

Productivity Commission Inquiry – Christopher Egan – small business owner, previously worked with NSW, VIC, WA, British and Australian Governments.

How does the current HFE system impact the Australian community, economy and state and federal governments

Is the current HFE system getting in the way of States pursuing higher economic growth and productivity, and at the expense of higher national prosperity? If so, how?

Horizontal Fiscal Equalisation is a process designed based on the egalitarian principles of Australian society. In the United States, a free market process is more engrained within the culture. In a blog I wrote, it looked at how these shaped welfare and service provisions in North Dakota and Western Australia – see attached blog <https://cegan.wordpress.com/2012/07/07/getting-beyond-the-simplistic-message-that-aussies-wont-travel-west/>

The reason Australia has Horizontal Fiscal Equalisation is because of a perceived egalitarian principle of – fair go. In the United States of America it is foreign to believe that a Goods and Services tax or royalties from resources in one state going through significant economic expansion should be spent in Mississippi.

HFE is an economic choice to redistribute income based on the principles of egalitarianism within Australian society.

Impacts on service provision and costs involved during periods of significant economic boom in North Dakota were also transferred to the private sector.

See attached blog on taxing credits in North Dakota for Oil companies who built affordable housing in 2012.

<https://cegan.wordpress.com/2012/06/22/north-dakota-leading-the-way-in-affordable-housing-policy/>

If HFE is not reformed to look at the complexities of economic situations it becomes less credible and additional taxes will be delivered on private companies. The view it is the government's requirement to deliver affordable housing when a resource industry over-stimulates an economy is not the principle which defined the North Dakota Housing policy in 2012.

In conclusion to this initial question is that the HFE system does not reflect the diversity of experiences that an economy goes through. It doesn't reflect the economic inputs that Western Australia had no market control over or ability to prepare for. The GST was created to reduce state taxes but this hampers the overall strength of preparing a state's economic future based on local context that North Dakota was able to develop during their equivalent oil and gas boom.

The provision of housing for a state like Western Australia was thus placed on government revenue rather than seeing that resource companies had a responsibility of housing new migrants and to encourage them via local tax incentives for affordable housing. There was still significant inflation in North Dakota, but the policy delivered a better result for both government revenues and the local community compared to the current restrictions placed by the agreements struck to deliver the GST.

If Western Australia was able retain more of its GST funding, increased productivity would have occurred as rail projects which would have aimed at reducing congestion would not have been cancelled due to political view that deficit funding should not be spent on infrastructure development. That it should be based on revenue and that in times of lower

revenue that the state government should balance the books. These books would be close to balanced right now if GST was done on a more equilibrium mindset for Western Australia.

Based on all of the above there is a distinct credibility problem behind HFE in Western Australia as it does not reflect the realities of the complex economic development delivered in a social context that has not delivered the same pork-barrelling that more protectionist states such as Queensland, South Australia and Tasmania have been offered over the last ten years due to the needs to win votes in Federal Elections.

The current disrespect for the HFE model in Western Australia will increase anger between Western Australians and those in other parts of the country which is reflected in current dialogue between the WA Premier and other state premiers.

This will become a significant economic issue long term if the anger in Western Australia is ignored – eg look at the issues Scottish and UK businesses felt based on the independence referendum. Scottish companies particularly found the discussion burdensome for future spending.

What evidence is available on whether and how the current HFE system affects the movement of labour and capital across State borders, particularly if a region is experiencing high labour demand?

The Horizontal Fiscal Equalisation program was designed to reduce state taxes with one Goods and Services tax under the Howard Government. An economic boom that Western Australia faced was not predicted when the system was designed and does not provide the structural support to initiate a tax on Mining/LNG companies to be part of the solution of housing development via tax concessions that occurred in the resource state of North Dakota in 2012.

See previous blog on North Dakota tax rebates from the previous question.

Does the current HFE system create perverse incentives or unintended consequences for reform at the State level? What evidence is there on how these incentives affect State policies and ultimately outcomes for the Australian community?

