

Griffith University submission to Productivity Commission's Inquiry into Horizontal Fiscal Equalization

1. Executive Summary

The main theme of this submission is that the discussion and rationale for HFE does not go far enough in the draft report. We agree with the Productivity Commission that reforming HFE (which is much needed) will deliver some benefit for the wider Australian community. However, the PC Draft Report has failed to clearly articulate precisely what type of reforms are needed to achieve this goal. In fact, it appears to have gone to great lengths to avoid mentioning any reform options.

Griffith University does not support haphazard changes being made to lower equalization levels without appropriate consideration of broader reforms to financial relations and fiscal capacity, some of which have been summarily dismissed in the draft PC report. The current PC recommendation calling on the Australian Government to articulate a revised objective for HFE is effectively an exercise in passing the buck, and will invite the Treasurer similarly to pass the buck. Even if such a revised definitional change to the criteria was accepted by the Australian government, in the current zero-sum game context, it is unlikely that such decision would gain bipartisan support or win support from all the states.

We note that two White Paper processes initiated by the former Abbott government in 2013 – Reform of the Federation and Taxation Reform were abandoned by the Commonwealth in late 2015 without consultation with State and Territory governments - their partners in Australian federalism. We note too, that federation reform principles endorsed by COAG at its meeting of 17 April 2015, are nowhere reflected in the draft PC report.

As detailed below, instead of focusing the draft report narrowly on the HFE through the GST, we consider that the PC could encourage policy-makers to consider broader reform scenarios and options that will take more time to implement - seeing Australia's problematic federal financial arrangements as a long term problem, not a quick-fix, short terms issue. It is crucial to highlight the important inter-connections between HFE and the other distortionary aspects of fiscal federalism. Before recommending any piecemeal change, a clear national consensus need to be reached on what the new financial arrangements ought to look like.

Accordingly Griffith University recommends that the PC final report should call on COAG to drive this consultative process to achieve better outcomes for all Australians. While such a strategy will not result in short term solutions, the PC should encourage the government to take steps toward achieving real and sound fiscal reform in the longer term that enjoys the broad support of the Australian public.

2. Structure

We welcome the opportunity to make a submission to the HFE review undertaken by the Productivity Commission. Our submission is in three parts: Part A discusses the draft report's position on the Inquiry's Terms of Reference. Part B discusses problems with the criteria used to assess HFE reforms and Part C discusses the need to emphasize the temporal nature of current relativities.

Part A: On the TOR and the need to consider VFE

We consider that the terms of reference for the PC's review of HFE are fairly narrow and restricting. Furthermore the PC in its draft report predominantly accepts the rationale for the current status quo, and has reduced the inquiry into the fairly innocuous question of whether the Federal Government should slightly amend the definition of HFE moving it to a second level of fiscal capacity or perhaps even the states average fiscal capacity. We feel that this is a conservative and misguided approach and will not allow the PC to adequately address some of the more fundamental aspects contained in the ToR such as how HFE affects productivity, efficiency, economic growth and the incentives for states and territories to undertake fiscal reform.

Principles for reforming the federation, including federal-financial relations were agreed by COAG at its meeting of 15 April 2015. Leaders agreed that the goal of federation reform is improve the living standards and wellbeing of all Australians. Accepting their *shared responsibility to achieve change*, COAG agreed any reallocation of responsibilities between governments should aim to:

- *Deliver better services* – recognising diversity as a strength of federation, it should be easier for people to receive, choose and access high quality services;
- *Drive economic growth* – encourage a productive and efficient economy supporting growth in the standard of living for all Australians;
- *Be fair* – all Australians should be able to receive, choose and access high quality services, regardless of personal circumstances, location or socio-economic background;
- *Provide clear responsibility* – people should be clear which level of government is responsible for services so they can hold them to account; and
- *Be durable* – arrangements need to stand the test of time and be adaptable and flexible enough to accommodate changes required over time.

COAG also agreed that an important context for discussing the Federation is the budgetary pressure for all states and territories and the Commonwealth

due to the expected growth rates in health and education expenditure and the underlying revenue base over time. Leaders committed to *work together* – through the *White Paper* process - to meaningfully address these long-term funding pressures and also look at structural reforms to ensure services can be delivered in the most efficient way.

COAG reiterated that Commonwealth, State and Territory *governments* need to be certain they would have appropriate revenue to meet their responsibilities and that this would be a key consideration of both the Tax and Federation White Papers, which [were] being progressed together.¹

The draft report does not reflect these principles, even with respect to HFE.

