

## The ABC of Economics, A Tale of Two Cities, Repairing Australia's Vertical Fiscal Imbalance.

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Explaining the critical path to adjust and repair Australia fiscal imbalance and why.

According to Pr David Solomon, "coming of Age", ch.6

"The State of the States

The Federal system in Australia is a mess. The States continue to exist only because the Constitution in effect prevents them from being abolished. But essentially they have become beggars...unable to raise enough revenue to fund their own expenditures..."

In economic hard time, normal Keynesian behavior is to expend business, credit and jobs rather than let the economy contract on itself but **Australian States do not follow "normal" rules of economics, because they have no currency of their own, no QE(Quantitative Easing)/printing capacity of their own. In their world no "normal" economic rule's thinking applies, their only priority is the relationship with and the rules of the Commonwealth combined with a false sentiment of State financial independence.**

Australian States have become sitting ducks, beggars passing the begging bowl to Canberra, but the Citizens of WA are real and will pay the pots cassés of not sharing an unavoidable 21<sup>st</sup> century common single tax system at the national level.

No matter how long States will borrow money, they will be a reckoning time, when the interests will start to bite because vertical fiscal imbalance has broken the system, should WA look for a different system for its development?

**Having different taxes and collection at State and Commonwealth today has become a joke and a recipe for disaster, creating discrepancies such as NSW which benefits from Tax Concessions on Capital Gains, Negative Gearing, Super and is going through a Real Estate and Construction boom while having a thriving finance industry with our \$2 trillion of Super and still receiving a per capita share of GST much higher than WA which is going through a recession. Of course some may argue that benefits in NSW finance and construction flow in part through WA and that the finance industry is bigger than mining.**

Our fiscal system itself is generating an amalgam of red tape and paperwork, the best example is Centrelink and the ATO, why is there not a single desk for both tax and means testing, all in front using a plastic card and cyber connections. No more data matching paper work red tape admin staff, and ditto for a flat straight sales tax collected at POS all in front rather than an old GST passed its use by date only creating jobs for CPAs deducting gizzmo's in from gizzmo' out instead of a paperless entirely automatic deduction all in front

### State versus Commonwealth funding

Currently the State versus Commonwealth funding system serves politicians well but may be not tax payers. It enables States to borrow money without being seen, but State's debt keep growing in WA, SA, Queensland.

**The Commonwealth is keen to see States topping up with borrowings the diminishing revenue it gives to them,** while once aware of the States borrowing it will decrease even further the revenue to the States, could it be Canberra **real GST agenda!!**

### History of States versus Federal funding

Until 1926 the simplified division of revenue was 75/25 that is the States had the bigger share of the pie by far. Until 1942 the States collected income tax, this right was removed by the Commonwealth during the war to help the Commonwealth supports the war effort, but collection of the essential taxes such as corporate and income was never returned to the States even so the move was temporary, as it was not validated by any referendum, albeit that means also it could be rescinded at any time.

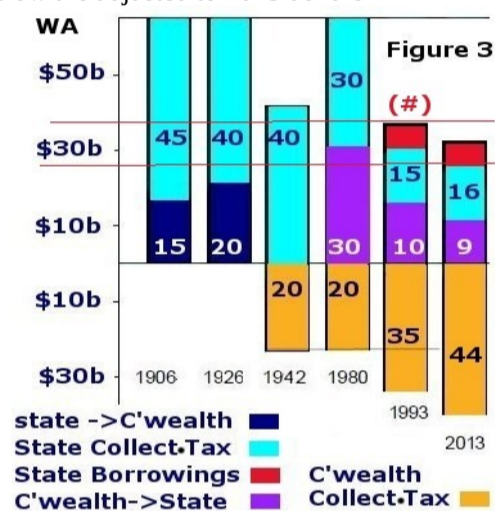
The next big change came in the mid 90s Howard Costello government when States were stripped of Tobacco, Alcohol, and Petrol tax collection for the GST (see diagram)

In "Coming of Age"(ch.6), Pr Solomon describes what came next, summarized below, diagram figure 3 :**The mid 90s squeeze(#)**

Before the 1990s the States received around 40% of the revenue from the Commonwealth, 53% in 1981, after this point the States were supposed to receive an extra 20% as they were stripped of the Tobacco, Alcohol, and Petrol tax, collection(see diagram).

