

# **Productivity Commission Inquiry into Australia's system of Horizontal Fiscal Equalisation**

Submission from the Government of South Australia on the Draft Report

November 2017

## Executive Summary

The Productivity Commission's (PC's) Draft Report into Australia's system of horizontal fiscal equalisation (HFE) fails to meet the standards expected of its Inquiry reports in two crucial and fundamental ways:

- it makes recommendations to fundamentally alter the objective of HFE without any supporting evidence; and
- the recommendations are inconsistent with the objective of achieving higher living standards for all members of the Australian community (as per s 8 (1) (a) of the *Productivity Commission Act 1988*).

In essence, the PC's recommendations support a fundamental change to the objective of Australia's system of federal financial relations. This would involve an acceptance (by all Australians) that residents of some states and territories (states) should have access to significantly higher quality essential services such as hospitals, schools and policing than residents of other states effectively because they live in a state which has greater mineral wealth than all other states. This finding is at odds with the PC's own analysis which says that sharing mineral wealth across the Federation is both fair and efficient, and despite the fact that this would reduce the welfare of all Australians by promoting inefficient migration of people and businesses.

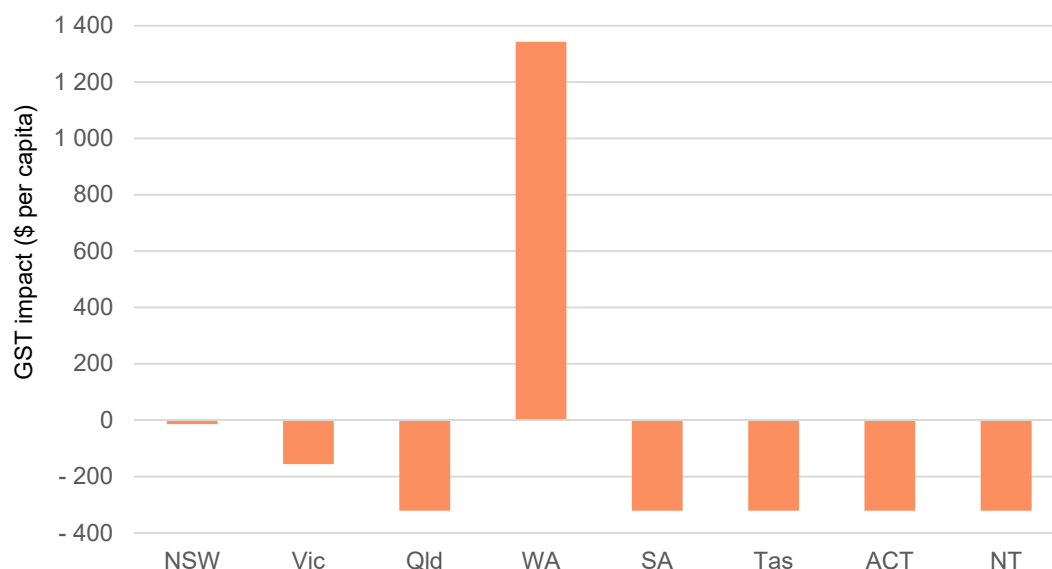
The PC's recommendations fail all of the basic tests of good policy:

- Equity - they clearly lead to less equitable outcomes across Australia based on which state a person lives in.
- Efficiency - the PC has provided no substantive evidence that HFE leads to inefficient economic decisions by state governments and ignores the evidence that less than full equalisation would reduce national economic welfare by promoting inefficient migration.
- Complexity - despite arguing that the present system is complex, the PC favours alternatives which are significantly more complex, arbitrary and undermining of the independence of the Commonwealth Grants Commission (CGC).
- Sustainability - the PC's recommendations would be unsustainable from an economic and fiscal perspective over time, through the creation of tax haven effects promoting a race to the bottom in state taxation, and through claims for special financial assistance from states which do not have the fiscal capacity to provide their residents with a satisfactory (nationally comparable) level of essential services.

The PC uses the term "GST outlier" in reference to Western Australia in an emotive attempt to suggest some type of statistical error or issue in the CGC's methodology. This is completely misleading and spurious. The story is simple. Western Australia collects over five times its population share of Australia's mining revenue so to ensure that fairness/equity is achieved, it then receives less GST revenue. Using the "outlier" language, Western Australia is a massive "outlier" on mining revenue and the GST distribution process necessarily offsets that. That is what is meant to happen.

One of the PC's suggested HFE approaches, the so-called equalisation to the "average" (not really the average as discussed later) produces the following 2017-18 estimated per capita outcome that favours Western Australia at the expense of all other states.

**Chart 1: Impact of the PC's "equalisation to the average" proposal, 2017-18**



Source: Productivity Commission, 2017, Horizontal Fiscal Equalisation, Draft Report, page 227, Table C.2

The Draft Report finds that HFE is widely supported and Australia's system of HFE is the most comprehensive of other comparable countries. South Australia believes that this is an achievement and a strength of the Australian Federation that should be celebrated and retained.

