

## **Submission to the Productivity Commission on its draft report, *Horizontal Fiscal Equalization***

By Saul Eslake, Independent Economist and Vice-Chancellor's Fellow, University of Tasmania

November 2017

---

This submission seeks to make four points about the Productivity Commission's draft report on *Horizontal Fiscal Equalization*, published in October 2017.

### **1. The Draft Report did not convincingly establish that Australia's system of HFE is 'now under significant strain, or that it 'struggles with extreme circumstances', or that something less than 'full equalization' would be a more appropriate objective.**

The undisputed fact that never before has one state (or territory) received so small a share, relative to its share of Australia's population, of whatever form of general revenue payments have been made by the Commonwealth to State and Territory governments, as Western Australia has in recent years, does not of itself constitute persuasive evidence that 'the system' is 'struggling' or 'under significant strain'.

As the Draft Report notes (on p. 177), the "fundamental purpose of fiscal equalization ... is *not* to distribute GST revenues 'fairly' among the Australian population (that is, distribute an equal amount of GST revenue to each Australian)". Hence, there is no valid reason why the extent to which any state or territory's share of the GST diverges from what it would obtain under an equal per capita distribution should be regarded as evidence of any failing in the HFE system. Yet the assertion that it does forms a large part of the case made by the Western Australian and New South Wales Governments' case for changes to the present system – certainly in the public arena, if not necessarily in their submissions to the present inquiry.

The low level to which Western Australia's GST relativity (as calculated by the Grants Commission) has declined in recent years can be viewed as the logical corollary of the fact that during the recent 'resources boom' Western Australia became 'wealthier', relative to the rest of Australia, than (as far as can be determined) any other state or territory has ever been.

Over the five years to 2014-15, Western Australia's per capita gross state product – which is a reasonable proxy for its revenue-raising capacity (albeit without conveying anything about its expenditure requirements relative to those of other states or territories) – was, on average, more than 49% above Australia's per capita gross domestic product. When New South Wales was Australia's richest state, by this measure, during the 1990s, its per capita gross product was never more than 9% above the national average.

From this perspective, the relativity which the Grants Commission has determined for Western Australia in recent years should be seen as evidence that the HFE system is working as it should – albeit in unprecedented circumstances – rather than as evidence that there is 'something wrong' with the system.

The mere fact that an overwhelming majority of Western Australians feel that the present HFE system is 'unfair' – a fact which is not disputed – is no more evidence that there is 'something wrong' with that system than the fact that many people in the top personal income tax bracket think there is something 'unfair' about a system which requires them, who represent 3% of the total number of taxpayers, to pay 30% of the total amount of personal income tax, means that there is 'something wrong' with the personal income tax system.

**2. The Draft Report has not provided persuasive evidence that Australia's system of HFE creates 'perverse incentives' which dissuade states and territories from pursuing growth-enhancing reforms, or which encourage them to forego opportunities to increase economic activity within their jurisdictions.**

Like the 2012 GST Distribution Review, the Commission's Draft Report was unable to find any "direct evidence that GST effects have played into specific policy decisions in the past" (p. 114).

However, the Draft Report then goes on to assert that "an absence of evidence is not evidence of absence". This is exactly the same assertion as was used by the Bush Administration, the Blair Government and the Howard Government to justify the 2003 invasion of Iraq, notwithstanding that United Nations inspectors had concluded that there was no evidence that Iraq still possessed 'weapons of mass destruction'. The outcome of that episode ought to provide a salutary warning against using such a trite assertion as the basis for making a substantial change to a system which has served Australia well.

The Draft Report does make some more persuasive arguments – for example in Box 4.1 (on p. 93) - that the present HFE system treats changes in tax rates differently from changes in tax bases in determining states' and territories' fiscal capacities (and the corresponding averages for all states and territories), and that these differences in treatment may have the effect of dissuading states or territories from, for example, replacing stamp duties with a more broadly based land tax (or, alternatively, from lowering the rate and broadening the base of payroll tax) – although, again, the Report presented no evidence that this had actually been a major obstacle to reforms of this nature.

However, while this conclusion might logically support a recommendation for a change in the methods used by the Grants Commission to assess states' and territories' fiscal capacity, it does not constitute a valid reason for retreating from the objective of 'full equalization'.

**3. The 'alternative approaches' canvassed in Chapter 8 are all different ways of determining who 'loses' so that Western Australia can 'win'**

The four 'alternatives' to the current HFE system discussed in Chapter 8 of the Draft Report all entail large increases in Western Australia's share of the revenue from the GST – ranging from \$1.8bn (under an actual per capita distribution in 2017-18) too \$4.5bn (under an equal per capita distribution – as do most (though not all) of the other options considered in Appendix C.

The main practical difference between the various alternatives is which states or territories in effect 'pay' for Western Australia's gains.

Under an equal per capita distribution, Western Australia's large gains (and the somewhat smaller gains accruing to New South Wales and Victoria) are at the expense of Queensland, and the smaller States and Territories. One way of describing the changes set out in Table C.1 on p. 226 of the Draft Report, New South Wales gains around \$2.4bn from Queensland; Victoria takes \$1bn from Tasmania; and Western Australia takes \$2bn from South Australia, \$2¼bn from the Northern Territory and \$¼bn from the ACT.

Under the 'equalization to the average' alternative, Western Australia's gains (of \$3½bn) come largely at the expense of Queensland (\$1½bn), Victoria (\$1bn) and South Australia (\$½bn), with much smaller 'contributions' (in absolute terms) from New South Wales, Tasmania and the two Territories.

