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FOUR PROBLEMS WITH GST REDISTRIBUTION AND HOW TO FIX THEM

Morgan Begg, Research Fellow

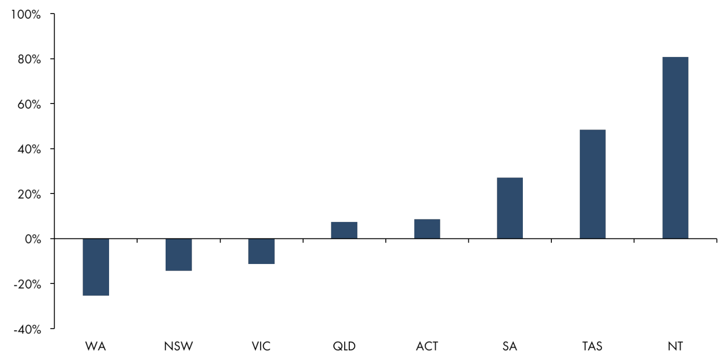
On 5 April 2018, the Commonwealth Grants Commission released its report that explains how the revenue collected from the Goods and Services Tax (GST) will be distributed between the states and territories in 2018-19.[1] The CGC's report uses the same methodology that has meant the states responsible 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.[2]

Figure 1: Total difference between GST generated in each state and the final distribution of GST under horizontal fiscal equalisation from 2000/01 to 2016/17 (in 2016/17 dollars)

Source: Institute of Public Affairs; Commonwealth Government Budget Papers 2017-18; Australian Bureau of Statistics cat. no. 5220.0.

Figure 2: Proportion of GST revenue received by each state that is generated in (or donated to) other states (2000/01-2016/17)



Source: Institute of Public Affairs; Commonwealth Government Budget Papers 2017-18; Australian Bureau of Statistics cat. no. 5220.0.

HFE is a complex formula the Commonwealth Grants Commission (CGC) uses to distribute the GST pool to the states and territories. The CGC makes assessments based on the three most recent years for which reliable data is available about

- How much the states need to spend to provide the average national level of services and infrastructure
- How much revenue the states could raise by themselves under average national tax regimes.

As this reseach brief explains, the equalisation process suffers from significant data and methodological problems, creates damaging incentives for state governments, and compounds the central problem affecting state government finances – namely the near-complete loss of state fiscal autonomy.

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."[3] 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).[4]

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."[5]

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."[6]

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.

For more information contact Morgan Begg, Research Fellow at mbegg@ipa.org.au

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.

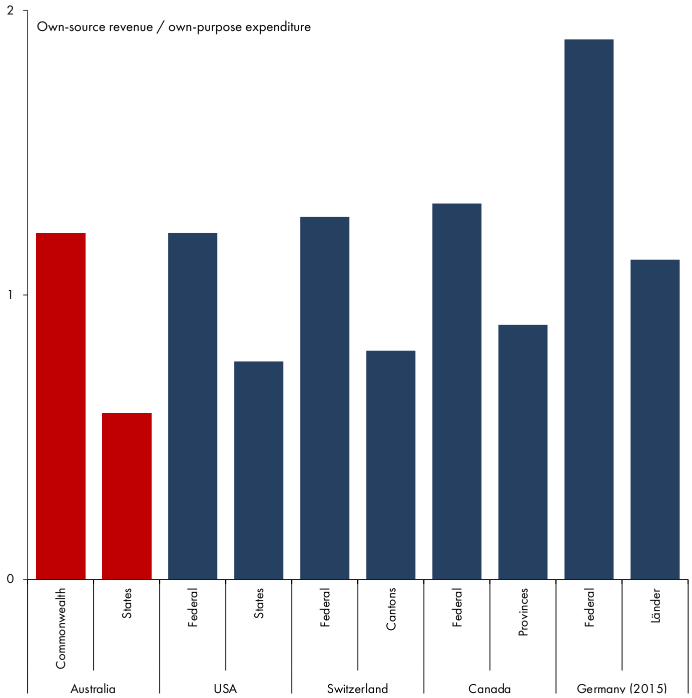
In the same way that people can be induced to remain in joblessness by way of financial dependence on the government, state governments can also fall into similar poverty traps.[8] By effectively rewarding smaller jurisdictions to forego revenue from their own state, equalisation perversely makes those 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.

Figure 3: Vertical fiscal imbalance in Australia and other comparable federations



Source: Institute of Public Affairs

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.

1 Commonwealth Grants Commission, 'Report on GST Revenue Sharing Relativities: 2018 Update' (2018).

2 Morgan Begg, 'Time to end GST redistribution: 2018 update' (Research report, Institute of Public Affairs, 2018).

3 Mikayla Novak, 'Beyond its use-by-date: Australia's system of fiscal equalisation, and how to reform it' (Submission, Institute of Public Affairs, 2011) 10-11.

4 Australian Bureau of Statistics, 'Australian Capital Territory records the nation's largest population growth' (Media release, 070/217, 27 June 2017) and Australian Bureau of Statistics, '2016 Census reveals changing face of Northern Territory' 071/2017, 27 June 2017).

5 Novak (2011) 12.

6 Simon Benson and Anna Patty, 'Doesn't add up – NSW ripped off by GST officials who 'couldn't pass uni' Daily Telegraph, 24 March 2005.

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).

8 Neil Warren, 'Fiscal equalisation and state incentive for policy reform' (2012) 10(1) eJournal of Tax Research 165, 172. See also Novak (2011) 9, which raises the potential for recipient states to engage in rent-seeking behaviour to maximise their grant share.

9 *Ha v New South Wales & Hammond v New South Wales* (1997) 189 CLR 465.