South Australia does not believe that the Draft Report has advanced the debate or considered any new aspects of Australia's system of HFE that were not identified or considered by the GST Distribution Review completed in 2012 by Nick Greiner, John Brumby and Bruce Carter (the Greiner Review).

The Draft Report makes a number of assertions that the current system is under significant strain, undeliverable and corroding confidence. No evidence is provided to support such claims, other than references to the statements of stakeholders with a vested interest.

A move away from full equalisation to a "reasonable standard" of equalisation is by definition less equitable than the status quo and practically unworkable. There is simply no logic in noting our system of full equalisation achieves its objective and then arbitrarily deciding we should not do the task properly and accept "good enough" outcomes. Australians deserve better than "good enough".

The "reasonable standard" aim would require the degree of "acceptable inequality" to be subject to some form of complex and protracted process that would ultimately be politically determined at the discretion of the prevailing Commonwealth Government. The independent role of the CGC would be severely compromised.

There is also a question of how sustainable a move to a "reasonable" standard would be in the longer term. Adoption of a "reasonable" standard means that fiscal capacities are not

equalised and this would result in the fiscally strongest state, currently Western Australia, having the capacity to adopt revenue and expenditure policies that could be markedly different from other states. Western Australia may have the capacity to cut business taxes like payroll tax leading to a relocation of head offices or other businesses and migration of people which would lead to inefficient resource allocation and reduce national welfare.

South Australia believes that the current full equalisation objective allows the CGC to undertake assessments without the need for subjective value judgements about what states should do or what level of “acceptable inequality” should prevail. Any other equalisation benchmark will ultimately be politically determined.

South Australia also believes that the terminology used in the Draft Report is confusing and implies that the current system of HFE is doing more than what it is actually seeking to do. In particular, through the use of terms such as “equalisation to the average” and equalisation to the “second fiscally strongest state”. Any approach that does not have full equalisation as its objective should be referred to as a partial equalisation approach.

With regards to so-called incentive effects of HFE, the PC has not been able to find any evidence that HFE is inhibiting states from pursuing productivity and growth strategies. Nonetheless, it states that “an absence of evidence is not evidence of absence”.

The PC does suggest tax reform disincentives may exist in theory but the main cameo prepared by the PC and used to support this is extreme and unrealistic. A partial switch from stamp duty to a broader based land tax could not realistically be implemented in a single year with perfectly off-setting revenue flows. It would be more appropriate for the PC to examine some real tax reform initiatives like the ACT Government’s property tax reforms and South Australia’s business tax reform package.

South Australia continues to hold the view that HFE is not about providing incentives for economic reform or tax reform; it is about equity and this should remain its sole focus.

The Draft Report does contain some positive findings including rejection of arbitrary GST distribution methods including an equal per capita distribution (and variations to this), relativity floors and discounts on mining revenue. The PC has seen these approaches for what they are – completely devoid of rationale, inequitable and harmful to the Australian Federation. The same conclusion should apply to the “reasonable” equalisation approach proposed by the PC. In effect, these proposals (like equalisation to the second strongest state) deliver an arbitrary floating relativity floor or discount to mining revenue given that mining revenue is the largest source of state based fiscal advantage.

The PC has also made a number of references to the complexity of the current HFE system. However, many aspects of public policy are inevitably complex. Fringe Benefits Tax arrangements, the social security system and the immigration system could be viewed as Commonwealth policies that have complex policy settings and complex assessment processes. It is unlikely that the PC would recommend that the Commonwealth Government sacrifice optimal policy outcomes in these areas purely in the interests of reducing complexity.

The PC and others often advance the concept of simplicity as a reason for reform. There is no logic to this for two reasons:

- Simplicity alone is no reason to reduce equity and fairness between citizens.

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- No proposal (including the PC's draft recommendations) addresses simplicity. The inherent nature of this work involves some complexity. It will simply not be understood by the general public, and it does not need to be. The best thing for the community is an independent body delivering the best possible fairness and equity to all Australians.

To summarise, the PC says that the current equalisation objective goes too far and that determining the degree of equalisation is ultimately a matter for political resolution. But the degree of equalisation now is directly the result of decisions by government. To say that equalisation is extreme is to disregard the actual decisions of governments. Do the PC now propose that the Commonwealth add a funding loading to Western Australian schools in its Gonski model? Or cut income taxes in Western Australia?

## Scope and definition of HFE – unfair equity

The Draft Report provides no strong rationale to support an alternative equalisation objective, apart from the fact that Western Australia is currently getting a relatively low share of GST revenue. However, the PC has proposed the following objective:

*The primary objective of the HFE system should be to provide the States with the fiscal capacity to allow them to supply services and the associated infrastructure of a reasonable standard.*

*This objective should be pursued to the greatest possible extent, provided that:*

- *It does not unduly influence the State's own policies and choices beyond providing them with fiscal capacity*
- *It does not unduly hinder efficient movement of capital and people between States.*
- *The process for determining the distribution of funds is transparent and based on reliable evidence.*

