INEQUALITY, EFFICIENCY AND AUSTRALIA'S SYSTEM OF HORIZONTAL FISCAL EQUALIZATION

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by

Saul Eslake

Independent Economist, and Vice-Chancellor's Fellow, University of Tasmania

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Introduction: dimensions of inequality

The subject of inequality in the distribution of income and wealth has been an increasing focus of research and discussion by and among economists in recent years, in Australia and in many other countries. That partly reflects a growing awareness that inequality in the distribution of income and wealth has been increasing, in Australia and elsewhere (see, for example, Dollman et al 2015, Whiteford 2015a). And, at least for economists, it reflects a growing (though by no means universal) consensus that (beyond some point) increasing inequality detracts from economic growth (Causa et al 2014; Cingano 2014; Ostry et al 2014; Dabla-Norris et al 2015).

One dimension of inequality which seems to have attracted less attention than others, including in Australia, is that of 'spatial inequality' - that is, inequality between or among different regions within a country. According to the OECD, "the spatial concentration of income inequality has been increasing everywhere" (OECD 2016).

In countries with federal systems of government, like Australia, subnational governments typically play an important role in shaping and implementing public policies with regard to education, health, housing and other areas which in turn have a key influence on the well-being of and life opportunities available to their citizens.

It therefore seems appropriate that, at a conference such as this, which is focussed on taxation reform in the context of financial relationships between different levels of government in Australia, some consideration is given to the impact of these relationships on the degree of inequality between different parts of our nation.

Inequality among states or provinces within Australia and other federations

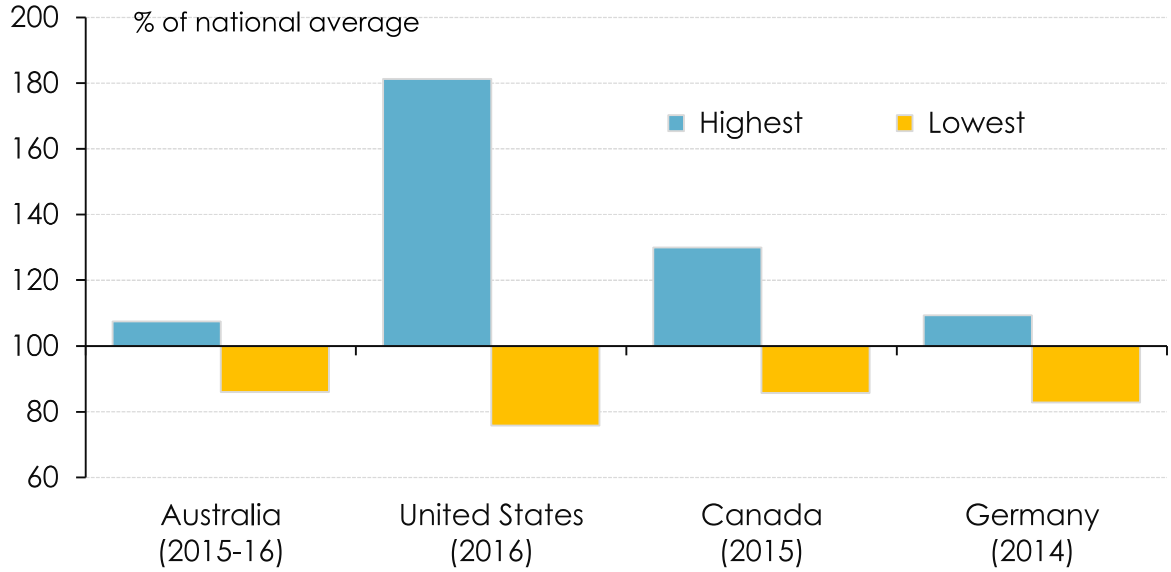
The gap between Australia's richest and poorest States, measured in terms of per capita household disposable income, is less than the equivalent in any of the three federations with which Australia is most commonly compared – Canada, the United States and Germany (Chart 1).

In the 2015-16 financial year, the latest for which data are available, per capita household disposable income in New South Wales (which in that year regained its position as Australia's richest state by this measure after eight years in which it had been held by Western Australia) was 7.5% above the national average; while in Tasmania (Australia's poorest state by this measure) per capita household disposable income was 14.0% below the national average[1] .

By contrast, household disposable income per capita in Connecticut, the richest State in the United States by this measure, was 81.3% above the US national average in 2016, while in the poorest State, Mississippi, it was 24.6% below the national average.

[1] In these comparisons, Territories with very small populations (Australia's Northern Territory, and Canada's Yukon, Nunavut and North-West Territories), capital city territories (Australia's Canada, the US' Washington DC and Germany's Berlin) and Germany's city-states of Hamburg and Bremen have been excluded.

Chart 1: Per capita household disposable income in the richest and poorest states or provinces, Australia and other federations



Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; Statistics Canada; Statistisches Bundesamt (German Federal Statistics Office); author's calculations.

In Canada, per capita household disposable income in Alberta, the richest province, was 30.0% above the national average in 2015, while the equivalent measure for Quebec, (which was the poorest Canadian province on this measure in 2015) was 14.2% below the national average.