In 2013-14 after redistribution of the GST, a supposedly States equalization tax, if one looks at WA the WA State does not even receive 40% let alone 60%, the State of WA raises \$16billion of its own revenue for \$9billion of Grants and GST instead of the opposite raising \$9billion and receiving \$16billion, that is 36% of the budget while the federal government collected about \$44billion of taxes related to WA activities in 2013, possibly more as for every Mining Job during the construction phase two or three other jobs were created, some in other states.

Figures below are adjusted to 2013 dollars



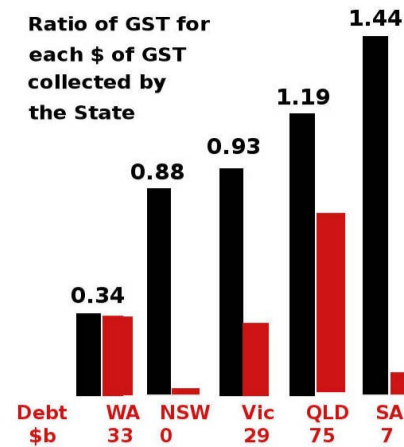
The federal debt kept growing until the mid 90s then decreased after, the State's Gross debt took the relay at twice the speed including forward liabilities. This scenario of increasing Fed revenue(yellow above) at the expense of the States revenue accumulating debt and liabilities is visible above, it is not a bad dream, it is real. What is "unreal" is the hypocrisy behind State politicians and their borrowings!

Building infrastructures is right, but the debt contracted by the State to build infrastructures **on its own rather than with Canberra's money** is creeping the State economy and some of the mining revenue development potential has been lost, possibly forever, while at the same time housing boom and banking in Sydney, thanks to generous tax concessions in CG(capital Gains), NG(Negative Gearing) and super has been filling up the coffers of NSW without any compensation flowing effects to WA for the day after the mining construction phase. Already in 2013 an article in the West Australian estimated that WA had been short changed \$15b of revenue in just a few years.

### A balance increasingly tilted toward Canberrists and Sydney siders.

The WA State had a budget of \$25billion in 2013 with a net Debt of \$17billion(roughly the amount of revenue loss mentioned previously). WA had Asset Investments/liabilities of \$7billion for around \$9.5billion of grants including GST Revenue, WA supplied itself then 64% of its funding, not the 40% only it was supposed to raise to pay for its expenditures according to plans with the GST.

Even after redistribution of the GST, the GST alone does not explain all the short comings, but it shows the political intent of the Sydney siders supported by the generous tax concessions mentioned above. The GST distribution diagram confirms that a deliberate political agenda was set in place with the method of calculation of the GST to serve political interests in Canberra and the Eastern sea board, without any intention to correct it, and this agenda started 20 years ago, a dual agenda, to pass the buck to the States and get the successful Hawke Keating tandem out of office at the same time, the tandem that brought to us the market currency and the super that feeds the market loop and its jobs making modern economics Australia today!



Note: GST accumulated loss to WA is \$22billion and the WA State debt will climb from 3.6b in 2008 to 42.3b in 2020 from the present 33b, the latest borrowing in 2017 was 11.5b from the current Mc Gowan State labor government

WA population growth, slowing mining boom, need for infrastructures, hospitals, schools, transport...and funding to encourage mining and adding value, and to diversify the WA economy are all in conflict with the GST share above and the shrinking revenue that the diagram beside confirms, the GST is one component, but one component only of missing revenue, overall funding has decreased in a lot of areas, for example senior's concessions which now comes out of State's revenue. Part of labor's recent borrowings in WA may have been used to plug this gap, and the widening gap of the cost of utilities in our State, one of the richest state in energy on planet earth!

### Vertical Fiscal Imbalance and the GST whizzbang absurd calculation/distribution is the most toxic cocktail for WA.

First of all increasing revenue today through increasing taxes in WA or increasing State borrowings has become totally useless, given all borrowed money and taxes will end up directly into the coffers over East creating jobs over East and killing jobs in WA because of an extraordinary vertical fiscal imbalance and the Commonwealth switching off the tap in proportion to the revenue increase!