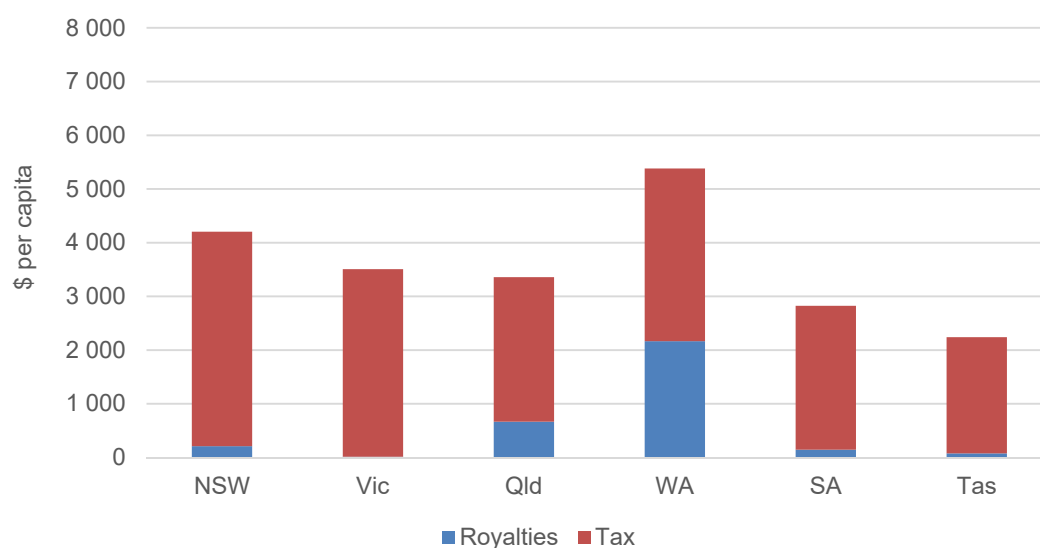
Further, it is suggested that the Commonwealth Government should take on a greater leadership role in specifying the objective in yearly CGC updates and five-yearly methodology reviews. It is also suggested that this process could be undertaken through a collaborative process with the states to “create an environment of mutual accountability”.

However, the definition proposed in the Draft Report is inequitable, unworkable and opens up the GST distribution process to political interference.

South Australia does not support any move away from the full equalisation objective embodied in the CGC's current definition of HFE. A move away from a full equalisation objective would automatically mean that there is acceptance by the Commonwealth Government and broader community that certain states would be in a position to provide a higher level of services or reduce state taxation to a greater extent than other states.

The following charts demonstrate the unequal ability for states to generate revenue and how HFE addresses this imbalance through the current GST distribution. The first chart highlights Western Australia's ability to generate own source revenue especially from mining activity.

**Chart 2: Per capita royalty and tax revenue, 2017-18**



Source: Jurisdictions' 2017-18 Budget papers and 2017-18 Commonwealth Budget Papers

The following chart shows that with a full system of equalisation, after GST revenue is included, all states have access to relatively similar levels of per capita revenues.

**Chart 3: Per capita revenue including GST, 2017-18**



Source: Jurisdictions 2017-18 Budget papers and 2017-18 Commonwealth Budget Papers

The unequal distribution of mineral resources is the major factor currently influencing the strongest state's pre-equalisation fiscal capacity. In the Australian context, the only reason a state will have a major revenue differential in relative fiscal strength is because of mining revenue and where borders happen to be drawn, particularly if the state population is relatively small. The arbitrary allocation of mineral resources is the most important factor that the HFE system must recognise and reflect in the redistribution process.

This position is supported on page 19 of the Draft Report:

*Mining revenue is a prime example of a source-based advantage – one a state benefits from by virtue of where its borders happen to be drawn – and should prima facie be included in the equalisation process.*

Notwithstanding this finding, the PC, in a fundamental inconsistency, favours equalisation approaches which would significantly reduce the redistribution of mining revenues (i.e. equalisation to the so-called “average” or the “second strongest state”). Such approaches have the practical effect of removing or limiting the impact of mining revenue from the assessment system as they significantly reduce or remove the impact of the fiscally strongest state, Western Australia, which derives its fiscal strength from mining revenue.

### **The use of confusing terminology in the Draft Report**

The Draft Report uses misleading and emotive terminology when it refers the current system as being equalisation to the fiscally strongest state and then proposes equalisation to an “average” as being more reasonable. There is no reference to the use of the strongest state, or any other state, as the equalisation benchmark in the HFE definition currently used by the CGC. In some CGC reports and updates, the terminology “equalisation to fiscally strongest state” has been used merely as an alternative way to quantify and view the equalisation task. In contrast, the PC has used this terminology as a (deliberately) misleading description of the objective of HFE.

