

The Australian

The fiscal fighting turns feral

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FISCAL federalism is dead; feral fiscalism - in which each jurisdiction tries to snatch revenues from others - has replaced it. The old regime was nothing to boast about; its successor is deformed at birth.

Not that the old regime's collapse is surprising. The system has long been dysfunctional.

The states' abject financial dependence on the commonwealth causes constant conflicts and inefficiencies, while the redistribution of tax revenues from richer to poorer states has reduced the states' incentive and ability to adjust to changing circumstances.

It was therefore inevitable that a resource boom, shifting the power balance between states and between the boom states and the commonwealth, would cause trouble.

But Labor's mismanagement of federal financial relations has aggravated the tensions, with the mining tax proving a flashpoint.

None of this is as promised. In 2005, Kevin Rudd committed to rebuild Australian fiscal federalism, making it "more workable, more rational and less dysfunctional".

An ALP advisory group on federal-state reform detailed the blueprint for change. Centralisation had gone too far. In future, the commonwealth should be involved in state services "when there are genuine national interests at stake, but only to that extent". To that end, more of the funding the states received would be untied; that is, available for the states' discretionary use. And even where funding was tied, Labor would streamline the special purpose grants, replacing prescriptive requirements with agreed outcomes: how outcomes were achieved would be a matter for each state.

In practice, the opposite has happened. The proportion of commonwealth payments to the states that is genuinely untied has diminished.

As for how funding is delivered, the introduction of national partnership payments merely put old wine in new bottles, as the Howard government's 96 special purpose grants morphed into more than 100 national partnership payments and detailed implementation plans.

And if federalism Howard-style could involve stifling bureaucracy, Labor's hallmark has been COAGulation: a paralysing illness characterised by a tendency to confuse announcements with achievements, processes with products and inputs with

outputs.

Little wonder nothing came of the promised shift from a focus on inputs to a focus on outputs. Rather, Julia Gillard set the pace in the Building the Education Revolution agreement, which prohibits spending on airconditioning while obliging states to "accept required branding of all projects, as determined by the Australian government".

Even worse, however, was happening to the GST. It was to provide "a robust tax base that can be expected to grow over time and will be available for use by the states and territories for any purpose". But the government's attempt to claw back GST revenues as part of the health reforms showed not even the GST was safe.

Those attempts were ham-fisted. But they were grace itself compared with the resource super-profits tax and the minerals resource rent tax.

Gillard's ill-considered promise to credit all royalties against the MRRT meant once the commonwealth fixed its tax rate well above current royalty rates, there were overwhelming incentives for resource states to increase royalties until MRRT liabilities were exhausted.

With Western Australia smarting from the Commonwealth Grants Commission's redistribution of its mining revenues to other jurisdictions, it was hardly likely to hold back.

Yes, higher royalties may lead to WA getting a reduced share of GST revenues. But that will take several years, and what will be left in increased revenues is still worth more to WA than the infrastructure spending the commonwealth offered.

That spending would have been commonwealth-controlled, with the only certainty being mandatory photo ops for Julia and co. In contrast, revenues from the royalty increases will be the state's own.

It is therefore only a matter of time before other resource states follow WA's lead. This faces the government with a choice. It can huff and puff, bluster and bully. Or, more sensibly, it can renew its 2005 commitment and start comprehensive reform.

Two realities should guide that reform process.

First, the policy of systematically redistributing wealth between states was put in place during the Great Depression.

But already by the 1980s, income divergence between states was one-third to one-half lower than it was in the 1930s.

And population mobility and a more flexible economy have since reduced the spread in growth rates between the states by about one percentage point per decade.

This fiscal redistribution has therefore largely lost its purpose. It is now a form of middle-class welfare, in which West Australian miners subsidise Tasmanian greenies and arts festivals in South Australia. And worse, it is positively counterproductive.

Western Australia's challenge, for example, is to attract labour. One way to do so is by using growing royalties to improve public services, increasing WA's relative attractiveness as a place to live. Yet large chunks of those royalties are redistributed away, undermining that adjustment.

With such distortions in place, it is unsurprising that income convergence between Australian states has been slower than in Canada and the US, where structural change is allowed to more fully run its course.

Second, while being weaned off fiscal redistribution, the states need more efficient revenue sources of their own.

An increase in the GST, offset by cuts in income taxes and in inefficient state taxes, would be an important step in that direction. Unfortunately, with all GST revenues flowing to the states, raising its rate and widening its base is all pain, no gain from the commonwealth's perspective.

Our flawed fiscal federalism will therefore not be fixed quickly or easily.

But there are signs of hope, not least the Brumby-Greiner review of the allocation of GST revenues. And focusing the tax forum on these issues might kick-start change, if there is a real political commitment to build on.

That may be too much to ask from a government that struggles to rise even to the level of its own shortcomings.

But the alternative is a brawl with the states that will do nothing to fix the underlying problems. Gillard says she is willing to tackle the toughest issues. Here is her chance to prove it.

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