Should the States Be Paid to Do the Right Thing?

Competition policy payments are back in favour, with the Rudd Government, the States and even the Business Council all embracing the idea that States should be paid for undertaking reforms. But even if competition payments were a good idea in the 1990s, do they make sense now? The answer is that they do not.

In the mid-1990s, the States were asked to undertake reforms which would have removed from their direct control what had been significant taxing sources – for example, the major public utilities. By corporatising or even privatising those utilities, and placing control over their prices in the hands of independent regulators, the States would increase the efficiency with which utility services were provided and contribute to the development of national markets for rail, electricity and natural gas. While this seemed likely to yield significant national benefits, it also meant that the ability of each State to use utility charges as a way of raising revenue would be reduced, if not eliminated.

At the time, the States lacked a source of tax revenue that was clearly linked to overall economic growth, while the Commonwealth had such a source in the income tax. As a result, the efficiency improvements would flow into the Commonwealth's tax base rather than into that of the States. Maintaining the fiscal balance unchanged therefore required an offsetting payment from the Commonwealth to the States.

Providing for such a payment had another advantage. The States' revenue base was largely inefficient, as it depended on tax sources (including implied taxes on public utilities) that caused substantial distortions to producer and consumer decision-making. Put in the language of economics, the revenues the States were foregoing through the reforms involved large "excess burdens": at the margin, raising $1 of revenue cost significantly more than a dollar, perhaps $1-50 or more. The Commonwealth's revenue sources, which would fund the competition policy payments, were somewhat less distorting. There was therefore an added gain to the economy that came from replacing a more distorting by a less distorting source of income.

Finally, the payments may also have reflected "spill-over" effects, whereby reforms by each State flowed largely to the benefit of its neighbours. Had those "spill-over" effects been large, it is possible that (absent offsetting Commonwealth payments) some States would have borne more in costs than they secured in efficiency gains, even in the long run.

In practice, however, it is doubtful whether the spill-over effects were all that great. Rather, the largest States are likely to have borne the bulk of the costs and secured the bulk of the efficiency benefits. Moreover, even if there were some spill-overs, the net benefits to each State still likely outweighed the costs each State had to bear, especially given a coordinated reform program. Aside from the fiscal issues, it would therefore have been sensible for each State to go along with the reform program, even if some part of the benefits was captured by others. Again using the language of economics, the externalities (i.e. the spill-over benefits) were "infra-marginal" to the reform decision, and in the absence of the tax distortions, would not have justified offsetting payments.

Seen against that background, today's situation is radically different from that in the mid-1990s. In particular, the GST means that the States now benefit from a very effective growth-linked tax source. To the extent to which reforms will increase the income base going forward, those gains will flow to the States in line with the growth in GST revenues. Of course, there are arguments about the overall split of revenues between the States. However, those arguments have no direct bearing on the funding of particular reforms, and in any event, could not be sensibly resolved through payments linked to individual policy changes. As a result, the major justification which there may have been in the past for compensating payments no longer exists.

Nor do spill-over effects between the States provide compelling arguments for such payments. It is obviously true that each State's reforms in areas such as education and health will secure some gains for other States, both directly (for instance, through population movement) and indirectly, through stronger economic growth. However, there is nothing to suggest that these benefits will be asymmetric, with some States benefiting on net at others' expense, or so large that one or more individual States might find that the costs to them exceeded the benefits. Rather, if the reforms are sensible, a coordinated program of reform will yield benefits to each State that outweigh each State's costs.

As a result, to the extent to which the reforms are worthwhile, the States should have both the incentive and ability to undertake them.

This is all the more so as there is no evidence that the States lack the fiscal ability to carry out worthwhile reforms. The fact of the matter is that the revenues accruing to the States have increased very substantially in recent years. Since 1999-2000, total payments to the States and Territories have increased at an average annual rate of 3.6 per cent in real terms, exceeding the rate of growth in GDP. Real transfers to the States and Territories per capita have also grown materially, rising by 2.1 percent annually on average since 2000-01.

Given these increases and the scope for substantial productivity improvements in the efficiency with which State and Territory services are provided, it seems difficult to believe that any worthwhile reforms could not be undertaken within existing budget constraints. While the States will always cry poor, it would be very foolish indeed for those cries to be accepted at face value.

As a result, the economic case for renewed competition policy payments is very thin indeed. Is there nonetheless a political case for doing so, based on the need to bribe the States into an otherwise worthwhile reform program?

The most obvious problem with such bribes is that once started, they will never stop. If the signal the Commonwealth sends is that it is willing to pay the States to undertake changes that they should undertake in any event, then the response will be continued demands for payments. Having made so much of its ability to get the States to agree, the Rudd government will likely have to cave in to a succession of demands for payment that have no merit other than that of maintaining a façade of Commonwealth/State unity.

Even if the individual payments this gives rise to are small, the cumulative costs of such an approach would be substantial. The crucial fact is that each dollar paid to the States must come from somewhere – and where it comes from is Commonwealth taxes. Those taxes have high and continuing economic costs, costs which have increased in recent years as more of the tax take has come from relatively inefficient taxes on corporate incomes.

Bribing the States into doing the right thing requires those taxes to be higher than they would otherwise be, and in any event, diverts tax dollars to State governments that often make poor use of resources. The risks in this respect are magnified by the political element involved in dividing up the payments among the States, with the obvious danger that large, unjustified, payments will be made to States that are close to elections. Those payments will then be squandered on projects that are politically attractive, but have little real value.

The bribes therefore offset the gains from the reforms – and it does not need large payments for that offset effect to be substantial. The Commonwealth consequently needs to decide: is it going for smiles at the end of COAG meetings, or for real efficiency improvements? If it is the former, dollars will always paper over the cracks; but if it is the latter, some tough love needs to be put back on to the agenda.