

# Submission to Senate Select Committee on State Government Financial Management

Submission by

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I have recently published an article on federal-state financial relations, available at [http://ceda.com.au/public/research/federal/six\\_myths\\_federal\\_state.html](http://ceda.com.au/public/research/federal/six_myths_federal_state.html)

I will summarise the main arguments of the CEDA paper, emphasising the competition aspect (Part A), and supplement the discussion of fiscal equalisation (Part B). These relate to your first term of reference. My submission concludes with a discussion of borrowing (Part C, relating to ToR f).

## ***Part A: Fiscal Federalism Generally.***

### **Competition between governments.**

The CEDA article argues that Australian federalism is in reasonably good health. Improvements are possible, and there are threats to face.

My CEDA paper concentrates on two types of inter-governmental competition.

The first type is *vertical competition*. It is competition for the support of voters, between the Commonwealth, on the one hand, and the States and Territories, on the other. The competition occurs in policy and service areas traditionally regarded as being the responsibility of the States. Vertical competition between governments is possible only in federal countries. It supplements electoral competition (between political parties) for control of the state legislatures and executives. In a federation, a citizen can look to two sovereign governments, operating over the same territory, as competing sources of supply of what the citizen wants from government.

Vertical competition leads to overlap and duplication. Nonetheless, on balance vertical competition is advantageous to Australians.

In theory, one sure way to remove overlap and duplication, and to secure clear lines of governmental responsibility, is to assign full responsibility for the specified matters to one level of government.

Easier said than done—so long as the states exist, and have significant functions, then a cashed-up federal government will always be tempted to obtrude into the affairs of the states for an electoral advantage, or when the federal government thinks that it is in the national interest. And issues of electoral or national importance do not always fit neatly into pre-arranged categories of responsibility.

The second kind of competition is *horizontal*—that is, competition between the States. It exists whenever a citizen has the opportunity of moving from one state (or country) to another. The mere threat of mobility can put pressure on governments to

perform. This kind of migration is easier between states within a federation, than between countries.

Horizontal competition can lead to inter-state differences in policies and regulations. Differences, at least temporary ones, are in the very nature of competition—one state tries something different from what it was doing, or from what other states are doing; if it works, others may follow, at least to some extent.

When these differences in state policies and regulations are minor, they are often criticised as being clearly not worth the cost that they cause to firms that operate or want to operate in more than one state (eg, differences in OH&S legislation and regulation—a matter discussed in a Productivity Commission report); or the cost and inconvenience they cause to citizens migrating from one state to another (eg, differences in schooling arrangements or curricula).

However, it is important to note that the result from a non-competitive process may not be the average of the results of inter-state competition. In particular, uniformity across the nation, especially in regulation, can lead to the most onerous state regulation being imposed on everyone. For example, nationally-uniform OH&S may include the NSW industrial manslaughter laws, an outcome that some unions may welcome, but some firms outside of NSW may not. Or, a national curriculum for public schools may have features that some parents rejoiced were absent from their own state's public schools' curriculum (and the contra-positive).

## **Tax competition and vertical fiscal imbalance**

In my CEDA paper, I gave very qualified support to inter-state tax competition, and strong support in principle to vertical fiscal imbalance.

The assignment of tax bases, between the Commonwealth and the States, should take account of the different degrees of inter-state mobility of tax bases. For reasons of economic efficiency, the aim is to minimise the excess burden of taxation—that is, to minimise that part of the burden on taxpayers which is over and above the tax revenue that they contribute. All taxes 'distort' the decisions of tax-payers, inducing them to act otherwise than they would, absent the tax. In economic terms, there is a loss in economic efficiency, due to the 'substitution effect' or 'relative price effect' of taxation. For any given quantum of revenue, the efficiency loss is minimised when tax rates are set so to equalise marginal excess burdens across taxes.

The arguments about inter-state tax competition and fiscal imbalance are set out in more detail in the CEDA paper, where I refer to the death of death duties in Australia, and the destructive effects of too much inter-state tax competition in the US. Australia has avoided some of the worst outcomes of tax competition, by the centralisation of the income tax and recently of the GST, and the centralisation of the responsibility for social welfare. (So, in particular, payroll tax rates would be much higher if the states were forced much more onto their own resources, to fund the expenditure they make today. Inter-state differences in the rates of payroll tax would then have more salience for firms, than they do today.)