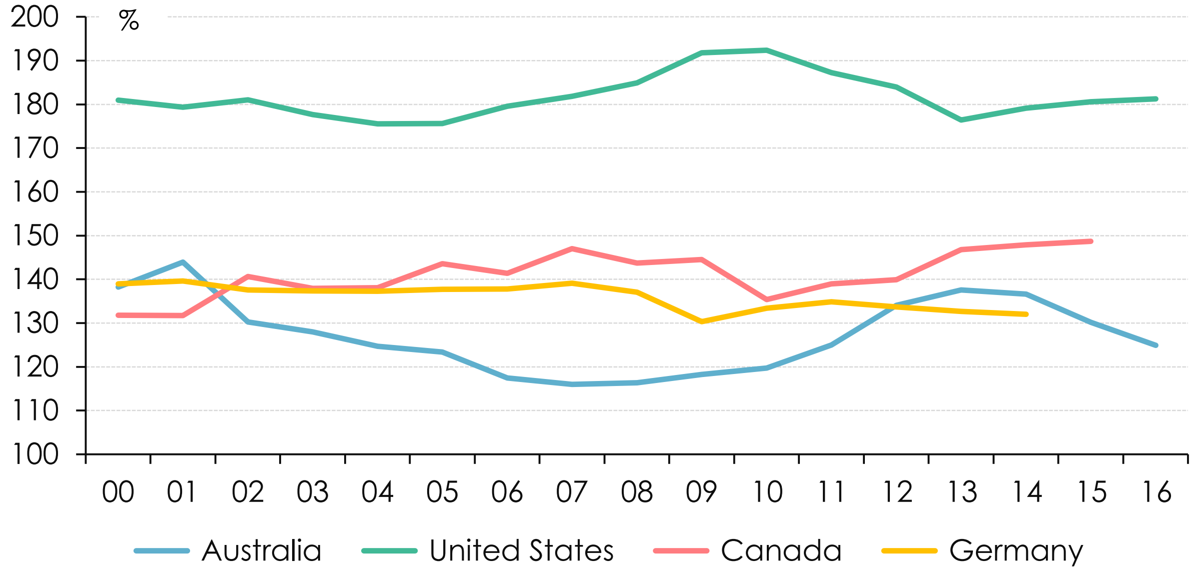
And in Germany, per capita household disposable income in the richest Land, Bavaria, was 9.3% above the national average in 2014 (the latest year for which data are available), while in the poorest, Mecklenburg-Pomerania, per capita household disposable income was 17.2% below the national average.

It is also notable that the difference in per capita household disposable income between the richest and poorest Australian States has narrowed over the past fifteen years, in contrast to the trends in the United States and Canada (Chart 2).

In Australia, Canada and Germany the difference in per capita gross product between the richest and poorest states or provinces is much wider than the corresponding difference in per capita household disposable income (Chart 3).

The only reason that this isn't also the case in the United States is because while Connecticut has the highest per capita household disposable income of any US state, New York's per capita gross product is 14% higher than Connecticut's: it is also 81% higher than Mississippi's, which is a bigger margin than that by which New York's per capita household disposable income exceeds Mississippi's. This presumably reflects the large number of people who commute from Greenwich, Stamford and other well-heeled communities in the south-eastern corner of Connecticut into Manhattan, whose output contributes to New York's gross product but whose (high) salaries and other income is recorded as accruing to residents of Connecticut. Such anomalies are less common in other federations.

Chart 2: Ratio of per capita household disposable income of richest state or province to that of poorest, Australia and other federations, 2000-2016[2]



Note: data for Australia are for financial years ended 30 June; for other countries are calendar years.

Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; Statistics Canada; Statistisches Bundesamt (German Federal Statistics Office); author's calculations.

This generally smaller divergence between per capita household disposable income and per capita gross product between the richest and poorest states or provinces in these federations reflects, among other things, the effects of national taxation and social security systems, which are to varying degrees explicitly designed to redistribute income from rich households to poor ones, and hence will also typically have the effect of redistributing income from relatively rich areas to relatively poor ones, all else being equal.

Thus for example, in Australia residents of South Australia and (even more so) Tasmania pay less (in total) in personal income tax than they receive (in total) by way of social security benefits, while residents of the other States and Territories pay more in personal income tax than they receive in social security benefits (Chart 4).

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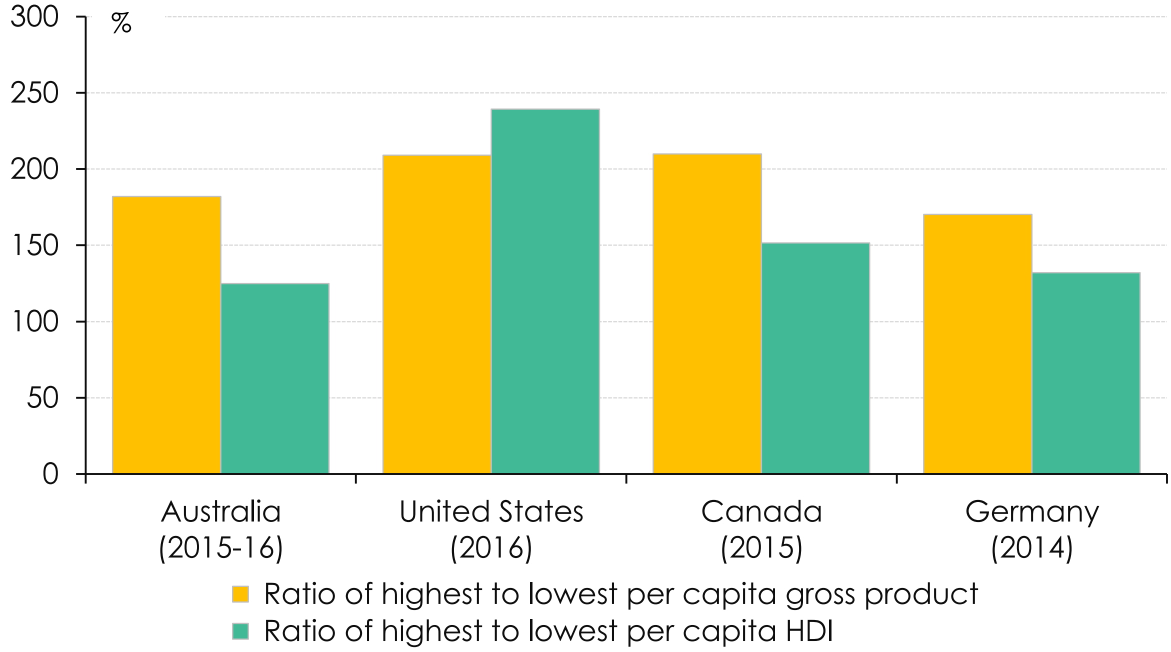
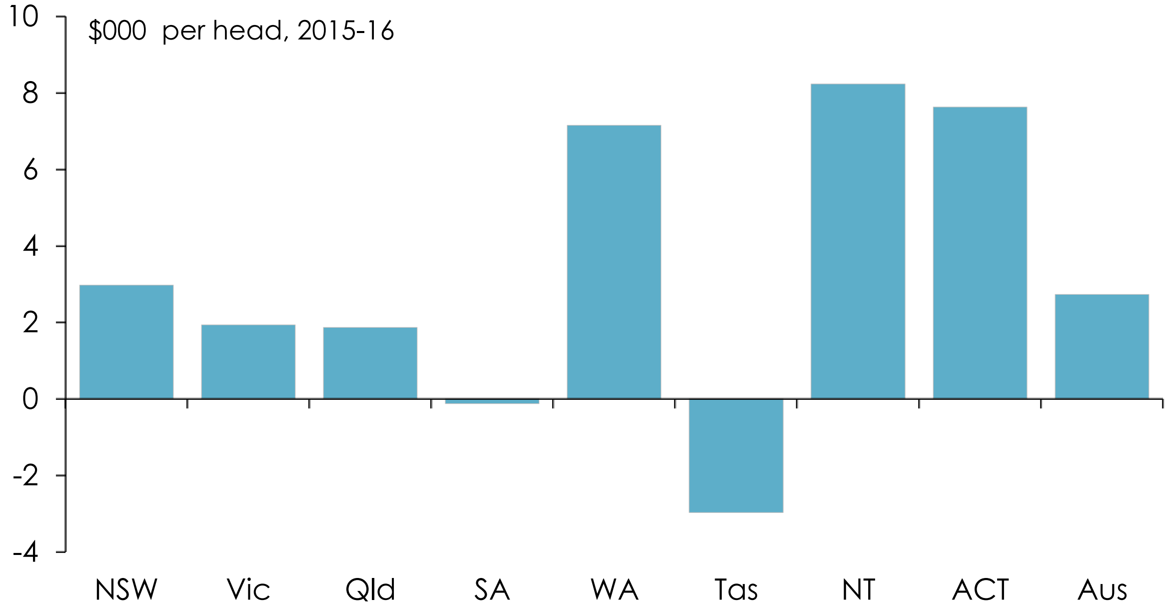
[2] The richest and poorest states or provinces are not necessarily the same from year to year. For example, New South Wales had the highest per capita household disposable income (HDI) of any Australian state up until 2006-07, and in 2015-16, but in between these years Western Australia had the highest per capita HDI of any state; Tasmania has had the lowest per capita HDI of any Australian state since at least 1979-80. In the US, Connecticut has had the highest per capita HDI of any state since 1986, while Mississippi has had the lowest since at least 1950, except for 2005 and 2007(when Idaho ranked 50th on this metric). Alberta has had the highest per capita HDI of any Canadian province in every year shown in Chart 2, while Newfoundland and Labrador had the lowest until 2007, after which either Quebec (in 2010 and 2015) or Prince Edward Island had the lowest per capita HDI of any province. In Germany, Bavaria has had the highest per capita HDI of any Land every year since 2000 (except for 2006 when that position was held by Baden-Württemberg), while Mecklenburg-Pomerania has the lowest (except for 2003-2008 when that position was held by Saxony-Anhalt).