- – **Does the HFE system impede State tax reform over time, including States' decisions on developing their revenue bases and rates? If so, how and to what extent?**
 - The HFE system is often used by states such as South Australia and Tasmania to deliver on political decisions that are based around not going into deficit. An economy like Western Australia which had a need for infrastructure development to happen concurrently is disadvantaged by the more conservative approaches from protectionist states who choose to balance the books rather than to grow the GST collections from their individual populations.
- – **Does the HFE system impede the efficiency of State service delivery, infrastructure investment and policies affecting where people live? If so, how and to what extent?**

As mentioned previously the GST does not provide for the right tax policy when an economy goes through an expansionary period such as WA. A more intensive and localised tax system to encourage investment in social services by businesses which require services and affordable housing during the rapid scale up processes of iron ore and LNG development is currently hindered by the philosophy of the GST being a tax to get rid of individual state taxes and the promotion of harmonious systems. This adversely impacts proper economic processes and user pay systems developing in regions such as the Bowen Basin and Pilbara during the previous decade.

- **Is policy neutrality adequately addressed under the average state policy approach? Why or why not?**

Policy neutrality is not common as the GST has developed a system of fiefdoms which states wish to protect their own local systems to continue to gain power. Local populations want extra services so believe it is their right to get as much money as possible to deliver the infrastructure their populations to develop. I do not believe policy neutrality enters into any conversations when it comes to the GST, rather an approach to either keep their allocation or to fight for more. They use facts and statistics to back their case up for the varied perspectives that each states local environment encounters.

- **Does the current HFE system influence State policies to facilitate, restrict or tax the development of**

economic activity, and in particular energy and mineral resources?

As mentioned above the HFE system does not allow state governments to introduce tax incentives for affordable housing for workers to support the development of large scale mining and oil and gas projects. HFE is based on the decisions of equilibrium which is at the disadvantage of residents who are displaced as inflationary pressures squeeze out residents not employed in the sector with the revenue being placed into other states and residents from this activity. Resource companies tax incentives are based on a state basis rather than more localised aspects such as Affordable Housing which the Government is expected to address.

What evidence is there for the HFE system affecting State policy choices relating to resource extraction (including regulatory restrictions on development)?

In South Australia the infrastructure between Adelaide and Moona has been a dirt track for a major Gas hub for many year. This restricts private investment which does not happen by the service provision that Western Australia has developed all over the state to encourage foreign investment in the resource sector. HFE has enabled South Australia to gain increased revenue without a KPI requirement to increase their infrastructure that would encourage more foreign investment into iron ore, LNG which was a hallmark of the Western Australian economic miracle since the 1960's. South Australia's HFE at a per capita basis above what they should get should be framed around how they can grow the GST pie such as better infrastructure to its resource regions rather than just allowing them to spend it how they like.

Government priorities have delivered increased revenue to Western Australia but it has become penalised and had its revenue shifted to states which are not prepared to develop equivalent infrastructure that makes developing mines a better commercial decision for private enterprise as has happened in WA.

How does the current CGC relativity process affect States' fiscal management from year to year and over time? How does this affect policy outcomes and economic activity in each State?

- – **Does the current process impact the ability and propensity for States to manage budgets through cycles, especially for those states relatively more reliant on large and volatile revenue streams?**

In Western Australia the development of infrastructure that was required to service a rapidly increasing population delivered significant inflationary prices to budgets for government infrastructure to service a rapid growth. As many economists note, a significant economic boom is not a process that is 'ideal' for a state. This protracted boom meant that service delivery from revenues was at increased costs than would have been the case if they were in more 'normal' economic environments. Penalising states during this process lacks a local context that delivery of services is much more expensive during an economic boom that reduces a states unemployment rate to 2.7% and teachers are poached from the private

industry which delivers pressures to government budgets to ensure they have enough teachers to teach children. These inflationary pressures on public service delivery through rapid economic growth are not considered in the present GST model. It simply looks at population growth, which doesn't tell the whole story of the pressures a state faces during an economic boom.