The WA Vertical Fiscal Imbalance is created by sharing the Australian currency with different tax systems at both State and Commonwealth level with completely different economic capacity and resources between the stakeholders and a legacy of different absurd funding mechanisms, this imbalance is due in part only, by the GST. It means that some State debt will be increasing forever, even if we sell all State assets today. Greece in the Eurozone knows about fiscal imbalance and selling assets, and what sharing a currency without fiscal integration means, ie dreamland for Germany with an undervalued currency, but hell for Greece having an incompatible fiscal system and a massively over valued currency together with no serious and consistent over time compensation mechanism.

The State **fiscal imbalance** is not as bad as Greece and NSW is not Germany because we have more things in common with the Commonwealth apart from the currency but our funding system between State and Commonwealth has reached its use by date, Sydney Melbourne and the Commonwealth decide how to cut the cake and which taxes or concessions for whom.

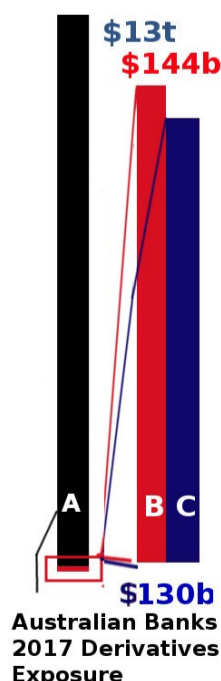
As a result of this fiscal imbalance most of the WA's debt has been transferred by the back door to utilities which have increased the burden to all WA households and local industries and businesses, any new State tax in WA with the existing WA massive fiscal imbalance will be killing or transferring more local jobs over East.

Our very successful migration kept us with no recession and a growing economy for more than 30 years, finance and construction industries turn at full speed in Sydney Melbourne creating million of jobs! ...

but real solutions to fix the States debt are overlooked by fear of displeasing federal lobbying groups, the best example is Bank Derivatives(A diagram to the right), the Australian Banks Exposure is (\$13trillion\*) , a simple one time 1% levy(C) a very tiny fraction on this massive Exposure (\$130billion) or a tiny 0.3% tax in 2018 on derivative turnover for all transactions (\$150b+ a day\*) could help refunding our States Debt(B)\$144billion in a single year but there is a twist that will be explained in the articles about Derivatives and about planning for technology!!

\*Source CEC Report,

ABS. Projections from RBA and BIS Documents 2016





**State Debt is the result of the chronic vertical fiscal imbalance associated with the States funding system.**

The States funding system is like an ATM sitting at the parliament house back door that anyone can use without even a card. Politicians currently win not to be seen using it until the States Gross Debt and sold assets and forward liabilities bubble explodes and the States possibly get abolished or the function of the States is changed with a more limited role in finance administration.

To put it simply, the States have been denied the means to raise enough revenue to refund their own debt, in 1942 the brakes were removed from the car, since 1993 the foot is on the debt accelerator with a rubber stamp loan council, and recent Canberrists efforts such as the attempt of grabbing also States mining taxes have jammed the steering wheel. It is time for a move, the States are sitting ducks and the shooting season has just started.

It is more than just fixing the funding, as proposed by many people here and over east. Is having the States collecting some of the income tax a "real" solution if the Commonwealth is going to catch part of this additional revenue by the other hand?!

**Two immediate questions comes to mind: Are the States still relevant in their current form?**

**What is the debt burden to the States?**

**Are the States still relevant in their current form?**

One thing is certain, in our Australian constitution the States cannot file for bankruptcy, unlike in the USA. Ultimately our Australian Commonwealth Government is responsible in our constitution for the debt of the States. One might say, so what is this fuss all about, well well well..., can we trust the people in Canberra to respect this point in our constitution, given the little respect they are showing for it when many members should not even be in our parliament?

Furthermore one has to be suspicious of some people in Canberra very keen at introducing a new concept of "State development Product" and having rating agencies rating the States...why such thing if the States ultimately are not liable for their debt?

