attempts to address vertical fiscal imbalance, it merely entrenches the imbalance and further undermines competitive federalism. Vertical fiscal imbalance can only resolved if state revenue raising ability and state expenditure responsibilities are brought closer to parity. This would require fundamental reform to decentralise the national taxation system, including aspects of the GST. This is described in the next part of the report.

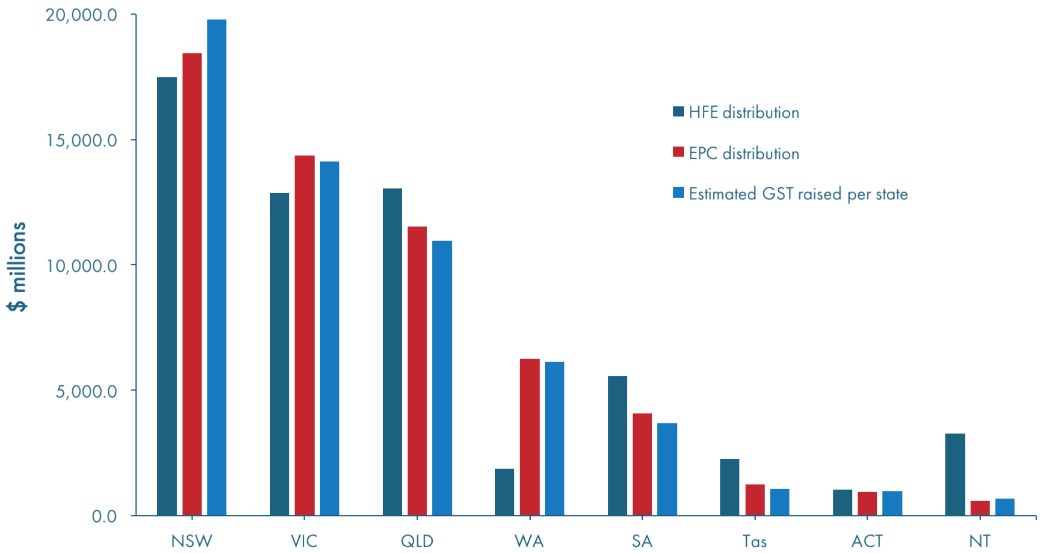
24 Geoffrey Brennan & James M. Buchanan, *The Collected Works of James M. Buchanan, Vol. 9 The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Originally published in 1980) (Indianapolis: Liberty Fund, 2000) 212-3.

4. Proposals for reform

Given the significant problems identified in the previous part of the report, substantial reform of the GST revenue distribution process is required. The principle of equalisation is fundamentally flawed, so any proposal that retains equalisation as an objective is inadequate.

In the absence of fundamental reform, equalisation should still be abandoned as a policy objective in favour of either an equal per capita distribution model or the state of origin revenue distribution model. Equal per capita distribution would simply distribute GST revenue to the states in proportion with their share of the national population. State of origin distribution would allow the states to effectively keep what is raised in each state respectively. A calculation of each of the hypothetical distribution methods reveals a significant deviation from the actual distribution of GST revenue in 2015-16:

Figure 4: Distribution of GST revenue according to Horizontal Fiscal Equalisation principles in 2015-16 compared to alternative hypothetical distribution methods.



Source: Commonwealth Government Budget Papers 2016-17; Australian Bureau of Statistics, Australian National Accounts, State Accounts 2015-16 cat. no. 5220.0

As Figure 4 indicates, approximately $40 billion of the GST revenue pool in 2015-16 was generated in the states of New South Wales, Victoria, and Western Australia. However, those states received only approximately $32 billion in GST revenue, with NSW losing approximately $5.30 billion in GST revenue, Western Australia losing approximately $4.25 billion and Victoria losing $1.24 billion in that financial year.

While either the equal per capita or state of origin method would deliver better results, both would fall short of delivering the benefits of competitive federalism. More fundamental decentralisation of the Australian taxation system is required, and this paper accordingly proposes that the states should be given the ability to alter the rates that apply in each state.

4.1 Retain equalisation as an objective, but adjust the formula

There are a number of proposals to amend the existing equalisation formula to achieve fairer outcomes to avoid anomalous results, such as the exceptionally low relativity for Western Australia in recent years. These proposals include:

- Impose a discount of 25 per cent or 50 per cent on the assessment of mining revenue.[25]
- Impose a relativity floor, so that a state's relativity does not fall below a certain figure (for example, 0.7).
- Adopt partial equalisation by equalising states to a point less than the fiscally strongest state, rather than up to the fiscally strongest state.
- Equal per capita distribution plus top up funding to the fiscally weaker states as determined by the Commonwealth Grants Commission.