How does data reliability and the three-year averaging process affect fiscal management? Is there a better trade-off between GST relativity precision and timeliness?

- – **What is the ability (and track record to date) of States to project and anticipate their own GST relativities, including any impacts of major State initiatives?**

During an economic boom such as the one in Western Australia it is impossible to predict when a final investment decision is made by mining companies which will result in either increased royalties entering the state treasury or a vast reduction. It also has to ensure it meets immediate needs of schools, having enough teachers and police, rampant skill shortages which meant sky-rocketing inflationary pressures and fiscal equalisation result in an inability to save for that rainy day. When states such as Queensland went through similar rapid economic expansion, political decisions delivered one off large infrastructure expenditure for these regions. This did not happen at any time during the WA economic expansion, it still has not received any money for the Perth Stadium, unlike the huge funds that were delivered into the Adelaide Oval precinct based on the need to increase economic revenue. The cross-over of individual funding decisions from commonwealth to state governments needs to be taken into account by GST relativities.

On a Western Australian element, poker machines being banned in the state should be seen in a productivity and economic cost model to attach to the GST process. Money being spent in poker machines is a negative externality that is not measured on the east coast. What 'incentive' or 'reward' for Western Australia for that negative externality for the productivity of an economy can be placed inside the GST model.

- – **What resources do individual States expend dealing with HFE matters?**

For the Western Australian government it is the biggest issue, it prevents dealing with other social issues and increases a sense of isolation between Western Australia and Australia. There is a case of 'we have to do everything and rely on nobody but ourselves'.

What preferable alternatives are there to the current HFE system of equalising State fiscal capacities?

What should be the objective of HFE?

- – **Should HFE address fiscal divergences across States due to both structural factors (beyond State influence) and cyclical factors (beyond State influence)? If so, over what time period should this be achieved?**

Greater context behind individual economies and more localised HFE to particular regions of Australia should be implemented if HFE is seen into the future. GST money should be targeted at particular regions of high unemployment or infrastructure deficiencies that severely impact the local economy. This would reflect on a yearly basis changes in economic performances within states and particular regions. Areas such as Mandurah, Northern Adelaide, Townsville would be preferenced and have principal based objectives to meet a target to reduce unemployment rates from +10% to 5% as they adjust. This would then lower costs from people moving from these regions to over-

heated economies in Sydney and Melbourne which do not have the housing to accommodate 'economic' migrants.

- – **Should HFE compensate States for fiscal divergences where a State has by choice diverged from efficient tax arrangements and service delivery?**

HFE should be responsive and guided by localised impacts of an environment. Efficient tax arrangements for affordable housing in Burnie Tasmania in 2012 would not be efficient for Port Hedland as its economy went through an historic economic event that was prompted by the Global Financial Crisis and China's unexpected massive stimulus package. An efficient tax arrangement in hindsight would have looked to utilise corporate tax incentives for resource companies to apply its benefits at a more localised level than just national or state treasuries. It would have encouraged the development of more affordable housing, a role which was spent by the WA Government through the Royalties for Regions. It has to be said the policy objective of delivering affordable housing in the Pilbara to ensure the LNG and Mining industry had the shop assistants, hairdressers to service the sector has been a success, but at considerable revenue loss. Thus service deliver and tax arrangements need to respond to localised circumstances, especially during historic events that occurred in Western Australia over the last decade.

- – **Should past State policy decisions (such as on economic development, revenue bases and rates, or budget provisioning) influence the form or degree of fiscal equalisation? If so, how?**

Principles behind fiscal equalisation should respond to the issues that occur in a society. If there are infrastructure reasons why one state has attracted more fiscal capital than another, HFE should have a role in directing where money taken from one state to another should be spent. It should also look at the costs of providing services in an economy that is not providing enough skilled workers because it has over-heated from a policy decision in a foreign nation. Solutions to problems and efficient reform should be put into context at a local level. Are current resource concessions responding to the needs of the population living in the areas directly impacted.