Chart 3: Per capita gross product and household disposable income of richest and poorest states or provinces in Australia and other federations



Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; Statistics Canada; Statistisches Bundesamt (German Federal Statistics Office); author's calculations.

Chart 4: Personal income tax payments less social security benefits received, per capita, Australian states and territories, 2015-16



Sources: Australian Bureau of Statistics; author's calculations.

Although Australia's tax-transfer system is relatively small by OECD standards, because Australia's tax system as a whole is more highly progressive and the transfer system more tightly targeted than in most OECD countries means that, by at least some measures, Australia nonetheless achieves a substantial measure of redistribution of primary income (Whiteford 2015b; Productivity Commission 2015, pp. 23-42).

The significant difference between the ratios of the highest to the lowest per capita gross state product of Australia's richest and poorest states, on the one hand, and the highest to the lowest per capita household disposable income, in Australia is consistent with that hypothesis.

'Horizontal fiscal equalization' and inequality among states or provinces

However, the national tax-transfer system is not the only means by which income can be redistributed within a federal system. Another vehicle is through financial transfers between different levels of government. Australia goes further in seeking to equalize the fiscal capacity of its sub-national governments than any other federation (Garnaut and FitzGerald 2002b; Pincus 2009).

Since 1981, this has been achieved by distributing funds from the national government to state and territory governments in such a way as to provide that "after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency" (Commonwealth Grants Commission 2017).

The most commonly-used measure of the extent of redistribution resulting from Australia's system of horizontal fiscal equalization is the difference between the amount which each state and territory actually receives by way of 'general revenue assistance' from the Commonwealth (in the form of their share of the revenue from the goods and services tax or GST) in accordance with the recommendations of the Commonwealth Grants Commission, and what they would have received if the revenue from the GST had been distributed on an equal per capita basis. Chart 5 shows this difference for 2015-16 in dollar terms while Chart 6 shows the difference in per capita terms.

Chart 5: Difference between states' and territories' actual shares of GST revenue and a notional equal per capita distribution, 2015-16

Source: Australian Government, *Final Budget Outcome 2015-16*, p. 64.

Chart 6: Difference between states' and territories' actual shares of GST revenue per head of population and a notional equal per capita distribution, 2015-16

Sources: Australian Government, *Final Budget Outcome 2015-16*, p. 64; author's calculations.

