

## A note on the efficiency of Horizontal Fiscal Equalization

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The supplementary submission to the Review by Jonathan Pincus and Henry Ergas (20 March 2012) enables me to close a gap in my earlier submission (15 March 2012). In that submission I proposed treating Horizontal Fiscal Equalization (HFE) as federal financial assistance using Commonwealth (non-GST) revenues, and treating GST separately as internal State revenue to be distributed in proportion to Gross State Productivity (GSP).

Pincus and Ergas provide a strong rebuttal for modelling on behalf of the South Australia government, which had found HFE to be efficient in Australia. By cancelling out cross-border incentives for individuals to migrate in search of more fiscal benefits, HFE was found to add \$295 million or 0.025 per cent of GDP. But individuals are not the only actors making decisions; state political communities also make decisions affecting the economic landscape within which those individuals move. Pincus and Ergas show that in order to conclude that HFE really is efficient, it was necessary to assume these state decisions were not influenced by economic signals – that they were just part of the furniture. The state is assumed to have no significant decisions to make other than what mix of services to provide using its share of Australia's funds, and how cost-effectively to provide them.

This enables me to speak of efficiency in a way that I avoided doing in my submission, because I do not have the qualifications to gainsay claims by experts on the efficiency of HFE. I can now say that the realignment of Australia's existing fiscal instruments that I proposed in my submission would establish two distinct layers of state funding:

- an *efficient layer* comprising *state earnings including GST*, the latter distributed in proportion to GSP
- and an *equity layer* of *HFE financial assistance* from the federation, paid for out of federal revenues and potentially (but not necessarily) subject to federal tied-grant conditions.

To the extent that federal governments tend to impose conditions on grants which may serve their own political ends more than those of the recipient state government, this would make the efficiency layer – state earnings including GST – somewhat more desirable for state governments than the HFE equity layer of financial assistance, in much the same way that a welfare recipient would rather receive a given amount in cash than in food stamps. State governments would be motivated to maximize their GSP and thus win their way clear of unwelcome federal interference, fund their own election promises instead of those of the federal government, take the political credit for funding their own schools, hospitals and infrastructure, and focus their full attention on voters rather than negotiating for federal grants. Voters, for their part, would be more clearly able to see the difference between the fruits of good state government and gifts from the federal community.

In this way, the economic signals of efficient GST distribution would be somewhat counterweighted, but not entirely swamped, by top-up HFE grants from the federal government to states with lower GSP. This would answer point 6A(a) of the terms of reference to "*ensure that HFE does not provide a disincentive to State tax reform*" or any other state reforms aimed at economic growth.

My proposal runs into a serious barrier if HFE is efficient as the South Australia government claims, because HFE doctrine requires equalizing grants to be policy neutral and use only untied grants, otherwise federal constraints could make some states more responsive than others in the choice of services they provide, reintroducing the distortions that HFE is intended to eliminate.

If HFE were no longer considered efficient – and Pincus and Ergas provide grounds for doubting that it is – it would still continue to be used in Australia, but without the need for an efficiency pretext for

something we were going to do anyway. The doctrine requiring HFE to be policy neutral would no longer be relevant, apart from broader questions of the merits or otherwise of federal tied grants.

In any case, the requirement for HFE to be policy neutral is already contaminated by the presence of tied grants within the HFE system. Most tied grants received by states are counted towards their revenue capacities in HFE calculations, directly affecting their GST distributions. So the HFE system is in reality made up of both tied grants and untied GST grants, even if the final top-up is done using only the latter. Suppose a state received a tied grant for some service – say schools – in excess of the amount it needed for providing average school services. The HFE formula ignores the effect of this constraint, so the state would be left short of funds for services other than schools. (Conversely, note that if the amount of the tied grant for schools is less than the state is likely to spend on schools, the grant condition is superfluous.) The result is the same as if the Commonwealth Grants Commission were distributing tied grants, except that the Commission could calibrate tied-grant distributions to state requirements more accurately than the federal government is capable of doing.

Furthermore, some tied grants (called “National Partnership Payments” under the 2008 Intergovernmental Agreement on Federal Financial Relations) are incentive bonus grants for state governments to meet federal targets, and these are usually quarantined from the HFE process. Clearly, if one state receives a bonus grant and another state does not, and if the difference is quarantined from HFE, then a fiscal disparity is introduced and individuals would have an incentive to migrate to the state which received the bonus. If HFE is efficient, then incentive bonus grants compromise that efficiency.

This raises the broader question of whether federal government is in a better position than state voters to judge what incentives are appropriate for state governments. State voters are also federal voters, and if they lack the competence to judge their state governments, or need guidance from the federal government in doing so, does that not equally deny the legitimate authority of both elected governments?

Be that as it may, this is all grist for the mill of making HFE grants less desirable for state governments than GST earnings, differentiating the efficiency and equity layers of state funding. Tied grants are a political fixture in Australian federal financial relations, so we might as well make a virtue of necessity – use state government ambivalence towards tied grants to motivate them to prefer internal earnings. And if federal governments play fast and loose with conditions that undermine or pervert the course of democracy, they could find those conditions coming under increased public scrutiny in the struggling states most affected by them. And, crucially, any political arbitrariness in tied grants would be tamed by the rule of leaving it to the Commonwealth Grants Commission to determine their distributions to individual states.

The framework for doing all this is outlined in my submission of 15 March 2012. This would –

- motivate state governments efficiently to raise as much GST income as possible by maximizing GSP;
- allow state voters their democratic prerogative and responsibility to judge their governments’ performance, with a clearer view of how much fiscal benefit is funded internally (including GST earnings) and how much is provided by federal assistance;
- and still take care of those citizens who, either through geographic misfortune or failure to elect good governments, require federal financial assistance to provide their equal share of state goods – albeit with potentially higher levels of federal influence, and less political versatility for the state government dispensing those goods.

The supplementary submission by Jonathan Pincus and Henry Ergas, by providing substantial support for the idea that efficiency applies not only to individual decisions but also to state decisions, enables me to close this weakness in my previous argument in regard to efficiency. With apologies to Prof Pincus and Prof Ergas for using their work to serve an argument which is substantially different from theirs, and which they might not agree with.