On 5 April 2018, the Commonwealth Grants Commission released its report that explains how the revenue collected from the Goods and Services Tax (GST) will be distributed between the states and territories in 2018-19. The CGC’s report uses the same methodology that has meant the states responsible for generating most of the GST revenue lose billions of dollars in revenue to underperforming states. This is due to the deeply flawed redistribution process known as “horizontal fiscal equalisation (HFE).”

IPA research calculated that $87 billion has already been transferred from New South Wales, Victoria, and Western Australia to prop up the finances of the other states and territories since the GST was introduced in 2000. This is projected to reach $104 billion by 2018/19.

**Problem 1: HFE produces inequitable results**

Attempting to ensure intergovernmental equity “does not necessarily translate into improved equity between citizens of different states, nor within a given jurisdiction.” Indeed, HFE may have inequitable effects by effectively transferring income from Australians in larger states to people with higher incomes in the two Territories. For instance, the Australian Capital Territory and the Northern Territory are net beneficiaries under GST equalisation while its residents have the highest and second highest weekly media income in the country ($998 and $871 for individuals respectively, compared to the national median weekly income of $662 in 2016).

**Problem 2: Flawed data and methodology**

The calculations made by the CGC are complex and lack transparency. Dr Mikayla Novak explained in 2011 that the “CGC requires vast amounts of data to support its assessments which, in many cases, are not available or incomplete... The CGC frequently resorts to judgment – in other words, a best guess.”

The reliance on guesswork undermines the credibility of the equalisation system. As academic Professor Jonathan Pincus noted in 2005, “the CGC research does not... reach the standards that would be expected of academic publications. It would not deserve a pass if it were submitted as a third-year undergraduate project in econometrics.”

Additionally, the use of old data (the three most recent years for which reliable data is available) may mean that changing economic circumstances are not reflected in the GST distribution determinations until years later.
Problem 3: Creates perverse incentives for state governments

The persistent fiscal redistribution under equalisation principles leads to the deeper consequence of creating or perverting damaging incentives for people and governments.

Equalisation suppresses labour and capital migration between the states

A key rationale for HFE is that it reduces naturally occurring labour and capital migration incentives that arise in a federal system. However, it is not clear that such incentives should be discouraged, as capital and labour migration is an important but overlooked source of productivity gain.7

Equalisation discourages state fiscal reform

Equalisation reduces the incentives for state governments to pursue pro-growth policy reform, since states bear the political costs of promoting contentious reforms, but do not fully receive the benefits of such changes. For example, a state that reduces barriers to gas exploration and production risk being labelled as anti-environmental, but the GST calculations will take into account a change in the state’s tax base, thereby reducing the state’s slice of the GST pie.

In the same way that people can be induced to remain in joblessness by way of financial dependence on the government, state governments can also fall into similar poverty traps.8 By effectively rewarding smaller jurisdictions to forego revenue from their own state, equalisation perversely makes those states reliant on other jurisdictions. It is hardly a coincidence that it is Tasmania and South Australia that have consistently been the beneficiaries of equalisation.

Problem 4: Does not address underlying fiscal imbalances between the states and the Commonwealth

HFE attempts to address the phenomenon known as “vertical fiscal imbalance”. A key feature of a high vertical fiscal imbalance is centralised taxation and a lack of fiscal autonomy of state-level jurisdictions. These jurisdictions have little control over a major source of their own revenue and are unable to alter tax rules to suit their unique circumstances. As figure 3 shows, Australia has a remarkably high level of vertical fiscal imbalance compared to other comparable federations.

While HFE does potentially address some of the fiscal shortcomings of some states, it does not address the underlying problem that creates those shortcomings – the loss of autonomy.

The solution: Restore fiscal autonomy

The annual GST redistribution should be abandoned and replaced with a method that restores fiscal autonomy. Following flawed High Court decisions in the 1990s, the states would not be permitted to pass their own consumption taxes in place of the federal GST.9 However, each state should be permitted to set the rate that applies within each state’s boundaries and to keep the revenue that it generates.

Fiscal autonomy would unlock the benefits of competitive federalism, as exists in countries like the US and Canada. Decentralised taxes would see the states compete to implement the regulatory mix that finds the best balance between collecting revenue while ensuring businesses and investment does not leave for more attractive regulatory environments.

Ending the current system of revenue sharing would also result in more direct pressure on states such as South Australia and Tasmania to be more competitive and to engage in pro-growth reform to grow their economies and their revenue base.

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7 See for instance Gary Banks, ‘Australia’s mining boom: What’s the problem?’ [Speech to the Economic and Social Outlook Conference, Melbourne, 30 June 2011].