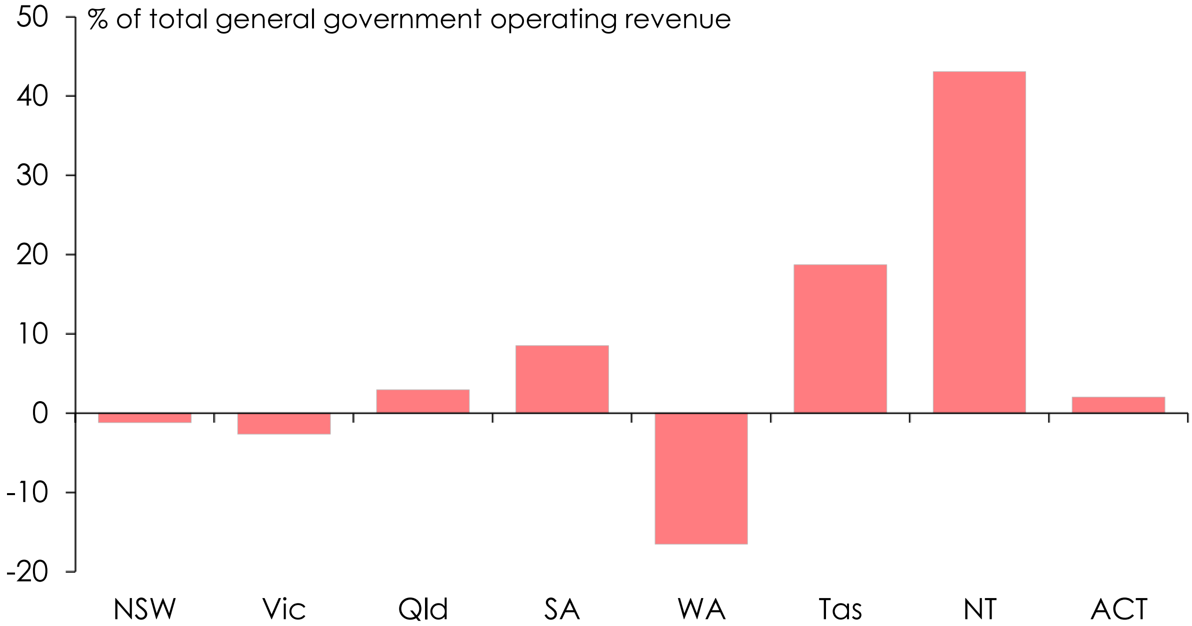
Chart 5 indicates that, in 2015-16, some $6.8bn was 'taken' from New South Wales, Victoria and Western Australia – compared with the amounts those states would have received had the revenue from the GST been distributed on an equal per capita basis – and 'given' to Queensland, South Australia, Tasmania and the two territories. Chart 6 indicates that, per head of population, the amount of redistribution away from New South Wales and Victoria and to Queensland and the ACT was relatively small, while the redistribution away from Western Australia and to South Australia, Tasmania and (especially) the Northern Territory was rather larger.

Another way of thinking about the extent of redistribution inherent in Australia's system of horizontal fiscal equalization comes from considering the impact of the distribution of revenue from the GST on each state and territory government's total revenue, as shown in Chart 7. This implicitly gives some consideration to differences in each state and territory's capacity to raise revenue.

Chart 7 shows that the amount of GST revenue which was 'redistributed' in 2015-16 as a result of horizontal fiscal equalization represented less than 3% of the total general government 'operating' revenue of New South Wales, Victoria, Queensland and the ACT: but almost 9% of South Australia's 'operating' revenue, 16½% of Western Australia's, almost 19% of Tasmania's and over 43% of the Northern Territory's.

In other words, Australia's system of horizontal fiscal equalization does not have a particularly marked impact on the financial position of New South Wales, Victoria, Queensland or the ACT; but it has a fairly, or very, significant impact on the financial position of South Australia, Western Australia, Tasmania and the Northern Territory. Put differently, a shift to an equal per capita distribution of GST revenue, as advocated by some, would not make much difference to the financial positions of the three most populous states or the ACT: but it would have a much larger impact on the financial positions of Western Australia and (in the opposite direction) of South Australia, Tasmania and the Northern Territory.

Chart 7: Difference between states' and territories' actual shares of GST revenue and a notional equal per capita distribution, as a pc of total 'operating' revenue, 2015-6



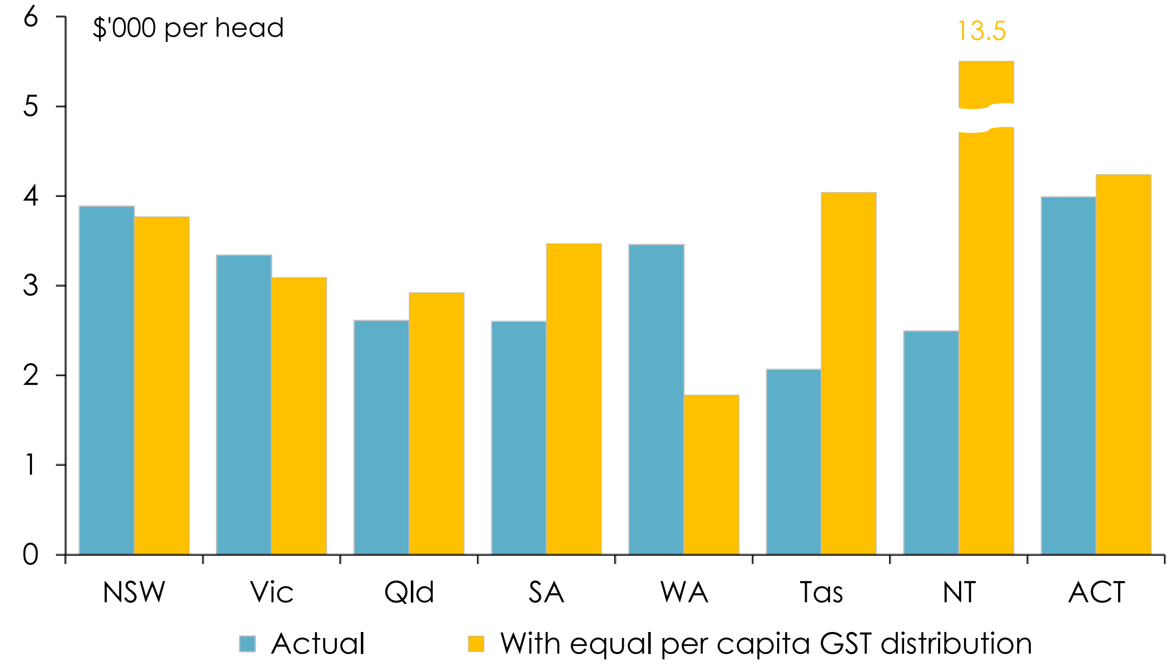
Sources: Australian Government, *Final Budget Outcome 2015-16*, p. 64; ABS, *Government Finance Statistics* 2015-16; author's calculations.

One way of thinking about this is to consider the changes in state taxation which would result from a shift to an equal per capita distribution of GST revenues, where each state and territory sought to maintain an unchanged level of spending on public services, and an unchanged budget 'bottom line'.

