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Mr Paul McCullough  
Secretary  
GST Distribution Review  
The Treasury, Langton Crescent  
PARKES ACT 2600

Dear Mr McCullough

### **SUPPLEMENTARY SUBMISSION TO THE REVIEW OF THE GST DISTRIBUTION**

The South Australian Department of Treasury and Finance (DTF) has commissioned a report from Independent Economics on the efficiency aspects of HFE.

It is expected that the Report will be of great value to the Review. A copy of the Report is attached to this supplementary submission.

The Report finds that there would be a significant welfare loss if there were a departure from HFE. This is a very important finding and represents a breakthrough in quantitative modelling in the Australian context.

As per the initial South Australian Government submission, DTF draws attention again to the parallel between HFE and the implicit equalisation occurring within the Commonwealth Budget, and the complementary nature of explicit equalisation at the state level. Overall this ensures that individual households and firms are not treated arbitrarily by their governments at both Commonwealth and state levels on account of the accident of state borders. The equal treatment of equals by the Commonwealth in its dealings with taxpayers and benefit recipients is consistent with economic efficiency. Economic efficiency would be damaged if the Commonwealth treated households and firms differently merely on account of the geographical source of taxes collected or the differing socioeconomic or demographic makeup of areas within Australia. Similarly national economic efficiency would be damaged if State taxpayers and users of tax funded services were treated differently merely on account of the amount of revenues collected and expenditures incurred within state boundaries resulting from factors not in the control of state governments.

The Independent Economics Report quantifies 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.

The Independent Economics Report also critiques previous modelling of HFE conducted by Dixon et al as part of the Garnaut Fitzgerald Review prepared for the NSW, Victorian and WA Governments in 2002.

Internationally, a recent modelling exercise by Albouy (2010) found that the Canadian HFE system detracted from locational efficiency. However, it is our view that this is due to the partial and non-systemic nature of equalisation practiced in Canada. Albouy's analysis does not evaluate the efficiency impacts of equalisation, it represents the efficiency consequences of incomplete revenue equalisation and apparently inaccurate expenditure equalisation. Further comments on Albouy are provided in Attachment A to this letter.

I trust that the Review will find the Independent Economics Report a valuable input to their deliberations. The principal author, Chris Murphy, is available to present his findings to the Review Panel and / or the Secretariat.

Yours sincerely

  
Brett Rowse  
UNDER TREASURER

21 February 2012

cc: Martin Parkinson, Secretary to the Treasury

Comments on *Evaluating the Efficiency and Equity of Federal Fiscal Equalisation*, by D. Albouy (2010), National Bureau of Economic Research, Cambridge

Albouy is a critique of 'equalisation' arrangements in Canada (as they applied in 2001). Albouy finds that current funding arrangements within the Canadian Federation lead to inefficient outcomes, with some provinces being overpopulated and others underpopulated as a result.

These adverse findings in respect of efficient location of population relate to the fact that equalisation transfers in the Canadian system do *not* achieve full equalisation of net fiscal benefits. The 'equalisation' system in Canada considered by Albouy has two components:

- Explicit equalisation of provincial revenue (but with a 50% discount for natural resource revenue); and
- A distribution of federal 'block' grants for health and social welfare services favouring the Atlantic provinces but without any independent assessment of needs between States.

The finding that the prairie provinces are overpopulated is no surprise in the case of Alberta, consistent with less than full equalisation of provincial revenue providing capacity for Alberta to apply relatively lower taxes.

The finding that the Atlantic (and non Alberta prairie) provinces are overpopulated, and other provinces underpopulated, relates to the federal grant distribution which is disproportionate to population share (and average federal tax of residents of provinces) and which does not necessarily achieve correct equalisation for expenditure needs.

There are some aspects of the Albouy methodology which can be queried (particularly taking a 'province of federal tax origin' approach and seemingly making no allowance for fixed costs of provincial governments).

In any event, the analysis does not apply to the Australian situation, where:

1. Commonwealth grants to the states (base GST payments and SPPs) are distributed equal per capita (or converted to equal per capita by CGC treatment by inclusion); and
2. Expenditure needs are systematically assessed (and annually reassessed) on the expenditure side of state budgets as part of explicit equalisation, and where full equalisation of NFBs is actually achieved.

To sum up, Albouy is really a calculation of the locational efficiency loss from *not* actually achieving full equalisation of NFBs in Canada<sup>1</sup>(arising from an unduly unfavourable treatment of Ontario and Quebec), not a calculation of the efficiency outcome if equalisation of NFBs were properly achieved. In particular, it must be noted that the Albouy efficiency loss findings do not relate to *full* equalisation of the mining revenue strength of Alberta, but stem from *less than* full equalisation of those revenues.

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<sup>1</sup> Footnote 16 of Albouy records that in 2001 Canada Health and Social transfers are being phased from a block grant arrangement to per capita funding