Business Council of Australia

SUBMISSION

Submission to the Productivity Commission Inquiry into Horizontal Fiscal Equalisation

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The Business Council of Australia is a forum for the chief executives of Australia's largest companies to promote economic and social progress in the national interest.

About this submission

This is the Business Council of Australia's submission to the Productivity Commission's Inquiry into Horizontal Fiscal Equalisation (the inquiry).

The Productivity Commission has been asked to look into the effect of Australia's system of HFE on productivity, economic growth and budget management for the states and for Australia as a whole.

The Business Council supports the principle of HFE, which is broadly that states and territories should have the fiscal capacity to ensure Australian citizens are able to access comparable standards of services regardless of the jurisdiction in which they reside.

However, the Business Council is making a submission to the inquiry because we are concerned that the way HFE is implemented in Australia has become a barrier to national reform, inter-state cooperation and broad-based tax reform.

The system of HFE as it is currently applied by the Commonwealth Grant's Commission (CGC) is too complex, and is not well suited to dealing with very large disparities between jurisdictions – as occurred during the recent resources boom – or when economic fortunes of states rapidly change.

The historic increase in the terms of trade and their subsequent rapid decrease have strained the system of HFE. In particular the practice of applying three-year moving averages to the data used to calculate the distribution of the GST has proved to be problematic when fiscal and economic fortunes change. This is a key issue for the inquiry to examine.

The Business Council thinks that the key issues for the Productivity Commission to consider in the inquiry are:

- how equalisation can be implemented in a way that works better during times of large inter-jurisdictional disparities
- to reduce the complexity of the current system and the number of factors over which equalisation is applied
- to ensure the system, while remaining policy neutral, does not disincentivise productive reform or impede national and inter-state cooperation.
- to manage the transition to a new system that allows states sufficient time and fiscal capacity to make required adjustments.

As the inquiry considers how to remove barriers to national reform and cooperation, it will need to also examine if the system of HFE should remain 'policy neutral'. That is, if the methodology should be adjusted to specifically incentivise specific reforms, for example, by making HFE grants contingent on jurisdictions implementing particular policies. This would be a major shift in the underlying philosophy of HFE as it has been applied in Australia. The view of the Business Council is that such a shift would need a complete rethink of Commonwealth–state financial arrangements.

The inquiry is the latest of many reviews in to the system of HFE in Australia. Previous reviews have not led to systemic or lasting change. One of the challenges for the inquiry will be to chart transitional arrangements that enable lasting reform.

Key recommendations

Managing structural changes and shocks

- **Implement a floor in relativities below which a jurisdiction should not fall** to provide stability for all jurisdictions during economic booms. The floor should be set initially below the lowest current relativity (Western Australia currently at 0.344) and progressively raised to an agreed relativity. A key issue for the inquiry will be to determine how states that fall below the floor are funded – by top-up payments from the Commonwealth or from within the GST pool.
- The inquiry should **consider if the practice of using three-year moving averages to calculate relativities can be discontinued** without causing unpredictable fluctuations to the GST grant or subsequent revisions due to data updates.
- The inquiry should make recommendations on the appropriateness of the Treasurer making more active use of the Terms of Reference provided to the CGC to manage economic shocks.

Partial pool equalisation and transition

Partial equalisation would reduce (but not remove completely) the disincentive introduced by the current system for jurisdictions to pursue productive reforms. The inquiry should consider:

- **Quarantining a certain percentage of the GST pool for equal per capita distribution** (say 25 per cent initially) with the remainder being equalised through a simplified process.
- **Reducing the number of expenditures over which equalisation occurs.** The equalisation of expenditures could be confined to focus on comparable levels of service for an identified safety net of services relating to health, education and other agreed services, for example.
- **Tackling Indigenous disadvantage through targeted financial transfers from the Commonwealth**, including clear and transparent performance measures for closing the gap. This would leave the total funding allocated to Indigenous Australians unchanged, but improve transparency and accountability for Commonwealth and state expenditure.
- As a transitional arrangement, **territories and smaller states could be paid block grants** to ‘make good’ their expected revenue requirements so that they are no worse off during the transition to partial equalisation. This payment would guarantee that the smaller jurisdictions have the minimum level of funding required to meet additional costs per person of providing government services to smaller populations.