Chart 8 suggests that, in 2015-16, this would have enabled modest reductions in per capita state taxation revenues in New South Wales and Victoria, of 3% and 7½%, respectively, and increases of 6% and 12% in the ACT and Queensland, respectively. However, it would have allowed Western Australia to reduce per capita state tax revenues by almost 50% - from a level which was actually 5% above the average for all states and territories to one which would be notionally just over half the average for all states and territories. And it would have required South Australia, Tasmania and the Northern Territory to increase their per capita tax collections by 33%, 96% and 440%, respectively – to levels which would then have been 5%, 22% and 308%, respectively, higher than the average for all states and territories.

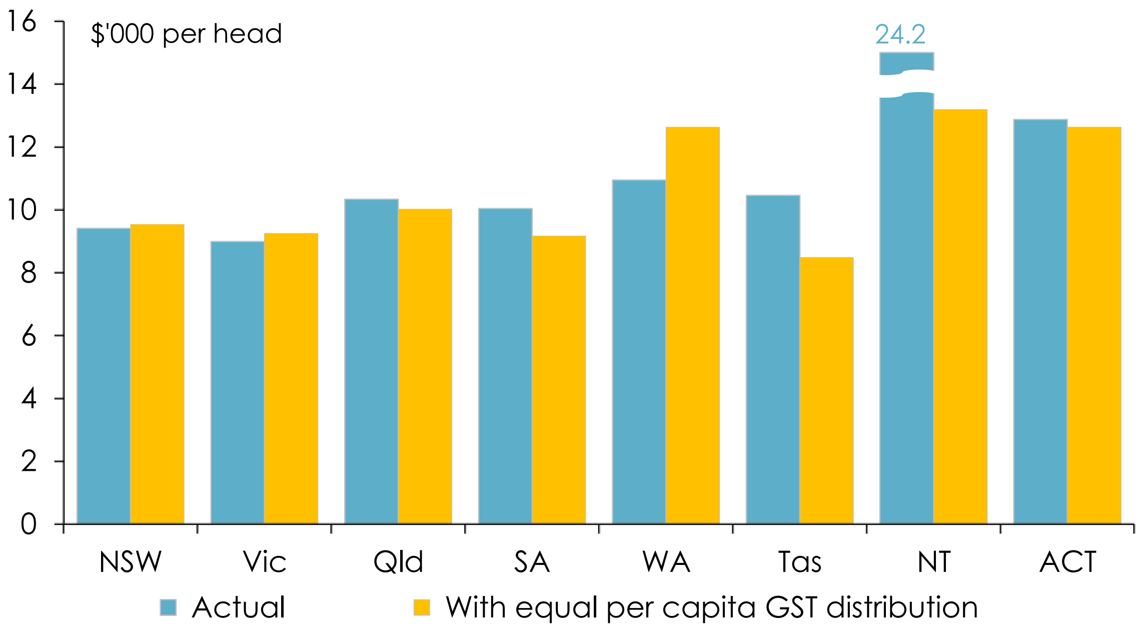
Alternatively, as shown in Chart 9, if the impact of a shift to an equal per capita distribution of GST revenues in 2015-16 were to have been absorbed entirely on the expenditure side of state and territory budgets, then New South Wales and Victoria would have been able to increase their per capita 'operating expenses' by 1¼% and 2¾%, respectively, while Queensland and the ACT would have needed to cut their 'operating expenses' by 3% and 2%, respectively. But Western Australia would have been able to increase its per capita spending by more than 15%, to a level 27% above the average of all states and territories. South Australia, Tasmania and the Northern Territory would have needed to cut their operating expenses by 9%, 19% and 45%, respectively – to levels which, for South Australia and Tasmania, would have been 7¾% and 14½%, respectively, below the average for all states and territories.

Chart 8: State taxation revenue per head in 2015-16 compared with the level required to maintain unchanged levels of 'operating expenses' and 'operating balance' with an equal per capita distribution of GST revenue



Sources: Australian Government, *Final Budget Outcome 2015-16*, p. 64; ABS, *Government Finance Statistics* 2015-16; author's calculations.

Chart 9: State 'operating expenses' per head in 2015-16 compared with the level required to maintain unchanged levels of own-source revenues and 'operating balance' with an equal per capita distribution of GST revenue



Sources: Australian Government, *Final Budget Outcome 2015-16*, p. 64; ABS, *Government Finance Statistics* 2015-16; author's calculations.

Given that Western Australia is Australia's richest state, and Tasmania and South Australia are Australia's poorest, whatever combination of lower taxes and higher spending in the former and higher taxes and lower spending in the latter were to emerge from a shift to – or even towards – an equal per capita distribution of GST revenues – or from any step in that direction from the current arrangements – would inevitably result in a more unequal spatial distribution of income than obtains under the current arrangements.

Some further reflections on the idea of an equal per capita distribution

While an equal per capita distribution of revenue from the GST provides a useful benchmark for assessing the magnitude of the redistribution of fiscal resources which occurs under Australia's system of horizontal fiscal equalization, that does not mean that an equal per capita distribution represents some kind of optimum, or ideal, as suggested (for example) by the New South Wales and Western Australian Governments in their submissions to the Productivity Commission's current review of the GST revenue sharing arrangements (NSW Government 2017 p. 3; Government of Western Australia 2017b, p. 109).

In this context it is worth noting that Commonwealth general purpose payments to state and territory governments have *never* been distributed on an equal per capita basis.

Between 1946 and 1959, 'tax reimbursement grants' (as they were called) were distributed on the basis of state populations adjusted for the number of children aged 5-15, and the sparsity of each state's population distribution: these adjustments were intended "to reflect, albeit on an arbitrary basis, differences in relative costs of providing state services due to differences in demographic structure and diseconomies of widely dispersed operations" (Mathews and Jay 1972, p. 212). In addition, during this period, Western Australia, South Australia and Tasmania received 'special grants' on the recommendations of the Grants Commission.

In 1959, 'tax reimbursement grants' were replaced with 'financial assistance grants' on terms which, as Mathews and Jay (1972, p. 242) relate, "sw[u]ng the balance of distributional advantage much more in the direction of South Australia, Western Australia and Tasmania". During the 1960s, *ad hoc* variations to the distribution of financial assistance grants were made in favour of Queensland and Victoria; while when Western Australia ceased to be a 'claimant state' in the late 1960s, an amount equal to its 'special grant' in 1967-68 was added to its share of financial assistance grants.