In the Draft Report, the PC suggests that one of the deficiencies of the HFE system in its current form is that:

*Equalisation is taken too far: equalising comprehensively and to the fiscally strongest state means that where there is an outlier, the redistribution task is considerable and the standard being equalised to is potentially volatile.<sup>1</sup>*

The aim of the current GST distribution system is to equalise to the average fiscal capacity of the states inclusive of Commonwealth grants; not to the fiscally strongest state. This is clearly reflected in the definition of HFE as articulated by the CGC:

*State governments should receive funding from the pool of goods and services tax such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.<sup>2</sup>*

The PC’s equalisation to the “average” involves equalising the “fiscally weaker states” up to the pre-equalisation average of all states and then allocating the remainder of the GST pool on an equal per capita basis. The stronger states retain any fiscal strength above the average. This results in the “fiscally stronger states” receiving a greater proportion of the GST pool and does not result in the equalisation of fiscal capacities. The “fiscally stronger states” will get

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<sup>1</sup> Productivity Commission, Inquiry into Australia’s System of Horizontal Fiscal Equalisation Draft Report, p.16

<sup>2</sup> Commonwealth Grants Commission, *Report on GST revenue sharing relativities – 2015 Review* Final Report, p.2  
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relatively stronger over time and the “fiscally weaker states” will get relatively weaker. The CGC has previously (and more appropriately) described this approach as a “partial equal per capita” distribution.

The clear objective of HFE as defined above is to give states the same (or average) fiscal capacity to provide services to their citizens. There is no reference to the use of the strongest state, or any other state, as the equalisation benchmark.

### **“Reasonable” equalisation**

Reasonable equalisation means a departure from full equalisation to some undefined and vague objective. As full equalisation is the most equitable objective for HFE, South Australia does not believe that the proposed definition “puts equity at the heart of HFE”. The PC aims to confuse horizontal equity and ‘safety net concepts of vertical equity’. Horizontal equity must remain the principal objective of HFE.

The PC must make it clear that a move to reasonable level of equalisation is a move to partial equalisation and acceptance that residents of some states will receive a lower standard of services or be subject to higher tax rates than residents in equivalent circumstances that reside in other states.

The 2012 Greiner Review considered equalisation to a “comparable” or “materially-the-same” standard and chose not to provide a firm view on this issue. That review did, however, contain the following statement:

*We understand that a change to ‘comparable’ is being urged by the large States as a step in the direction of an EPC distribution and that outcome is strongly opposed by the small States. Given our analysis earlier in this Chapter, it should be clear that we do not support changes in this direction on that basis.<sup>3</sup>*

South Australia agrees with the notion that any move away from the current “full” equalisation approach represents a first stage in the dismantling of HFE and an ultimate move towards an equal per capita distribution.

The Greiner Review examined variations of partial equalisation along the lines of the PC recommendations. It rejected them. It noted that they would potentially undermine confidence across the Federation.

HFE approaches that aim to deliver less than the “same” level of services would require the establishment of subjective processes to determine what acceptable level of services would be and implicitly, what is “acceptable inequality”. The CGC has examined this issue on several occasions.

It is suggested that achieving a “reasonable” level of equalisation could be achieved by adopting an equalisation framework, that using the PC’s preferred terminology, is equalisation to the “average” or “equalisation to the second fiscally strongest state”. As we have already mentioned these partial equalisation approaches should be more transparently described.

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<sup>3</sup> GST Distribution Review 2012, Final Report, Page 61.  
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The PC's equalisation to the "average" was described by the CGC as their partial EPC equalisation approach in their *Achieving HFE – other approaches to distributing the GST* staff discussion paper released in May 2017. Under this approach the GST pool is used to finance the additional amounts fiscally weaker States are assessed to require. The balance of the pool is distributed on an equal per capita basis. Under this approach the current recipient states (with relativities above 1.0) would have received over \$22 billion less in GST revenue grants from 2000-01 to 2017-18.<sup>4</sup> The CGC concluded that:

*The implication of this distribution is that fiscally weaker States would be under-equalised. At least one fiscally stronger State would be over-equalised, but it is possible for some fiscally stronger States (depending on their fiscal capacities) to be under-equalised.*<sup>5</sup>

It is clear that this approach, and the conceptually similar approach of equalising to the second strongest state, would not be equitable and would not even deliver a remotely reasonable equalisation outcome. Equalisation to the second strongest state or another ranked state is also akin to having a floating relativity floor, an approach rejected by the PC.

South Australia believes that historical practices in the "claimant era" of HFE also highlight the extreme nature of moving to an equalisation benchmark that does not fully reflect the fiscally strongest state and the second fiscally strongest state. For most of the claimancy era, the equalisation standard was based on either the average of the two fiscally strongest states or the average of all "non-claimant" states. Under either approach the fiscally stronger states were always a part of the determination of the level of equalisation payments.

As adopting some form of proxy approach is unlikely to be able to deliver reasonable equalisation, other "mutually agreed" but undefined approaches to determine reasonable would have to be developed.

It is suggested by the PC that the Council for Federal Financial Relations (CFFR) or possibly some other inter-jurisdictional body could take a role in developing a "reasonable" framework that could develop over time.

In reality, any interjurisdictional fora would not be able to reach consensus on what constitutes a reasonable level of equalisation. By default, there would have to be agreement on what constitutes an acceptable level of horizontal equity. Taken to the next level, there may have to be agreement as to what specific services (e.g. health and schools) could be provided to a lower standard and for how long would that be acceptable. No state with a lower than average fiscal capacity could realistically agree to an equalisation objective that delivers a lower level of services or poorer quality services and in the longer-term, for example, lower health and educational outcomes for their citizens. Ultimately, the definition of reasonable would have to be determined by the Commonwealth Government. This immediately opens the HFE system up to political interference. Interference that is inconsistent with the implicit equalisation that is practised by all governments in their own spheres.

