

# Horizontal Fiscal Equalisation

NSW Business Chamber submission to the Productivity  
Commission's Draft Report

November 2017

## Introduction and overview

The NSW Business Chamber (NSWBC) welcomes the opportunity to provide a submission to the Productivity Commission's (PC) Draft Report into Horizontal Fiscal Equalisation (HFE).

As you may be aware, NSWBC is one of Australia's largest business support groups, with a direct membership of more than 20,000 businesses and providing services to over 30,000 businesses each year. NSWBC works with businesses spanning all industry sectors including small, medium and large enterprises. Operating throughout a network in metropolitan and regional NSW, NSWBC represents the needs of business at a local, State and Federal level.

This submission is intended to complement NSWBC's initial submission to this inquiry. The views put forth in NSWBC's initial submission remain current.

NSWBC welcomes the PC's findings that Australia's current approach to equalisation provides disincentives for reform. In making that judgement, it is important to assess HFE within a long run context and to ask whether Australia is taking a myopic approach to fiscal equalisation which ultimately constrains economic opportunity and, in turn, the fiscal capacities of our states and territories. NSWBC is of the view that ultimately, this is the case, and that NSW has been disadvantaged over the longer term.

NSWBC is particularly pleased that the PC has shone a much needed light on how NSW would be penalised if it sought to pursue much needed reforms to improve the efficiency of its tax base. With the dividends of responsible Government distributed away it is clear that fiscal incentives, which would otherwise reinforce ambitious and beneficial reform, are muted by HFE.

As noted in our initial submission, NSWBC supports equal per capita (EPC) distribution underpinned by subsequent changes to other funding arrangements to mitigate extreme outcomes. NSWBC notes the PC's view that:

*"...an EPC approach would fail to meet the core equity objective of HFE and is therefore not a viable option."*

Draft Report, p.20

Despite our support for change, NSWBC is not convinced by the draft report that "reasonable equalisation", taken in essence to mean that fewer dollars should be equalised, is viable as a second best solution. The concept of "reasonable equalisation" as a solution to concerns about HFE implies that it is the aggregate amount of equalisation pursued which accounts for any and all economic costs. Many of the economic costs of equalisation are the result of the method of equalisation rather than the extent of equalisation alone. For example, the contention that jurisdictions are not sufficiently rewarded when developing a resource base is a more compelling argument for evolving the current model to more explicitly factor in tax base development rather than an argument in favour of moving to some other model built around the concept of "reasonable equalisation".

Indeed, resource development has been considered in previous Commonwealth Grant Commission's (CGC) review process and these ongoing reviews have precipitated an evolution of the GST distribution model over time. While reasonable arguments can be made as to whether all of the concerns raised by stakeholders are satisfactorily dealt with by the CGC, NSWBC is not convinced that the current system is broken beyond repair in its capacity to deal with some of these specific concerns.

It is not clear why "reasonable equalisation" has been preferred over more targeted methods, such as making adjustments for specific factors in line with the approach already taken. In particular, "reasonable equalisation" would appear to be incongruous with the PC's preference

against approaches which would deliver windfall gains to resource-rich jurisdictions (embodied by its views on a discount for mining).

NSWBC is concerned of the risk that “reasonable equalisation”, if not calibrated correctly, could over compensate some jurisdictions for relatively marginal gains in terms of policy independence and, in turn, economic prosperity.

Recognising the current approach does not satisfactorily deal with all of the concerns of stakeholders, including NSWBC’s concerns that HFE impedes tax reform, mechanisms for further targeted adjustments may be justified.

For this reason NSWBC urges the PC to give more thorough consideration as to how the CGC could better deal with the concerns of stakeholders by making adjustments within the current framework. As a starting point, NSWBC would welcome consideration of mechanisms to compensate jurisdictions wishing to pursue tax reforms such as those highlighted in Box 3 of the draft report.

This submission notes NSWBC’s caution at potential models which could form part of the PC’s concept of “reasonable equalisation”.

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## **What should be embodied by the concept of “reasonable equalisation”?**

The Draft Report emphasises that there are trade-offs associated with the extent of equalisation pursued and policy independence, that is, the ability for state governments to pursue alternative policy settings without impacting their GST shares.

For the most part, our current system of HFE is able to deliver equalisation without compromising the objective of policy independence. However, as noted in the Draft Report, practical realities mean that at some point, trade-offs between policy independence and equalisation accelerate in the pursuit towards full equalisation.

The trade-off between policy independence and equalisation accelerates because it is difficult to equalise some revenue sources without consequences for policy independence (such as revenue sources contingent on a government decision to develop an industry or resource base). It is not linearly proportionate to the amount of equalisation pursued, but rather depends on the nature of individual revenue sources to be equalised.

