Submission on the Productivity Commission's Draft Report on Horizontal Fiscal Equalisation

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Disclaimer: The opinions presented here are my own and do not purport to represent those of any organisation or agency.

The Commissioners are to be congratulated for taking seriously, the questions at the centre of the debate:

- Do the existing arrangements for the distribution of the GST revenue present a trade off between equity and efficiency?
- If so, how material is it?
- What changes would likely lead to a better balance between the primary goal of equity and the secondary goal of economic efficiency, broadly conceived?

The Commissioners are to be congratulated for bringing to our attention that clause 5(1) of the Act that governs the Commonwealth Grants Commission uses the phrase 'not substantially different' rather than complete equalisation, which is the overriding goal that the Grants Commission adopted on its own initiative: 5(1) *References in this Act to the grant of special assistance to a State shall be read as references to the grant of financial assistance to a State for the purpose of making it possible for the State, by reasonable effort, to function at a standard not appreciably below the standards of other States.*

Evidence of efficiency effects

There are at least four kinds of evidence of efficiency consequences, detrimental or advantageous, of the Grants Commission's procedures for arriving at recommendations on the distribution of the GST revenues:

1. Pure economic theory
2. Modelling of a computable general equilibrium kind
3. Other modelling that is tested or simulated
4. Casual empiricism and anecdotes.

(To be clear: any kind of modelling must rest on theoretical foundations.)

For the early years of fiscal equalisation in Australia, one can infer an implied efficiency argument that had to do with fiscal risk pooling: using fiscal transfers as a way of cushioning the uneven and imperfectly correlated effects across the

States, of monetary unification in what was not a pure optimal currency area. This argument is rarely advanced these days, having largely lost its force, now that the Commonwealth has an active fiscal policy, and there are plenty of automatic stabilizers; even with respect to large swings in the terms of trade, presumably other mechanisms do the job better, especially the floating exchange rate.

Otherwise, pure economic theory of the efficiency effects of HFE first came in the work of James Buchanan and colleagues. The argument was basically the following: if one State offered a mobile worker a fiscal residuum that was sufficiently superior to that offered by another State, the worker would tend to migrate or locate in the former State, even if he or she was more productive in the latter State; national efficiency would thereby be damaged.

This is the common, maybe universal theoretical underpinning of computable general equilibrium models of HFE. Without any forces ranged on the other side, the model must show that HFE improves the efficiency of the allocation of mobile factors of production.

Various contrary forces can be arrayed, but they need to be parameterised if they are to be included within a CGC model. So, for example, the Centre for Policy Studies modelled possibly inefficient crowding within cities, using relatively standard theory of circular cities, with appropriate parameters (elasticities and the like).

The Commission's Draft Report focuses on two kinds or sources of possible inefficiencies, the first being the HFE-induced disincentive facing a large State contemplating a substantial change in the tax mix—in particular, a revenue neutral shift from stamp duties to land tax; and the second being, as the Draft Report puts it (page 13), that 'Any State that developed contentious mining activity would bear the full political cost of development, but only retain its population share of the royalties.'

Here, the point must be emphasised: no GCE model (to my knowledge) has included either of these two possible sources of inefficiency: they are ruled out by assumption, justified, if at all, by the technical difficulties of their inclusion, or by *a priori* theorising or casual empiricism and anecdote.

Thus, it is not valid to argue that the Commission's cameos (or statements like that quoted from page 13) are merely theoretical, speculative and not factual and, therefore, cannot go against the conclusions of computable general equilibrium modelling.

Unpacking the CGC methodology

The CGE modelling commissioned of Chris Murphy by the 'Griener' review and, later, by the SA government, is frequently cited as showing that HFE improves economic efficiency. Chris Murphy did not model the possibilities raised in the

Draft Report. Moreover, in later and different modelling, presented at the HFE workshop in Adelaide earlier this year, Chris Murphy concluded that some aspects of the CGC methodology are detrimental to economic efficiency (those relating to cost differences). This new modelling did not take account of either of the channels discussed in the Draft Report. Moreover, it is not at all clear that the considerations at the centre of this new modelling could be included within a conventional CGE model.

Equity, efficiency and mobility

Care must be taken to reconcile the following two claims, frequently both made by proponents of HFE as it is practiced in Australia:

1. HFE has prevented Tasmania from becoming the Australian equivalent of Appalachia, West Virginia, or the maritime provinces of Canada
2. HFE has not had a significant effect on the size and composition of the population of Tasmania; or, as the Draft Report puts it (page 14), 'Fiscal differences by jurisdiction are unlikely to play a significant role [in interstate migration].'

A counter-example, to the second proposition, is given by the episode usually called 'the death of death duties": Queensland started to attract older and richer people wishing to take advantage of that government's abolition of death duties—the migration effects of the fiscal difference played a significant role in inducing other States to match Queensland.

More generally, the claim about the efficiency advantages of HFE—as was discussed earlier—rests on the argument about fiscally induced migration or location decisions (interstate or international). In contrast, the claim about equity rests on the assumption that those affected are immobile. For mobile populations, the forces of 'spatial equilibrium' leads a person to be indifferent as to the choice between two locations, having taken account of the costs of moving and resettling. For immobile populations, there is no escaping to another State that offers a better fiscal deal.

Clearly, within any State population there are various degrees of mobility, ranging from very fugitive, to those with deep emotional ties to a particular place. For the latter, no other location in Australia offers a higher level of satisfaction or wellbeing, than 'right here'. For them, the equity argument must be that they should not be deprived of State services in consequence of their attachment to place—but of course, HFE merely gives their State the necessary funding, without imposing conditions as to how it will be spent.