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<sup>4</sup> 2020 Review, *Achieving HFE – other approaches to distributing the GST*, Commonwealth Grants Commission, May 2017, page 8.

<sup>5</sup> 2020 Review, *Achieving HFE – other approaches to distributing the GST*, Commonwealth Grants Commission, May 2017, page 6.

In the current climate, it is widely acknowledged that the Commonwealth Government is facing a political challenge in Western Australia. If the Commonwealth Government determined what is reasonable, it could easily devise a “reasonable” approach that delivered extra GST revenue to Western Australia in an attempt to address falling electoral support.

The independent role of the CGC would be lost as all it would be tasked with doing is implementing a distribution approach that may or may not be truly equitable.

For this reason, South Australia believes that continuation of the full equalisation objective allows the CGC to retain its independent role and lessens the chance of opportunistic political interference in the HFE system.

### **Supporting pillars of the PC’s proposed definition**

The PC’s proposed HFE objective states that equalisation should be pursued to the greatest possible extent subject to three conditions.

South Australia does not have any issues with the following two conditions as they are consistent with the CGC’s current supporting principles:

*It does not unduly influence the State’s own policies and choices beyond providing them with fiscal capacity.*

*The process for determining the distribution of funds is transparent and based on reliable evidence*

The other condition proposed by the PC is that:

*It does not unduly hinder efficient movement of capital and people between States.*

As discussed in our initial submission, the efficiency impacts of the current system of HFE were the subject of a detailed review undertaken by Independent Economics (IE) (commissioned by the South Australian Government) for consideration in the Greiner Review. The report prepared by IE (principal author, Chris Murphy) found that there would be a significant loss in overall national economic productivity if there was a departure from full HFE.

Although HFE has equity as a core objective, it also promotes economic efficiency by enabling businesses and people to locate where their productivity is maximised rather than on the basis of where services are greatest and taxation is lowest due to the arbitrary nature of the location of resource endowments or demographic profiles.

The IE modelling provides evidence in support of the current full equalisation. The PC asked for evidence based submissions and then ignored it in favour of a general sense that it wanted to change the model.

### **Other issues with the “reasonable” approach**

South Australia makes two other observations about the “reasonable” objective:

The Draft Report proposes that what constitutes reasonable equalisation could vary between years and evolve over time. This immediately raises the issue of predictability and volatility in the projection of GST revenue grants. A fixed HFE objective, like equalisation to the same

level of services, does not eliminate volatility as there will always be population, pool size and data update issues. However, if the objective of HFE itself is a moving target then the volatility and predictability of GST revenues will deteriorate further. This is not a desirable outcome.

Adoption of a reasonable standard will also increase complexity. There would still be a need to undertake category-by-category assessments and compare outcomes to a full equalisation objective.

### **Comparison to a system of unitary government**

HFE should seek to provide the residents of each state with the same level of services they would have under a unitary system of government. The Draft Report (page 54) has incorrectly discounted this fundamental perspective and has taken the view that:

*Taking the concept of HFE as replicating a unitary government, it is unlikely that any unitary government would raise and lower the level of services it provided based on revenue fluctuations in only one part of the country. Instead, it would likely provide a level of services to all residents that remained relatively consistent from one year to the next, and which may likely be closer to the average across the nation. Yet equalising to Western Australia has meant equalising to a benchmark that is relatively volatile.*

If Australia had a unitary system of government and had a specific region that was generating higher than average mineral resource revenues it would either be used to increase services to all Australians, decrease other taxes for all Australians or placed in some form of sovereign wealth fund for the future welfare of all Australians. It is unlikely that the additional revenue generated would be used just to benefit those people living in close proximity to where the minerals were extracted.

The current system of equalisation is based on what governments do and is therefore most likely to reflect the decisions of a unitary government. The CGC measures the material factors that affect each state's spending needs and taxing capacity, and uses this to determine the appropriate distribution of grants. South Australia notes that the CGC has not found that governments' decisions are materially affected by the fiscal capacity of an area. If that were the case, there would be a commensurate impact on the equalisation between states under the current system.

### **Current system - economic inefficiency**

The majority of states have indicated in their initial submissions to this Inquiry that there is no concrete evidence of HFE influencing state policy decisions in practice. This is consistent with the findings of the Greiner Review.<sup>6</sup>

The PC itself has found that there is no direct evidence that GST effects have played into specific policy decisions in the past. Despite this, the PC insists that "an absence of evidence is not evidence of absence"<sup>7</sup> and suggests that HFE could present disincentive effects with regard to large-scale tax reform. The PC's recommendations appear to be driven by these

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<sup>6</sup> GST Distribution Review Final Report, p.135

<sup>7</sup> Productivity Commission, *Inquiry into Australia's System of Horizontal Fiscal Equalisation Draft Report*, p.100  
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potential effects, rather than evidence. There is an obvious conflict between this approach and the PC's requirement that submissions to this Inquiry should be "evidence heavy".

