

SUBMISSION TO PRODUCTIVITY COMMISSION INQUIRY

GST DISTRIBUTION SYSTEM: MAIN POINTS

1. HFE is a concept possibly useful in undergraduate economic study but its application in Australian federalism is arbitrary and nowhere prescribed in detail.
2. The CGC's choice of HFE model has defects; it over-reaches and is illogical. Better to confine its equalisations to Services & Revenue items which are "common/core" in all/most States in order to ensure improved equity, incentives, productivity & economic growth objectives.
3. For States with above/below per capita averages of Services expenses and Revenue, the CGC has an onus to interpret these and to justify its HFE procedures because these impede economic objectives.
4. CGC's treatment of Revenue impedes growth, equity and incentives, and may reward inactivity & bad policy: refer WA Mining. Suggest delete HFE on all Revenue, abandoning CGC's limit of 40%, unless narrower common/core selection is acceptable.
5. For Services with above/below State-average expenses per capita, there is need for more scrutiny from a productivity perspective, and possibly a different conclusion would be reached than CGC's in many instances.
6. Calculating funding for deemed deficiencies: needs divorcing from GST distribution and funding by Cwlth. as recommended by 2012 Review, not only for NT & ACT (Cwlth.'s creations) but also for other recipients. Estimations need specialist expertise and probably closer coordination with Cwlth. Payments to States for Specific Purposes.
7. The Cwlth. benefits the most from present defective system. (Hence Cwlth's reluctance to initiate repair of broken system). Recipient States will always oppose a new system if this penalises.
8. The rigidity about securing unanimous agreement about "basic" changes is incompatible with, and risks effective national economic management, long term. Domestic & international influences are volatile and policy instruments need to be flexible. The 2000 GST Act needs amendment to correct this. (Australia was lucky in the GFC downturn but good fortune may not be repeated).

In conclusion, the PC will be hard-pressed to recommend departing from the Brumby/Greiner/Carter model. This was for equal per capita (HFE) population in the GST Distribution. Also for the Cwlth. to face up to its Federation responsibilities by funding deemed deficiencies. These could be assessed on more modern, improved bases to benefit its own creations (NT/ACT) as well as for those States with more limited resources or undergoing worsened economic circumstances from natural or periodic economic disasters. These assessments could engage with more appropriate indicators than are presently employed in the CGC model. Consequences of the resultant model could better and more directly achieve the objectives of the Terms of Reference, namely equity for WA & elsewhere, less disincentives, higher productivity, growth & employment. JP McAuley

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GST DISTRIBUTION SYSTEM

Although the 2000 Act governing the GST Distribution system requires this to be in general terms of the principles of Horizontal Fiscal Equalisation (HFE), the Act did not specify the detailed application of HFE, nor how this should be interpreted by the Cwlth. Grants Commission (CGC) in devising a system making use of HFE, nor necessarily conferring any degree of legitimacy on the detail of CGC's choice of model.

HFE is a concept useful in undergraduate economics, akin to many other useful concepts such as division of labour, "laws" of supply & demand etc. Application of such concepts to practical situations may aid understanding and give guidance without necessarily guaranteeing acceptable solutions (eg housing affordability may be usefully considered in terms of demand-supply issues, but its application in Sydney would certainly vary from that in Perth). The term HFE, though maybe still beloved of lawyers, engineers, & politicians, public servants etc, is now somewhat outdated within the economics profession. This is possibly because of analytical tools developed from modern studies: eg for preserving equity amongst groups, of productivity elements, for application of fiscal policy instruments, incentives to progress, economic growth etc, issues with which this Inquiry is concerned. The versions of HFE applied in USA, Europe, Germany and elsewhere give little guidance to likely good practice in Australia.

The essential element of HFE in its application to Australian States (including in this term, the two territories, NT & ACT), is "Equalisation". I consider this essentially implies equity via equalisation of common/core Services/Revenue - subject to reservations mentioned later.

Some Revenue items are not common/core to all or most States and therefore should not be equalised. I would prefer no Revenue at all should be equalised because States' budgets should be left to reflect the differing policy options and often unique circumstances leading to many variations in State Revenue per capita.

The CGC follows this exemption from HFE in respect of about 40% of own-state Revenue but I would extend the exemption to 100% , especially Mining in which WA bears the brunt of the equalisation (details later, but here I may note: 1. the differing State environmental & agricultural policies on allowing mining of onshore oil & gas etc which may inhibit revenue, and 2. I note also the difficulty of fully measuring and offsetting from royalties, the incentives/facilities given by govts. to induce mining and royalties, employment etc in remote areas).