Issues with HFE in Australia

HFE in various forms has existed since federation and is likely to remain a feature.

The method by which the distribution of the GST is calculated by the Commonwealth Grant's Commission is a critical element in achieving the objective of HFE.

This method and the objectives of HFE have been reviewed many times. The most recent comprehensive review was undertaken in 2012 by the independent review of GST Distribution (the 2012 Review) conducted by Nick Greiner, John Brumby and Bruce Carter. (The Commonwealth Grants Commission also reviewed its methodology in 2015.)

In reviewing HFE the Productivity Commission should consider significant developments in Commonwealth–state fiscal relations since the 2012 review, major changes to Australia's economic context and the deteriorating fiscal positions of many state governments.

At a deeper level, the PC should consider if the objectives of HFE remain contemporary in the current Australian Federation and how HFE can be applied at a time when governments are predominantly delivering services through markets by way of private or not-for-profit providers, and the Commonwealth and states are structuring their funding agreements accordingly.

The Business Council thinks that the key issues for the Productivity Commission to consider in the inquiry are:

- how equalisation can be implemented in a way that works better during times of large inter-jurisdictional disparities
- to reduce the complexity of the current system and the number of factors over which equalisation is applied
- to ensure the system, while remaining policy neutral, does not dis-incentivise productive reform or impede national and inter-state cooperation
- to manage the transition to a new system that allows states sufficient time and fiscal capacity to make required adjustments.

Rapidly changing jurisdictional outlooks and economic disparities

Much of the agitation for reform of HFE and of the distribution of the GST is because Western Australia's relativity has fallen to 0.344 (see Table 1 below). That is, WA receives 34.4 cents for every dollar of GST compared to its equal per capita share of the pool. The relativity has been lower in recent years.

Table 1: Share of GST relative to share of population

NSW	Vic	Qld	WA	SA	Tas	ACT	NT
0.877	0.932	1.188	0.344	1.440	1.805	1.195	4.660

Source: Commonwealth Grant Commission, Report on GST Sharing Relativities, 2017 Update

This outcome is driven by a 'once in a century' increase in the terms of trade driven by the rising prices paid for by natural resources, particularly coal and iron ore. The terms of trade peaked nearly 85 per cent above the average of the preceding century.[1] It was also a very long boom, lasting for a decade at elevated levels. This increased WA's revenue capacity well above that of other states, which drove down its GST grant.

The terms of trade have now fallen substantially from their peak but WA's relativity remains very low, prompting strong calls for change as the state faces very difficult fiscal circumstances.

The inquiry should consider if the current system of HFE is equipped to deal with major economic shocks or structural disadvantage where they are concentrated in one jurisdiction.

Moving averages

The CGC's choice to apply a three-year moving average to the data which is used to calculate relativities exacerbates WA's low relativity at a time when its circumstances have changed dramatically. The terms of trade boom has passed and the state now finds itself with a vastly different economic and fiscal outlook than it did three years ago.

The three-year time lag, as experienced by WA for example, can exacerbate cyclical swings in a government's fiscal position. It contributes to already strong receipts during times when revenue is increasing due to rising tax receipts (as a result of rising land or commodity prices, for example) and exacerbates declining revenue when these sources of revenue stabilise or decline.

The use of moving averages is to ensure that the GST grant does not fluctuate too much from year to year. The Business Council thinks that the balance between grant stability and contemporaneity needs to be examined.

The inquiry should consider if the practice of using a three-year moving average to calculate relativities can be discontinued without causing unpredictable fluctuations to the GST grant or subsequent revisions due to data updates.