None of the various changes to intergovernmental financial arrangements made during the 1970s sought to move the distribution of general revenue assistance towards an equal per capita basis. And, as noted earlier, since 1981 the distribution of general revenue payments to states and territories has been in accordance with assessments by the Commonwealth Grants Commission based on the principle of horizontal fiscal equalization.

It is also worth noting that state governments do not themselves allocate grants within their own jurisdictions on an equal per capita basis.

For example, the Western Australian Government provides funding to local governments "on the basis of horizontal fiscal equalization to ensure that each local government in the State is able to function at a standard not lower than the average standard of other local governments", subject to a requirement that the minimum grant to any individual local government "cannot be less than 30 per cent of what the local government would receive if all grants were allocated on a per capita basis" (Government of Western Australia 2017a).

Other state governments follow similar principles.

More generally, state governments do not allocate expenditures on schools, hospitals, police or transport across regions on an equal per capita basis, but rather in accordance with their judgements as to the needs for those services.

Those state governments which advocate that the revenue from the GST be distributed on an equal per capita basis are thus doing so despite not following the same principle in their own back yards.

To what extent is the distribution of GST revenues in recent years unprecedented?

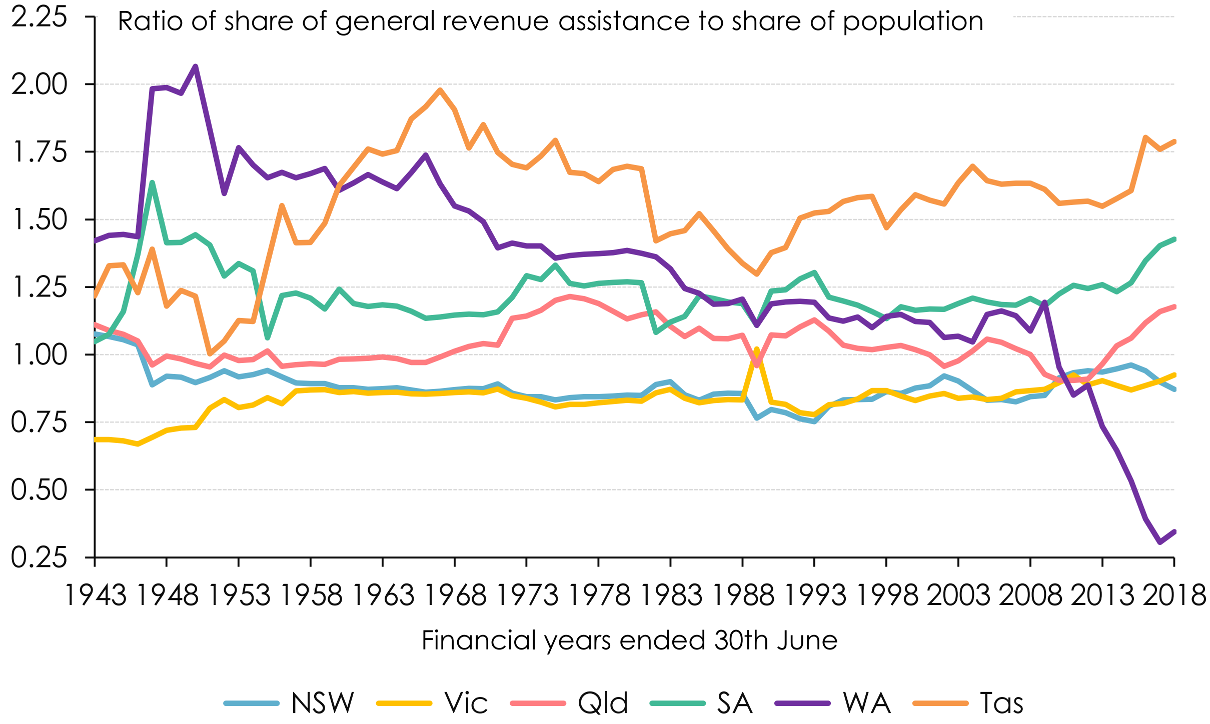
One of the arguments put by successive Western Australian governments in recent years for changes in the way that GST revenues are distributed among the states and territories is that the share of the GST which Western Australia has received in recent years diverges from what it would have obtained under an equal per capita distribution by an unprecedented margin. As Western Australia put it in its submission to the current Productivity Commission inquiry, "from 1942-43 to 2012-13, no State had ever had a relativity below 67%. However, Western Australia's relativity has now remained below 38% for four years" (Government of Western Australia, 2017b, p. 9).

It is indisputable that there has never been an occasion prior to the last four years when a state's share of general revenue assistance from the Commonwealth has been as low, relative to its share of the population, as Western Australia's has been since 2013-14. Prior to then, the lowest share any state had ever received, relative to its share of the population, was in the mid-1940s when Victoria received less than 70% of what it would have received had all general revenue assistance been distributed on an equal per capita basis (Chart 10). In more recent times the lowest share of general revenue assistance relative received by a state, relative to its share of the population was in 1992-93, when New South Wales received 75% of what it would have obtained under an equal per capita distribution.

Chart 10 also shows that up until the mid-1980s, Western Australia's per capita relativity was higher than South Australia's, either then or now; and for much of the 1950s was higher than Tasmania's, either then or from the early 1980s until about four years ago.

However, before rushing to the conclusion that the mere fact that the level to which Western Australia's relativity has fallen in recent years is unprecedented means that it is also unfair, it is worth considering something else which is also, as far as can be ascertained from currently available data, unprecedented – namely, Western Australia's revenue-raising capacity relative to other states.