Under the 'equalization to the second strongest state' alternative, Western Australia's gains (of about \$3¼bn) funded largely by New South Wales and Victoria (which would lose just over and just under \$1bn, respectively), Queensland (\$¾bn) and South Australia (\$¼bn).

An alternative way of assessing the impact of these alternatives is to express the gains or losses as a proportion of each State and Territory's forecast total revenues in 2017-18, as set out in the table below:

| Alternative to current system | <i>Effects of alternative approaches on State and Territory Governments as a pc of forecast 2017-18 total 'operating revenues'</i> |      |      |       |      |       |       |      |
|-------------------------------|------------------------------------------------------------------------------------------------------------------------------------|------|------|-------|------|-------|-------|------|
|                               | NSW                                                                                                                                | Vic  | Qld  | SA    | WA   | Tas   | NT    | ACT  |
| Equal per capita              | 3.3                                                                                                                                | 1.8  | -4.7 | -11.3 | 16.9 | -19.8 | -37.0 | -4.2 |
| Equalization to the average   | -0.1                                                                                                                               | -1.7 | -3.1 | -3.2  | 13.6 | -3.1  | -1.3  | -2.7 |
| Equalization to 2nd strongest | -1.6                                                                                                                               | -1.6 | -1.4 | -1.5  | 12.2 | -1.4  | -0.6  | -1.3 |
| Actual per capita             | 1.4                                                                                                                                | -1.9 | -4.0 | -4.7  | 7.0  | -4.4  | 9.2   | 14.8 |

Sources: Productivity Commission, *Horizontal Fiscal Equalisation – Draft Report*, October 2017, Appendix C; State and Territory 2017-18 Budget Papers.

This table shows that Western Australia's gains are particularly large when expressed as a proportion of its total revenues (more than 10% under each alternative other than the 'actual per capita' option).

It also shows that the losses incurred by Queensland, South Australia and Tasmania are proportionately much larger than those incurred by New South Wales or Victoria under the 'equalization to the average' scenario, or than the changes in the largest states' positions under the 'actual per capita' option.

Finally, it shows that under the 'equalization to the second strongest state' alternative, all of the eastern states would experience similar losses (as a proportion of their total revenue) in order to finance the redistribution to Western Australia.

#### **4. There is no principled reason for favouring 'equalization to the second strongest state' as an alternative to the current system**

The Draft Report conveys the impression (at least to this reader) that the Commission is presently disposed towards 'equalization to the second strongest state' as its preferred alternative to the current system of HFE.

Based on the foregoing discussion, that would seem to be the 'least worst' option from the standpoint of the smaller states and territories (although New South Wales, Victoria and Queensland would no doubt see it differently).

But a more fundamental point is that – in contrast to the present system, which seeks (as the Draft Report notes on pp. 47, 52 and elsewhere) to fulfil the principle that people should have similar access, on similar terms, to public services such as education, health care, policing, etc., irrespective of in which sub-national jurisdiction they live – there is no similar or equivalent principle underlying the notion of equalizing to the second strongest state.

It is merely a way of appeasing the demands of Western Australia for a larger share of the revenue from the GST, one which (arguably) entails less overall political cost (for the Commonwealth, perhaps) than any of the other alternatives which the Commission has considered.

Moreover, as the Commonwealth Grants Commission has noted in its recent submission on the Draft Report, equalization to the second strongest state would "create a system with one playing field for seven states ... and a different playing field for the fiscally strongest state ... which would have a structural fiscal advantage over all other states"; and that, as a result, the fiscally strongest state "would be able to provide services in excess of the average, and/or provide services of a higher quality than the average, and/or levy lower than average own-source taxes and charges, and/or retire debt at a faster rate than other states" (pp. 5-6).

It is difficult to think of any valid reason why one state should be thus advantaged – especially considering that its superior fiscal capacity is largely the result of luck (that is, having been endowed with a uniquely rich resources base, the value of which has been greatly enhanced by increased demand for those resources from the world's most populous nation), rather than as a consequence of policy decisions made by that state in the past.

The Draft Report contends that "it would assist policy debate if the policy rationale for 'less than full equalisation' was clearly articulated" (p. 4). But the Draft Report does not provide such a rationale, other than that Western Australians' concerns about the existing system are 'not invalid' (p. 56).

"To those that hath shall be given even more" (Matthew 13:12; Mark 4:25) has never been a principle on which Australian inter-government arrangements (or indeed any other aspect of economic or social policy) has been premised in the past: and the Commission's Draft Report does not provide any compelling reason as to why it should be so in this context.

### **So what should the Commission's final report conclude and recommend?**

This submission does not seek to argue that the current system of HFE is perfect, or that it should not be changed in any way. The existing system is, as the Draft Report notes, 'highly complex' (p. 56), 'poorly understood' (p. 16), and arguably conveys 'a false sense of precision' (p. 18). As noted earlier in this submission, the Draft Report also points to inconsistencies as between the treatment of changes in tax rates and tax bases, which may have undesirable consequences.

It would be preferable for the Commission to focus on recommending changes in the Commonwealth Grants Commission's methodology which would address these and other specific concerns, rather than starting from the (unproven) proposition that it is the objective of full equalization that is the source of the problems with the system, and therefore that this objective should be abandoned.

It may well be that changes to the way in which the Commission determines what is required in order to achieve 'full equalization' results in less implicit 'redistribution' from fiscally stronger to fiscally weaker states and territories than occurs under the current system – in much the same way that the methodological and other changes which the Grants Commission makes of its own volition, or in response to submissions from interested parties, can result in changes in the relativities of individual states and territories from one year to the next.

But if that were to be the outcome, it would be more readily acceptable than a set of changes which had, as their explicitly stated rationale, reducing the extent of equalization that the system seeks to achieve.