With this "evidence heavy" requirement in mind, the PC, in the Guidance Note accompanying its request for initial submissions, asked:

*"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?"*  
(Question 1a); and

*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?"*  
(Question 1d)."

It is clear from the majority of state submissions that HFE does not discourage them from pursuing economic growth and productivity gains, and that it has no material influence on state policy. In fact, there is evidence to show that states have pursued economic growth and productivity despite the related HFE impacts. South Australia, Victoria, Tasmania, the ACT and the Northern Territory all presented evidence in this regard.

South Australia maintains that there is no "absence of evidence" that states have undertaken policy decisions that would otherwise not make sense if HFE implications were the only (or main) consideration. Examples provided by South Australia and other states in their initial submissions include the fact that despite HFE:

- Western Australia progressively increased its royalty rate for iron ore fines between 2010-11 and 2013-14;
- the Northern Territory actively pursued the INPEX Ichthys project, one of the largest infrastructure projects in the Territory's history; and
- South Australia has consistently pursued the expansion of its mining industry, which has resulted in the state's consistently high international ranking in terms of policy support for mining. Notably, South Australia is one of the few states with no ban on gas development.

While the related GST impacts may well have been considered by some states as part of the broader policy development process, there is no evidence that they drove the ultimate decisions. State policies are influenced by a wide range of considerations, including community support, social impacts and economic factors. For example, Western Australia's decision to increase its royalty rate for iron ore fines was part of a broader reform of iron ore royalties and was driven by factors including:

- a desire to align the iron ore fines royalty rate with that applied to lump iron ore and other 'crushed and screened' ores;
- the fact that iron ore fines accounted for the majority of the state's iron ore shipments; and

- recognition that iron ore fines were no longer considered an inferior product in the global market.<sup>8</sup>

The PC refers to Western Australia's argument in the Greiner Review, that the nature of HFE is such that Western Australia could actually increase its GST grant by \$2.8 billion per annum if it abolished iron ore royalties altogether and replaced them with a revenue-neutral increase in payroll tax. However, the fact that Western Australia has not actually acted on this theoretical incentive effect is telling. Instead, Western Australia raised its royalty rates for the reasons stated above.

In addition, if examples are not enough, the GST Distribution Review showed there was no discernible relationship between effort and average policy incentives.

Finally, the PC provides no assessment of how its recommendations would address these theoretical incentive effects. The scenarios illustrated in the appendices would not make any difference to these theoretical incentives except for the strongest states.

### **HFE and state tax reform**

The disconnect between theory and the real world is also evident in the cameos used by the PC in attempting to demonstrate how HFE could act as a disincentive for state tax reform. The cameos depict extreme circumstances and do not reflect what states would do (or consider doing) in practice. This is effectively acknowledged by the PC itself when it states:

*"...the cameos assume that a state can fully and seamlessly offset its revenue and/or balance its spending in the same year the reform is implemented. This analysis does not consider a transition path for reform, such as the gradual phasing in of the new policy, or any indirect effects that might occur as a consequence. This analysis also does not consider the complexity of the tax reform, costs of administration or compliance."*<sup>9</sup>

In other words, the cameos bear very little resemblance to the actual circumstances under which state governments operate and need to make policy. For example, the first cameo assumes a case where a state halves its stamp duty on property in a single year and replaces the foregone revenue with a new tax on residential land in the same year. This cameo contrasts with the real-world experience, where such a significant reform would most likely be phased in over a number of years due to a range of equity, practicality and administrative considerations. For example, a similar reform introduced by the ACT in 2012-13 is expected to be phased in over at least 20 years.<sup>10</sup>

The cameos also swap an equalised tax for a currently unequalised one and factor in large elasticity effects which governments are unlikely to have regard to in the financial modelling underpinning decision making.

While South Australia understands the PC's attraction to cameos as a means to illustrate the potential impacts of HFE on state policies, the use of unrealistic examples that yield distorted

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<sup>8</sup> Western Australian Government, 2011-12 Budget Paper No. 3, p.74

<sup>9</sup> Productivity Commission, *Inquiry into Australia's System of Horizontal Fiscal Equalisation Draft Report*, p.237

<sup>10</sup> ACT 2012-13 Budget, Budget Paper No. 3

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results does not assist the debate. Rather, there should be a focus on actual, observed state behaviour, which would be consistent with the “evidence heavy” approach requested by the PC.

It is also worth noting that the reforms considered in the cameos have broadly been discussed in the past, particularly the potential replacement of conveyance duty with a broad-based land tax (though certainly not in the context of implementing such a reform in a single year). The fact that these reforms have not been implemented can be attributed to a range of factors other than HFE.

For example, in 2016 the New South Wales Government rejected a proposal to replace stamp duty with a broad-based land tax on numerous grounds including:

- lack of community support;
- interactions with the federal tax system;
- equity and the need to ensure that reform results in the majority of citizens being better off; and
- potential financial impacts on homeowners.<sup>11</sup>

HFE was not cited as a reason for not adopting the proposed tax switch. Equally, if HFE was an incentive, states that would gain from this reform would have done it – they have not.