Role of the Treasurer

Each year the Treasurer provides the CGC with terms of reference to develop the per capita relativities of the GST grant. In these terms of reference the Treasurer typically directs the CGC to include or exclude certain Commonwealth grants to the states from its calculations and how to treat some state own source revenue streams.

During times of economic shock, it would be open to the Treasurer to make more active use of the Terms of Reference provided to the CGC to ensure that the calculated relativity is contemporary with current economic and fiscal circumstance.

The inquiry should make recommendations on the appropriateness of the Treasurer making more active use of the Terms of Reference.

[1] Tim Atkin, Mark Caputo, Tim Robinson and Hao Wang, 'Australia after the terms of trade boom', Reserve Bank of Australia, Bulletin, March 2014.

Exclusion of mining revenue

The Business Council notes the WA Chamber of Commerce and Industry's calls to exclude a portion of mining revenue. There is a disincentive imposed by the HFE system for the states to unilaterally develop any tax base, including mining revenue. At a theoretical level, there is no policy rationale for treating mining revenue differently from other forms of revenue in the system of HFE. However, in practice, states exercise considerable control over the development of their natural resources, and hence the development of mining revenue. Victoria's moratorium on the development of onshore gas resources is a case in point.

The Business Council encourages the inquiry to consider the costs and benefits of partial exclusion of mining revenue, particularly against other, more general forms of partial equalisation that also seek to remove disincentives for reform of service delivery.

Complexity

Australia is unique in that it attempts to implement full HFE on a relative needs-based model. This means that all material revenue and expenditure categories contribute to the calculation of equalisation.

Notwithstanding some simplification to the methodology, there remain 27 revenue and expenditure assessment categories that the CGC utilises to calculate the GST relativities (including Commonwealth non-GST payments). Each of these assessment categories has several data sources and sub categories. And the assessments necessarily involve much judgement. It remains a complicated process: largely opaque save for a few people in the CGC and state and Commonwealth treasuries.

This is an issue, given the large amounts of revenue redistributed, the risk of false precision, and the central role that HFE plays in the Australian Federation. Perhaps the biggest concern with complexity is it acting as a barrier to accountability – very few citizens or the journalists that inform them will be able to understand if a state is receiving a fair share of the GST, or hold the CGC to account for the judgements they must make.

The inquiry should explore ways to simplify the process, particularly if a form of confined cost equalisation, where fewer factors are used to calculate relativities, can be implemented.

HFE should not act as a barrier to reform or economic development

The efficiency and equity impacts of Australia's system of HFE have been debated at length over the various reviews (the 2012 review and the various submissions to that review are a good source of material on this debate).

Several reports and reviews have shown that, at least in theory, the current system of HFE produces disincentives for reforms that achieve service delivery efficiencies by improving outcomes or reducing costs, or for reforms that develop revenue bases by increasing economic activity. See for example Broadway,[2] Warren,[3] Ergas & Pincus.[4]

As the Business Council has previously noted,[5] in the case of reforms that enhance a state's revenue base, the most critical impact of the GST distribution arrangements is that in absence of similar reforms from other states, it can reduce the reforming state's share of GST revenue under the equalisation process. The reforming state is effectively recognised as not fully exploiting the revenue-raising potential of its own tax base, particularly if the base expands, as intended by the reform, after the tax reduction.

Conversely, economic policy decisions that lead to slower economic growth on an ongoing basis will be compensated through equalisation of revenue disabilities. It has been suggested that this effect could reinforce growth-inhibiting policies in the most grant dependent states.

There is much debate about whether these disincentives are material to decision making. For example, the 2012 review found that there was no evidence that the GST had changed a state's decision on economic development or taxation, although there was potential for this to occur.

The Business Council continues to support a policy neutral system of HFE absent a major rethink of Commonwealth–state financial relations. The redistribution of the GST should not be used by the Commonwealth or donor jurisdictions to incentivise particular reforms or be made contingent on particular policies. However, all reasonable proposals should be considered to implement a system of HFE that is policy neutral and that does not unduly disincentivise service delivery improvements and economic growth.