We consider that some of the very good work conducted for the Reform of the Federation White Paper process (Issues Paper No 5) would greatly assist the PC to re-evaluate the complacent attitude to Australia's fiscal problems reflected in the draft report. In that paper it was pointed out that restricting the HFE to the net revenues collected from the GST essentially produced a counter-productive zero-sum game, whereby any claim to increase the share of one jurisdiction threatens the shares of others. Tying HFE to the GST makes it impossible to move to an equal share of GST revenue on a per capital basis (as recommended by the 2012 review and 2014 Commission of Audit) or even to put a floor under the minimum share to which a state can fall (say 70 cents in the dollar).

In some ways the more historical method of redressing imbalances of fiscal capacity (untied financial assistance grants – FAGS) was a better and more defensible way of providing assistance, even though it was politically determined and often arbitrary (but so too is tying HFE purely to the GST base). The time may have come to re-evaluate whether the pool of GST funds is the appropriate way to compensate jurisdictions for weaker fiscal capacity.

As lump sum payments are less distortionary than a regressive tax like the GST, one idea would be to ask States to make payments from their operating budget into a federal funds that is then redistributed to states to finance capital (rather than current) expenditure. There can be other mechanisms through which we can use lump sum payments as opposed to GST revenues to achieve fiscal equalization.

The discussion in the draft report talks of people being accepting of HFE and that it is fundamental to the federal mission. A few quick points here: HFE is not required in the constitution, nor is it hinted at. Most other federations do not have it (or have it to far less degrees) and some not at all. Moreover, while the Constitution stipulates that the Commonwealth should not treat states differently (on taxation so as not to discriminate between states), then excessive HFE (or an overly generous compensation for the lack of fiscal

¹ COAG Communique, 17 April 2015.

capacity) could itself be unconstitutional if challenged because it violates this principle of non-discrimination.

From the outset of Australia's federation there was not much HFE in the early decades, indeed the Commonwealth even attempted and was successful in keeping surplus revenues and paying funds into trust accounts for future use. HFE began as an intergovernmental convention accepted across Australia from the 1930s (and defined in 1936), in times of severe economic depression and financial stress where the Commonwealth could assist weaker states and mitigate momentum for outright secession. Later this was formalised around the 'claimant state' procedures – where states feeling aggrieved at least had to make a case for additional support (this was also in a time when exact information on a state's budgetary position or methodologies was not readily transparent).

HFE lives with certain fictions that we have come blindly to accept. First although HFE is calculated by the CGC as recommendations and then authorised by the Commonwealth, it is calculated on complex positive/negative criteria to try to determine a jurisdiction's fiscal capacity to deliver equal services. Yet in allocating these funds, the Commonwealth does not insist jurisdictions actually spend any additional funding on these services. It saves most of its prescription for National Partnership Agreements, which are unpredictable and subject to arbitrary and often partisan changes that affect the largest and most complex areas of service provision.

What is the point of equalising the capacity to deliver services and then not implementing the equalisation? Yet we allow the fiction to ride on... Second, we look to higher performing delivering jurisdictions (and sometimes at average delivery standards) but it is often far cheaper to deliver services (lower salaries, contract costs, housing costs, transport costs, less congestion etc) in regional areas than in Sydney or Melbourne. Equalising for service delivery can greatly advantage Tasmania, South Australia where the costs of delivering services are much lower than in larger more populous states or in large metropolitan cities (the two-staged economy, Sydney/Melbourne real estate booms etc).

If we are serious about equalising service delivery levels across Australia to some uniform standards, then why do we base such calculations on the revenues the jurisdictions collect – or could conceivably collect if they behaved like the others or the average. This is a non-sequitur. We should base service delivery levels and the costs of providing them on the expenses involved. Then allow the states to reform their tax bases as they wish without fear of any reform being counted against them by the CGC. State and territory taxation seems a red herring to the exercise of equalising service provision. One can only conclude that the Commonwealth is not serious about equalising provision, but tolerant towards providing additional assistance to jurisdictions with lesser fiscal capacity.

The complexity of the methodologies and data-collecting processes have created their own problems in determining relativities. Time lags can be major problems in the immediate term. States whose economy is relatively stable and not growing by rates above the average will not be greatly affected, and could be advantaged by not pursuing economic growth. However, states with greater economic fluctuations of cyclical economic boom/busts will be affected far more onerously, making their state budgetary position difficult to manage.

While the ToR asks the PC to examine how well states have the ability to prepare their annual budget, the HFE is not the real problem with this issue – rather the biggest problem for the states is not having a guaranteed revenue share of the 82% of taxation taken from ordinary Australians and companies living and operating in the states and territories. The fluctuations in HFE are irritants rather than the cause of much budget uncertainty. The nervousness and conservatism that the states and territories display in making any attempts at fiscal reform are largely due to the fact that they have no guaranteed share of the revenues collected on their behalf. This uncertainty makes them timid in contemplating reform to say land tax or payroll tax reform, and discourages them from getting rid of the small but inefficient taxes and duties that these jurisdictions maintain and fight to hold onto. It has also contributed to the increased prevalence of gambling taxes and the growing dependency upon them by these sub-national jurisdictions.