However, it is important to note that, despite the huge Commonwealth grants to the states, a state government bears one hundred percent of the costs of any additional spending that they make on own account; or saves one hundred percent of any reduction in own spending (absent a punitive clause in an SPP). If margins matter, as they usual do in economics, then states have strong marginal incentives not to waste federal general revenue grants. (Quantitative work, commissioned of the Centre of Policy Studies by the Garnaut-FitzGerald inquiry into fiscal equalisation, supports this contention.)

Ken Henry, according to press reports, said in his recent Ian Little Memorial Lecture that vertical competition would not have brought about the splendid results of National Competition Policy. I agree. In my CEDA paper, I discuss how Australian governments have managed to arrive at a reasonably satisfactory balance between competition and cooperation. Cooperation is most beneficial when independent action by a state ignores spillovers between the states (or between the states and the Commonwealth), and when there are synergies of joint action (eg, unilateral reform of electricity in any one states was made more beneficial by improvements in inter-connectors, which required joint action across states.)

### **Threat: Specific Purpose Payments, SPPs**

The main threat to the effective operation of Australian federalism is an excessive use of Specific Purpose Payments, which tend to convert the states into mere agents of the Commonwealth. As this is a matter of investigation by the Rudd government, and as recent government documents relating to SPPs are not available to me, there I will leave the matter.

### ***Part B: Improvements in fiscal equalisation***

A new system of horizontal fiscal equalisation between the states should be built on six blocks:

1. All Specific Purpose Payments should be dealt with by the Commonwealth Grants Commission's method of exclusion.
2. Payments on account of remote Indigenous populations should be made through a Specific Purpose grant.
3. On the side of revenue capacity, the only factor to be taken into account should be natural resource endowments.
4. No adjustment should be made for differences across the states in the unit costs of services to the five sub-populations.
5. Otherwise, all payments should be made on the basis of equal per capita grants for the standardised or adjusted population.
6. The adjustments to arrive at standardised populations should be confined, at most, to five sub-populations.

The new system needs to be relatively simple, unlike the current one. Then it will be able to be understood by more than a few specialist economists, which would be a benefit to the federal system of governance.

## **Why fiscal equalisation?**

There is a strong argument, on the basis of fairness as well as economic efficiency, for fiscal equalisation to offset the cost side effect on the fiscal capacity of states, of significant differences in the composition of the population. I will be brief, as my main purpose is to propose reforms to the system of fiscal equalisation.

There are many instances in which differences in the composition of populations lead to differences in fiscal capacity and pressure. To take an example: Tasmania has more old folk per head, than any other state. Without fiscal equalisation that takes account of this fact, Tasmania would be faced with two kinds of budget choices: cut the levels of services, and/or increase own revenues, through collecting more taxes and charges.

Either option damages the productivity of the Australian economy. If the higher taxes and charges induce businesses to leave Tasmania, or not establish there, even though Tasmania is where their efforts would be most effective, then the productivity of the Australian economy is reduced. Similarly, if the reduction in state services (say, to old folk) cause people to settle other than in Tasmania, even when the cost of their services are dearer in the other state, then again the efficiency of the Australian economy is damaged.

Fiscal equalisation which takes account of this difference in population structures, can reduce the loss in economic efficiency.

It is the case that a state can, through policy, alter the composition of its population, at least temporarily. Queensland, under the Bjelke-Petersen regime, competed for retirees by reducing and then eliminating death duties. However, demography is not very susceptible to ‘gaming’ in response to the incentives of fiscal equalisation.

Nonetheless, there is a balance of efficiency considerations to be taken into account. This leads me to suggest that Australia should not continue to strive for utter and complete fiscal equalisation. As Ross Garnaut has pointed out, Australia starts with a more equal inter-state distribution of economic welfare than other countries, and yet sets out to equalise fiscal capacities more thoroughly than the other federations that Garnaut and FitzGerald examined.

I now turn to the six elements of a reformed system of fiscal equalisation.

### **1: Specific Purpose Payments.**

The Commonwealth makes grants in the form of Specific Purpose Payments to the states, on conditions that the states must follow. The conditions are various, and need not detain us here, for the point is that the rules of the SPPs do not echo the rules used by the Commonwealth Grants Commission, when the CGC recommends the distribution of the GST monies. Some SPPs, the CGC treats by exclusion (eg, those relating to the C-S health agreement). The others, the CGC treats by inclusion. In effect, the CGC assumes that the conditions on those SPPs in no way reduce the capacity of the state to supply state services, as the state decides.