The PC has requested stakeholder views on the amount of equalisation that should be pursued, including options such as equalising to the fiscal capacities of the average or second strongest jurisdiction.

NSWBC is cautious about concepts of “reasonable equalisation” that fail to recognise that there is no stable relationship between the point at which greater equalisation implies a loss of policy independence, and in turn, any negative economic consequences (which is what policymakers should ultimately be concerned about).

Specifically, models that target the aggregate extent of equalisation to be pursued do not properly cater to the specific factors that make some revenue types more challenging to equalise under the current system. Selecting a numeric share of revenue attributable to the leading state, or some other reference point embodied by a synthesis of the performance of other states (e.g. the average or second-best performing state) would be arbitrary and risk sub-optimally trading-off equalisation in the pursuit of policy independence which is a subordinate objective.

To illustrate, if differences in the assessed revenue capacity of jurisdictions were fully accounted for by differences in their endowments, then equalising to the average jurisdiction would simply reward jurisdictions with the greatest endowments without gains to reform incentives (because by definition governments cannot make decisions to alter their endowments).

### **A way forward?**

NSWBC supports the general principle that equalisation should be pursued to the greatest extent where possible, except where it results in unjustified economic costs.

For the reasons noted above, NSWBC contends that the optimal amount of equalisation which should be pursued depends on the prevailing circumstances. Specifically it depends on the nature of individual revenue sources (including how amenable they are to equalisation) and it cannot be represented by metrics based on the performance of other jurisdictions (e.g. the average or second strongest jurisdiction). For example, if the CGC can assess that a Government hasn't taken a step to develop a tax base to the same extent as other jurisdictions, then it could factor this into GST relativities (and hence a lesser amount of equalisation occurs). Similar approaches could be taken in other circumstances where it is suggested that HFE precipitates significant economic costs.

In this light it might be asked whether the level of “reasonable equalisation” isn’t already indirectly determined by the CGC through specific adjustments made to avoid unacceptable economic costs (such as WA keeping above-benchmark royalty levels).

## **A de facto exemption for mining royalties**

Equalising to the second best jurisdiction may, in practice, become a de facto exemption for mining royalties. Where differences in the amount of own-source revenue collected by the leading jurisdiction and the second strongest jurisdiction can be accounted for by differences in mining royalties, then this could be argued to be a de facto exemption for mining royalties.

To illustrate, if all jurisdictions have equivalent tax bases (and collect taxes to the same effort), but only one jurisdiction has the additional tax base of mineral resources upon which mining royalties can be collected, then the difference between the fiscal positions of the first and second strongest jurisdictions will be fully accounted for by mining royalties. When equalising to the second strongest jurisdiction, all other jurisdictions will be on par as the second strongest and no equalisation will occur. A similar effect (though different in magnitude) is present when equalising to the average jurisdiction.

The PC noted extremities in Australia’s contemporary experience with HFE. These extremities can mostly be explained by one jurisdiction having a significant revenue source that is unavailable to other jurisdictions. So while Australia’s circumstances might not precisely match the illustration provided above, there are some similarities.

As noted in the draft report when discussing a discount for mining royalties:

*“A discount does not sit well with the main equity objective of HFE. Mining revenue is a prime example of a source-based advantage — one a State benefits from by virtue of where its borders happen to be drawn — and should prima facie be included in the equalisation process.”*

p.19

Given the sentiment behind the PC’s position on the treatment of mining royalties, it is difficult to reconcile how it might come to support an option which may deliver a similar outcome within the contemporary Australian context.

## **Further targeted adjustments - Is complexity a necessary evil?**

This submission has questioned whether “reasonable equalisation” isn’t already embodied in the nature of the work already undertaken by the CGC. Recognising the current approach does not satisfactorily deal with all of the concerns of stakeholders, including NSWBC’s concerns that HFE impedes tax reform, mechanisms for further targeted adjustments may be justified.

For this reason NSWBC urges the PC to give more thorough consideration as to how the CGC could better deal with the concerns of stakeholders by making adjustments within the current framework. As a starting point, NSWBC would welcome consideration of mechanisms to compensate jurisdictions wishing to pursue tax reforms such as those highlighted in Box 3 of the draft report.

NSWBC acknowledges that further targeted adjustments would give rise to additional complexity. But simplicity is hardly a desirable objective if achieving it fails the people of Australia on the higher-priority objectives of HFE (namely equity and economic prosperity). Front of mind should be that the rationale for further targeted adjustments is to achieve greater economic prosperity without compromising equity.

Absent more significant reform to simplify HFE (such as EPC distribution), approaches such as “reasonable equalisation” are unlikely to significantly simplify HFE in Australia. Benchmarked against this counterfactual, any additional complexity generated by further adjustments would be only marginal in nature.