Part B: defining 'reasonable' levels of government services

A key feature of the report is the use of stringent criteria to dismiss reform proposals. The specific criteria used was to only consider ideas that **'strengthen equity, efficiency at simplicity at once'** (page 158 of draft report). At the same time, in the PC's own deliberation and recommendation there were no ideas that actually do meet this criteria. This suggests that the use of these criteria is fundamentally counterproductive. If no reforms meet the criteria, the criteria need to be changed. The use of unrealistic criteria degrades public confidence in the PC recommendations, since these also do not meet the criteria that the PC has used in its evaluation.

For example, a key recommendation in the report is that the Australian Government should articulate a revised objective for the HFE which would involve a lower degree of equity but still provide states with the fiscal capacity to provide a 'reasonable' level of government services. Yet the draft report has not clearly defined what exactly the government should consider 'reasonable' and how this can be achieved while strengthening equity, efficiency and simplicity. For this reason, the ultimate impression the reader gets from this approach is that the PC has assigned HFE to the 'too hard' basket and has written the recommendations in such a way that provides some cover the Federal government to undertake some type of arbitrary reform that reduces equity without directly specifying what these should be.

This lack of transparency is not consistent with the PC's mission to be an independent advisory body.

Ultimately, a defensible definition of reasonableness should involve an assessment of the needs / preferences of Australian taxpayers and the extent to which existing levels of government services satisfy these preferences. When considering which states should receive resources and how resources should be transferred between states, there are two basic types of preferences worth taking into account:

Preferences for public goods. Contingent Valuation methods (Mitchell et al. 1989) to assess Willingness to Pay can be used to assess preferences for public goods. These are a widely accepted methodology that could reveal differences in the provision of government provision of services reflect differences in citizen demand for them (Tiebout 1956).

Redistributive preferences. Apart from their general preferences for public goods, an equally important question is to what extent citizens favour redistribution. Do citizens actually support the principle of equity? The degree to which equalisation should be achieved should ultimately take into account citizen's preferences for redistribution. This is an important second dimension as their view on the role of government in redistributing resources may be quite distinct from their demand for public services. There exists a growing number of articles that have studied the nature of redistributive preferences and their chief determinants via International Social Survey Program and World Values Survey (Guillard 2013, 2017). These suggest that preferences for redistribution are strongly conditional on income. High income earners prefer less redistribution while low income earners tend to prefer more redistribution. If preferences for redistribution can be inferred from the citizen's position in the income distribution, this suggest that the extent to which HFE should be equitable should take into account changes in the average income of citizens and the degree of income inequality in Australia. Ceteris Paribus, there is greater demand for redistribution among low income countries/states and less demand for redistribution among high income countries/states. In terms of income inequality, in years where income inequality is high, the current system of full equalisation may better meet the redistributive preferences of Australian citizens.

Part C: The mining boom is over and why this is worth emphasizing

A key factor that has triggered recent debate on HFE is the recent mining boom which is now largely over. The mining boom was mainly responsible for the sharp drop in WA's relativities. This is implicit in the report but not strongly emphasized. Moreover, what seems to be underemphasized is that WA relativities will naturally recover in future years as mining revenues decline. This is reflected in the WA's Treasury forecast (see Chart 2.1 on page 12 of WA government submission). It is therefore worth questioning to what extent the impact of any possible reform favouring WA's relativity will be

rendered obsolete by the time it is implemented. The PC draft report would do well to put greater emphasis on the temporal nature of current relativities. Reforming the overall should not be influenced by unpredictable events such as the mining boom. Immediate changes in the HFE could create expectations among states that the HFE formula is up for discussion any time a significant upswing or downswing in economic activity occurs.

A better alternative is to reform HFE in the long run interests and welfare of the Australian people. As such it is worth emphasizing more that the HFE is to some extent self-correcting and if the industrial composition of the Australian economy continues to revert back to its long run average, New South Wales and Victoria will likely revert to being the fiscally strongest states in the medium term.

Conclusion

In light of the above, Griffith University recommends that the PC final report should call on COAG to drive this consultative process to achieve better outcomes for all Australians. While such a strategy will not result in short term solutions, the PC should encourage the government to take steps toward achieving real and sound fiscal reform in the longer term that enjoys the broad support of the Australian public.

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