These ‘included’ SPPs are considered by the CGC to be ‘infra-marginal’—this is economic jargon for the assertion that they do not constrain the state. The assumption

is that the state, if freed from the conditions of the SPP without losing the grant, would have (voluntarily) spent more than it is required to spend under the SPP.

This is a very strange situation. Via SPPs, the Commonwealth discriminates in favour of some states and against others, on grounds of differential willingness or capacity to satisfy conditions imposed by the Commonwealth. Later, the CGC assumes that those conditions are not economically binding, for 'included' SPPs.

For the sake of political and administrative clarity, all SPP grants should be kept outside of the HFE system.

## **2: Remote Indigenous**

In a report that I made to Heads of Treasury a couple of years ago, on the methodology of the Grants Commission, I argued that the Commission did not follow and could not follow its regular procedure, when it came to consider the fiscal consequences of provision of state services to remote Indigenous populations.

The regular CGC method is to calculate the average level of a particular service, across the states, eg, of public schooling of students in a specific age group, and then to cost out that level in the specific state's circumstances. A state with more children in that age group, per head of population, will thereby require more funds per head of population, to meet the standard level of service, than would a state with fewer children.

Regarding remote Indigenous people, the circumstances of states vary too greatly for such an averaging procedure to be a satisfactory step. My own conclusion was that, to a large extent the Commission, rather than following its regular averaging procedure, arrived at what it thought was a reasonable level of service, using site visits and discussions with experts and so on.

Given that the Constitutional amendment of 1967 permitted the Australian government to make laws regarding the Aboriginal 'race', there seems to be a strong basis for the Commonwealth to use a Specific Purpose Payment for state services to remote Indigenous people. Under my proposed reform, the monies involved in that SPP would be removed from the GST pool, and not subject to fiscal equalisation.

The amounts involved are relatively large, in the context of the fiscal equalisation, and make it much harder for observers to understand what exactly is going on, under HFE.

## **3: Natural resource endowments.**

Currently, the CGC adjusts the recommended GST grants according to differential capacity to levy taxes and charges. The Grants Commission researches a large number of taxes and charges. Its purpose is to estimate what the state could raise if it imposed the state-average tax schedule to the state's own tax base; and thereby for the CGC to arrive at an estimate of revenue capacity that is not influenced by state policies.

I am willing to argue that the only good basis for adjustment on account of revenue raising capacity is natural resource endowments.

The method used by the UN Environment Program in 2005, to calculate ‘natural capital’ of the various countries of the world, could be used to calculate the ‘natural capitals’ of the various states. It is an attempt to do what the CGC wants to do, which is to arrive at an estimate that is not influenced by state policies. The estimate would not be changed for 20 years.

First, I will sketch the case for fiscal equalisation on account of differences in natural resource endowment. If states were permitted to retain all the revenue advantages of differential resource endowments, then this can lead to fiscally-driven and economically-inefficient decisions about where workers settle. Consider the budgetary position of Western Australia in the absence of fiscal equalisation on account of mineral or natural resource endowments. That government could afford to reduce payroll taxes, say, or to increase the quantity or variety of state services. A worker whose wage rate is lower in WA, after any adjustment for any differences in price levels, may find it advantageous to migrate to WA, because of its more attractive fiscal situation. The overall productivity of the Australian economy would thereby be reduced, since the worker would produce more valuable output in the state of origin, than in the state of destination.

Secondly, I need to state the case for restricting adjustments on the revenue side to natural resource endowments. My main argument is that only natural resource endowments represent a genuine indicator of the capacity of state fiscal systems to cause the kind of inefficient patterns of settlement—just discussed—of people and firms, in response to fundamental differences in the fiscal capacity of the various states.

My secondary argument is that one can dispute the basis used for the other calculations made by the CGC of revenue capacity. For example, urban land values are used as the basis of the calculation of land taxes. Peter Abelson has argued very convincingly that high urban land values do not generate high capacity to pay taxes, as the CGC assumes.

There is also a problem of aggregation of taxable capacity. For example, the tax base for gambling taxation is set by the Grants Commission according to some measure of disposable household income; but surely, those states that rely heavily on gambling taxation have lower capacities to tax other things, due to the syphoning off of gambling profits. I do not think that the CGC makes any such adjustment.

My final argument is that surely it cannot be true that state policies are irrelevant, or largely so, for differences in per capita incomes, or in urban land values, or indicators of revenue capacity other than the natural resource base. Any state government that accepted such a proposition maybe should consider immediate resignation.

#### **4: Unit costs**

The CGC adjusts for estimated differences in the unit cost of service. So, for example, a state with a small population has a large cost per head of establishing and maintaining a government and an administration, and receives additional GST grants in compensation.