### **Equity vs efficiency**

South Australia has long contended that HFE does not have a negative impact on economic efficiency, and that HFE in fact promotes efficiency by enabling businesses and people to locate where their productivity is maximised, rather than on the basis of factors such as a higher standard of services or lower taxes.

South Australia is supportive of the pursuit of greater economic efficiency; however, HFE is simply not the appropriate vehicle for this purpose. The primary objective of HFE is horizontal equity.

## **Scope for reform, education and complexity**

### **The CGC - education role and governance**

In relation to Australia’s system of HFE, the PC stated in its Draft Report that:

*The system is beyond comprehension by the public, and poorly understood by most within government – lending itself to a myriad of myths and confused accountability.*

South Australia strongly supports the continued role of an independent and well-resourced CGC. However, it is agreed that the CGC could take a more vocal and proactive role in educating the community on HFE and correcting misunderstandings on how Australia’s

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<sup>11</sup> ABC News, *Replacing stamp duty with land tax could create 10,000 jobs in NSW: business and welfare advocates*, <http://www.abc.net.au/news/2016-04-05/nsw-treasurer-rejects-call-to-replace-stamp-duty-with-land-tax/7299564>



system of HFE operates. This view was supported by recommendations in the Greiner Review.

South Australia supports the view that the CGC, through its Chair and Commission members, should provide a strong, independent voice in national debates on HFE. There have been numerous uninformed or simply incorrect comments made about HFE by media commentators, industry bodies, members of parliament (State and Federal) and other members of public that usually go unchecked. State governments can respond to incorrect or misleading comments on HFE, but no state can provide a truly independent view.

The CGC could take an active role in correcting misstatements and incorrect assertions, without providing subjective comment or taking a side. The CGC could take on a “fact-checking” role.

South Australia believes that the CGC could take a greater role in educating both the public and decision makers (in particular, parliamentarians) on what HFE is and how it operates. Currently, the public’s knowledge of HFE is influenced by campaigns that focus on how many cents in the dollar a state gets back compared to its population share of GST collections. There is little information provided on what HFE really is, what it is attempting to achieve and why it is fair for states to get different GST allocations.

In response to an information vacuum, the South Australian Government launched its *Horizontal Fiscal Equalisation – Fair for all* website in 2015 in an attempt to educate the public and interested parties on the importance of HFE to Australia.

The PC has also confused consideration of HFE reform in its Draft Report. It is disappointing that the PC has used confusing terminology around equalising to the “average” and “the strongest state” in its Draft Report (as explained in the section “The use of confusing terminology in the Draft Report” above). The terminology used by the PC in its Draft Report has confused not only the public but also people who deal with HFE issues on a daily basis.

South Australia supports the CGC issuing “draft rulings” on the proposed treatment and likely impact of state policy changes, national reform processes and new Commonwealth payments. Such an approach would increase transparency of the system and in a more timely manner.

In their annual New Issues paper, the CGC could indicate how they propose to treat Commonwealth payments that have their first payment in the application year, not just the latest assessment year. New Issues papers have a section listing payments expected in the application year, but do not provide any guidance on their likely HFE treatment.

### **Simplification and complexity**

The PC made the following draft recommendation in its Draft Report (Draft Recommendation 7.1):

*The Commonwealth Government should direct the CGC, through terms of reference it receives, to consider approaches to assessment that deliver significant simplification and “good enough” equalisation outcomes. The use of more highly aggregated assessments should receive detailed consideration as part of the current CGC process.*



Implementation of this recommendation would automatically mean an acceptance of compromised equalisation outcomes. Such a recommendation would also be difficult to interpret, would require subjective judgement and would be difficult to implement in a transparent and equitable manner.

Aspects of the current CGC assessment system do have a level of complexity but given the national importance of the equity objective that the HFE system achieves, South Australia believes that the current assessment system is appropriate and not overly complex.

Many aspects of public policy are inevitably complex. The income tax assessment system, the social security system and the immigration system could be viewed as Commonwealth areas that have complex policy settings and complex assessment processes. It is unlikely that the Commonwealth Government would sacrifice its desired policy outcomes in these areas purely in the interests of reducing complexity and simplification, particularly where complexity is inherent and producing no real detriment in its own right.

In addition, the current system has a degree of complexity because it reflects what states do. The CGC makes an assessment of the material factors that explain each state's provision of services in different areas. As acknowledged by the PC, it has the most comprehensive system for doing so. Rather than simply relying on states to tell the CGC which factors they use in determining the distribution of government resources, the CGC determines the appropriate distribution of grants in accordance with what states actually do.

The PC's suggested approaches of equalising to the "average" or "the second fiscally strongest state" do not address any perceived concerns about complexity. Both approaches would still require the current equalisation system to determine what level of equalisation transfers would be required to equalise the states with a lower fiscal capacity to the "average" and to "the second fiscally strongest" state. A "reasonable" HFE objective by itself will not address complexity, rather, it will exacerbate it.