Each of the above are marginal improvements of the existing system but are flawed for either arbitrariness or complexity. The issues identified in part 3 of this report are not resolved by the above proposals because the fundamental flaw of the current GST distribution scheme is equalisation itself.

4.2 Equal per capita redistribution

One proposal that finds a significant amount of support is equal per capita distributions. In this scenario, each state would receive a share of the total GST revenue pool equal to its share of the national population.

Equal per capita distribution has the benefits of procedural simplicity, and would reduce the perception of some jurisdictions being treated unfairly. Abolishing the equalisation formula would also remove the possibility of negative policy incentives identified in Part 4 of this report. However, there are a number of shortcomings to this proposal:

- Equal per capita distribution is at least somewhat arbitrary as it doesn't take into account how much of the GST revenue is generated in each state. A stronger performing state may still see some GST revenue generated in that state redistributed to the other states.
- Equal per capita distribution doesn't address Australia's Vertical Fiscal Imbalance. Under this proposal the control, administration and collection of the GST remains under the control of the central government, who are not accountable for how that money is spent.

For the above reasons, equal per capita distribution is the third best option.

4.3 State of origin distribution

The GST revenues could be returned to the states and territories on the basis of GST revenue generated with each jurisdiction. Under this scenario, the Commonwealth would retain the responsibility for administering the GST, including its collection, but would account for where the revenue was generated.

This proposal would have the benefit of removing the arbitrariness that is present under other proposals. It would also largely minimise the negative incentives that are present in equalisation

25 For instance, Canada applies a 50 per cent discount on the assessment of mining revenue in its revenue equalisation formula.

mechanisms. In fact, it would encourage state governments to promote greater economic growth, as such growth would lead to higher consumption spending, thereby increasing GST revenue receipts.

Currently there appears to be a significant amount of funding which is misallocated under state of origin principles. According to calculations based on ABS household expenditure data in 2015-16 an estimated $7.8 billion was collectively redistributed away from New South Wales, Western Australia, and Victoria.[26] See Appendix A of this report for a full breakdown of these calculations.

In the absence of fundamental structural reform, state of origin distribution is the most preferable option to replace Horizontal Fiscal Equalisation.

4.4 GST decentralisation

As much as possible, the decentralisation of taxation powers should be pursued. Decentralised taxes are the foundation of competitive federalism which, as Brennan and Buchanan explained, constrained the revenue-maximising instincts of the 'leviathan' state:

> ... [i]ntergovernmental competition for fiscal resources and interjurisdictional mobility of persons in pursuit of 'fiscal gains' can offer partial or possibly complete substitutes for explicit fiscal constraints on the taxing power. ... Total government intrusion into the economy should be smaller, *ceterus paribus*, the greater the extent to which taxes and expenditures are decentralised, the more homogenous are the separate units, the smaller the jurisdictions, and the lower the net locational rents.[27]

Ideally, any fundamental reform would see a total reversal of the current fiscal imbalance so that decentralisation and jurisdictional competition is maximised. The Institute of Public Affairs in 2011 suggested that an alternative to top-down revenue sharing is a system of reverse revenue sharing to revive competitive federalism.

Given that the GST was introduced solely for the benefits of the state governments, giving them more power over the tax is the logical end point. However, there is considerable doubt that the GST in particular could be completely decentralised. In two 1997 cases the High Court invalidated a range of franchise and licence fees on the basis that they constituted excise, and were hence an intrusion into an exclusive power of the Commonwealth (section 90).[28] In the court's majority judgment, it applied a broad definition of excise, so that any tax on any step in the production, manufacture, sale or distribution of goods is, for constitutional purposes, an excise. Accordingly, it is arguable that a state based GST would be inapplicable inasmuch as it applied to a tax on goods.

26 This is arguably a lower bound estimate as total household final consumption expenditure on food is fully excluded from the calculation. In reality, only some food items are exempted from GST. This means the final taxable household consumption figure is understated, which produces lower figures for revenue raised in each state.

27 Brennan and Buchanan (1980) 215-6.

28 *Ha v New South Wales & Hammond v New South Wales* (1997) 189 CLR 465.

