

TasCOSS response to the Productivity Commission Draft Report of the inquiry into horizontal fiscal equalisation

TasCOSS, the Tasmanian Council of Social Service, welcomes the opportunity to comment on the *Draft Report* of the Productivity Commission's review of horizontal fiscal equalisation (HFE).

As the peak body for the community sector in Tasmania, TasCOSS wishes to emphasise to the Commission the deep disadvantage faced by many Tasmanians, and the demand for services this places on the Tasmanian Government. Tasmania's population is the most dispersed of any state or territory, and has the lowest proportion of its population living in its capital city. Tasmania has the highest median age of any state or territory (ABS, 2017).

Tasmania's per capita household disposable income remains 14% below the Australian average (Eslake, 2017a)—and this is despite the combined redistributive effects of HFE across states and territories, and the tax-and-transfer systems which is principally the activity of the Commonwealth. Tasmanian young people remain less likely to complete year 12 than their peers in any state or territory, besides the Northern Territory (Productivity Commission [PC], 2017).

These facts are, of course, well known to both the PC and to the Commonwealth Grants Commission (CGC). It is beyond the scope of this submission to consider the adequacy of how these disadvantages are weighed by the CGC in apportioning GST revenues to achieve HFE. Instead, the purpose here is to draw attention to the persisting extent of need and disadvantage in Tasmania, despite decades of equalisation between the states and territories of the federation.

HFE responds to structural differences in fiscal capacities between states which are entrenched and resistant to policy change, such as urbanisation, level of population, and isolation. Western Australia was indeed the continuous net beneficiary of Commonwealth-state transfers in various forms for almost 100 years before its GST relativity dropped below 1.0 in 2008-09 (Eslake, 2017a; Eslake, 2017b; Brumby et al., 2012). Importantly, this was not an aberration, but the predictable response of the CGC to the historically unprecedented strengthening of WA's fiscal position over the other states (Eslake, 2017a).

Defining an objective for HFE

TasCOSS is of the fundamental view that all Australians are entitled to the same access and quality of essential services, such as health, education, and transport, and to corresponding equality of opportunity in life. TasCOSS further believes that this expectation is shared by the Australian public.

Australia has a high degree of vertical fiscal imbalance, and state governments have limited powers to generate revenue. While TasCOSS's interest is in the services and opportunities apportioned to individuals and communities, full horizontal equalisation between Australian state governments is necessary so long as the provision of education, health, transport, and other essential services is the remit of state governments.

TasCOSS endorses the existing CGC definition of HFE and its objective:

State governments should receive funding from the pool of goods and services tax revenue 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.

(CGC, 2015, p. 2)

As observed in the *Draft Report* and as evident in their submissions, a majority of states and territories—Tasmania, South Australia, the ACT, the NT, Queensland, and Victoria—in effect support full equalisation.

TasCOSS rejects the proposal of equalisation between states for the provision of services and associated infrastructure to a ‘reasonable standard’ contained in the *Draft Report*. This proposed standard is nebulous, inadequate to ensure equality of opportunity of residents between states, and would be highly liable to political erosion.

Recommendations

- The equity of the capacity of states to provide services and infrastructure should be the primary objective of the HFE process.
- The existing CGC definition of HFE should be retained, for the purpose of full equalisation.

Efficiency effects of HFE

TasCOSS believes the question of efficiency effects of HFE was well addressed by the earlier GST Distribution Review. In particular, TasCOSS wishes to draw the PC’s attention to Finding 9.1:

The current system creates perverse theoretical incentives in some instances, but there is little evidence that they have any effect in the real world. In particular, there is no evidence that HFE acts as a material disincentive to State tax reform.

There may be some merit in addressing perverse incentives on principle alone. However, after exploring the alternatives, **the Panel has concluded that they cannot be meaningfully reduced without significant reductions in equalisation outcomes. As there is little evidence of efficiency losses in practice, the Panel is not convinced that this would be a worthwhile trade-off.**

One area where there may be merit in further investigation by the CGC is in relation to the impact of tax rates on the size of State tax bases.

(Brumby et al., 2012, p. 140 [emphasis added])

Elsewhere in the report, the panel states:

To recommend any form of approach to promote efficiency, the Panel would have to be able to conclude that States that have higher expenditure needs (either overall or at an assessment category level) are *less efficient* and those with lower expenditure are *more efficient*. We have been presented with no evidence to support such a claim, and have no other basis to come to that conclusion.

(Brumby et al., 2012, pp. 49-50)

In the *Draft Report*, the PC states on the topic of disincentives for state tax reform that “absence of evidence is not equivalent to evidence of absence” (2017, p. 13). TasCOSS would caution that “absence of evidence” is nonetheless no basis for sound policymaking, and in that context, any action to reduce equalisation in pursuit of efficiency gains not supported by evidence is dubious. Any speculative increases in efficiency must be weighed against the very evident adverse outcomes for equity.