The primary objective is to achieve equalisation. A simplified version of HFE is at great risk of not achieving equal capacity. Less complexity should not be an end in itself. The degree of complexity in the current system does not have any specific adverse consequences for stakeholders. The amount of redistribution arising from the methodology should not be seen as bearing any relationship to the degree of complexity that is appropriate. The overall relativities are the result of numerous individual assessments which, for each jurisdiction, involve positive and negative transfers. Even if these assessments were exactly offsetting, for all jurisdictions, this would still justify the exercise because in the absence of the assessment we would not be able to conclude that an equal capacity objective (or any other objective) has been achieved.

South Australia also believes that the CGC is a relatively small and efficient organisation given that they are tasked with recommending the allocation of over \$60 billion between the states.

### **Aggregated assessments and the use of broad indicators – "good enough" equalisation**

The PC has advocated that the CGC should implement assessment processes that deliver "good enough" equalisation outcomes. For South Australia, this is a worrying and illogical

recommended approach. In fact, we all deserve better than “good enough” effort when ensuring that all Australians are treated equally.

As discussed, Australia’s system of HFE is regarded internationally as being one of the most comprehensive systems in terms of its objective and its application. This a major strength of the Australian Federation and there should be a focus on trying to improve an already strong system rather than attempting to weaken or compromise its integrity.

The PC has indicated that a potential example of how the CGC could deliver a “good enough” outcome is through the use of broad indicators in assessments or aggregated assessments.

A global revenue assessment is the most common example put forward for the use of an aggregated assessment approach driven by the use of a broad indicator. In this case, the use of Gross State Product (GSP) or household income has been suggested in the past.

Such approaches are flawed and would compromise equalisation outcomes as states do not actually tax GSP or household income. GSP includes corporate profits which are not taxed by states. In the case of household incomes, states only tax labour incomes (not including Commonwealth employees) and do not tax retirement or investment incomes. A tax by tax approach based on what states do ensures that the magnitudes of HFE transfers reflect and adapt to changes in actual tax mix and actual tax design.

## **Commonwealth grants**

South Australia supports the PC’s draft recommendation that clear guidelines are required on the Commonwealth’s approach to quarantining certain payments to the states from the equalisation process.

The CGC has a clear and transparent approach to considering whether a Commonwealth payment should impact on relativities. In the 2015 Review, the Commission adopted the following guideline to decide the treatment of all payments on a case by case basis:

*“Payments which support State services, and for which expenditure needs are assessed, will have an impact on the relativities.”*

South Australia has and continues to support this guideline. However, in practice payments are still quarantined on a discretionary and inconsistent basis, often reflecting the outcome of lobbying by states.

## **Long term reform of federal financial relations**

South Australia supports the PC’s draft recommendation that longer term reform of federal financial relations is required. South Australia was an active participant in recent attempts to reform relations including the Federation White Paper process, the Taxation White Paper process and more recently, through proposals developed that would see the Commonwealth share a proportion of personal income tax revenue with the states, with the Commonwealth ceasing certain tied funding agreements. The two White Paper processes were abandoned by the Turnbull Government and the Commonwealth Treasurer has expressed no interest in progressing a personal income tax sharing reform.

All states are facing the challenge of meeting rising cost pressures in the health sector and it is well recognised that states' revenue growth will struggle to meet the growth in health expenditure. The states require long-term and sustainable access to a revenue base that will meet the challenge of rising health costs.

However, in any reform process, equity must be a key issue.

As acknowledged by the PC, HFE is only part of the "broader Commonwealth-State financial relations landscape." South Australia agrees and continues to support the reform of federal financial relations. However, the key issues in federal financial relations stem from the Commonwealth's failure to support reform and uphold the agreements it has made.

As noted above the Commonwealth abandoned its two White Paper processes and while agreeing to consider South Australia's personal tax sharing proposal, later expressed no interest in such a reform.

The Commonwealth has also failed to uphold the agreements and reforms it has agreed. The Commonwealth continues to refuse to honour the health and education reform agreements it made in 2011 and 2013. In addition, the Commonwealth has failed to keep the commitments made in the most significant reform of Australia's federal financial relations in decades, the Intergovernmental Agreement on Federal Financial Relations (IGAFFR).

While the IGAFFR established that national agreements would not include financial or other input controls, the Commonwealth announced in the 2017-18 Budget that it would introduce conditions on the funding provided under the Quality Schools and the Housing and Homelessness national agreements.

In addition, the Commonwealth made a clear commitment in the IGAFFR to make ongoing agreements with few prescriptions rather than routinely renewing national partnerships. However, the Commonwealth's 2017-18 Budget indicates state funding uncertainty will continue, with the rolling over of the Adult Dental and Universal Access to Early Childhood Education agreements for example.

There is little prospect for reform to federal financial relations where the Commonwealth cannot honour its current agreements or past reforms. If the PC supports the Commonwealth to break its commitment to HFE, as was recommended in the Draft Report, it will be facilitating a further breakdown in federal financial relations resulting in very little prospect for reform.

It will also be hard to see how national reform initiatives could be pursued in an environment with "reasonable" equalisation where the playing field is not level and all parties at the table are not equal partners. Indeed, the PC's *Shifting the Dial: 5 Year Productivity Review* acknowledges reforms may languish "due to budget and service quality pressures – particularly on the smaller states and territories."