Given that full decentralisation is problematic, reform should utilise the pre-existing federal tax collection mechanism but should seek partial decentralisation. This would involve state of origin distributions, with an additional power conferred on the states to select or set the rate of GST that applies to its respective jurisdiction. Australian tax law expert Keith Kendall proposed a similar scheme for the income tax in 2012 where the tax was enshrined in federal law while giving the states flexibility over the rates that applied:

> The preferable alternative, especially in light of the uniform legislation, is for the Commonwealth to collect the revenue and distribute it to the States. This would need to be a strict agency arrangement, however; there can be no discretion at the Commonwealth level or even through an independent body allowing for a reallocation according to need or whatever basis is decided to be flavour of the month... The system proposed in this paper reflects that used in Canada, where the Federal Government collects the income tax revenue on behalf of the provinces (except for Quebec). This would undoubtedly require the States to make some contribution to the costs of the Commonwealth's administrative apparatus and each State would need to determine their most cost effective means of raising and collecting their own income tax revenues.[29]

Applying the principles to the distribution of GST revenue would be significant step towards restoring competitive federalism and accountable representative government.

29 Keith Kendall, 'The Case for a State Income Tax' (Paper presented to the Annual Conference of the Samuel Griffith Society, Brisbane, 17-19 August 2012) 66.

Concluding remarks

Far from securing the integrity of the Federation, horizontal fiscal equalisation in Australia not only imposes a range of costs on the Australian economy but entrenches a high degree of vertical fiscal imbalance that undermines the integrity of federal-state relations.

This paper reiterates the argument put forward by the Institute of Public Affairs in 2011, that horizontal fiscal equalisation "cannot be divorced ultimately from the central problem of Australian federalism, viz. the unwarranted dominance of the Commonwealth government in fiscal affairs."[30]

To address this problem will require wide ranging and fundamental reform to the national taxation system. Abandoning horizontal fiscal equalisation and returning to the states the power to set GST rates that apply in their own jurisdiction would be an important step towards reviving a framework of competitive federalism that would reduce the revenue maximising instincts of the Leviathan state.

30 Novak (2011) 26.

Appendix A

The data for alternative GST distribution methods for 2015/16 was obtained from the 2016-17 Commonwealth Budget Papers and household expenditure data from the Australian Bureau of Statistics, applied to a total GST revenue distribution of $57,450m. The data tables used in this report are shown below (any discrepancies are due to rounding).

Table 1: Hypothetical equal per capita distribution and actual distribution according to HFE principles

	Population	Share of national population	**Equal per capita distribution ($m)**	GST relativity	**2015/16 HFE distribution ($m)**
NSW	7,693,875	0.3211	18,448	0.94737	17,496.7
VIC	5,992,339	0.2501	14,368	0.89254	12,872.0
QLD	4,806,849	0.2006	11,526	1.12753	13,044.0
WA	2,607,541	0.1088	6,252	0.29999	1,882.6
SA	1,704,186	0.0711	4,086	1.35883	5,573.2
TAS	517,536	0.0216	1,241	1.81906	2,265.7
ACT	393,480	0.0164	943	1.10012	1,041.8
NT	244,205	0.0102	586	5.57053	3,274.0
Total			57450		57450

Table 2: Calculation of GST revenue raised by state, according to ABS data on household consumption expenditure

	HFCE ($m)*	Minus food ($m)	Minus health-care ($m)	Minus	Taxable total ($m)	**Initial calculation ($m)****	Scaling down ratio^	**Final estimate of GST revenue raised by each state ($m)**
NSW	316821	-28702	-17225	-13767	257127	23375.18	0.847	19797.85
VIC	236507	-23513	-16789	-12890	183315	16665	0.847	14114.59
QLD	182808	-19215	-13534	-7677	142382	12943.82	0.847	10962.898
WA	102158	-10870	-6841	-4717	79730	7248.18	0.847	6138.92
SA	61553	-6801	-3980	-2716	48056	4368.73	0.847	3700.14
TAS	17749	-1995	-1229	-608	13917	1265.18	0.847	1071.56
ACT	16446	-1943	-885	-806	12812	1164.73	0.847	986.48
NT	10466	-1025	-426	-215	8800	800	0.847	677.57
Total						67830.82		57450

Notes: * HFCE refers to 'household final consumption expenditure.

** Taxable total divided by 11 to find the initial estimate of consumption that is comprised of GST.

^ Total initial calculation is greater than the actual distribution of GST revenue in 2015-16. This is because the estimation is not able to factor in the amount of GST revenue that is absorbed by the Commonwealth in its administration of the GST or because of the adjustment of final payments due to the timing of receipts. This ratio is calculated to scale down the initial calculation total to better reflect the actual amount of GST revenue that was distributed in 2015-16.

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