Submission to the Productivity Commission inquiry into Horizontal Fiscal Equalisation

James McDonald, 29 June 2017

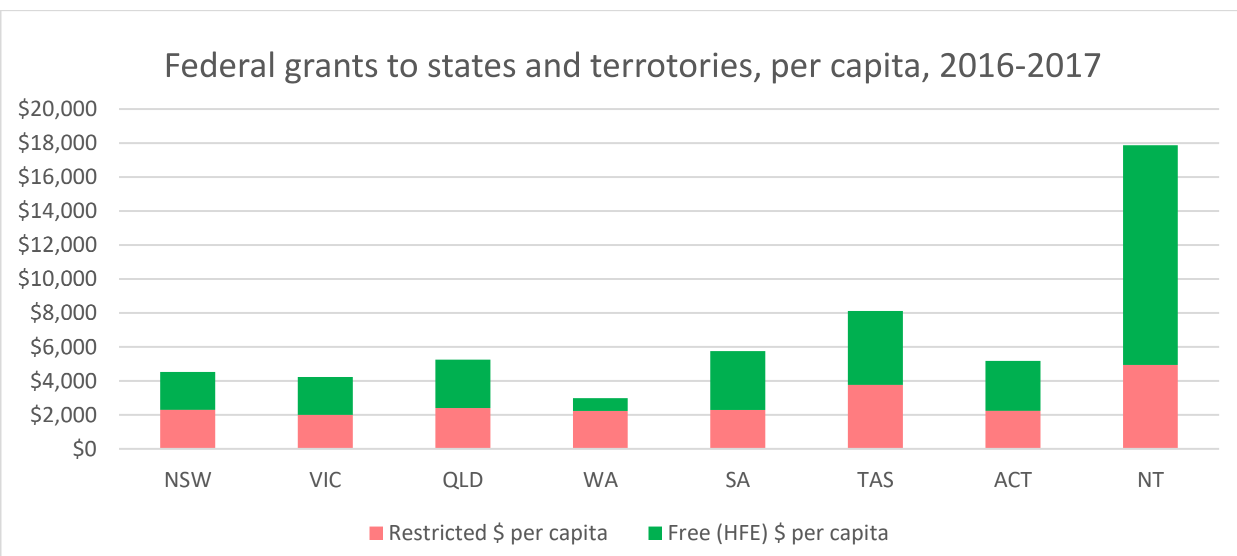
There are two streams of federal grants to the states in Australia: free grants (General Revenue Assistance) and restricted grants (Specific Purpose Payment). The free grant stream is the output of Horizontal Fiscal Equalisation (HFE). The restricted grant stream is one of its key inputs, since SPP grants count towards state revenue capacity. The table on page 2 summarises the differences.

By examining both streams together, I hope to show that it is possible to improve (not perfect) the incentive structure of the HFE system by applying an equalisation process to the restricted grant stream instead of the free grant stream. This could be done with minimal political stress at the federal level, by calibrating it to maintain (for now) something close to the current total grant amounts to each state.

The key to this is to observe that:

1. Free grants serve the political interests of state governments by enabling them to fund their own choices of election promises to state voters, so they can stay in office longer.
2. Restricted grants are used mainly to fund federal election promises to federal voters, and support the people in a state without necessarily helping their state government stay in office.
3. Under the current system, economically weak states – HFE transfer recipients – receive most of their federal grant money in the form of free grants, which help their state governments remain in office. Economically strong states – HFE donors – receive most of their federal funding in the form of restricted grants, which are less useful to state governments for staying in office.

Point (3) is illustrated in the graph below, which shows the per capita amounts of free and restricted grants received by each state and territory in 2016-2017 (figures from the 2017 federal budget papers).



As the graph shows, Western Australia received only 25 per cent of its federal funding in the form of unrestricted GST grants; South Australia, 60 per cent; the Northern Territory, 72 per cent.

The Northern Territory is a good example of point (1) above. It receives the biggest HFE transfer amount due to its remote Indigenous population, and every few years it is accused in the media of "siphoning" a large portion of that HFE transfer money into politically expedient suburban projects in Darwin. The NT government invariably responds to these accusations by pointing out – correctly – that HFE grants are unrestricted in their use, and the assessments of needs in the HFE formula are empirical, not normative. The unearned reward for the incumbent NT government – enabling it potentially to stay in office longer than it otherwise could – arises not from any abuse of the HFE system but from the flaws inherent in it.

For clarity, the following table compares the two grant streams as they are now.

