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Mr Paul McCullough
Secretary
GST Distribution Review
The Treasury
Langton Crescent
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Dear Mr McCullough

SA RESPONSE TO COMMENTS FROM J. PINCUS AND H. ERGAS ON INDEPENDENT ECONOMICS REPORT (20 March 2012)

In February 2012, the South Australian Department of Treasury and Finance submitted a report to the GST Distribution Review commissioned from Independent Economics on the efficiency aspects of horizontal fiscal equalisation (HFE).

The Independent Economics Report quantified the efficiency loss if GST grants were distributed to the States on a per capita basis (other than for Indigenous needs), rather than on a full equalisation basis, as $295 million per annum.

Jonathan Pincus and Henry Ergas have submitted some comments on the Independent Economics Report to the Review. The SA Department of Treasury and Finance contests some of the points raised by Pincus and Ergas in their submission.

1. Pincus and Ergas claim that a welfare loss of $295 million per annum is 'insignificantly different from zero, that is, smaller than the margin of error'. This claim has no meaning in the context of general equilibrium modelling as the modelling does not provide standard errors for a statistical analysis to be undertaken to determine if the estimated welfare loss is statistically significant.

   The scale of welfare effects from rigorously conducted general equilibrium *comparative statics* analysis always tends to be small. Large welfare effects are often reported in modelling which assesses policy issues purported to involve dynamic productivity effects, but the rigour of these exercises is open to question.

   Sensitivity analysis was conducted as part of the Independent Economics modelling. There is sensitivity to empirical parameters but the result will always be non zero and of the same sign. This means that there will always be a positive efficiency effect from HFE if population migration based on the attraction of 'tax havens' is avoided.

2. Pincus and Ergas provide no evidence for their claim that states negotiate with mining companies in a way that reduces productivity or the output from a mining enterprise. The Pincus and Ergas assertion is not borne out by the recent South Australian Olympic Dam Expansion experience.

   In addition, Pincus and Ergas provide no empirical analysis to examine whether more populous states with smaller ' HFE tax rates' demonstrate the alleged behaviours to a lesser extent than the smaller states, or exhibit greater mining productivity. Also there is no evidence that States are uninterested in mining activity because the Commonwealth Budget benefits from company taxes on mining.

All States seek to facilitate mining activity for the jobs and incomes that these industries provide, subject to management and regulation of environmental impacts. This behaviour is apparent in all states. Pincus and Ergas provide no evidence that State governments influence the productivity of their mining industries.

3. Pincus and Ergas suggest that there is a shortage of labour in WA, with the implication that this is grounds for departure from full HFE. If there is an artificial problem created by various policies, it does not follow that HFE should be weakened temporarily or permanently. HFE is a long term structural semi-constitutional feature of Australia which promotes long term equity and efficiency. If there are labour supply problems, and fly-in fly-out does not meet these needs, that is a matter to be resolved between employers and potential employees and efficient labour market design policy. Emerging employment opportunities and labour demand can occur in any part of the country, whether in a donor or a recipient state.

   Further, it is not apparent how more people living and working in Perth, potentially attracted by WA 'tax haven' status, would assist in alleviating Pilbara mining labour shortages.

4. Pincus and Ergas make other technical observations regarding the possible asymmetrical impact of fiscally induced migration flows between more populous and less populous states. They imply that there are more costs, financial and psychological, in moving from a larger to a smaller state. They state that artificial costs involved in moving, such as stamp duties on property transactions, could be overcome if WA offered a 'superior fiscal deal' for new residents. These observations are contingent upon the current donor status of WA. The Independent Economics report points out that the efficiency gain from HFE is systemic regardless of the prevailing direction and quantum of HFE transfers.

I hope this correspondence has clarified some of the issues raised by Pincus and Ergas in their submission to the Review. The principal author of the Independent Economics Report, Chris Murphy, is available to present his findings to the Review Panel and the Secretariat should you require further clarification of any aspects of the Report.

Yours sincerely

Brett Rowse

Brett Rowse
UNDER TREASURER

13 April 2012

cc: Martin Parkinson, Secretary to the Treasury