In the service of simplicity, and in the spirit of not attempting to equalise fully, adjustments of grants for differences in unit costs should be abandoned.

Geoffrey Brennan and I have covered the economic argument against adjusting for differences in unit costs, in “Fiscal Equalisation: Some Questions of Design,” *Revista Di Politica Economica* (July-August 2004), pp. 79 – 104. Special issue on “Coercive Power and its Allocation in the Emergent Europe”, Geoffrey Brennan, ed. Reprinted in G. Brennan ,ed., *Coercive Power and its Allocation in the Emergent Europe*. Basingstoke, UK: Palgrave Macmillan, 2005, pp. 77-102. See also N. Gravel and M Poitevin, “The progressivity of equalization payments in federations,’ *Journal of Public Economics*, 90 (2006) : 1725-1743.

The basis of the argument is that obtaining greater degrees of fiscal equalisation has a cost, in terms of economic efficiency, when the source of fiscal differences across states is that it requires more economic inputs in some states than in others, to provide the same service to individuals in different states but with virtually identical other characteristics. A defensible philosophical position is that there is an ethical trade-off between marginal improvements in equity of outcome, and marginal improvements in efficiency. (The alternative is to hold to extreme philosophical positions—go for equality, and damn efficiency; or, go for efficiency, and damn equality.) Unfortunately, the equity advantage, which could be obtained from subsidising high unit-cost providers of services, is insufficient to justify the loss in economic efficiency.

There is the technical issue of inter-state differences in wage costs, which I can discuss with the Committee. If a cost-level adjustment is to be made, then the ABS’s recently-devised estimates, of price-level by state, could be used.

## **5 & 6: Equal grants per head of standardised population**

The notion of a standardised population is common in family budget studies. For example, if an adult aged 20 to 60 typically costs the household one budget unit, then a child under five may cost 0.4 of a unit—I have made these numbers up. If a number of socio-demographic sub-populations are identified, and estimates of their budgetary costs are made, then these become ‘weights’ to be used to ‘standardise’ the population.

My suggestion is that fiscal equalisation grants should be made equal per capita of standardised state and territory populations. In earlier years, the Grants Commission reported its recommendation along those lines.

Ideally, only the cost-side differences that arise from differences in the composition of population should be taken into account, not the revenue side differences (apart from those arising from differences in natural resource endowments); and not unit cost differences. However, since I have not formulated exactly what statistical exercise is needed to arrive at reasonable estimates, I am not sure if it will be possible to isolate SDC factors from revenue and unit-cost factors.

### ***Simplify the calculation***

In order to avoid the opaque and complicated calculations of the Commonwealth Grants Commission, it is essential that a strictly-limited number of socio-demographic

sub-populations be used, in estimating grants. For SDC factors alone, I understand that the CGC used over 1000 categories or cells (in response to suggestions from one state or another, and after testing for significance and feasibility).

What I have in mind is a rather cruder estimate of differences in fiscal burden, based on aggregated budget information, not detailed line-by-line investigations.

### **Easing the transition**

The GST is a Commonwealth tax, and its distribution is a matter for Commonwealth decision. A change that promises or even threatens any state's share of HFE grants will be opposed by that state. The unanimity that Mr Costello as Treasurer called for, as a condition of changing the CGC formulae, will surely not arise unless the Commonwealth smooths the transition. It has been reported in the newspapers that the Rudd government is contemplating effectively converting many SPPs into unconditional grants. If this happens, it would increase the size of the pool available for HFE, and make the grants more valuable in the hands of the states, and may therefore reduce the political fall-out from a change in the HFE formulae. Otherwise, some temporary top-up funding by the Commonwealth may be needed, likely more onerous than the guaranty to the states under ANTS.

### **Part C: Government debt**

This section, which is not related to the CEDA paper, discusses arguments for and against the use of publicly-borrowed funds as the chief means of financing public capital formation, including for investment in human capital.

I will dodge the preliminary question of whether government should be engaged in the project or activity at all, or should be leaving it to the private sector, or entering into some partnership with the private sector. I am putting this important issue to one side, in order to concern myself only with the *form* of public finance for capital formation.

### **Physical capital**

If public capital projects with large up-front costs are not funded from borrowed funds, then they must be funded from accumulated surplus of general government, or from the accumulated surpluses of some government-owned entity, like a publicly-owned trading enterprise. (The only other important possibility—and this was used, for example, in Queensland to fund rail and ports—is for the private sector fund the capital outlays, and then pass the asset over to the public sector.)