Grant stream	General Revenue Assistance (GRA)	Specific Purpose Payments (SPP)
Type of grant	Free	Restricted – for prescribed purposes only – usually requires KPI reporting – may require matched spending – may require policy changes
Revenue source	GST	Other federal taxes, mainly personal and company income tax
Distribution formula	Horizontal Fiscal Equalisation (HFE) to level out all states' capacities for providing services and infrastructure, after taking into account their circumstances, capacities for internal revenues, and SPP grants received	Typically per capita, but may also be needs based (e.g. Gonski school funding) or ad hoc (e.g. grants for specific infrastructure projects)
Enables which level of government to fund its own election promises	State	Federal
Makes state policies accountable to which domain of voters	State	Federal

A better arrangement of grant streams and distribution formulae would reverse this: states with better economic performance would receive more free grants and thus more electioneering resources; states with weaker economic performance would remain on a tighter federal leash, with restricted grants that support the people without necessarily helping their state governments politically. Lifting economic performance would lead to greater political autonomy, even if it continues to be financially penalised.

How would this work? Here is a proposed outline for a modified HFE system.

1. GST revenue is distributed to states in proportion to a suitable economic performance indicator, such as the non-government component of Gross State Product.
2. Federal government defines national priorities that fall within state jurisdiction – for example Closing the Gap, NDIS, school funding, hospitals, and transport infrastructure
3. Federal government allocates total national sums for state grants pursuant to each of those national priorities, and the conditions to be attached to those grants, but does not determine state-by-state distributions of them
4. An independent commission, such as the Commonwealth Grants Commission, assesses the needs and fiscal capacities of each state to achieve parity of outcomes in those areas of defined national priorities. The categories of state needs are no longer assessed by empirical analysis of average state spending; they are instead based on the national priorities set by the federal government in its SPP grants. Anything that is left out of those national priorities – for example, public housing – is not taken into consideration in calculating the distribution of grants. However, there is nothing to stop a federal government defining an SPP grant for non-specific state services.
5. The SPP grants are distributed according to this modified HFE process, without any direct input from the federal government as to any state's share of an SPP grant.

This would have a number of advantages over the current system.

a) Governments of states with strong economic performance would be rewarded with more capacity to fund their own choices of election promises, enabling them potentially to stay in office longer

b) Governments of states receiving more money from the federation than they contribute to it, would be more tightly constrained to follow policies determined outside the state, regardless of whether those policies are politically expedient for those state governments.

c) Federal government would gain the ability to vary the degree of interstate redistribution. For example, it could choose to top up the GST pool, adding some money from income tax revenue to the GRA stream instead of the SPP stream.

d) Federal government would be strongly discouraged from continuing the common practice of making ad hoc deals with state governments, such as offering a state government extra money in exchange for endorsing a federal policy. Making such deals would still be legally possible but would become conspicuously abnormal, because it would require bypassing the apolitical distribution of SPP grants by an independent commission.

In conclusion, there is much about the HFE system, as well as the broad and coercive use of restricted grants, that probably weakens our federation both politically and economically. Nonetheless, combining them intelligently offers a way to mitigate their worst effects, and make a virtue of necessity.

Annex: further observations

Because Tasmanian households are poorer, on average, than other Australians, they pay less in personal income tax and receive more by way of pensions, benefits and other social security payments than households in any other State. Tasmania and South Australia are the only States whose households pay less in personal income tax, in aggregate, than they receive by way of social security payments – and Tasmanians do so by a considerably greater margin, on average, than South Australians. In 2015-16, this amounted to a net transfer of almost $3 billion to Tasmanian households from the Commonwealth Government – more than the Tasmanian Government received from its share of GST revenues.

Saul Eslake, John West Memorial Lecture, University of Tasmania, 16/3/2017, retrieved from http://blogs.utas.edu.au/isc/2017/04/28/saul-eslake-john-west-lecture-launceston-16-march/

[E]qualization policy in Canada appears to be inefficient and somewhat inequitable. Fiscal benefits are tilted toward less productive and less amenable provinces and seem to disadvantage minority households. Equalization policy would be more efficient if it redistributed source-based revenues more intensely and refunded interregional federal-tax disparities ... While it may be that Canadians wish to pay households to live in certain provinces for reasons not considered here, it could be that equalization policy has more of a political basis than an economic one.

David Albouy, "Evaluating the efficiency and equity of federal fiscal equalization", Journal of Public Economics 96 (2012), 824-839, retrieved from http://davidalbouy.net/equalization.pdf