Chart 10: Relativities implicit in the distribution of total general revenue assistance to state governments, 1942-43 to 2017-18



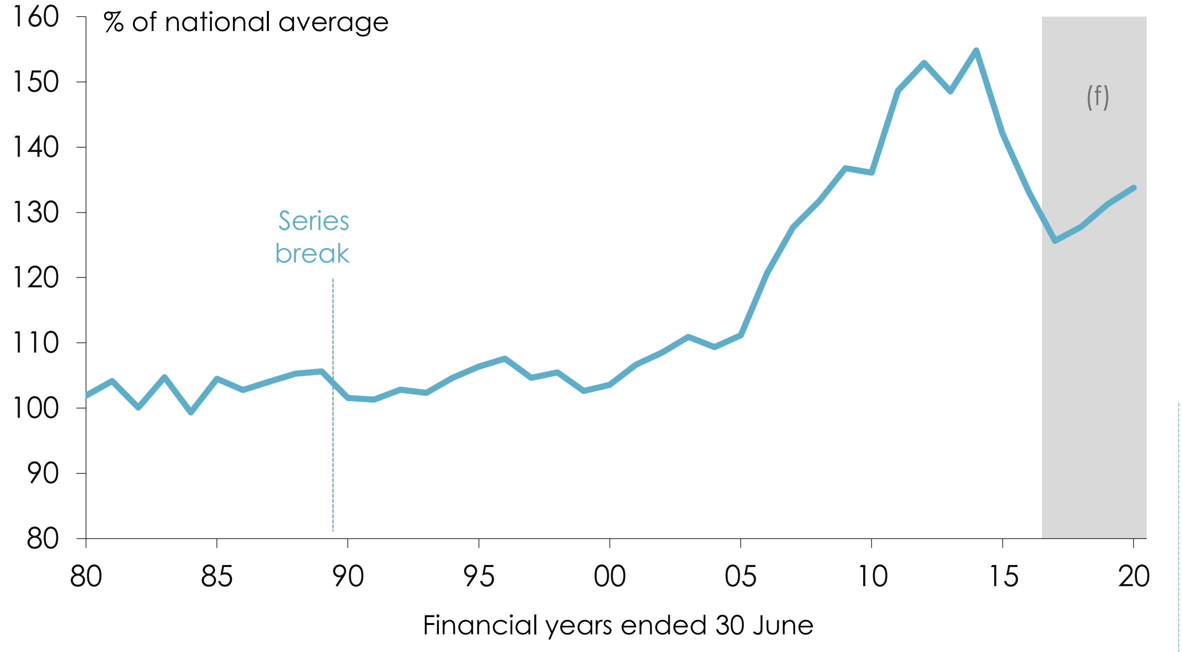
Note: 'General revenue assistance' includes tax reimbursement grants, financial assistance grants, tax sharing grants, GST revenues, health care grants (from 1981-82 to 1987-88), special grants, special revenue assistance, identified road grants (from 1991-92 to 1996-97), national competition payments (from 1997-98 to 2007-08), grant in lieu of royalties and other general revenue assistance. Territories not shown. Figures for 2016017 and 2017-18 are estimates.

Sources: Commonwealth Grants Commission, *History of general revenue assistance paid to states*; Australian Bureau of Statistics, *Australian Historical Population Statistics* (3105.0.65.001) and *State Accounts* (5220.0); Australian Government, *Budget Paper No* 3, 2017-18; and author's calculations.

Given that the majority of state and territory taxes are levied, in the first instance, on businesses, rather than individuals – and that a significant proportion of businesses operating in any state or territory are owned, in whole or in part, by residents of other states (or other countries) – per capita gross product is likely to provide a better approximation of a state government's revenue-raising capacity than per capita household disposable income.

Western Australia's per capita gross product rose sharply relative to the national average from the early 2000s onwards, peaking at almost 55% above the national average in the 2013-14 financial year (Chart 11). This is no less unprecedented than the level to which Western Australia's share of GST revenue, relative to its population, has fallen. When Victoria was Australia's richest state, by this measure – as it was between at least 1977-78 and 1988-89 – its per capita gross product was never more than 11% above the national average. When New South Wales was Australia's richest state, by this measure –as it was between 1989-90 and 2001-02, its per capita gross product was never more than 9% above the national average.

Chart 11: Western Australia's per capita gross state product relative to the national average, 1979-80 to 2020-21



Sources: Australian Bureau of Statistics, *State Accounts* (5220.0); Australian Government, *Budget Paper No. 1*, 2017-18; Western Australian Government, *Government Mid-Year Financial Projections Statement*, 2016-17; author's calculations.

This unprecedented increase in Western Australia's per capita gross product relative to the national average was of course largely driven by the 'minerals boom' – which directly and substantially enhanced the Western Australian Government's capacity to raise revenue from mineral royalties, and (to a lesser extent) from payroll tax (given the increase in employment, typically at relatively high wages, arising from the minerals boom) and stamp duties (given the impact of the minerals boom on the demand for residential and commercial property in Western Australia).

It could also be argued that some of the side-effects of the minerals boom – including the appreciation of the Australian dollar to a peak of more than 27% above its post-float average in trade-weighted terms, the rise in interest rates required (in the Reserve Bank's judgement) to contain the potential inflationary pressures associated with the minerals boom, and the 'pull' of workers from the eastern states – adversely affected the economic performance of the rest of Australia, and undermined the revenue-raising capacity of other state governments.

In other words, from a public finance standpoint the only thing that has been unprecedented about Western Australia's experience since the early 2000s has been the extent to which its capacity to raise revenue (as proxied by its per capita gross product relative to the rest of the nation) has risen relative to that of the rest of the nation. The decline in its per capita relativity under the GST revenue-sharing arrangements, is, by contrast, a relatively logical result of a long-standing system operating as intended under those circumstances.

It is *not* an argument – or at least, not a very persuasive one – that there is something inherently wrong with Australia's system of horizontal fiscal equalization.

It is of course true that the Western Australian Government's present financial difficulties have to some extent been exacerbated by the lags involved in the derivation of the relativities used to determine the distribution of GST revenues, now that iron ore prices have passed their peak. However, those lags worked to Western Australia's advantage while iron ore prices were rising: indeed, the Commonwealth Grants Commission has estimated that "over the mining boom, prior to the reduction in its iron ore royalty revenues in 2014-15, Western Australia received around $7 billion additional GST revenue than it would have if fully contemporaneous assessments had been in place" (Commonwealth Grants Commission 2015, p. 74).

It was of course open to the Western Australian Government to have saved this 'bonus', to be drawn down when the lags in deriving the GST relativities worked the other way (from Western Australia's perspective). Instead, however, the Western Australian Government chose to assume that what it regarded as a "now outdated and inequitable CGC redistributive system" would "not be sustainable after 2014-15" (Government of Western Australia 2011, p. 84), and carried on spending.