Capital assets produce services into the future. For reasons of equity as well as efficiency, it is generally appropriate that those who benefit from those services in the future should be responsible for the cost of the capital assets that produce the services. Except in what economists call 'the stationary state', the only way to ensure that the beneficiaries pay the costs of the service of the asset, is to borrow to fund the creation or acquisition of the asset.



*Equity.* There need to be strong reasons in equity to push onto past citizens, or onto today's citizens, the costs of serving future citizens, for the kind of everyday items that governments typically provide. It is a reasonable expectation that future generations will be richer than current and past generations. If so, then it is a reasonable ethical position to assert that the past or current generation can, via borrowings, leave the future to pay for themselves. This is feasible in an economy like the Australian, with access to net foreign capital inflows. (For more technical detail on the ethical issue, see the article by Geoffrey Brennan, 'Discounting the future, yet again', *Politics, Philosophy & Economics*, Vol. 6, No. 3, 259-284 (2007). <http://ppe.sagepub.com/cgi/content/abstract/6/3/259>.)

*Efficiency:* Borrowing brings a useful signal, in the form of the cost of loan. If accumulated funds are used, instead of borrowing, then it is often implied that, as the funds are there, they have no real cost. Of course, they do have costs: the funds could be used for other purposes. Borrowing is subject of closer scrutiny than is the use of retained public sector funds. (The situation is different in the private sector, when the alternative to the internal use of accumulated funds is to make a capital distribution to the shareholders.)

For public trading enterprises, there is an additional efficiency argument against funding capital formation through retained earnings. In too many cases, the 'profits' made by GTEs are the result of government's continuing to provide GTEs with shelter from the full force of competition, or of hidden subsidies (eg, cheap capital).

## **Funding human capital**

Human capital is costly to accumulate, and it provides services over a number of years. Why should it not be sensible to borrow to create human capital, if it generates an adequate rate of return?

Public schools are capital items. A new private school may well decide to borrow, in anticipation of future fees. Why should a new or refurbished government school not be funded by borrowing?

A couple of years ago at the University of Sydney, I heard a speech by the then-Treasurer of NSW, Mr Egan, in which I think that he asserted that his government would borrow only for those projects that made a commercial return, and which serviced their own debt. That dictum would rule out borrowing to build (or refurbish) public schools. It would certainly rule out borrowing anything at all to pay for the salaries of teachers.

Yet human capital formation is one of the most important forms of capital formation taking place in Australia. We are a rich and pleasant society because of the capacity of our citizens—that is, because of human capital (and our social and economic institutions).

Private borrowing to finance the accumulation of human capital does take place, even when the expenses are recurrent. Some parents, who send children to private schools, may well be borrowing to pay the recurrent fees. University students are able to borrow against their university fees, through the HECS system; some students borrow to cover part of their living expenses. The HECS system of loans makes good policy

sense. Yet, loans to finance new public schools seem to be ruled out, if the criterion is “Can the enterprise or activity make enough surpluses to service its debt?” Of course, public schools cannot make any such surpluses.

In the 1982 book entitled *Government and Capitalism*, by Butlin, Barnard and Pincus, in my section on public enterprises I discussed the idea of government as ‘one great public utility’. It was a nineteenth-century notion, which can be interpreted as follows: If a public capital investment adds more to the future flows of government revenues than it adds to its full opportunity costs, and regardless of where those flows occur, then the investment is worthwhile. There is a theorem in public finance proving a similar thing, with regard to tax revenue. (See textbook by Atkinson and Stiglitz).

There is a consequence for federal-state relations. Currently, the Rudd government and the states are engaged in discussions about the financing of the National Reform Agenda, and especially the human capital side of that agenda. The states argue that they will be faced with the early costs of pursuing that agenda, whereas the benefits will be greatly delayed in time, and will spill beyond the boundaries of the state making the human capital expenditure. Therefore, the states want ‘incentive’ payments from the Commonwealth.

The first reason—delays between spending and the arrival of benefits—provides at best a very weak argument for Commonwealth funding, although this is where the states put most reliance. The states can borrow to cover the time delay between spending and effect. That is what borrowing does, when the spending is on a capital item. Only the second ground, spillovers, should carry weight. Delays between expenditure and effect can increase the extent of spillovers. However, the case for federal payments depends on there being spillovers, and not on delays, *per se*. (In addition to spillovers, my CEDA paper discusses synergies as a basis for specific federal funding.)