In practice it will be difficult to find unambiguous evidence that the distribution of the GST has systematically affected government decision making. It is likely to be one of many factors considered by a Cabinet, and by those providing advice, when deliberating on a major reform. The impact of the GST distribution amongst other decision factors is also likely to be highly dependent on the outlook of the jurisdiction – if it is a donor or recipient state, in deficit or surplus, experiencing rapid growth or facing a static outlook, and so on.

Regardless of impact on state decision making, the distribution of the GST has certainly become a barrier to national reform and intergovernmental cooperation. The text box below contains a (non-exhaustive) selection of the views of current and former state premiers on the GST distribution and its impact on federal cooperation.

[2] Broadway, Robin, 'International Lessons in Fiscal Federalism Design' [2012] eJlTaxR 3; (2012) 10(1) eJournal of Tax Research 21.

[3] Warren, Neil (2010), 'Intergovernmental fiscal arrangements as a constraint on state tax reform under Henry', Paper presented to conference on 'Australia's Future Tax System: A Post-Henry Review', 21–23 June, Sydney.

[4] Ergas, Henry and Jonathan Pincus (2011), 'Reflections on Fiscal Equalisation in Australia', Submission to the GST Distribution Review, September.

[5] Business Council of Australia (2011), 'Submission to the GST Distribution Review' http://www.gstdistributionreview.gov.au/content/submissions/downloads/issues_paper/BCA.pdf

GST distribution and impact on federal cooperation

When speaking about possible increases to the GST former Premier Denis Napthine said: "Under the current arrangements we get 90 cents back for every dollar in GST we pay... Queensland, a resource-rich state, gets 106 cents for every dollar they pay. What we are saying to the Federal Government is we want our fair share."

"I think there is an argument for overall tax reform, but it should be a zero-sum-gain, not an increase in tax."

… ABC News, 20 September 2013

“It is a waste of time talking about tax reform, raising the GST – anything else – unless the commonwealth government addresses this issue.”

… Former Premier Colin Barnett, The West Australian, 21 February 2017

“If the Eastern States wanted our gas and if the Federal Government wanted our gas, well, then they can seek to pay for that,”

“And secondly, in order to get our agreement to it they’d need to make some improvements to the GST.

“If they treat us with contempt and they do not fix the major issues confronting WA, and yet when they have a crisis they expect us to help them – I would link those two issues absolutely.”

… Premier Mark McGowan, The West Australian, 26 April 2017

The inquiry should identify ways to remove, or at least dull, disincentives for states to improve the efficiency and effectiveness of service delivery reform.

Vertical fiscal imbalance and HFE

In Australia, HFE occurs in the context of an extreme vertical fiscal imbalance that requires very large transfers from the Commonwealth to all states. These transfers are of a similar size to the total GST grant.

The 2008 Intergovernmental Agreement on Federal Financial Relations (IGA FFR) sought to codify how these transfers were made. The IGA FFR provides for specific purpose payments (SPPs) which must be used by the states to achieve agreed outcomes and outputs, including for infrastructure projects, service delivery reforms and myriad other purposes.

As Professor Warren has noted,[6] because of this interaction there is the potential for a lack of transparency around how the objective of an SPP is being met and whether both the objectives of the SPP and HFE are being simultaneously undermined.

> Inefficiencies can […] arise when different grants are used to achieve a similar purpose, as with funding health both through specific purpose grants based on a particular objective and

[6] Warren, Neil (2010), ‘Intergovernmental fiscal arrangements as a constraint on state tax reform under Henry’, Paper presented to conference on ‘Australia’s Future Tax System: A Post-Henry Review’, 21–23 June, Sydney.

general purpose grants distributed on equalisation principles. What can result is a lack of transparency as to how an objective is being met and with it an erosion of accountability and ultimately a compromising of equity objective in the allocation of all grants.