A suitable alternative system for distributing GST, advocated with major State approval, was compiled in a top-level Review released in 2012 by ex-premiers Brumby & Greiner, and Bruce Carter. The HFE element of their proposal was that an equal Aust.-wide per capita GST would be distributed to each State in proportion to population. Also, the Cwlth. alone would be responsible for topping-up funds for deficiencies for smaller States.

Under the existing system, "donor" States pay out of their GST entitlements, the funds to cover deficiencies of "recipient" States on the recommendations of the CGC. In 2015-16,

these payments totalled \$6.8 B of which \$4.4 B was paid by WA alone, Vic \$1.5 B and NSW \$0.9 B.

Of course, the Cwlth. welcomes the \$4.4 B paid by WA and the other \$2.4 B paid by VIC/NSW, especially as it already paid the States \$53 B (incl. NT/ACT) for Health, Education and other Specific Services in 2015-16.

The recipients to benefit in 2015-16 from the existing system and the largesse of the GST, however broken or unfair this may be, were Qld & SA, each \$1.5 B above their per capita entitlement, Tas \$1 B, and NT \$2.7 B & ACT \$0.1 B. In the event of a changed system, smaller States would be likely to request assurances about not being penalised (they had done this when the GST had been introduced).

Since NT & ACT are actually direct creations of the Cwlth., it would be reasonable for the Cwlth. to cover funding for any deemed deficiencies. For the smaller recipient States, a move to a more appropriate and more reasonable distribution system, with the Cwlth topping-up for deficiencies, should be acceptable.

The PC's recommended repair of the Inter-Govt. Agreement Implementation (GST) Act 2000 should also include altering the need for unanimous agreement by all parties in order to secure a "basic" change. The reason is that for effective national economic management, central governments need flexibility in countering adverse economic volatility by having the capacity to speedily influence consumption and investment expenditures as and if necessary. In the past GFC, the repercussions on Australia were lessened by two factors: impetus given to larger public expenditure; enhanced growth in exports accompanying China's high economic growth. Both factors may not be inevitable nor readily available to Australia in the foreseeable future. A weakness is that items attracting GST are set too rigidly and comprise too high a proportion of total private consumption, thereby reducing the flexibility needed for policy purposes.

Table: Adjustments to GST under CGC's HFE Model for 2015-16 \$ B

	WA	NSW	Vic	Qld	SA	Tas
Expenses	2.3	-2.5	-4.8	1.6	0.3	0.5
Revenue	-7.7	1.6	3.4	0.0	1.6	0.7
Other (a)	0.9	0.0	-0.1	-0.1	-0.4	-0.2
Total Adjs.	-4.5	--0.9	-1.5	1.5	1.5	1.0

- indicates payt. by donor into pool for recipients; maybe rounding; (a) Other adjustments are for Investment, Borrowing & Cwlth. payments.

Expenses: The CGC's method is broadly that where a State has expenses per capita for selected Services above State-average, the surplus is available for distribution to the pool (& the reverse withdrawal when a below-average occurs). A high-spending State is thereby penalised (& low spending State encouraged). The method implies that the criterion for efficiency and economic progress is the amount of expenditure. This is a dubious notion.

In some/many cases, the very opposite would be a more accurate criterion, such as differential wage levels between States, special needs, population dispersion etc. The CGC model does not account for the real reasons but unjustifiably depends upon the \$ indicator for which statistics are readily available. The CGC model is suspect and unsupportable.

Revenue: Mining: Vic, Tas & ACT have little or no mining at all. The range of mining is limited in NSW, SA & NT (refer CGC's 2015 Review, pg 108). Except for the CGC's treatment of WA, the State would have been a recipient, not a donor, since it was penalised by losing \$7.7 B as shown in the previous table, a unique and extraordinary penalty.

As mentioned earlier, the CGC has exempted about 40% of State Revenue from the HFE procedure, but leaves in Mining Revenue which is so unevenly distributed throughout the States, and causes so drastic a penalty for WA, the only State to export substantial iron ore in quantity, and indeed to have substantial volumes in most minerals.

In my view, HFE is not designed to cover isolated Expenses and Revenue items because this discriminates and can produce unfair results, but HFE should be confined to common/core items. For Revenue, I would prefer to exempt altogether because of the statistical difficulties referred to earlier and lack of data and background circumstances in many instances.

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