TasCOSS strongly endorses the observation in the Queensland Government’s submission that HFE promotes economic efficiency and competitiveness, as “An educated, skilled and healthy population is likely to be more productive and obtain higher wages, to remain engaged in the labour market for longer, and to transition better into new forms of employment when structural changes in the economy alter the mix of skills and knowledge required by industry” (2017, p. 5). There is a growing view among economists that inequality itself is a drag on economic growth (Eslake, 2017a). Inequality can additionally “be expected to ... reduce labour and social mobility; and worsen intergenerational poverty” (Queensland Government, 2017, p. 6).

The provision of health and education services is the bedrock of a competitive and efficient economy through the promotion of human capital development; in the *Draft Report*, the PC notes the Commonwealth Treasury submission to the GST Distribution Review which emphasised the connection between health and education services and higher productivity and income. While the PC may not be considering the interface of HFE and individual equity, TasCOSS stresses that it is important to consider the relationship of HFE, human capital development, and the long-run balance of fiscal capacities of Australian states and territories.

Any reduction in human capital investment in Tasmania as an outcome of reduced equalisation would very likely lead to adverse productivity and employment outcomes for the State’s economy. The predictable consequence of increased disadvantage in the Tasmanian population would be increased Commonwealth-state or state-state transfers to Tasmania, which should not be considered a desirable efficiency outcome.

TasCOSS agrees with the view of the Tasmanian Government that full horizontal equalisation supports the efficient movement of labour and capital in the federation, as “the greater the uniformity in the net fiscal benefit across States, the more migration decisions will be influenced by employment-related factors, which leads to higher national productivity” (2017, p. 9).

Recommendations

- The Productivity Commission’s recommendations should be made on the basis of evidence, and there is very little, if any, evidence of inefficient incentives provided by HFE as it stands.
- HFE supports human capital development which is highly important to productive and competitive state economies, and to the long-run balance of fiscal capacities between states.
- By removing disparities in net fiscal benefit between states, HFE supports the efficient movement of labour and capital across state borders. Efforts to privilege the strongest state, such as through alternatives to full HFE discussed in the *Draft Report*, are likely to increase disparities in net fiscal benefit and so increase the inefficient movement of labour and capital.

The political context

TasCOSS does not intend to comment on the technical features of HFE, including contemporaneity. However, it should be emphasised that the present impetus for reform—the fall in WA’s GST relativity—could be fairly anticipated. During the upswing in the mining boom, WA benefitted from the lagged assessments employed by the CGC to assess its fiscal capacity. The CGC stated that “over the mining boom, prior to the reduction in its iron ore royalty revenues in 2014-15, Western Australia received around \$7 billion additional GST revenue than it would have if fully contemporaneous assessments had been in place” (2015, p. 74). These revenues had an obvious symmetry—during a downturn, there would be a lag before WA’s relativity would increase again.

References

- ABS. (2017). *Census 2016 – Community profiles*.
- Brumby, J., Carter, B., & Grenier, N. (2012). *GST distribution review: Final report*. Retrieved from http://www.gstdistributionreview.gov.au/content/reports/finaloctober2012/downloads/GST_final_consolidated.pdf
- Commonwealth Grants Commission [CGC]. (2015). *Report on GST sharing relativities: 2015 review: Volume 1 – Main report*. Retrieved from https://cgc.gov.au/index.php?option=com_docman&view=document&Itemid=258&layout=default&alias=179-r2015-report-volume-1-main-report-pdf&category_slug=report
- Eslake, S. (2017a). ‘Inequality, efficiency and Australia’s system of horizontal fiscal equalization.’ Retrieved from <http://www.saul-eslake.com/wp-content/uploads/2017-08-29-Inequality-inefficiency-and-HFE-Adelaide.pdf>
- Eslake, S. (2017b). ‘WA’ economic mismanagement is not a reason to review how the GST is carved up.’ *The Conversation*, May 2 2017. Retrieved from <https://theconversation.com/was-economic-mismanagement-is-not-a-reason-to-review-how-the-gst-is-carved-up-76944>
- Productivity Commission. (2017). Report on government services 2017, volume B, chapter 4 (with attachment tables). Retrieved from <http://www.pc.gov.au/research/ongoing/report-ongovernment-services/2017/child-care-education-and-training/school-education/rogs-2017-volumebchapter4.pdf>
- Queensland Government. (2017). *Queensland Government submission: Productivity Commission inquiry into horizontal fiscal equalization*. Retrieved from http://www.pc.gov.au/_data/assets/pdf_file/0005/218822/sub032-horizontal-fiscal-equalisation.pdf
- Tasmanian Government. (2017). *Productivity Commission review into horizontal fiscal equalisation: Initial submission by the Tasmanian Government in response to the Productivity Commission’s guidance note*. Retrieved from http://www.pc.gov.au/_data/assets/pdf_file/0011/218774/sub028-horizontal-fiscal-equalisation.pdf