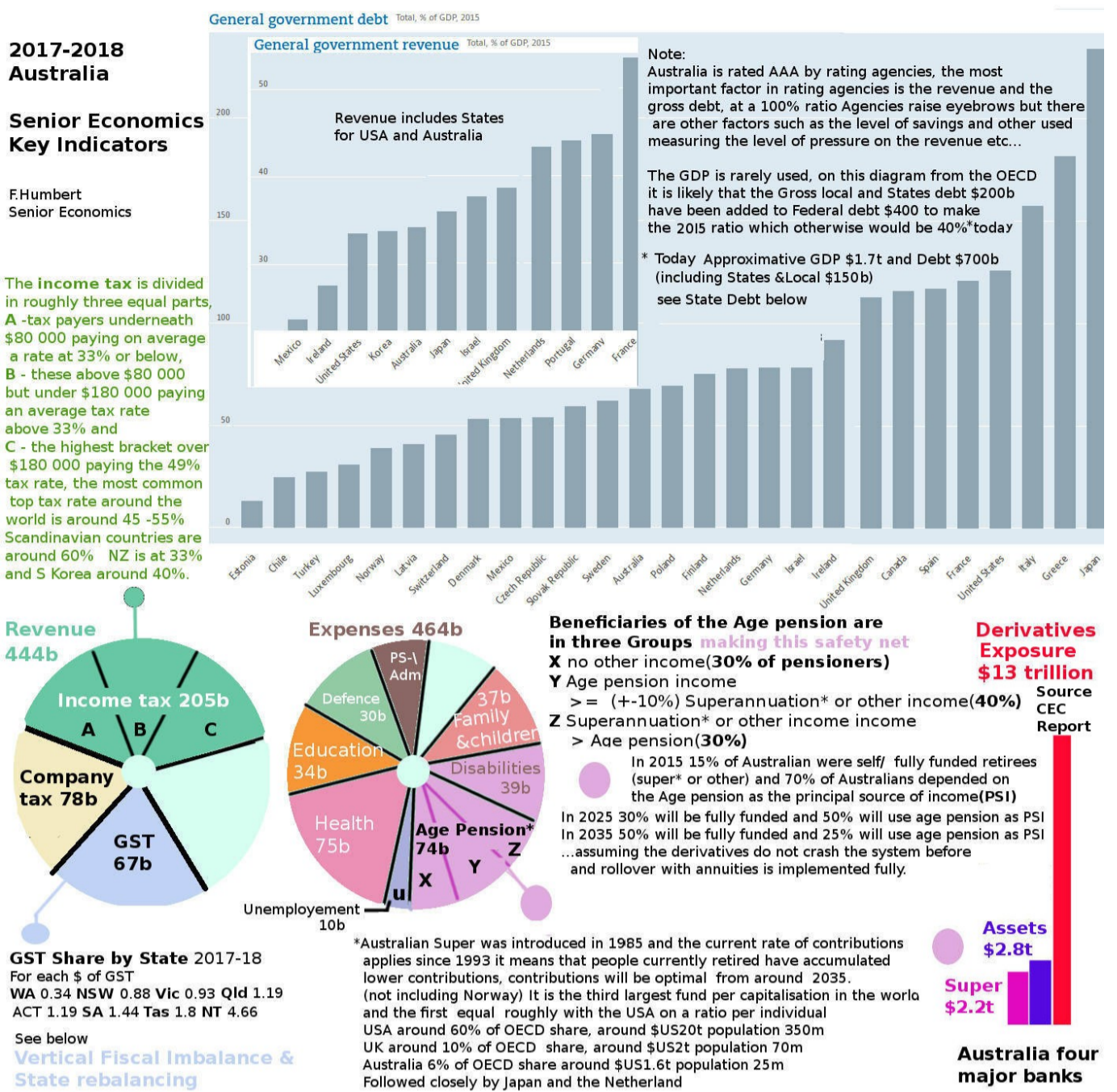
One can smell a rat behind Canberra's strategy, but to this day, even so citizen of WA can be abused by the system of funding, serving central political interests first, noone has ever thought of taking rating agencies to Court for the damaging situation in WA and other States of having higher rates and taxes that should have been otherwise had the Commonwealth Government been rated alone for the debt of the States and therefore been forced to look into WA and other States such as Queensland and SA interests more closely.

**What is the burden of the debt in WA, the biggest loser?**

As more debt is passed to WA, someone has to pay the interests(\$1b a year for a budget of \$25b) and the consequences, ie when this debt is transferred to utilities, it shows on the bills, businesses and households have to pay, at the moment WA households have the highest level of stress with the highest level of families behind in paying bills ever recorded, adding to it that the Australian Household debt is already the highest in the world, this makes the margin for manoeuvre getting smaller and smaller, a ridiculous situation for one of the richest State in Energy on planet earth.

