The Australian

GST punishes resourceful states to reward the rest

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TWO weeks after being elected, Kevin Rudd convened the state and territory premiers to announce "a historic new era of co-operative federalism" that would, at long last, "fix the federation". Five years later, Australian federalism lies in tatters.

The problems are not solely financial, but they cannot be resolved without putting our fiscal federalism on a sound basis.

Reforming fiscal equalisation, in which GST revenues are allocated among the states, must be a central element in that process. So there is much to welcome in the interim reports of the GST distribution panel comprising John Brumby, Bruce Carter and Nick Greiner, the latest of which was released last Friday.

But they fall well short of recommending the fundamental changes required.

That may be partly because the panel's terms of reference direct it to accept some form of equalisation. But even with that constraint, there is scope to pare back the current redistribution.

The resources boom makes doing so urgent. While the Australian states are roughly comparable in their access to most productive inputs, nature, in its wisdom, has located far greater mineral resources to some states than to others. As Asia's growth increases the value of those minerals, labour should flow to the resource states from other parts of the country.

There are, however, plenty of factors, including tax distortions, that discourage Australians from moving. Providing better public services and charging lower taxes than the other states is consequently crucial for the resource states to attract people. But fiscal equalisation undermines their ability to do so.

It does this by giving a smaller share of GST revenues to those states with above all-states average revenue-raising capacities from non-GST sources.The states with the greatest access to mineral royalties therefore find their GST allocation reduced, relative to their share of population.

The most dramatic effects are on Western Australia, which also faces the greatest difficulties in attracting interstate migrants.

Indeed, the GST distribution panel concludes that, as its mineral royalties rise, WA's share of GST revenues could "reach zero in the medium to long term". By the end of this decade, WA's revenues from royalties could be so great that it would entirely lose its GST allocation.

That this would punish WA for growing is obvious. At the same time, rising revenue transfers from the resource states could reduce pressures on the other states to adjust to the resources boom.

Those risks were not lost on the Commonwealth Grants Commission as it formulated its approach to equalisation in the mid-1930s.

"When changes in the price structure" occur, the CGC wrote in its 1936 report, "people must adapt their activities. Population must be free to move, and compensation (from the states that have gained to those that have lost) would hinder the necessary movement."

Yes, "there could be a case for relief to individuals" adversely affected; but relief, however provided, "must not take away the incentives to move to better natural resources."

Unfortunately, that advice is long forgotten. Instead, equalisation has become increasingly comprehensive over the years.

While the CGC originally sought to ensure financially weaker states could afford public services to a "minimum acceptable standard", by the 80s the goal had changed to that of making the states fully equal from a fiscal point of view.

As that happened, our fiscal redistributions came to greatly exceed, in scope and ambition, those in other federal systems.

Little wonder our economy responds poorly to shifts in the geography of economic opportunity. And it is surely paradoxical that both government and opposition lament WA's reliance on importing short-term migrants while defending fiscal arrangements that discourage domestic labour mobility.

What, then, should the panel recommend? At the very least, it should correct clear errors in the current system.

That system treats royalty payments as income, no different in kind from the revenues that states obtain from payroll or land taxes. But unlike those taxes, royalties are a charge for an exhaustible resource: each tonne of ore mined today is a tonne that cannot be mined tomorrow.

Revenues from royalties are therefore the proceeds of an asset sale, which gives rise to both a debit and a credit on the state's balance sheet. As with selling the family silver, the income properly attributed to such a transaction is not the entirety of its proceeds, but the (far smaller) amount by which consumption can be increased today without compromising consumption in future. The income is the return on the capital, not the capital itself.

By confusing those concepts, the CGC's methodology redistributes not just the income of the resource states, but their capital as well. It would be far better to treat resource revenues as accruing to a notional state-based wealth fund, as Jonathan Pincus has proposed, limiting the amount redistributed to the imputed interest such a fund, properly administered, would accrue.

The resource states would thus have the opportunity, though not the obligation, to ensure they provided for the living standards of future generations. That would encourage them to develop and charge for their exhaustible resources efficiently. And by materially reducing the cash drain from those states, it would help them finance the infrastructure and attract the skills needed to fully exploit the resource boom.

The gains would be all the greater if that change were accompanied by a return to a more modest goal for equalisation -- a goal of ensuring minimum standards, rather than complete parity.

After all, merely cloaking socialism in the mumbo-jumbo of fiscal federalism in no way makes it any less costly. That is not to downplay the difficulties in, and obstacles to, reform.

As long ago as the 1890s, the conventions that prepared the basis for our federation found financial relations between the commonwealth and the states "the hardest nut to crack", with the task of achieving justice all round beyond "even an archangel from heaven".

Deciding that "the task is too complicated, and the time inopportune", the framers of our Constitution simply postponed the most vexing problems to the future.

We have struggled with them ever since. Now, the resources boom is bringing new, increasingly powerful, pressures to bear on the creaking compromises born of those struggles.

Given our history, it would be unrealistic to hope for a complete solution. But the GST panel has an opportunity to take crucial steps in the right direction. It's up to it to show the boldness required.

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