The Australian

Europe's Greek tragedy has a lesson for Aussies

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MILTON Friedman was notoriously sceptical of the euro, predicting it was "going to be a big source of problems, not a source of help". When crisis hit, monetary union would prevent the eurozone countries from adopting solutions tailored to their individual circumstances. As large fiscal transfers between countries became necessary, old enmities would resurface and the edifice would collapse.

Though Friedman was not one to rejoice in the misfortunes of others, one can imagine a wry smile as he watches, from wherever he may be, the European debacle, in which the euro bears a central responsibility.

Without the euro, Greece would have paid far more for its loans, and would have had great difficulty indebting itself so heavily. Equally, the euro allowed Spain to have twice the wages growth of Germany without facing a severe balance of payments crisis.

Not that the euro's founders were unaware of the risks. Hence the tough fiscal rules built into the Maastricht Treaty, binding countries to budgetary virtue and preventing any one country from being required to bail out another.

But rules were made to be twisted, with Germany and France abetting (when they were not pioneering) creative interpretations of the fiscal constraints. The treaty's threat of huge penalties for budgetary lassitude proved ever less credible as the gamekeepers were themselves busy poaching.

Little wonder the situation deteriorated, leading to the present crisis and to a bailout that lacks transparency and seems unable to handle spiralling difficulties in Portugal and Spain.

Moreover, that agreement, against the strong advice of the governor of the European Central Bank, brings the International Monetary Fund in to the management of the eurozone. It is as if Canberra had to turn to the IMF to resolve a fiscal crisis in Tasmania.

Seen from an Australian perspective, such an outcome seems unthinkable. But it would be foolish to assume we are immune to the problems the eurozone is

experiencing.

Like the eurozone, Australia is a monetary union that experiences economic shocks that do not affect all its states in the same way at the same time. Of course, in contrast to Europe, our monetary union has been accompanied by a high degree of fiscal centralisation. But that centralisation has created long-standing difficulties.

Under the Australian constitution, the central government got the bulk of the revenues while the states retained far-reaching expenditure obligations, even in the face of economic shocks. Meeting those obligations required borrowing, and the states kept wide powers to borrow and lend, and more generally, to create, buy and sell real and financial assets.

Yet it was also soon clear that default (or likely default) by any one state would affect the terms on which other Australian governments could borrow, and that (as an authoritative government report concluded in 1936) "the commonwealth is ultimately responsible for state debts, and is bound to meet all interest under pain of itself defaulting".

While the architects of the euro tried to deal with these interdependencies by imposing fiscal rules, Australia has relied on a mechanism and two processes.

The mechanism is section 105A of the constitution, an amendment passed in the late 1920s, whereby the commonwealth and a state can agree for the commonwealth to take over the state's debts and manage them, including paying interest or redeeming them, with the state indemnifying the commonwealth for so doing. This provision allows the commonwealth to bail out a state, as happened with NSW in 1932.

The two processes are first, the loans council, which in its various guises has sought (usually unsuccessfully) to co-ordinate the borrowing programs of the various jurisdictions, and second and most important, fiscal redistribution, both vertical (from the commonwealth to the states) and horizontal (between the states).

It would be British understatement to say these mechanisms work poorly. The difficulties are highlighted by the Commonwealth Grants Commission's latest decision on GST funds allocation. Because the GST is levied on transactions that often span several states and is collected centrally by the commonwealth, GST revenue is a single pot. The simplest way to share that pot would be to divide it on an equal per capita basis, giving each state a share of revenues equal to its share of the Australian population. An equal per capita allocation seems fair, as it treats all "capitas" alike, regardless of where they live. It also provides a degree of income sharing, and hence of insurance against shocks, as revenue losses to states that hit hard times would be partly cushioned by transfers from those doing well. It thereby balances efficiency and equity, in a way that corresponds to the framework for assessing social welfare developed by the Nobel laureate John Nash (of A Beautiful Mind fame).

But rather than such an equal allocation, the commission uses opaque formulas to shift GST revenues to states that are judged to suffer from "disabilities". Inevitably, this fiscal socialism creates myriad perverse incentives.

These incentives have been accentuated in the commission's latest report, which introduces an entirely new basis for redistribution, namely net financial worth. The mechanics are complex, but the results are not: a state that allows its financial position to deteriorate relative to the average can gain by so doing, so long as it can attract a growing population. At the same time, the adjustment causes a deterioration in the financial position of a state with a better than average balance sheet when its population expands.

The incentive, therefore, is for Western Australia's government (to which the commission only allocated 68c of its per capita GST dollar) to allow its solid fiscal stance to more closely resemble debt-laden Queensland's (which got 91c in the GST dollar).

This outcome reflects a process that has lost its way. Devised in the 1930s, before commonwealth-funded social security provided a safety net for all Australians, the commission's immense machinery of calculations has become a sledgehammer in search of a nut. It would be a pity if it cracked the few remaining incentives for prudent state finances.

It is easy to mock the Europeans' current difficulties. But Australian fiscal federalism is also in a shambles. Strong economic growth disguises the consequences, but cannot do so forever. As part of the COAG negotiations on health, WA has demanded the equalisation arrangements be reformed. It is right to do so. For unless we take a fresh look at fiscal relations in the federation, it may be only a matter of time before our union too faces a crisis as painful as it is unnecessary.

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