The latest borrowings of \$11.5billion by the WA State, represents \$11K for every households in the States, at its current rate the debt will be representing 50K per household in ten years and 100K per household in twenty years, the interest alone could be close to 5 to 10k a year for each and every households.

A last point, why should States sell their assets, just to receive less funding from Canberra? A similar situation to WA also applies to Queensland and SA. So is it time for a change? Yes, because at best our State politicians have lost the plot, by serving their own interests.



**Evaluating changes :** There has been around 40 attempts to change the Constitution since 1906, yet only around half a dozen **Constitutional amendments** were passed. David Solomon summarizes well the playing field regarding Constitutional amendments.

"Unlike the situation in Britain(where there is no written constitution at all, and the parliament can pass any laws it wishes) or the United States(which includes several means of amending the constitution) the Australian Constitution is extremely difficult to change. Any proposed alteration must first passed by the Commonwealth Parliament(or under special circumstances just one house of parliament) and then put to people in the form of a referendum. The referendum must then be approved by a majority of voters throughout Australia, and by a majority of voters in a majority of the states. This means that as well as obtaining an overall majority, any alteration must also be approved by a majority of people in four of the six states. There is another proviso that any state whose voting strength or geography is affected by any proposed constitutional amendment must approve it...In practice the use of the referendum as the means of changing the Constitution has made it almost impossible for any controversial measure to gain formal approval.

In Australia the only issues where a government can be fairly certain of being able to change the Constitution are those where there is no difference between the major political parties on the merits of the proposal and where no state thinks it will be adversely affected by the change.....Thus the Constitution is still very largely in the form in which it was passed by the British parliament in 1900."

Australia's Government and Parliament, 7<sup>th</sup> Edition, Pr David Solomon

Even with a clearly explained change to all stakeholders and a bi-partisan approach, amendments alone in the constitution are unlikely to work, because sometime a regional rather than state base flavor is needed, so the amendment approach doesn't always make sense and looks doomed! To evaluate any change in the collection and distribution of revenue, and to fix the States versus Federal funding system, we need an audit of the State vs Commonwealth relationship in term of stakeholders, activities, policies,... to find generic long term solutions, with this article, we went down this road a long way, we can now take a step back for the conclusion.

1 A change in the constitution is unlikely, why should they be, the constitution was never amended for funding arrangements, so this increases the chances of a wider more practical and systemic solution.

2 The Commonwealth should be absorbing the current debt of the States which has been created artificially by Canberra anyway, at the same time, apart for regional arrangements, the financial role of the States should be limited, so that one State or group of States does not limit the development capacity of the other states, at the end of the day it all comes down to one aberration, sharing a common currency without fiscal integration is a total absurdity, like we all play Footy, Rugby and Soccer at national level, it is time to share a single tax system for all Australian States and the Commonwealth.

3 Funding arrangements without a complete fiscal integration, ie a single tax system for all, is just gobbledygook, so let's clear the desk and press the reset button, after nearly 80 years, it is about time, and the outcome of having a single tax system will be much more paperless!

4 Full fiscal integration does not prohibit funding compensation happening with the evolving situation of the States though, at the contrary it will inhibit a clearer funding mechanism !

Alternatively an automated State + Commonwealth more ambitious approach would be possible by transiting incrementally through a kind of swedish cashless model, which is enabled through a joint Government and Business plastic card anyone swipe for purchase, it combines POS and internet transactions to supply instantly the business and households tax balance and would also in Australia enable to check our fiscal's integration, ultimately new technologies and Methods of Payment will render changes to interactive taxation unavoidable.

About the Author: Born in a business family employing 80 people in the Family's SME, the author learned economics hands on, carrying out missions for the French Premier Raymond Barre such as leading the first large computerisation of the Renault Group Budget, and developing software to control the Trading Floor and multinationals fraud ...sorry, tax optimisation, he had access to many FYO Documents from US CIA and GAO and internal discussions at the OECD and the IMF, the author also received a formal Post Graduate Education at Curtin University with Harvard Master units. Peter Costello and Wayne Swan attended some of these units when the Head of School was R Galliers( A B Harvard)