Since the IGA FFR and the most recent comprehensive review of HFE in 2012, several reforms have occurred in federal fiscal relations that have possibly made this interaction more acute and increased the risk that non-GST grants made to the states by the Commonwealth are in tension with the objectives of HFE. These reforms include:

- health reform on the basis of activity and efficient price
- education on the basis of need (Gonski 2.0)
- national disability services on the basis of need (the NDIS).

Each of these funding arrangements provide funding from the Commonwealth, at least in part, on the basis of individual choice of provider – choice is often an explicit objective; this choice may or may not attract co-funding from the state government. Conversely, the funding may be provided to assist an individual to access a service through a private or not-for-profit provider.

The Business Council encourages the Productivity Commission to consider the issue of how payments to fund the gap created by VFI and the HFE system interact, particularly when the Commonwealth funds individuals to access services rather than funds the states to provide services (regardless of if the state also contributes funding to these services).

Reform options and transitional arrangements

Managing structural changes and shocks

- **Implement a floor in relativities below which a jurisdiction should not fall** to provide stability for all jurisdictions during economic booms. The floor should be set initially below the lowest current relativity (WA currently at 0.344) and progressively raised to an agreed relativity. A key issue for the inquiry will be to determine how states that fall below the floor are funded – by top-up payments from the Commonwealth or from within the GST pool.

A floor would ensure that all states could be assured of receiving a minimum GST grant during times of rapid economic and fiscal change. It would recognise that during boom times there are additional expenses that cannot be foreseen by the current CGC methodology and that circumstances can change on a time scale quicker than the current methodology can account for.

- The inquiry should **consider if the practice of using three-year moving averages to calculate relativities can be discontinued** without causing unpredictable fluctuations to the GST grant or subsequent revisions due to data updates.
- The inquiry should make recommendations on the appropriateness of the Treasurer making more active use of the Terms of Reference provided to the CGC to manage economic shocks.

Partial equalisation

The Business Council thinks that the inquiry should recommend a form of partial equalisation with the following features:

- **Quarantining a certain percentage of the GST pool for equal per capita distribution** (say 25 per cent initially) with the remainder being equalised through a simplified process. Consideration could be given to progressively raising the amount of the pool distributed on an equal per capita basis.

Quarantining a portion of the GST pool for equal per capita distribution would potentially lessen the disincentive for states to pursue reforms that grow their revenue base or achieve service delivery improvements.

In this model the GST relativities would be calculated on the full GST pool, but applied only to an agreed fraction of the pool – 75 per cent in the example cited above; the remaining 25 per cent would be distributed on an equal per capita basis.

- **Simplifying the expenditures over which equalisation occurs:** The equalisation of expenditures could be confined to focus on comparable levels of service for an identified safety net of services relating to health, education and other agreed services.

As noted above, this would assist with accountability and lessen disincentives for reforms that achieve service delivery improvements in the largest expenditure categories.

- **Tackling Indigenous disadvantage through targeted financial transfers from the Commonwealth**, including clear and transparent performance measures for closing the gap. This would leave the total funding allocated to Indigenous Australians unchanged, but improve transparency and accountability for Commonwealth and state expenditure.

Tackling Indigenous disadvantage is a goal to which all Australian governments are committed and which requires a high degree of policy coordination. In 2017-18, $1.729b was redistributed on the basis of 'Indigenous status',[7] second only to 'remoteness and regional costs' of the expense categories. The Business Council thinks that Indigenous disadvantage should not be a permanent factor that is beyond the capacity of government policy to influence. Accordingly, this expenditure should be funded through a specific purpose payment with clear objectives and accountabilities.

If it were to be funded in this manner, it would also contribute to the simplification of the HFE process and assist with wider reform.

- As a transitional arrangement, **territories and smaller states could be paid block grants** to 'make good' their expected revenue requirements so that they are no worse off during the transition to partial equalisation. This payment would guarantee that the smaller jurisdictions have the minimum level of funding required to meet additional costs per person of providing government services to smaller populations.

[7] Commonwealth Grants Commission, '2017 Update' 2017.

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