Does Australia's system of horizontal fiscal equalization really act as a disincentive for the pursuit of growth-enhancing tax and other reforms?

Proponents of reducing the extent of horizontal fiscal equalization in Australia frequently argue that the existing system provides penalizes state or territory governments which actively pursue higher rates of economic growth, or create perverse incentives for state and territory governments to eschew growth-enhancing reforms, including tax reforms (Garnaut and FitzGerald 2002 pp. 133-153; Ergas and Pincus 2011; Business Council of Australia 2017, pp. 6-7).

It is indeed relatively easy to construct theoretical propositions along these lines. However, there is very little evidence to suggest that these propositions have any substantial validity in practice.

Back in 1993, the Industry Commission (as it then was) pointed to "a lack of conclusive empirical evidence about the efficiency costs of fiscal equalization" as a reason leading it to conclude that "a case for radical reform of fiscal equalisation has not been established" (Industry Commission 1993, p. xxx). More recently, the 2012 GST Distribution Review, whose three members included two former state premiers who, when in office, had been vigorous proponents of more limited horizontal fiscal equalization, concluded that "the current system can and does create perverse incentives in theory, but that there is little evidence of those incentives having any effect in the real world. In particular, there is no evidence that HFE acts as a material disincentive to State tax reform" (Brumby, Carter and Greiner 2012, p. 135).

It is notable that Western Australia, in particular, has been an habitual laggard with regard to micro-economic reforms, for example maintaining the most restrictive retail trading hours and taxi regulations of any state, and only recently abandoning its long-standing practice of dictating where and by whom potatoes can be grown, and at what prices they can be sold (Economic Regulation Authority of Western Australia 2014, pp. 13, 233-264 and 265-291).

I've not seen, read or heard anyone seriously suggest that retail acts between consenting adults at mutually convenient times on weekends, or transactions in potatoes among people (none of whom have been 'approved' by a state authority) at mutually agreed prices, would have been decriminalized sooner, or at all, if Western Australia had received a 'fairer' (by its lights) share of revenue from the GST.

Western Australia and Tasmania are the only states where the entire electricity system remains in public ownership. Yet given that Western Australia and Tasmania are polar opposites under the GST revenue distribution arrangements, it's not at all obvious how their decisions in this regard have been affected by the system of horizontal fiscal equalization.

I accept that the system of horizontal fiscal equalization does, to some extent, shield the governments (and the residents) of 'poorer' states from the consequences of their states' poor economic performance.

But I find it hard to believe that if that system were altered as long advocated by governments of 'richer' states, that the citizens of South Australia and Tasmania who would as a result become measurably worse off would, as a result, be motivated to demand that their state governments pursue growth-enhancing reforms which they have hitherto eschewed – any more than there is compelling evidence to support the view that cutting benefits to the long-term unemployed makes them more willing to look for work,

Conversely, it's not as if the prosperity which Western Australians have enjoyed in recent years is the result of any bold reforms, wise decisions or astute investments undertaken by earlier Western Australian state governments.

Previous Western Australian governments did not put vast iron ore reserves under the Pilbara, nor did they do much to find them; more recent Western Australian governments have not driven up the price of iron ore; and contemporary Western Australian governments have not, for the most part, provided the capital from which the development of new mines, the expansion of existing ones, and the provision of the infrastructure enabling minerals to be moved from mines to and through ports has been funded.

Nor are the companies which have provided that capital preponderantly owned by Western Australian residents.

And I suspect that if, by some quirk of history, the southern border of the Northern Territory had been drawn so as to extend along the 26th parallel south latitude all the way to the Indian Ocean, rather than stopping at the 129th east parallel of longitude (as in Chart 12), the majority of current-day Western Australians who live south of the 26th parallel would have a rather different view of Australia's horizontal fiscal equalization arrangements.

Chart 12: How would Western Australians feel about the GST revenue-sharing arrangements if state borders had been drawn up like this?

Conclusion

It's not been my intention in these remarks to suggest that Australia's system of horizontal fiscal equalization is as close to perfection as it's possible to get. It is complex; it is poorly understood; it does rely, in places, on arbitrary judgements.

It does produce some puzzling results. It's hard to understand how the Northern Territory does as well as it does out of the current arrangements – even allowing that the unit costs of providing public services in the Territory is much higher than elsewhere – given that its per capita gross product and per capita household disposable income are more than 35% and more than 15%, respectively, above the corresponding national averages.

Conversely, given that Victoria's per capita gross product is now about 10% below the national average, and its per capita household disposable income is now the second lowest in Australia, it's not immediately obvious why Victoria's share of GST revenues should have been between 7 and 12 percentage points below its population share over the past decade, even allowing that the unit cost of providing public services is generally lower than elsewhere.

However, most of the 'quick fixes' that have been proposed in recent years do little to resolve these problems, as opposed to merely improving the outcome from the standpoint of one state, or some states, at the expense of others.

For example, the proposal to create a 'floor' below which a state's share of the GST revenue relative to its population share cannot fall is the equivalent of suggesting that once a high-income taxpayer's income exceeds a certain level, it should no longer be taxed at the top marginal rate.

Likewise, the suggestion that revenue assistance to the financially weaker states be provided (by the Commonwealth) outside of the GST revenue-sharing arrangements would leave them vulnerable to the vicissitudes of federal budgets: it seems unlikely that future federal governments would unquestioningly accept recommendations from the Grants Commission regarding both the volume and the distribution of 'special grants' to 'claimant states' in the way that they did from the mid-1930s until the early 1980s.

There is almost always some trade-off between efficiency and equity – and in a democracy the extent to which each of these objectives is pursued at the expense of the other is ideally resolved through political processes.

What seems clear in the context of the extent to which the pursuit of horizontal fiscal equalization in Australia involves trade-offs between efficiency and equity is that there is plenty of 'hard' evidence as to the benefits in terms of equity of current arrangements, and very little 'hard' evidence as to its costs in terms of efficiency.

The complaints that have been made about Australia's system of horizontal fiscal equalization in recent years, which have prompted the federal government to commission yet another inquiry into it, and the majority of the proposals that have been made for changes to it, amount in practice to suggestions that "to those that already hath shall be given even more".

I find it difficult to accept that yielding to suggestions of that kind will make Australia more prosperous, or a better place in which to live.

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