HFE should be based on a yearly level targeting localised regions with unemployment rates above 10%, infrastructure bottlenecks because of inferior infrastructure which delivers negative externalities to commercial interest in one state over another and the requirement to understand what happens in an economy during a period of over-heating.

That service provision is far more expensive which creates long term higher service costs than would have occurred without the boom. Eg Teachers and Police wages in Western Australia are at a far higher level than would have occurred if the competition was not so fierce for workers during the mining boom which involved the 'auctioning' off at airports according to some media reports.

- – **What are the advantages and disadvantages of targeting full versus partial fiscal equalisation across States?**

See above, Fiscal equalisation should have a KPI objective to improve efficiencies, should direct funding to localised regions rather than states and have a principled based objective of ensuring that region is supported to move their unemployment rate to 5%, this is reviewed annually to ensure funding provisions adequately reflect where money is most needed.

- – **To what extent should States be held accountable for how they use funds received via equalisation?**

The model I have suggested ensures accountability is based on principles of delivering fiscal equalisation that supports jobs in areas which have dramatic increases in

unemployment to socially unacceptable levels of 10% and utilises a federal perspective of implementing funding that would encourage capital investment to the same scale as other states. If a particular state is not funding infrastructure to encourage private investment in a sector that has delivered positive results in another state, this should be taken into account and directives of any HFE payments above a base rate should be on condition they implement the particular reform that has generated jobs and economic growth in another state. Ensuring the benefits of federalism are utilised and spread across the country in an efficient and fact based system. One off payments and commonwealth funding outside of the GST during election campaigns and 'localised' biases such as the Redcliffe extension and Adelaide Oval redevelopment should be incorporated into HFE allocations.

What are some alternatives to the current system and how would they affect States' incentives to pursue higher prosperity? How would the alternatives perform, relative to the current system, in terms of efficiency, equity and simplicity, and ultimately which approach is best for national productivity and wellbeing?

As my commentary above suggests the HFE system should be directed to localised regions and taxes reformed which take into account situations of heightened economic growth and heightened economic recessions. At present the GST model is built in a world very different to today and which did not predict that Western Australia would go through the economic expansion that undertook. HFE is a particular Australian phenomenon and the Oil state of North Dakota utilised different taxes and policy situations to deal with an overheated economy in 2012.

How do these alternative approaches fit within the wider scheme of federal financial relations? Are some inequalities across States better dealt with outside the HFE system?

No, the delivery of one off funding such as the Redcliffe Train extension which delved into state responsibilities but had the backing of a Queensland Prime Minister distorts the funds delivered to particular states because these funds are not incorporated into equalisation funding arrangements. It penalises states such as Western Australia which had to fund the Butler and Thornlie rail extensions on state funds based on state responsibilities. This has skewed the relevance and reflectivities that the Commonwealth Grants Commission looks into. It ensures Western Australia holds the outcomes that are delivered with contempt. Negative externalities for an economy such as gambling are also not rewarded when making assessments.

What practices in other federations offer pertinent evidence for the Commission's considerations?

As mentioned above the state based tax system of North Dakota provided better service delivery and incentivised the private industry disrupting the economy and over-heating it to deliver some of the services rather than it being the outcome of a state to ensure that delivery of affordable housing occurred. This would ensure concessions given to deliver infrastructure development in resource regions are returned to the regions and populations who may receive negative externalities to this development eg increased rent and cost of living. These populations as North Dakota noted are vital for the industries that over-stimulate the economy and the tax system needs to reflect this in CSG outcomes.

I would suggest looking at other federations but also looking at a new approach with an Australian perspective to outline incentive GST payments for states that look to increase infrastructure to attract private investment, ensuring one off payments that are done by governments are taken into account, negative externalities that a state doesn't implant on an economy are rewarded and the system looks to solve problems of high unemployment on an annual basis with a principals based outlook to redistribute the money there to reduce unemployment to 5%. This would ensure that the negatives of an over-heated and recessed economy are taken into account by CSG.